Lecture plan and reading list

Books


Introduction

Balance of payments


CA definition

Intertemporal approach to CA: 2-period small open economy

- OR chapter 1 pp.1-14, 23-31 Required
- Obstfeld, M and K. Rogoff "Intetemporal Approach to current account", HIE III Ch. 34, also NBER WP 4893, October 1994.
- Obstfeld, M "International Macroeconomics: Beyond the Mandell-Fleming Model" IMF Staff Papers 47 (Special Issue, 2001), 1-39 A review of the development of international macroeconomics in the recent years and introduction to new open economy macro.

Intertemporal approach to CA: 2-period small open economy (continued)

2-country world

- OR chapter 1 pp.23-31. Required

A model with investment


Dynamic CA models: deterministic and stochastic

- OR chapter 2 pp 57-96 Required

Empirics on CA model

- OR chapter 2 pp 90-94 Required
- A. Kraay and J. Ventura, "Current Accounts in Debtor and Creditor Countries," Quarterly Journal of Economics, November 2000. A model of CA with high investment risk and low diminishing returns illustrates the assertion that the CA response to the shocks is proportional to the share of foreign assets in total assets. Empirical analysis of industrialized countries supports this assertion. Their recent paper "Current Accounts in the Long and Short Run " distinguishes between short and long run, just as title suggests, in a similar empirical exercise.


CA and policy issues: open-economy OGM

- OR chapter 3 pp.133-137, 156-161. Required
• Tornell.A. and P. Lane (1994) "A Windfalls a Curse? A Non-Representative Agent Model of the Current Account and Fiscal Policy", NBER W.P. No.4839, August. Representative-agent models predict positive correlation between temporary terms of trade shocks and current account. This is not supported by the data. Some explanation lies in fiscal policy effect of terms of trade and some in the lower return on windfall money. The model to illustrate this introduces fiscal decisions made by different groups of agents in a dynamic game setting. Model predictions are confirmed with some case studies.

• Backus, D.K., P. Kehoe and F. Kydland (1993) "International Business Cycles: Theory and Evidence", NBER W.P. 4493, October. Presents a two-country RBC (dynamic GE) model with trade, compares the predictions to the data on correlation of real variables across countries and variance of terms of trade. Model does not explain the data. Paper suggests some extensions that could potentially account for the discrepancies.

Feldstein-Horioka puzzle and capital mobility

• OR chapter 3 pp 161-164 Required
• M ch.1 pp.3-11 Required, ch. 6 p.128-152.
• Cole H. and M. Obstfeld, "Commodity Trade and International Risk Sharing: How much do financial markets matter?" Journal of Monetary Economics 1991, 28: 3-24. A model shows that if gains from international portfolio diversification are small (simulations show that they might be small for large industrialized countries), then small barriers to international capital flows might discourage large volume of international trade in capital, while the interest rate differentials will remain small. Available for free in electronic format through Yale library .
• Blanchard, Olivier and Giavazzi, Francesco. (2002) "Current Account Deficits in the Euro Area. The End of the Feldstein Horioka Puzzle?" MIT department of Economics Working Paper Series, Working Paper 03-04, September 17, 2002. Using a workhorse model and applying it to the integration in Europe and then looking at panel data show that large CA deficits in Portugal and Greece are what we would expect. This shows that there is no longer FH puzzle.

January 25. Lecture 5.

Exchange rates: stylized facts

The PPP puzzle - slow convergence and high volatility of real exchange rate

- OR sections 4.1-4.5 **Required**
- M ch. 7 **Required**
- Engels C. and J. Rogers, "How wide is the border", AER 1996, 86:1112-1125. Empirical paper that shows empirically with gravity regression that the trade across border between US and Canada is less than between the states within US and Canada, other things being equal.

The Backus-Smith puzzle - low correlation between relative consumption and real exchange rate

- Corcetti, Giancarlo, Luca Dedola and Sylvain Leduc "International Risk Sharing and the Transmission of Productivity Shocks", mimeo, 2003. The paper retells the Bachus-Smith puzzle and presents the model that produces low correlation, due to incomplete markets and distribution costs (which are intrinsically non-tradable).

