

Lecture One

Introcution of International Finance

Fan Xiaoyan

SOE, Fudan University

Outline

1. Course Introduction
2. The global macroeconomy
 - 2.1 Foreign Exchange: Currencies and Crises
 - 2.2 Globalization of Finance: Debts and Deficits
 - 2.3 Government and Institutions: Policies and Performance

What is international finance?

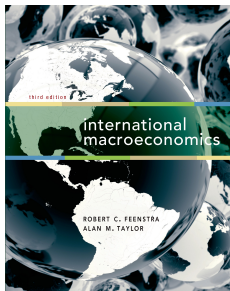
International finance, or international macroeconomics, is devoted to the study of large-scale economic interactions among interdependent economies.

Three parts:

- Exchange rates
- The balance of payments
- Applications and policy issues

Textbook

R.C. Feenstra, A.M. Taylor, and J. Taylor 2014: International Macroeconomics(3rd edition), Worth Publisher



What do you need for the course?

Before exploring the new world, you are need to get prepared.

- Some interesting questions
- A study group with friends
- Lots of effort



Source: Christopher Columbus on Wikiwand.

What are you going to get from the course?

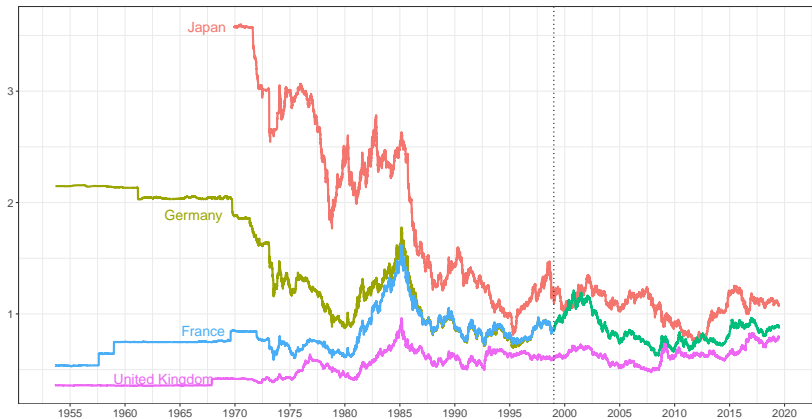
- ① Knowledge and framework
- ② **Methods**: Fishing is much more important than fish.
- ③ Friendship

$$1 + 2 + 3 = \text{FUN!}$$

Data

- China Data:
 - Academic Resource Portal in Fudan
 - China Foreign Exchange Trade System (CFETS)
 - NBSC, PBC, etc.
- International Data:
 - International Settlement Bank (BIS)
 - IMF, WB, OECD, etc.

Exchange Rates of Main Currencies to USD



Data Source: US dollar exchange rates (daily), BIS.

Note: The unit is 100 JPY, DEM, FRF, and GBP per 1 USD. After 1999, the currency is EUR for Germany and France.

Exchange Rates of RMB to Main Currencies



Data Source: CSMAR.

How exchange rates behave?

??? $\rightarrow E$

- ① How are exchange rates determined?
- ② Why do some exchange rates fluctuate sharply in **the short run**, while others remain almost constant?
- ③ What explains why exchange rates rise, fall, or stay flat in **the long run**?

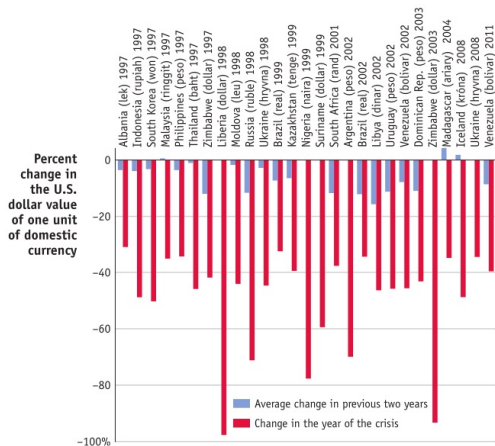
Why Exchange Rates Matter?

$$E \rightarrow P, Y, W$$

- 1 How do changes in exchange rates affect international prices of goods and services?
- 2 How do exchange rates affect the demand for goods from different countries, and hence the levels of national output?
- 3 How do changes in exchange rates affect the values of foreign assets, and hence change national wealth?

Exchange Rate Crisis

During the exchange rate crisis, a currency experiences a sudden and pronounced loss of value against another currency, following a period in which the exchange rate had been fixed or relatively stable.



Economic crisis in Iceland in 2008



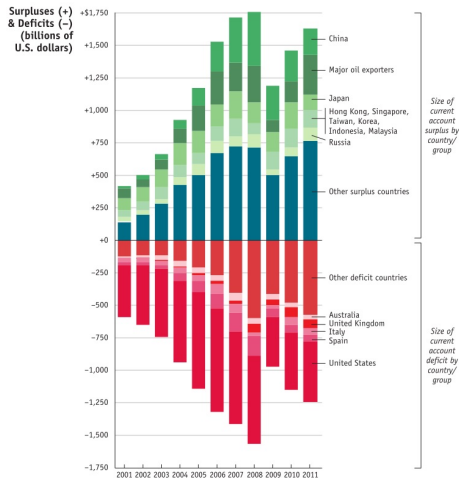
HALLDOR KOLBEINS/AFP/Getty Images

Protesters outside the Icelandic parliament in Reykjavik demand that the government do more to improve conditions for the recently poor.

