University of Illinois, Chicago
Finance 494, International Financial Markets
Fall 2012

- GENERAL INFORMATION -

Instructor: Dr. Özgür Arslan-Ayaydin

TA: Janice Hou, (email: jiayinhou10@gmail.com)

Time & Place of the Course: 01:00 – 01:50 (Mondays, Wednesdays and Fridays), BSB 319

Office Hours: My office is in UH # 2416. Please e-mail me at orslan@uic.edu to set up a time for a meeting.

In-Class Examinations: There will be two quizzes and two in-class examinations. No make-up will be offered neither for the quizzes nor the examinations unless there are compelling medical reasons which are supported by an official certificate of a medical doctor.

Exam Format: Exams will consist of a combination of true/false questions, multiple choice questions, short and/or long essay questions and problems requiring calculations. There will be a final group assignment in place of a final examination. It will not be cumulative but will build on the material covered throughout the course.

Class Participation: You are expected to enrich class discussions by your participation and this will constitute a portion of your grade. You are expected to attend all the lectures and attendance will be taken at the end of every lecture. You need to keep up with readings and any changes to them. During the term, those changes will be announced in the class and you will be held responsible for being abreast of such changes. Please be aware that around 30% of the lecture material is not covered in the text-book therefore you are strongly advised to take notes during the each class.

Assignments: Assignments are to be submitted on due dates. Late submission will be penalized.

Honor Code: This course is being administered under the policies of the *University of Illinois at Chicago College of Business Administration Honor Code*. All students are expected to respect and uphold this code. For the exams, no consultation of any form is allowed except that you are allowed to ask me questions for clarification. Please turn off your cellular phones during the lectures.

Weighting	News Analysis & Presentation	15 %
	Class Participation	5 %
	Quiz1	10 %
	Quiz 2	10 %
	Examination 1	20 %
	Examination 2	20 %
	Final Group Assignment	20 %

Grading	A	90% - 100%
	B	80% - 89%
	C	70% - 79%

Required Text: 1) R.C. Feenstra, and A.M. Taylor (2012) "International Macroeconomics", *Second Edition*, Worth Publishers, ISBN: 1-4292-4103-9

Recommended: 1) The Wall Street Journal
2) Financial Times
3) The Economist

Schedule of the Classes

Date	**Topics**
August 27	- Introduction to International Financial Markets
August 29	- The Global Macro Economy, - Foreign Exchange: Currencies and Crisis - Quotations of Exchange Rates
August 31	- The Bid-Ask Spread - Cross Rate Trading Desk - How Do Exchange Rates Behave? - Why Do Exchange Rates Matter?
September 3	**Labor Day: No Class**
September 5	- When do Exchange Rates Misbehave? - Globalization of Finance: Debts and Deficits - Debtors and Creditors: External Wealth - Introduction to Balance of Payments
September 7	- Key Interpretation of the Balance of Payments
September 10	- Country Risk and Defaults - Government and Institutions: Policies and Performance - Independence and Monetary Policy: The Choice of Exchange Rate Regimes
September 12	- Exchange Rates and the Foreign Exchange Market - Factors that Affect Exchange Rates in the Long Run - Equilibrium in the Foreign Exchange Market - How do Exchange Rates Change From this Equilibrium?
September 14	- Response of Exchange Rates Due to Changes in Domestic Interest Rates (Real Interest Rates versus Expected Inflation) - Multilateral Exchange Rates - Exchange Rate Regimes: Fixed versus Floating
September 17	**1st QUIZ (Covering the Lectures between August 29 and September 14)**
September 19	- Currency Unions and Dollarization - European Central Bank versus US Federal Reserve Bank - The Market for Foreign Exchange (The Spot Contract and Derivatives.)
September 21	- Arbitrage and Spot Exchange Rates - Arbitrage with Two Currencies - Arbitrage with Three Currencies
September 24	- Arbitrage and Interest Rates

	- Explanations on Interest Rate Parity (IRP)
September 26	- Covered Interest Arbitrage - Uncovered Interest Arbitrage (Currency Carry Trade)
September 28	- The Monetary Approach to Exchange Rates - Exchange Rates and Prices in the Long Run: Purchasing Power Parity (PPP)
October 1	- The Real Exchange Rate - Absolute PPP and the Real Exchange Rate - Absolute PPP, Prices and the Nominal Exchange Rate
October 3	- Relative PPP, Inflation and Exchange Rate Depreciation - Explanations on Deviations from PPP
October 5	**1st EXAM (Covering the Lectures between September 17 and October 3)**
October 8	- Money, Interest Rates and Prices in the Long Run: a General Model - The Demand for Money: The General Model - Long Run Equilibrium in the Money Market - Inflation and Interest Rates in the Long Run
October 10	- The Fisher Effect - Real Interest Parity
October 12	- Exchange Rate Forecasts Using the General Model
October 15	- The Asset Approach to Exchange Rates
October 17	- Exchange Rates and Interest Rates in the Short Run - Risky Arbitrage
October 19	- Equilibrium in the FX Market - Adjustment to FX Market Equilibrium
October 22	- Interest Rates in the Short Run: Money Market Equilibrium - How are Nominal Interest Rates Determined?
October 24	- Adjustment to Money Market Equilibrium in the Short Run
October 26	**2nd QUIZ (Covering the Lectures between October 8 and October 24)**
October 29	- Changes in Money Supply and Nominal Interest Rate *- Case Study: Can Central Banks Always Control the Interest Rate? A Lesson from the Crisis of 2008-2009.*
October 31	- The Asset Approach: Applications and Evidence
November 2	- Fixed Exchange Rates and the Trilemma - How Does Pegging Sacrifices Monetary Policy Autonomy in the Short Run?
November 5	- How Does Pegging Sacrifices Monetary Policy Autonomy in the Long Run? *- Case Study: The Trilemma in Europe*
November 7	- Exchange Rate Crises: How Pegs Works and How They Break - How Costly are Exchange Rate Crises?
November 9	- How Do Pegs Work? The Mechanics of a Fixed Exchange Rate - Fixing, Floating and the Role of Reserves
November 12	*- Case Study: Risk Premiums in Advanced and Emerging Markets*
November 14	- How Do Pegs Break? Inconsistent Fiscal Policies
November 16	- The Euro