The Mussa puzzle - real exchange rate depends on the nominal exchange rate regime

- Mussa (1990)
- Lothian & Taylor (1997?) Show that Mussa’s finding is not always true.

The exchange rate "disconnect" puzzle - exchange rate does not depend on fundamentals

- Chinn M. e.a. (2003)

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Monetary model of exchange rate determination

- OR 8.1, 8.2, 8.4.1 **Required**
- M ch.4 **Required**
- In continuous time: Obstfeld and Stockman, Exchange Rate Dynamics, chapter 18 in HIE II, section 2. **Required**
February 1. Lecture 7.

Exchange Rate Stabilization

**Target zones**

- OR 8.5-8.7 *Required*
- M, 10 *Required*
- Pesenti Paolo "Exchange Rate Dynamics and Target Zones: an Introductory Survey" Yale University 1990.

**Liquidity models**


February 3. Lecture 8.

**Mundell-Fleming (M-F) and Dornbusch-M-F and overshooting**

- OR 9.2, 9.3 *Required*
- M ch. 8 (only pp. 185-194 & 200-203 are required)
- Marston, Richard, Stabilization policies in Open economies, Chapter 17 in HIE II. *Required*
- Obstfeld and Stockman, Exchange Rate Dynamics, chapter 18 in HIE II, section 3. *Model of exchange rate overshooting in continuous time.*
- Luis Felipe Cespédes, Roberto Chang, and Amanda Velasco and. Cespédes "IS-LM-BP in Pampas". *An application of Mundell-Fleming model to a resource-based economy.*
- Obstfeld (1985)


**NOEM Basics**

- OR chapter 10. *The chapter is based on the "Redux" paper*
- Corsetti G. and P. Pesenti, " Welfare and macroeconomic interdependence", QJE May 2001 *Required*
- Obstfeld, Maurice and Kenneth Rogoff "Exchange rate dynamics redux", *Required*
- Cedric Tille. "The role of consumption substitutability in the international transmission of shocks" JIE, 2001 also Federal Reserve Bank of New York Staff Report 67 *This is a general framework comparing and contrasting the previous two contributions.*

Closed vs. Open Economy

- Corsetti G. and P. Pesenti, "International Dimensions of Optimal Monetary Policy" NBER 8230. **Required**
- Michael Woodford: Interest and Prices (handouts)
  "Price-Level Determination under Interest-Rate Rules," Chapter 2
  "A Neo-Wicksellian Framework for the Analysis of Monetary Policy," Chapter 4
  "Inflation Stabilization and Welfare," Chapter 6

February 15. Lecture 11.

International transmission

- Corsetti G. and P. Pesenti, " Welfare and macroeconomic interdependence", QJE **Required. Use older version with graphs from Corsetti's web site.**

International Policy coordination

- OR 9.5.5. **Required**
- OT chapter 5.

February 17. Lecture 12.

Law of one price vs. local currency pricing: International transmission and open-economy policy trade-off

- Corsetti G. and P. Pesenti, "International Dimensions of Optimal Monetary Policy" NBER 8230. **Required**
- Michael Devereux and Charles Engel, Fixed vs. Floating Exchange Rates: how price setting affects the optimal choice of Exchange Rate Regime, 1998 (PDF format)
Nominal rigidities and endogenous international pricing


More open economy policy trade-off: sectoral shocks and nontraded goods

- Tille, Cedric [2002], "How Valuable is Exchange Rate Flexibility? Optimal Monetary Policy under Sectoral Shocks", Federal Reserve Bank of New York Staff Report 147, March.


Modeling International Price Discrimination

- Corsetti G. and Luca Dedola, "Macroeconomics of International Price discrimination", mimeo. Required

More evidence on deviations from the law of one price


Financial Frictions vs. goods market imperfections

- Pierpaolo Benigno, Towards a simple approach to International Monetary Policy Coordination with Micro-foundations, Princeton University, 1998.