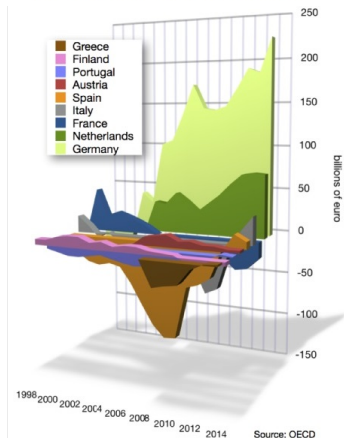
When Exchange Rates Misbehave?

- Why do exchange rate crises occur? Are they an inevitable consequence of deeper fundamental problems in an economy or are they an avoidable result of "animal spirits" – irrational forces in financial markets?
- Why are these crises so economically and politically costly?
- What steps might be taken to prevent crises, and at what cost?

Global Current Account Imbalances: CA



Current account imbalances (1998–2014)



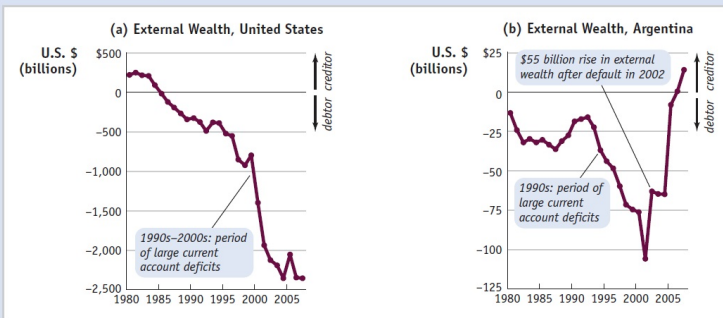
Source: Wikipedia.

Deficits and Surpluses: The Balance of Payments

- How do different international economic transactions contribute to current account imbalances?
- How are these imbalances financed? How long can they persist?
- Why are some countries in surplus and others in deficit? What role do current account imbalances perform in a well-functioning economy?
- Why are these imbalances the focus of so much policy debate?

External Wealth: W

FIGURE 1-4



External Wealth A country's net credit position with the rest of the world is called external wealth. The time series charts show levels of external wealth from 1980 to 2007 for the United States in panel (a) and Argentina in panel (b). All else equal, deficits cause external wealth to fall; surpluses (and defaults) cause it to rise.

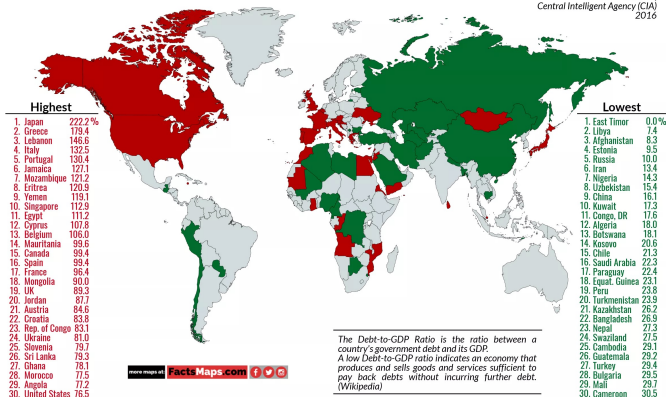
Source: Philip R. Lane and Gian Maria Milesi-Ferretti, 2007, "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004," *Journal of International Economics*, 73(2), 223–250 (and updates).

What's next? Global Debt crisis?

30 Countries with the Highest and Lowest Debt-to-GDP Ratio

*Not included countries with less than 1 million inhabitants

Source:
The World Factbook,
Central Intelligence Agency (CIA)
2016



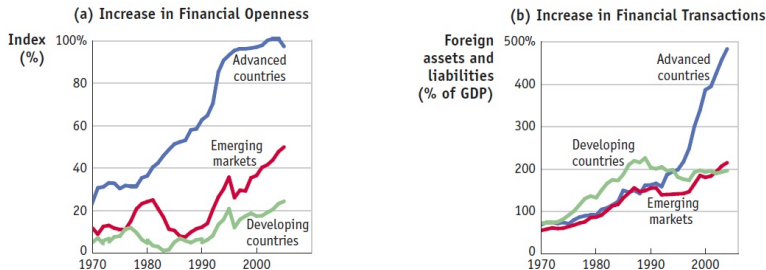
Source: Facts Maps.

External Wealth and Debt Crisis

- What is the forms and composition of a nation's external wealth?
- What determines the level of a nation's external wealth?
- How important is the current account as a determinant of external wealth?
- Why do countries default?
- What are the determinants of risk premiums? How do risk premiums affect macroeconomic outcomes such as output, wealth, and exchange rates?

