International Finance

Module Introduction and Overview

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1 Introduction to the Module

The emergence of an open, liberal international financial order has been one of most notable developments in the global economy in the last 20 years. The growth of a more open international economy since the Second World War produced an international environment in which markets have bypassed national regulations, and financial flows have seriously questioned the Keynesian demand management policies. The study of trade and production cannot, therefore, satisfactorily explain the behaviour of the international economy; finance and the institutions through which it flows should also be examined. In a world where consumption, production and investment are globalised, international finance has become an integral part of any serious academic study of international economics.

The main objective of this module is to study the economists' perspective on international finance, which is a policy-oriented perspective. The examination of the institutions of international finance and the key policy problems that have arisen in recent decades are the main concern of this module. In other words, it is the perspective that an economist would use when advising governments on how to work within the modern international financial system and how to overcome its problems.

In order to explore problems of policy within the international financial system, you need to learn three principal types of material:

- the institutional structure of the modern international financial system
- the principles of financial policy analysis for an open economy
- the principles affecting some current policy issues in international finance.

The institutional structure of the modern international financial system is discussed in Units 1 and 2. Unit 1 is concerned with the *Bretton Woods* system, the *Eurodollar* system, and the new institutional development arising from the *international debt crisis* of the 1980s. Unit 2 deals with foreign exchange markets as the foundation for all operations in international finance, and its relation to money markets. That unit presents an overview of the basic nature of foreign exchange markets, the distinction between spot and forward exchange rates, the different types of transaction that take place in the market and the policy relationships.

The principles of financial policy analysis for an open economy are presented in Units 3, 4 and 5. In Unit 3, you will study the concept of balance of payments and examine one important element of the balance of payments, the *current account*. Methods used to analyse the effects of different policies upon the current account, and their complementary nature are also explained in that unit. The methods analysed are the *multiplier framework*, the *elasticities framework*, and the *absorption framework*. Unit 4 will introduce the Mundell–Fleming Approach to the balance of payments, and Unit 5 considers the monetary approach to balance of payments policies. The monetarist analysis of the balance of payments and the evaluation of the monetary approach to balance of payments are the most important topics in that unit.

The principles affecting some current policy issues in international finance comprise the subject matter of Units 6, 7 and 8. An examination of the policy debates on fixed, flexible and managed exchange rate systems are the central theme of these units. In Unit 6, you will study the arguments in favour of, and the arguments against fixed, floating and managed rates. Unit 7 is about the policy implications resulting from fixed versus floating exchange rate systems at an international level. You will also learn how some countries, such as the EU members, have agreed to maintain fixed exchange rates among themselves (*currency blocs*), which some others have exercised to co-ordinate their exchange rate policies (*international macro co-ordination*). The evolution and objectives of the European Monetary Union are also discussed in this unit.

Unit 8 is concerned with problems of international finance faced by developing countries. In this unit, the validity of assumptions used in the standard economic models studied in this module, and the logic of abstraction employed in constructing simple models to represent the actuality of developing countries, are questioned.

2 Study Resources

This study guide is your central learning resource, it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying each unit and the associated readings will require 15 to 20 hours per week, but this will vary according to your background knowledge and experience of studying.

Key text

The key text for this module is:

Keith Pilbeam (2013) *International Finance*. 4th Edition. Basingstoke UK: Palgrave Macmillan.

This is a standard, good, modern textbook that gives a clear exposition of the main theoretical, institutional and policy issues taught in this module. I will refer to it simply as Pilbeam from now on.

Throughout this module, I will introduce you to the topic of each unit, set out the main questions and direct you to the sections and chapters of Pilbeam that deal with the material you are studying. I will explain concepts in Pilbeam that appear difficult, and discuss with you the conclusions you could draw from your reading. In some units, I will refer to articles instead of Pilbeam or in addition to that text.

