INTERNATIONAL FINANCE

KELLG_FE 316 - Winter 2012

Syllabus

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Kellogg – Financial Economics 316-0
International Finance

This class provides an introduction to the workings of the foreign exchange markets, factors impacting the course of exchange rates, the nature of foreign exchange risk, and important aspects of financial management of the multinational corporation. The first part introduces the different elements of the overall FX Interbank market and explores valuation and hedging of given nominal FC cash flows. The second part discusses the determination of exchange rates, monetary policy, and the international links between exchange rates, inflation rates and interest rates. The third part examines various concepts of exchange risk and analyzes hedging with foreign currency options. The fourth part considers longer term operational exposures and discusses the need to manage foreign exchange risk in a continually operating international business. Moreover, valuation of foreign projects is addressed. If times permits, we will end by discussing country risk, capital flows, and sovereign debt issues. Throughout, the connection to current events as reported in newspapers and journals is emphasized.

The only formal prerequisite for the course is KELLG_FE 310-0. However, familiarity with elementary principles of Macroeconomics and Derivatives are helpful throughout, although necessary concepts will be developed from first principles.

Textbook: **Eun, C.S. and B.G. Resnick: International Financial Management;**
Sixth Edition; McGraw-Hill/Irwin, 2012.

Other Readings: Perhaps a small packet of articles that will be available from the bookstore. Supplementary notes, problems and readings will be posted on the course website.

Course Requirements: Grading will be based on Class Participation (10%), Problem Sets and Case Write-ups (20%), a Midterm Exam (25%), and a Final Exam accounting for 45% of your course grade. I expect you to do the readings in advance of the class for which they are assigned. The format of the class is lectures and discussion. To facilitate this practice it is helpful if you bring your name plates.

Course Schedule

Week 1: **0. Introduction: Course Overview**

1. The Foreign Exchange Spot Market, Overview of Institutional Features

Introduction to Institutions of the Foreign Exchange Interbank Market
Foreign Exchange Spot Transactions; Bid-Ask Quotes; FX Appreciation
Eun & Resnick, Ch^{r}1, pp. 4-28; Eun & Resnick,Ch^r 5, pp. 111-129.

Week 2: ***Hand-In Solutions to Problem Set #1.***

2. Bid-Ask Quotes, International Money Markets, Hedging Transaction Risk

Foreign Exchange Forward Transactions; Eurocurrency Market; LIBOR;
Hedging FX Transaction Exposure; Interest Rate Parity Theorem;
Eun & Resnick, Ch^r 5, pp. 129-138; Eun & Resnick, Ch^r 8, pp. 200-203;
Eun & Resnick, Ch^r 11, pp. 268-279.

Week 3: ***Hand-In Solutions to Problem Set #2.***

3. Interest Rate Parity, FX Hedging Applications, Carry Trade

Checking Interest Parity with Bid-Ask Spread; Extensions to Interest Rate Parity;
Synthetic FX Forward; Hedging Multiple Currencies over Multiple Maturities;
Default Risk; FC Futures Contracts; Uncovered Interest Rate Arbitrage;
Forward Expectations Parity; FX Carry Trade;
Eun & Resnick, Ch^r 6, pp.139-148. Eun & Resnick, Ch$^{r\,7}$, pp. 172-179.

Week 4: ***Hand-In Solutions to Problem Set #3.***

4. Monetary Policy, Inflation, Interest Rates and Growth

Monetary Policy; Short Run Inflation/Unemployment Trade-off
Fisher Effect; Money Supply, Inflation and Interest Rates Linkages
Real and Nominal Interest Rates; Central Bank Balance Sheet
Mishkin, Ch^r 17; *Fed. Res. Bank of San Francisco*, U.S. Monetary Policy
Eun & Resnick, Ch^r 6, Fisher Effects, *pp. 155-157.*

Week 5: ***Hand-In Solutions to Problem Set #4.***

5. International Parity Conditions and Long Run FX Determination

Purchasing Power Parity; International Parity Conditions; Real Exchange Rates
Expected Future FX Rates; Real FX Risk; PPP FX Rates
Flow Market Model; Foreign Exchange Intervention
Eun & Resnick, Ch^r 6, pp. 148-155, 157-171

Week 6: **Midterm Exam**

Hand-In Solutions to Problem Set #5.

6. Balance of Payment, FX Determination, FX Volatility; Hedging Case
FX Flow Market Model; Balance of Payments; National Income Accounting;
Capital Flows; FX Volatility; Hedging Case;
Eun & Resnick, Ch^{r} 3, pp. 64-82; Hedging Case Material.

Week 7: **7. FX Derivatives and Hedging**
Foreign Currency Options; Pricing and Applications
Examples: Zenith and Lufthansa.
Eun & Resnick, Ch^{r} 7, pp. 180-188, 192-195.
Eun & Resnick, Ch^{r} 8, pp. 198-226.

Week 8: ***Hand-In Solutions to Problem Set #6***

8. FX Economic Exposure and Hedge Motives, Hedging Applications
Foreign Currency Options Hedge Examples
Types of FX Exposures; FX Hedging Philosophy;
Eun & Resnick, Ch^{r} 9, pp. 227-247.

Week 9: ***Hand-In Solutions to Problem Set #7.***

9. International Capital Budgeting and Valuation
FC Cost-of-Capital; Valuation of Foreign Projects
Accounting for Political Risk; FX Operating Exposure
Eun & Resnick, Ch^{rs} 17 - 18, pp. 435-479.
Salomon Smith Barney: Practical Approach to International Valuation.

Week 10: ***Hand-In Solutions to Problem Set #8.***

10. Valuation Case; Sovereign Debt Issues; Course Review
Valuation Case Review; Sovereign Debt Crises;
Eun & Resnick, Ch^{r} 2, pp. 29-63; Valuation Case Material.

Final Exam (In-Class) - 120 minutes