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PRINCIPLES OF INTERNATIONAL FINANCE I

FIN 612 – FALL 2008

Ross School of Business, University of Michigan

Purpose:

Finance 612 & 614 are designed to familiarize students with the basic tools and concepts of International Finance. The main goal of this sequence is to provide the analytical framework required for understanding how changes in international financial conditions influence the decision-making process of modern business leaders.

Within Fin 612, we will start by learning the major characteristics, institutions, and players of the exchange rate markets. We will then consider the interaction between cross-border trade, capital flows, interest rates, inflation, monetary and fiscal policies, and economic growth, and their impact on those markets. Finally, we will use these ideas to explore exchange rate regimes and Central Banks' intervention policies. In the follow-up course, Fin 614, we will examine various other international financial markets (equities, bonds, swaps, and other derivatives), and the opportunities they present for achieving risk management and asset allocation objectives. We will also attempt to understand and explain the recent wave of international financial crises affecting the global capital markets.

This sequence is tailored to students seeking careers in international banking and portfolio management or with finance and strategy departments of multinational corporations. Due to the nature of the material, we will make a fair use of quantitative tools you have learned in previous Finance, Economics, and Statistics courses. There will be no cases.

Instructor:

Name:	Paolo Pasquariello	**Office:**	E7602
Phone:	734-764-9286	**Email:**	ppasquar@bus.umich.edu
RA:	Alex Hsu	**Email:**	alexch@bus.umich.edu

Office Hours:

Tuesdays: 2:00 p.m. to 4:00 p.m. (room E7602)

By appointment as needed

Course Materials:

There are two required textbooks for this course:

1. ***International Financial Management*** by Geert Bekaert and Robert Hodrick (Pearson-Prentice Hall);
2. ***International Investments*** by Bruno Solnik and Dennis McLeavey, 5th or most recent edition (Pearson Addison-Wesley).

I will provide specific additional readings and lecture notes on the class website in the C-Tools portal. Additional, recommended textbooks are:

3. ***International Financial Markets***, by Richard Levich (McGraw-Hill Irwin);
4. ***International Money and Finance***, by Michael Melvin (Pearson Addison-Wesley).

Please always check the class website at least a day prior to each class session: YOU ARE RESPONSIBLE for downloading all class materials, handouts, and readings for a session. The website also contains a **discussion board**, where I will post messages with answers to frequently asked questions.

Homework:

Two homework problem sets will be assigned throughout the term. The homeworks will be posted on the class website. Due dates for the homeworks are indicated below. Homework may be done individually on in groups. Nonetheless, homework assignments must be submitted **individually, on my class desk, prior to class-time on the due date**. **You must show how you obtained all your answers**. Late homework will not be accepted.

Homework 1: Due at the beginning of class on September 24th, 2008 (LECTURE 7)
Homework 2: Due at the beginning of class on October 8th, 2008 (LECTURE 11)

Group Project:

There will be one group project. The purpose of the project is to write a "**currency report**."

Currency reports are routinely prepared and distributed by investment banks to clients worldwide. Typically, a currency report is focused on either one or a set of exchange rates. The report includes an analysis of the macro and microeconomic fundamentals of the countries involved, in absolute terms as well as relatively to the world business cycle: For instance, is the country in a recession? Does the domestic currency belong to any particular exchange rate regime? Then, the report often describes major economic, financial, and political events taking place in the selected currency markets in the last few weeks and months: Elections, Central Bank interventions, important monetary or fiscal decisions recently taken, etc. Finally, the report uses all this and other information to formulate a short (up to 1 year), medium (up to 3 years), and long-term (up to 5 years) forecast of the selected exchange rate(s).

Your team has to prepare and submit such report to me. **The report itself will have to be of no less than three but no more than four pages in length**. Indeed, global investors tend to be busy and have little or no time for lengthy dissertations. Hence, your recommendations will have to be prominently placed in the report.