Financial Integration

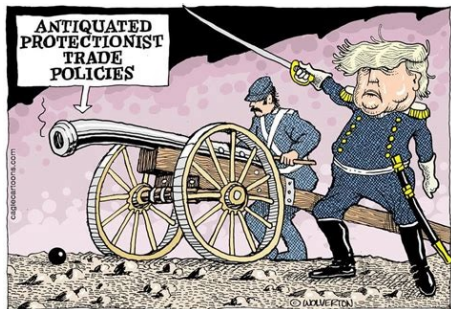
FIGURE 1-5



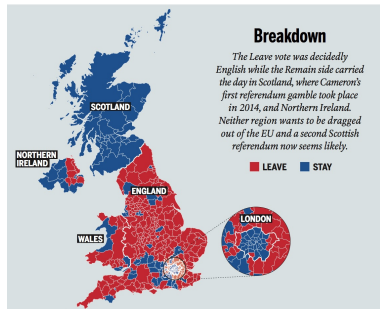
Financial Globalization Since the 1970s, many restrictions on international financial transactions have been lifted, as shown by the time series chart in panel (a). The volume of transactions has also increased dramatically, as shown in panel (b). These trends have been strongest in the advanced countries, followed by the emerging markets and the developing countries.

Sources: Philip R. Lane and Gian Maria Milesi-Ferretti, 2007, "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004," *Journal of International Economics* 73(2), 223–250 (and updates); Menzie D. Chinn and Hiro Ito, 2006, "What Matters for Financial Development? Capital Controls, Institutions, and Interactions," *Journal of Development Economics*, 81(1), 163–192 (and updates). Country classifications are an extended version of those developed by M. Ayhan Kose, Eswar Prasad, Kenneth S. Rogoff, and Shang-Jin Wei, 2006, "Financial Globalization: A Reappraisal," NBER Working Paper No. 12484.

Globalization or Deglobalization?



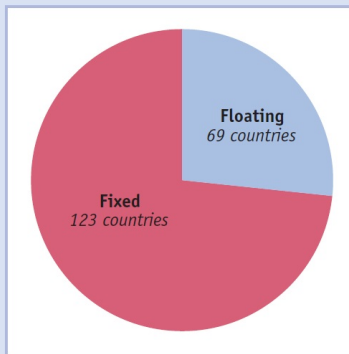
Source: Heatherhastie.



Source: MacLeans.

The choice of exchange rate regimes

FIGURE 1-6



Exchange Rate Regimes The pie chart shows a classification of exchange rate regimes around the world using the most recent data from the year 2010.

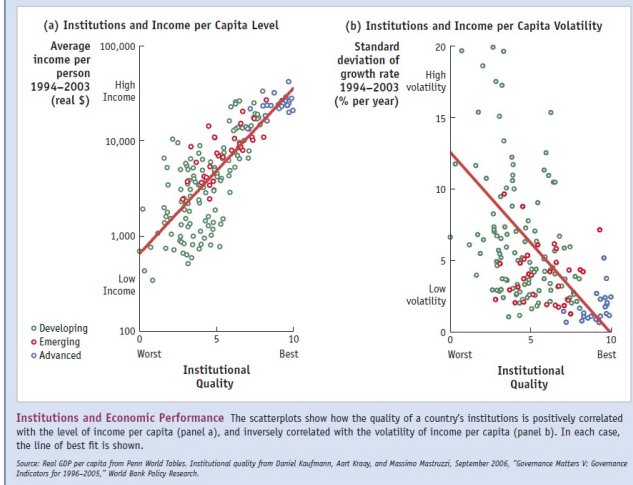
Notes: The fixed category includes: No separate legal tender, Pre announced peg or currency board arrangement, Pre announced horizontal band that is narrower than or equal to $\pm 2\%$, De facto peg, Pre announced crawling peg, Pre announced crawling band that is narrower than or equal to $\pm 2\%$, De facto crawling peg, De facto crawling band that is narrower than or equal to $\pm 2\%$

The floating category includes: Pre announced crawling band that is wider than or equal to $\pm 2\%$, De facto crawling band that is narrower than or equal to $\pm 5\%$, Moving band that is narrower than or equal to $\pm 2\%$ (i.e., allows for both appreciation and depreciation over time), Managed floating, Freely floating, Freely falling, and Dual market in which parallel market data is missing.

Source: Ilzetzi, Ethan, Carmen M. Reinhart and Kenneth S. Rogoff, 2010, "Exchange Rate Arrangements Entering the 21st Century: Which Anchor Will Hold?" See the next chapter for more details.

Institutions and Economic Performance

FIGURE 1-7



Policy issues in International Finance

- Why do some countries create a common currency or adopt another nation's currency as their own? Why do some of the countries that have kept their own currencies maintain a fixed exchange rate with another currency? And why do others permit their exchange rate to fluctuate over time, making a floating exchange rate their regime choice?
- Are there any "optimal" policies or regimes for a country? How to think about and formulate policies in a volatile era?
- What is the new normal for the global economy? How to fix the international monetary system? What are the characters of the global governance in the future?