

BA 218 International Finance

Haas School, UC Berkeley

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Course Description

The course is organized around 4 modules:

- (1) Exchange Rates: Relationships and Institutions (\approx 7 sessions—1.5 hours each)
- (2) International Financial Instruments (6)
- (3) International Corporate Finance (7)
- (4) International Portfolio Management (8)

The broad coverage makes it relevant to a wide range of professional interests (e.g., corporate finance, global portfolio management, and corporate treasury management). The main objective is to enable students to work effectively in the context of international financial uncertainty. International financial events are both pervasive and important. Firms and investors cannot afford to neglect them. Those with expertise find it an enduring source of advantage.

The course prerequisite is BA 201B, or the equivalent (i.e., pass the waiver or make the case successfully to me). Finance background beyond BA 203 will be helpful, though not required.

Requirements

There will be four problem sets (25% of grade), an applied project (35%), and a final (40%). I encourage working together on the problem sets (3 per group maximum, hand in only one copy per group). Be forewarned of the stiff penalties for late problem sets: from a possible 10 points, four will be deducted for problem sets up to one lecture late; those more than one lecture late will not be accepted. The following page describes the applied project.

Readings

The required text is available at the bookstore: *Multinational Financial Management* by Alan Shapiro, New York: Wiley, sixth edition, 1999 (Denoted “MFM” below). A reader with additional articles is currently available and is required. There are two texts that will be helpful for backup reading, but are not required: (1) *International Investments* by Solnik, fourth edition (Addison-Wesley, 1999); and (2) *International Economics* by Krugman and Obstfeld, fifth edition (Addison-Wesley, 2000). Also, I expect you to keep abreast of international topics; I strongly recommend a student's subscription to either *The Economist* or the *Financial Times*.

The Applied Project

Description

The applied project is an opportunity to tailor the course to specific interests. You may work in groups from one to three people. The paper should be tightly focused, and roughly two thousand words of text irrespective of number of authors (about 8 pages, not including tables, figures, etc.). A one-page tentative proposal is due on Tuesday, February 26. The final draft is due in class on Tuesday, April 30. In addition to the written document, a few pairs will have an opportunity to brief the class on their projects in the last two weeks of the semester (≈ 10 minutes per briefing). Being a member of this select group can only help your grade.

Acceptable Topics

You have considerable leeway in selecting a topic, as long as it involves international finance. Past topics have generally fallen into three broad categories: (1) International Financial Institutions and Instruments, (2) Managing Corporate Currency Risk, and (3) International Portfolio Investment. Three representative titles appear below, one from each category:

- Searching for the Best Exchange Rate Mechanism: The Argentine Case.
- Currency Hedging by a Japanese Multinational: NEC Corporation.
- Mexican Bonds: To Buy or Not To Buy? How do I Evaluate the Question?

Depending on your topic, you should consider your audience to be the head of research at an investment bank or the CFO of a corporation. Imagine that this person has charged you with addressing a particular issue on her mind. Your paper is your best effort to do so. It should be short, tightly constructed, and as prescriptive as possible.

Strategies For Topic Selection

- Scan issues of *Euromoney* and the *Journal of Portfolio Management* for topics.
- Scan *The Economist*, the *Financial Times*, or the *WSJ* for recent inspiring events.
- If you have contacts at a firm that operates internationally, you'll have an advantage on topics in the area of Managing Corporate Currency Risk.

Good Sources

- *Datastream* is an extremely rich source of international financial data (currencies, stocks, bonds, macro statistics, etc.). This is available on-line in the Computer Center and in Long Library.
- *International Financial Statistics*, published monthly by The International Monetary Fund, contains much financial and macroeconomic data for IMF member countries.
- *The Economist's* Intelligence Unit publishes quarterly *Country Reports* and annual *Country Profiles*. These are good, for example, for details on countries' foreign exchange regimes.
- Commercial and investment banks: most produce valuable research on current developments (e.g., Bank of America's monthly *Currency Review*).
- *Euromoney* is a periodical that focuses on issues relevant to this class; occasionally, a particular topic will be treated in depth in a *Euromoney Supplement*.
- The National Bureau of Economic Research (NBER) produces a working paper series that contains current academic articles on international topics (check <http://www.nber.org>).
- See my web page for links to useful sites in international finance (www.haas.berkeley.edu/~lyons).