International spillovers and the new open economy macro

- Obstfeld and Rogoff: Do We Really Need a New International Monetary Compact? PDF (671 K)
- Michael Devereux and Charles Engel. "Monetary Policy in the Open Economy Revisited: Price Setting and Exchange Rate Flexibility"


Empirical performance of NOEMs

- M, 9.
March 1. Lecture 15.

International asset trade: theory

- OR chapter 5 pp.270-279,285-289,300-304. **Required** (I assume you are familiar with asset pricing - pp. 306-317)
- OT chapter 1. **Strongly recommended**
- Obstfeld, Maurice, "Risk-Taking, Global Diversification and Growth," *American Economic Review* 84 (December 1994), 1310-1329. A model of global portfolio diversification that shows the link between financial openness and economic growth. Calibration shows that international portfolio diversification can lead to substantial welfare improvement. Available from JSTOR
- K. Froot and J. Stein, "Exchange Rates and Foreign Direct Investment: An Imperfect Capital Markets Approach," Quarterly Journal of Economics, November 1991. Most models do not draw a relationship between capital flows and exchange rates, yet FDI and exchange rates appear to be highly correlated. The model explains how exchange rate movements, through their effects on wealth and thus demand for investment, can affect FDI. Available from JSTOR


March 22. Lecture 16.

International asset trade: empirical analysis. Puzzles and measures of risk-sharing

- OR chapter 5, pp.329-332. **Required**
- Obstfeld and Rogoff "Six major puzzles." See above. **Required**
- OT Part One.
- Van Wincoop "How Big are Potential Gains from International Risk Sharing?" Journal of International Economics, 47, 1999, 109-135. *A model is presented that could be used to calculate gains from risk-sharing depending on the underlying parameters. The results for the realistic values of parameters suggest that gains could be quite large for OECD countries. Available for free in electronic format through Yale library.* **Required**
- Dumas, B. "Partial versus General Equilibrium Models of the International Capital Market", NBER W.P. No.4446, September; also HIM Chapter 10. *A paper discusses relative merits of testing empirically GE models and PE (CAPM-type) models of international capital markets. An international CAPM is proposed and tested. Basic GE models are tested as well.*
Earlier draft available as CEPR Discussion Paper No. 2231, September 1999. This paper constructs estimates of the stock of foreign assets and liabilities for a sample of 67 industrial and developing countries.


Consumption correlation puzzle

- OR chapter 5, pp.290-292, 323-325 Required
- Backus, D.K., P. Kehoe and F. Kydland (1992) "International Real Business Cycles", Journal of Political Economy, August. The paper presents a two-country RBC model and documents the discrepancies between theory and data. In the data outputs are more correlated across countries than consumption, the theory, however, predicts the opposite. Available from JSTOR.
- Lewis, K., "What Can Explain the Apparent Lack of International Consumption Risk-Sharing? " Journal of Political Economy 104 (April 1996): 267-297. Nonseparabilities in the utility function and capital restrictions together provide an explanation to the consumption correlation puzzle, but neither one is sufficient by itself to explain the puzzle. Available from JSTOR.
- Obstfeld, M. (1993) "Are Industrial Country Consumption Risks Globally Diversified ?", NBER W. P. No. 4308, March; also in L. Leiderman and A. Razin (eds.) Capital Mobility, Cambridge University Press, 1994. A model of international consumption co-movements with possibly incomplete capital markets is developed and tested empirically. The results show that the seven largest industrial countries show a trend of increasing coherence between domestic and world consumption.
- Kollman (1996)

Portfolio home bias puzzle

- Jermann (2002)
- Portes, Rey, Oh (2001)
- Ahearne, Griever, Warnock (2000)
- Rowland, Tesar (1998)
- Pesenti, Van Wincoop (1996)
- Boileau (1996)
- Pakko (1994)
- Lane, Milesi-Firetti
March 24. Lecture 17.

The logic of currency crises: an introduction on first vs. second generation models

- OR 8.4, 8.6, 49.5.4 Required
- M, 11 Required

The coordination problem in the theory of currency crises

- Rigobon, R. (1998) "Informational Speculative Attacks: Good News is No News," mimeo, Sloan School of Management, MIT. A model where investors have imperfect (but the same) information about fundamentals that leads to over-investment and then learning leads to over-reaction.