Module readings

You are also provided with some academic articles and other reports, which are assigned as readings in the study guide. You are expected to read them as an essential part of the module although you will find that some academic articles range more widely than the study guide or use more advanced techniques and have a greater level of conceptual difficulty than the textbook. That is the nature of academic articles, but I have selected articles and reports whose main arguments can be understood and appreciated at the level appropriate to this module.

3 Learning Outcomes

When you have completed this module, you will be able to do the following:

- outline the decline of Bretton Woods and the rise of the Flexible Exchange Rate Regime, 1973 to the present
- analyse and discuss fixed versus flexible exchange rate regimes
- explain the difference between hedging, arbitrage and speculation and the interaction of hedgers, arbitrageurs and speculators
- discuss the parity relationships between spot and future exchange rates
- demonstrate how a balance of payments is constructed with a series of transactions, and show how transactions are recorded
- explain how the national income framework and elasticities framework can be linked to the absorption framework.
- discuss the policy problem the Mundell–Fleming model is designed to address, and the historical circumstances that made it relevant
- differentiate between the assumptions of the Polak model and those of the Mundell–Fleming model
- assess the strengths and weaknesses of the monetary approach
- relate the traditional arguments for and against fixed and floating exchange rates
- explain the rationale behind discretionary intervention in the foreign exchange market
- give an account of the development of the European Monetary System and the European Monetary Union.

4 Study Advice

The module units (or 'study guide') serve much as a lecture in a conventional university setting, introducing you to the literature of the subject under study and helping you to identify the core message of each reading you are assigned. As you work through the units, you should study the readings as suggested and answer the questions set. Where you are already familiar with the particular topic introduced, you may find that skim-reading is sufficient, as long as you can answer the relevant questions.

The objectives of each unit are set out in the introductory section of each unit, and it's a good idea to review these when you have finished that unit's work to make sure that you can indeed complete each task suggested. These are the sorts of issues you are likely to meet in examination questions and your ability to write on them should set you up well for success in the module.

You should always read your module materials critically and evaluate carefully the strengths and weaknesses of economic models that are being presented. Remember that no model is perfect in its attempt to explain a particular aspect of economic behaviour. Train yourself, therefore, to adopt a critical approach to all your module material, including these units.

During the scheduled weeks of the module, you must complete two assignments in which you will be asked to write essays. The essays will be marked by your tutor in London, who will send you detailed comments and advice. The grades on your two assignments will account for 30% of your final module grade. To complete the module, you will take an examination, according to the University of London examination schedule, which will account for the remaining 70% of your total module grade.

Please keep in mind that your essays, examination and study of the module should reflect its principal themes and ways of reasoning. I hope that, by the end of your study of the module, you will be able to

- identify and clearly define significant policy problems
- use an appropriate theoretical model to analyse policy problems
- and, when necessary, place the argument in the context of the institutional setting.

The best marks will be awarded for essays and examination answers that include these elements. Moreover, we will give great weight to the use you make of theoretical models in your essays. Recall that models presented in diagrams or equations are usually the clearest. Your work in each unit will be organised around one or two thematic questions relating to that unit.

The overall, broad question, which runs through the module as a whole, is:

- What policies and strategies can countries adopt to solve international financial problems, and what are their strengths and weaknesses?

5 Module Overview

Unit 1 Evolution of International Financial Systems

1.1 Introduction to Unit 1
1.2 Bimetallism – before 1879
1.3 Classical Gold Standard – 1879–1914
1.4 The Interwar Period – 1914–1944
1.5 The Bretton Woods System – 1945–1972

Unit 7 Currency Blocs, Financial Integration and International Co-ordination

7.1 Introduction
7.2 Types of Financial Co-operation
7.3 Macroeconomic Policy Co-ordination
7.4 European Monetary Union

Unit 8 Currency and Financial Crises and the International Financial System

8.1 Introduction
8.2 Modelling Currency Crises
8.3 The East Asian Financial Crisis
8.4 The 2007–08 Financial Crisis
8.5 Financial Innovations before the Credit Crunch
8.6 Dimensions and Causes of the Credit Crunch
8.7 Policy Responses to the 2007–08 Crisis