Your analysis has to employ the tools and techniques we will discuss in class, as well as any other economic, financial, or statistical tool you may be comfortable with. Currency reports are generally not too technical in nature, since they strive to be read by the largest possible number of clients. Therefore, you will attach an **Appendix of no less than two and no more than four pages in length** in which you describe the analytics and details of the methodologies you used to prepare the report. **Shorter or longer reports will be penalized.**

This project is to be completed in groups of three to four members, not necessarily in the same section. You have to submit only one report for the entire group, being careful to note all the names of group members, via email to me, in PDF format only,

by 9:00 am of the due date: October 18th, 2008. Late reports will not be accepted. The report will be graded based on quality of content, quality of exposition, and the extent to which it feels "professionally" executed.

I cannot stress this enough: Start planning and working on this project early … few hours of work prior to the due date are insufficient to generate a "passing grade" report.

Data Collection: The Tozzi Center

As you will soon notice, one of the most challenging tasks for your project is to collect data.

In the Resources section of the class website, there is a subsection **titled International Finance Web Resources**; there you will find links to sources for most of your data needs.

In addition, you can look for the data you need in the Tozzi Center. Located in the first floor of the Executive Residence, the Tozzi Center is a state-of-the-art lab with PCs running the most important data applications in Finance (Reuters, Bloomberg, Datastream, etc.).

Kai Petainen is the manager of the Tozzi Center and has kindly agreed to provide data retrieval help to the students of FIN 612. He has prepared a special folder with all the information you may need to collect data in the Tozzi Center, as well as with the most requested data series. He can also help you find any new data you may be looking for.

The Tozzi Center is open all day long; Kai is usually available throughout the day, although he tells me that the best times for him to help you are usually in the mornings and in the late afternoons.

Final Exam:

The final exam will be a 2-hour in-class exam on **October 15th, 2008 from 1:30 to 3:30 pm**. **<u>There will be no makeup exam</u>**, unless you miss the exam because of a well-documented, valid written medical excuse (e.g., a doctor's note stating that it would have been impossible for you to be in class by the scheduled day/time). The exam will be closed-book. You are not allowed to use any laptop during the exam but only **financial calculator(s)**. **You will be allowed to bring one 8-1/2" x 11" sheet of paper with notes and formulas** (both sides are ok) **on it**. The **paper does not have to be handwritten** (yet, it cannot contain any of the slides from the lecture notes) and has to be handed in along with the exam.

Grading Policy:

Class Participation / Attendance	10%
Homework	10%
Group Project	40%
Final Exam	40%

I will grade this course according to the grading policy set by the Ross School of Business at University of Michigan (RSB) for MBA students. The official Grade Distribution Guidelines set by the Ross School of Business for MBA Electives impose the following forced curve assigning (approximately):

"Excellent"	to 0 – 35% of the students
"Good"	to 0 – 40% of the students
"Pass", "Low Pass", or "Fail"	to 0 – 25% of the students.

Personal integrity and professionalism are fundamental values of the Ross Business School community. This course will be conducted in strict conformity with the **Academic Honor Code**. The Code and related procedures can be found at the following website: www.bus.umich.edu/Academics/Resources/communityvalues.htm. The site also contains comprehensive information on how to be sure that you have not plagiarized the work of others. Claimed ignorance of the Code and related information appearing on the site will be viewed as irrelevant should a violation take place. Non-Ross Business School students taking the course should also familiarize themselves with the Code as they will be subject to the Code as well while in this course.

Attendance & Seating Policy:

Attendance to this class is mandatory. Lectures will stress the most important issues addressed in the course and may go beyond the scope of the textbook for certain topics. You are responsible for announcements in class; consult a colleague if you are absent. Perfect attendance will factor into grading for those on the edge of grade distributions. I will distribute in class a seating chart at the beginning of the second class (September 8). You will be expected to use the seat you choose that day for the remainder of the term. I will post a copy of the seating chart on the class website. **Please place a name tag with your name in front of your seat at all times and fill the face card form available on the class website by the beginning of the second class**.