March 29. Lecture 18.

International financial crises

- Rodrik, D. and A. Velasco (1999), "Short Term Capital Flows"NBER Working Paper 7364. Theoretical and empirical analysis of short-term debt as a crisis predictor. The authors also offer a policy implications as well as some discussion of capital controls.
International financial crises: theory

- Cole H. and P.Kehoe "Self-Fulfilling Debt Crises" Review of Economic Studies 67(1), January 2000, pages 91-116, also Federal Reserve Bank of Minneapolis Quarterly Review, July, 1998. A model of financial crises resulting from the loss of confidence in the government. Importantly, even thought the crises of this type are self-fulfilling, they can only occur if country fundamentals are in a certain range.
- Allen F and D Gale, Financial Fragility, May 2001, mimeo, New York University A model of financial crises in which under certain conditions only crises equilibria are robust.
- Detragiache, E. (1999), "Bank Fragility and International Capital Mobility," IMF Working Paper 99/113. A model showing that bank runs are more likely the more is the economy open to international capital. Impact of financial liberalization on depositors and on the economy as a whole is ambiguous in the model.
- Aghion, Ph., Ph. Bacchetta, et A. Banerjee (2000), "Capital Markets and the Instability of Open Economies," Working Paper, Studienzentrum Gerzensee. also CEPR DP 2083. An open economy dynamic TNT model that shows that economies can be financially unstable at the intermediate level of financial development. For those economies financial liberalization could be destabilizing. FDI, however, may not be destabilizing.
- Kumhof M. Balance of Payments Crises: the Role of Short Term Debt, mimeo, Stanford University, 2001. A model demonstrating that a stock of short-term domestic bond used by Central Banks as liquidity instrument can lead to a bond market bearing the largest impact of the balance of payments crisis.
- Chari, V.V. and P. Kehoe (2000), "Financial Crises as Herds," Federal Reserve Bank of Minneapolis Working Paper 600, March. A model of herd behavior with endogenous order of moves and continuous investment decision. Herds are robust to information-sharing. This model can be readily applied to international lending behavior.
- Goldstein I and A Pauzner, Demand Deposit Contracts and the Probability of Bank Runs pdf (143k)
International financial crises: evidence

- Bordo, M., B. Eichengreen, D. Klingebiel, and M.S. Martinez-Peria (2001) "Is the crisis problem growing more severe?" Economic Policy IV.B. *Looking at 120 years of the world financial history, the authors find that crises became more frequent since 1973, but not necessarily more severe.*

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April 5. Lecture 20.

International financial contagion:


International financial contagion: theory

- Calvo, G. (1999) "Contagion In Emerging Markets: when Wall Street is a carrier (Technical Supplement to "Understanding the Russian Virus")," May 2, 1999. *A model showing that learning costs could lead to investors herd behavior and thus contagion. Required*

International financial contagion: empirical challenges


… and evidence
April 7. Lecture 21.

Financial stability and the choice of an exchange rate regime

- OR 9.4, 9.5.1-9.5.3 Required.
- Calvo, G.A., Mishkin, F.S. (2003) "The Mirage of Exchange Rate Regimes for Emerging Market Countries," NBER 9808, June 2003. Argue that the exchange rate regime per se is of the second order, we should focus on institutions that create those regimes.
- Obstfeld, M. and K. Rogoff (1995) "The Mirage of Fixed Exchange Rates", NBER W.P. No.5191, July also Journal of Economic Perspectives, Fall 1995, Volume 9, #4, pp. 73-96. A paper draws on the experience of the ERM, Nordic and Mexican crises and on the existing theoretical and empirical literature to argue that fixed exchange rate regime is becoming too costly to maintain with increased international capital mobility.
- Tornell, A. and A. Velasco (1995) "Fixed versus Flexible Exchange Rates: Which Provides More Fiscal Discipline?", NBER W.P. No.5108. A model shows that since the costs of "bad behavior" under fixed exchange rates is far away, while under flexible exchange rates it is immediate, flexible rates impose more discipline on the governments that are impatient.
- Chang and Velasco, (1998) "Financial Fragility and The Exchange Rate Regime," NBER WP 6469. This paper proposes a model that can be used to compare equilibria under different exchange rate regimes and with different frictions. Lender of last resort, dollarized deposits, international borrowing are considered.