Topic Scan

Module 1: Exchange Rates: Relationships and Institutions

- Models of exchange rate determination.
- Key international financial relationships.
- Exchange rate forecasting.
- Fixed versus floating exchange rates.
- FX market microstructure

Module 2: International Financial Instruments

- Currency swaps and their use.
- Currency futures.
- Currency options.
- Uses and abuses of currency derivatives

Module 3: International Corporate Finance

- Distinguishing different types of currency exposure.
- Determining which types to hedge and to what degree.
- International accounting diversity.
- International tax management.
- Cases on hedging various exposures.

Module 4: International Portfolio Management

- The benefits of international diversification.
- Global asset allocation: equities, bonds, and currencies.
- Currency hedging foreign stocks and bonds.
- The forecasting of excess returns.
- Emerging equity markets.

Schedule

Module 1: Exchange Rates: Relationships and Institutions

- Jan. 22 (1): Course Overview**
Reading: • None.
- Jan. 24 (2): International Economic Linkages and the Balance of Payments**
Reading: • MFM Chapter 4.
• Optional: “EMU: An Awfully Big Adventure,” *The Economist*, survey.
- Jan. 29 (3): The Asset Approach to Exchange Rates (1)**
Reading: • “Currency Forecasting: Theory and Practice,” M. Rosenberg.
- Jan. 31 (4): The Asset Approach to Exchange Rates (2)**
Reading: • MFM Chapter 2.
- Feb. 5 (5): Key International Financial Relationships**
Reading: • MFM Chapter 7, Chapter 5 pages 157-167.
- Feb. 7 (6): Empirical Results: Forward Bias**
Reading: • “Anomalies: Foreign Exchange,” K. Froot and R. Thaler.
• “Is Currency Trading Profitable?” P. Green.
- Feb. 12 (7): FX Markets (1): Players and Institutions**
Reading: • “Overview of the Microstructure Approach,” R. Lyons.
- Feb. 14 (8): FX Markets (2): Prices and Order Flow Analysis**
Reading: • “Macro Puzzles: The Challenge for Microstructure,” R. Lyons.

Module 2: International Financial Instruments

- Feb. 19 (9): Currency Forwards and Futures**
Reading: • MFM Chapter 6, pages 172-178, 199-202.
- Feb. 21 (10): Currency Options**
Reading: • MFM Chapter 6, pages 178-199.
• “Uses and Abuses of Currency Options,” G. Dufey and I. Giddy.
- Feb. 26 (11): Currency Swaps (1)**
Reading: • “Currency Swaps,” T. O'Brien.
- Feb. 28: No Class**
- Mar. 5 (12): Currency Swaps (2)**
Reading: • “Currency Swaps,” J. Evans.
- Mar. 7 (13): Case: Using Currency Swaps**
Reading: • “R.J. Reynolds International Financing,” HBS.

Module 3: International Corporate Finance

Mar. 12 (14): Accounting Exposure: Measurement

- Reading: • MFM Chapter 8.
• “Foreign Currency Transactions and Translation,” T. Harris.

Mar. 14 (15): Accounting Exposure: Management

- Reading: • MFM Chapter 9.
• “International Accounting Diversity,” F. Choi and R. Levich.

Mar. 19 (16): Economic Exposure: Measurement

- Reading: • MFM Chapter 10.

Mar. 21 (17): Economic Exposure: Management

- Reading: • MFM Chapter 11.

Apr. 2 (18): Case: Transaction Exposure Management

- Reading: • “Dozier Industries.”

Apr. 4 (19): Managing a Multinational Financial System

- Reading: • MFM Chapter 14.
• “Corporate Risk Management,” *The Economist*, survey.

Apr. 9 (20): Case: Operating Exposure Management

- Reading: • “Jaguar plc”.

Module 4: International Portfolio Management

Apr. 11 (21): Portfolio Currency Risk: Should it be Hedged?

- Reading: • “The Free Lunch in Currency Hedging,” A. Perold and E. Schulman.
• “Risk Budgeting and the Currency Hedge,” Goldman Sachs.

Apr. 16 (22): Global Asset Allocation (1)

- Reading: • MFM Chapter 19.
• “Financial Statistics for the Non-statistician,” Bank of America.

Apr. 18 (23): Global Asset Allocation (2)

- Reading: • “Asset Allocation With Hedged and Unhedged Foreign Stocks and Bonds,” P. Jorion.
• “Stocks and Currencies,” *The Economist*.

Apr. 23 (24): Global Asset Allocation (3)

- Reading: • “Interest Rates and Country Allocation Strategies,” Salomon Smith Barney.
• “Lessons for International Asset Allocation,” P. Odier and B. Solnik.