Course Content & Class Schedule (tentative):

1. Course Introduction and Overview (LECTURE 1)

Themes of the course; structure of the course; international financial market features and recent developments.

2. The International Financial Setting

2.1. The Foreign Exchange Market (LECTURE 2)

Organization of the market; size of the market; traded contracts; the participants; the marketplace; currency quotes and prices; triangular arbitrage; settlement; bid-ask spreads; describing changes in exchange rates.

<u>Suggested readings</u>: Bekaert-Hodrick (Chap. 2); Solnik (Chap. 1); Levich (Chap. 1, 3); Melvin (Chap. 1, 3)

2.2. Forward Markets and Transactions Exchange Risk (LECTURES 3 & 4)

Transactions exchange risk; describing uncertain future exchange rates; hedging transactions exchange risk; the forward foreign exchange market; forward premiums and discounts.

Suggested readings: Bekaert-Hodrick (Chap. 3); Solnik (Chap. 1); Levich (Chap. 4); Melvin (Chap. 4)

2.3. Interest Rate Parities (LECTURES 5 & 6)

The time value of monies; a review of bond pricing; covered interest rate parity; the external currency market; covered interest arbitrage with transactions costs; hedging transactions risk with money market hedges.

Suggested readings: Bekaert-Hodrick (Chap. 6, 14.1); Solnik (Chap. 2); Levich (Chap. 5); Melvin (Chap. 5)

2.4. Speculation and Risk in the Foreign Exchange Market (LECTURE 7)

Speculating in the foreign exchange market; uncovered interest rate parity and the unbiasedness hypothesis; foreign exchange risk and the unbiasedness hypothesis; the importance of uncovered interest rate parity and the unbiasedness hypothesis; empirical evidence on the unbiasedness hypothesis.

Suggested readings: Bekaert-Hodrick (Chap. 7); Solnik (Chap. 2, 3); Levich (Chap. 5); Melvin (Chap. 6)

2.5. Purchasing Power Parity (LECTURE 8)

Price levels and price indices; the purchasing power of a money; the theory of absolute purchasing power parity; the law of one price; overvaluations and undervaluations of currencies; the MacPPP standard; exchange rates and absolute PPPs; explaining the failure of absolute PPP; comparing incomes across countries; relative purchasing power parity; the international law of one price; absolute purchasing power parity; relative purchasing power parity.

Suggested readings: Bekaert-Hodrick (Chap. 8); Solnik (Chap. 3); Levich (Chap. 4); Melvin (Chap. 8)

2.6. Real Exchange Rates, Real Exchange Rate Risk (LECTURE 9)

The real exchange rate; the real exchange rate as a relative price; real appreciations and depreciations; real foreign exchange risk; the international Fisher effect.
Suggested readings: Bekaert-Hodrick (Chap. 8); Solnik (Chap. 3); Levich (Chap. 4); Melvin (Chap. 8)

3. Exchange Rate Regimes, Determination, and Forecasting

3.1. Balance of Payments (LECTURE 10)

The balance of payments; current account and capital account dynamics.
Suggested readings: Bekaert-Hodrick (Chap. 4); Solnik (Chap. 2); Levich (Chap. 3); Melvin (Chap. 2)

3.2 Exchange Rate Regimes and Central Bank Intervention (LECTURE 11)

Exchange rate systems; fixed, floating and intermediate regimes; Central Bank intervention.
Suggested readings: Bekaert-Hodrick (Chap. 5); Solnik (Chap. 3); Levich (Chap. 2, 17); Melvin (Chap. 3, 10)

3.3. Exchange Rate Determination and Forecasting (LECTURE 12)

Parity conditions and exchange rate forecasts; forecast evaluation; fundamental exchange rate forecasting; technical analysis and exchange rate forecasting; devaluation prediction.
Suggested readings: Bekaert-Hodrick (Chap. 10); Solnik (Chap. 3); Levich (Chap. 6, 8); Melvin (Chap. 9, 10)