**Financial Economics (FIN 405/ECON 331)**

**Chapter 1: Keeping Up With a Changing World-Trade Flows, Capital Flows, and the Balance Of Payments**

This chapter begins by discussing on the importance of international economic integration and then continuous to provide opinions of advantages and disadvantages of international trade and finance. The second section of the chapter explains and defines the concept of globalization which includes market integration. The chapter then proceeds to distinguish the real and financial sectors. In the third section of the chapter, international balance of payments accounting is described in terms of a double entry bookkeeping system. The components of each of the three major accounts, (1) the current account, (2) the private capital account, and (3) the official settlements balance, are discussed in detail. The next section provides a discussion of what means for a country to be a net debtor and a net creditor in terms of capital account balance. The final section of the chapter connects current account balances to capital flows.

**Chapter 2: The Market for Foreign Exchange**

Chapter 2 begins with an explanation of the foreign exchange market. After explanation of exchange rates, the section describes currency appreciations and depreciations. The next section defines the concept of an "effective" exchange rate as weighted-average value of a currency relative to a selected group of currencies and also provides explanations of a composite currency, specifically the International Monetary Fund’s Special Drawing Rights. The next section of the chapter present foreign exchange arbitrage and an example of arbitrage is provided. The following section explains the supply of and demand for a currency. It then shows the determination of the equilibrium exchange rate. Finally, it uses the supply and demand diagram to show how a nations would intervene in the foreign exchange market to maintain a given exchange value. The final section of this chapter is included to the explanation of purchasing power parity (PPP) as a theory of the determination of the exchange rate. Specifically, absolute PPP and relative PPP are defined detail.

**Chapter 3: Exchange Rate Systems, Past to Present**

Chapter 3 begins with general discussion of monetary orders and exchange rate systems. The chapter present the historical evolution of the exchange rate system under three different systems: (1) the gold standard system from the mid 1870’s to World War I, (2) the Bretton Woods pegged exchange rate system which lasted from World War II through the early 1970’s, and, (3) the current post-Bretton Woods floating exchange rate system.

**Chapter 4: The Forward Currency Market and International Financial Arbitrage**

This chapter explains he forward currency market and its role in providing investor with opportunities to hedge against foreign currency exchange risk. The chapter begins with discussion of the various types of risk: (1) transaction exposure, (2) translation exposure, and (3) economic exposure. In the next section of the chapter, a forward exchange contract is explained which agents can cover themselves against these risks. The third section of the chapter covers international financial arbitrage. It presents a supply and demand model for the loanable funds market and shows how the equilibrium market interest rate is determined. Next it demonstrates that when expected returns on two different instruments are the same, it is implied that the real interest rates should equalize between the two, and presents this as interest parity. The fourth section introduces uncovered interest parity, which is described as a condition in which investors do not use the forward market to hedge against foreign exchange risk.

**Chapter 5: Interest Yields, Interest Rate Risk, and Derivative Securities**

Chapter 5 begins with a presentation of the concept of discounted present value and how it relates the market price of a bond to its yield. This discussion is followed by an explanation of how term to maturity affects interest-rate risk. The next section introduces the term structure of interest rates and the yield curve. This section proceeds with a discussion of various theories of the term structure: (1) the segmented markets theory, (2) the expectations theory and (3) the preferred habitat theory. The following section examines how excess returns arising from failure of uncovered interest parity contribute to differences among national interest rates. The chapter then turns to a discussion of ways in which investors can hedge against interest rate risk using derivatives. The section points out that forward exchange contracts are simply one example of a derivative security. Just as investors use forward exchange rate markets to hedge against exchange risk, investors can use derivative securities that are based on forward interest rates to hedge against interest rate risk. The chapter then describes some of the most common forms of available derivatives, such as interest rate futures, stock index futures, and currency futures. The uses of currency futures, options and swaps are also discussed.

**Chapter 6: International Banking, Central Banks, and Supranational Financial Policymaking Institutions**

The chapter begins with a discussion of the role of financial intermediation, and discusses two important reasons for the existence of indirect finance through intermediaries: (1) the existence of asymmetric information between borrowers and leaders, including situations that involve potential adverse selection and moral hazard problems, and (2) economies of scale. The chapter proceeds to consider the major global bank payment systems and their risks, which include liquidity risk, credit risk, systemic risk, and Herstatt risk. This followed by the discussion of financial instability and international financial crises, including inconsistencies of official exchange rates with economic fundamentals that engender speculative attacks, self-fulfilling anticipations and contagion effects, and structural moral hazard problems. The chapter next describes the various objectives of bank regulation and supervision, such as limiting the scope for insolvencies and failures, maintaining liquidity, and promoting efficiency. It addresses key programs, such as systems of bank capital requirements and deposit insurance, which many governments have adopted to promote banking stability. The chapter concludes with a description of the world’s two main supranational financial policymaking institutions, the International Monetary Fund and the World Bank.

Source: Daniels, J. P. and VanHoose, D. D., International Monetary and Financial Economics, Third Edition, South-Western.