Apr. 25 (25): Case: Global Equity Markets

- Reading: • “Global Equity Markets: The Case of Royal Dutch and Shell,” HBS.

Apr. 30 (26): Emerging Markets (1)

- Reading: • “The Emerging Markets Phenomenon,” D. Beim and C. Calomiris.

May 2 (27): Emerging Markets (2)

Reading: • “Special FX,” G. Cooper.
• “Top Secret Special FX,” N. Reed.

May 7 (28): Practitioner Visit and Project Briefings

Reading: • None.

May 9 (29): Review and Project Briefings

Reading: • None.

May 14 (30): Wrap Up

Reading: • None.

International Finance: Reading Packet Contents

1. "Questions on Readings," Professor R. Lyons.
2. "EMU: An Awfully Big Adventure," *The Economist*, 4/11/98, Survey pages 1-22, Economist Newspaper LTD.
3. "Currency Forecasting: Theory and Practice," M. Rosenberg, 1992, 1-23, Merrill Lynch & Co.
4. "Anomalies: Foreign Exchange," K. Froot and R. Thaler, *Journal of Economic Perspectives*, Summer 1990, 179-192, American Economic Association.
5. "Is Currency Trading Profitable? Exploiting Deviations from Uncovered Interest Parity," P. Green, *Financial Analysts Journal*, July-August, 1992, 82-86, Financial Analysts Federation.
6. "Overview of the Microstructure Approach," chapter 1 in *The Microstructure Approach to Exchange Rates*, Richard Lyons, MIT Press: Cambridge, MA, November 2001, pages 1-18.
7. "Macro Puzzles: The Challenge for Microstructure," chapter 7 in *The Microstructure Approach to Exchange Rates*, Richard Lyons, MIT Press: Cambridge, MA, November 2001, pages 171-220.
8. "Uses and Abuses of Currency Options," G. Dufey and I. Giddy, *Journal of Applied Corporate Finance*, Fall 1995, 49-57, Stern Stewart Management Services, Inc., 40 West 57th Street, NY, NY, 10019.
9. "Currency Swaps," T. O'Brien, *Global Financial Management*, 1996, Chapter 6, 157-183, John Wiley & Sons.
10. "Currency Swaps," J. Evans, *International Finance: A Markets Approach*, 1992, 521-531, Dryden Press.
11. "R.J. Reynolds International Financing," Harvard Business School, 9-287-057.
12. "International Accounting Diversity," F. Choi and R. Levich, *Financial Analysts Journal*, 1991, 73-82, Financial Analysts Federation.
13. "Dozier Industries," case: Stanford Business School S-F-163.
14. "Corporate Risk Management," *The Economist*, 2/10/96, Survey pages 1-22, Economist Newspaper LTD.
15. "Jaguar plc," Harvard Business School, 9-290-005.
16. "The Free Lunch in Currency Hedging," A. Perold and E. Schulman, *Financial Analysts Journal*, 1989, 45-50, Financial Analysts Federation.
17. "Risk Budgeting and the Currency Hedge," K. Winkelmann and R. Howard, Goldman Sachs, Investment Management Division, January 2001, 1-24.
18. "Financial Statistics for the Non-statistician Part Four: Regression Analysis," A. Sharma, *Currency Review*, Global Capital Markets Group, Bank of America, Spring 1997, 15-18.
19. "Asset Allocation With Hedged and Unhedged Foreign Stocks and Bonds," P. Jorion, *Journal of*

Portfolio Management, 1989, 49-54, Institutional Investor Systems.

20. "Stocks and Currencies," *The Economist*, 6/6/92, 87, Economist Newspaper LTD.
21. "Interest Rates and Country Allocation Strategies," L. Heckman and B. Gendreau, 1998, 1-18, Salomon Smith Barney.
22. "Lessons for International Asset Allocation," P. Odier and B. Solnik, *Financial Analysts Journal*, 1993, 63-77, Financial Analysts Federation.
23. "Global Equity Markets: The Case of Royal Dutch and Shell" Harvard Business School, N9-296-077.
24. "The Emerging Markets Phenomenon," D. Beim and C. Calomiris, Chapter 1 in *Emerging Financial Markets* (2001), pages 2-37, McGraw-Hill Irwin.
25. "Special FX," G. Cooper, *Risk: Currencies, Interest Rates, Equities, Commodities, Credit*, October 1993, 42-48.
26. "Top Secret Special FX," N. Reed, *Risk: Currencies, Interest Rates, Equities, Commodities, Credit*, April 1996, 12-14.