Credibility and fear of floating
April 12. Lecture 22.

**Sovereign borrowers: theory**

- OR chapter 6 pp.349-363, 379-392 Required

**Debt repurchase debate**

- OR chapter 6 pp.392-401 Required
- Bulow J. and K.Rogoff (1991) "Sovereign Debt Repurchases: No Cure for Overhang", Quarterly Journal of Economics, 106(4), November. A model that could be used to calculate upper and lower bounds on the country gain from the debt buyback. Applied to Mexico 1990 deal. Main result is that benefits are at best small, but could also be negative. Available from JSTOR.

**Reputation and repayment debate**

- OR chapter 6 pp.363-369,375-379 Required
- J. Bulow and K. Rogoff, "Sovereign Debt: Is to Forgive to Forget?" American Economic Review, March 1989. A paper that first challenged the idea that reputation is the main motive for the sovereigns to repay their debt. Available from JSTOR.
Sovereign borrowers: policy

- Sachs "The International Lender of Last Resort: What are the alternatives?", FRB Boston conference speech, June 1999. With an extensive comment by Jeff Frankel. *A debate over the IMF role as a lender of last resort.*
- Anne Krueger, Preventing and Resolving Financial Crises: The Role of Sovereign Debt Restructuring, Latin American Meeting of the Econometric Society, São Paolo, Brazil, July 26, 2002. *Latest (as of 8/22/02) in a series of her speeches about the sovereign debt restructuring procedure considered by IMF.*
- Dooley, M. (2000) "Can Output Losses Following International Financial Crises be Avoided?" NBER WP 7531. *Costly debt rescheduling is modeled as an incentive to repay the debt by being incorporated in the debt contract. This leads to costly rescheduling if crisis is unavoidable. This friction creates a role for international financial intermediary - the IMF. Also* Dooley, M. and S. Verma (2001) "Rescue packages and output losses following crises", NBER WP 8315. *Presents a more extended model.*

April 14. Lecture 23.

International financial architecture

- Rodrik, D. (2000) " Governing the Global Economy: Does One Architectural Style Fit All ?" Dessarolo Economico, vol.40. *The paper argues that we know little about developing countries and questions whether international capital mobility is an appropriate goal for the reform of the international financial architecture.*
- Jeanne O., " Debt Maturity and the global financial architecture " CEPR DP 2520, August 2000. *A model endogenizes the maturity structure of foreign debt and analyzes the welfare effects of LLR, capital controls and creditor coordination.*

Preventing financial crises

- Jeanne O. and C. Wyplosz, "The international lender of last resort: how large is large enough?" NBER WP 8381, July 2001. *A model considers how LLR can prevent self-fulfilling currency and banking crises. It considers two alternative LLR arrangements, both of which involve a powerful international organization.*
Minimizing costs of financial crises


Capital controls: theory

- Bartolini, L. and A. Drazen (1996) "Capital Account Liberalization as a Signal", NBER W.P. No 5725, August. *A model showing that liberalizing capital outflow can send a favorable signal.*

Capital controls: evidence

- Montiel and Reinhart, (1999) "Do capital controls and macroeconomic policies influence the volume and composition of capital flows? Evidence from the 1990s, Journal of International Money and Finance, 18 , pp.619-635. *An empirical analysis of the developing countries shows that sterilized interventions tend to increase the share of short-term and portfolio flows. Capital controls are found not to affect the overall volume of capital inflows, but to increase the share of FDI and decrease the share of short-term flows.*
- Edwards, S. (1999) "How Effective are Capital Controls?" Journal of Economic Perspectives, 13 (4), 65-84 also NBER WP 7413. *A historical and GARCH analysis of Chilean type capital controls shows that they have little effects except for lengthening maturity of foreign debt.*

*Last two lectures are reserved for catching up or student presentations or both.*