November 19	- The Economics of the Euro
November 21	- The Theory of Optimum Currency Areas
November 23	**Thanksgiving Holiday: No Classes**
November 26	- Optimum Currency Areas: Europe versus Unites States
November 28	- The History and Politics of the Euro
November 30	**2nd EXAM (Covering the Lectures between October 29 and November 28)**
December 3	- The European Central Bank
December 5	- The Eurozone in Crisis: 2008-2010.
December 7	Presentations of the Final Assignments

*The schedule may be subject to change during the term.

- ASSIGNMENTS -

Assignments are an integral part of this course and your grades. They are designed to amplify classroom work and to help you more fully understand the concepts in each chapter. Assignments are of two types. First, there is a team news analysis and classroom presentation, with a written summary. Finally there is a final assignment, which will be completed as a team project with basing on work in the latter part of the semester. Therefore, all the assignments require teamwork and the same team will work on the both assignments. You are required to select your team members and inform me no later than **September 14, Friday**. Teams may have a minimum of four (4) to a maximum of six (6) members. As soon as I learn the team makeup and number of teams, I will randomly select the order in which the teams will present their news analysis.

News Analysis & Presentation: The news analysis exercise should be considered as a mini-lecture for the class. You are going to be the expert on this topic. The assignment is intended to focus your attention on the financial press as it relates to investments. Each team is required to select an article that appeared in the financial press, either in *Financial Times, The Economist* or *Wall Street Journal*, no more than 15 days prior to the due date of assignment. This article will be one that illustrates or amplifies concepts we have discussed in class or raises questions about how these concepts apply in practice. A good analysis will summarize the story and show how the reported phenomenon conforms to the theory or diverges from what the theory predicts. You are encouraged to introduce material from other sources where you feel this will help the class to put the story into proper context. Your presentation to the class should be no more than 10 minutes, followed by a question and answer session. In addition to the oral presentation, you are required to submit your work in writing, accompanied by the copy of the article and references. You will be graded on the quality of your presentation and the thoroughness of the analysis. Each team member must participate fully in this project although not all members of the team have to present. Exactly how the presentation will be made is a decision for the group. The assignment must be submitted with a signature page with the names and signatures of each member of the group.

Final Assignment: This assignment is worth 20% of your grade. It must be submitted, in hard copy, during our last class on **Friday December 7**. It is a group assignment based on the group you currently have for the news analysis & presentation assignment. The assignment must be typed and accompanied by a signature page with the names and

signatures of each member of the group. **No late submissions will be accepted.** During the class on December 7, each group will be given 5 to 10 minutes to present their assignments.

- THE FINAL ASSIGNMENT -

Part 1:

1) Visit the following websites and download the exchange rates of 6 foreign currencies (at least 2 of them have to be from emerging markets) including the dollar.
oanda.com
xe.com
ft.com

2) Compute the one-year appreciation or depreciation against the dollar

(*Hint:* Remember, ($: U.S dollar, X: The foreign currency that you have chosen)
$S_t(X/\$)$ = Beginning Rate
$S_{t+1}(X/\$)$ = Ending Rate
The % appreciation (or depreciation) in X can be calculated as;
[(Ending Rate – Beginning Rate) / Beginning Rate] x 100

3) Visit the OANDA website (oanda.com) to explore recent exchange rate trends for the pairs of countries that you have selected (the time window depends on your choice, the wider the better). To plot trends, download the series to a spreadsheet (Or, you may also use FXGraph online graphing tools to plot trends).

4) Try to plot examples of some fixed and floating rates. Can you tell from the data, which countries are fixed and which are floating?

5) In the plots, can you locate data for an exchange rate crisis within your time-window?

Part 2:

1) Imagine you are a carry trader. Go to the ft.com site and locate the “Market Data” part of the site. Find one-month LIBOR interest rates for some major currencies: US dollar, pound, euro, Japanese yen, Swiss franc, Canadian dollar, and Austrian dollar (*Hint:* Google “ft.com money rates”). Find the lowest yield currency and call it X. How much interest would you pay in X units after borrowing 100X for one month? (*Hint:* The raw data are annualized rates.) Compute the exchange rate between X and every other high yield currency Y (*Hint:* Google “ft.com cross rates”). For each Y, compute how much X would be worth in Y units today, and then in a month’s time with Y-currency interest added. Revisit this question in a month’s time, find the spot rates at the moment, and compute the resulting profit from each carry trade. Did any of your imaginary trades pay off?