

## Economics 8383 International Financial Markets

Professor Jay Shambaugh

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Office hours: Thursdays 3-5, but I will generally be available by appointment

**Course description:** This course will cover core theory and empirical work in the field of international finance and open economy macroeconomics. Students should have completed the core macroeconomics sequence before taking this course. Professor Kaminsky will offer another course in the spring. The courses are not sequential – they can be taken in either order – and no knowledge of her course is presumed here. To prevent the courses from overlapping, though, large areas of the literature will not be covered here. In particular, crises and sovereign debt will receive very little attention in this course as they will constitute a large part of Professor Kaminsky’s class. For a true survey of the field, students should take both courses.

### Course organization and requirements:

*Class participation (including presentation) 30%*

*Exam 30%*

*Short papers 40%*

Students will be expected to participate in the discussion of the readings. Students will also make a 30 minute presentation / discussion of a paper later in the term. This will be part of your participation grade. There will be one exam in the middle of the term which will cover the basic models in the field. There will be 2 short papers. One is a referee report of a recent working paper (from the syllabus or preferably a recent NBER working paper that relates to topics in the syllabus). The second is a brief discussion of a major topic in the field (either a modeling question or an empirical puzzle) where the student will discuss 3-5 papers (at least 2 being recent papers that are not on the syllabus) and explore what the state of the literature is on a given topic.

**Course Readings:** Obstfeld and Rogoff’s *Foundations of International Macroeconomics* textbook is considered the standard in the field. I will occasionally assign sections of it, and you should go through it for reference. Nelson Mark’s *International Macroeconomics and Finance: Theory and Econometric Methods* is also a useful reference. Starred readings below are required. I will let you know each week which readings will be covered the following week. There is a great deal of material and we will not cover it all, you are expected to cover the rest on your own. If you’ve never done much macroeconomic history, I strongly recommend that at some point in your graduate career you sit down and read books like Barry Eichengreen’s *Globalizing Capital* or the short history of international monetary system sections in advanced undergraduate textbooks.

## ***Section 1: Core models in the field***

### *Basic models small open economies models*

Obstfeld and Rogoff Chapters 1&2 (especially pages 1-35 and 59-66)

Obstfeld, Maurice, and Kenneth Rogoff. 1995. "The Intertemporal Approach to the Current Account." In *Handbook of International Economics*, vol. 3, Gene M. Grossman and Kenneth Rogoff, eds. (Amsterdam: Elsevier). Chapter 34, pp. 1731-1799. Earlier version published as NBER working paper no. 4893.

Schmitt-Grohe, S. and M. Uribe, "Closing Small Open Economy Models" *Journal of International Economics* 2003.

### *2 country models and the exchange rate*

Lucas, Robert E., Jr. "Interest Rates and Currency Prices in a Two-Country World," *Journal of Monetary Economics*, July 1982.

Stockman, A., and L. Tesar, "Tastes and Technology in a Two-Country Model of the Business Cycle: Explaining International Co-Movements," *American Economic Review* 1995.

Aguiar, Mark, and Gita Gopinath. 2008. "Emerging Market Business Cycles: The Cycle is the Trend." *Journal of Political Economy* 115, 69-102.

Parts of Obstfeld and Rogoff chapters 8&9. (sections 8.3 and 9.2)

## ***Section 2: More recent models:***

Obstfeld and Rogoff chapter 10

Or Obstfeld and Rogoff "Exchange Rate Dynamics Redux," *Journal of Political Economy* 1995

P. Lane (2001) "The New Open Economy Macroeconomics: A Survey," *Journal of International Economics*, 54: 235-266

Paul Bergin, 2006, "How well can the New Open Economy Macroeconomics explain the exchange rate and current account?" *Journal of International Money and Finance* Volume 25, Issue 5, August 2006, Pages 675-701

Corsetti, Giancarlo; Luca Dedola; and, Sylvain Leduc. 2008. "International Risk Sharing and the Transmission of Productivity Shocks." *Review of Economic Studies* 75, 443-473.

Galí, Jordi, and Tommaso Monacelli. 2005. "Monetary Policy and Exchange Rate Volatility in a Small Open Economy." *Review of Economic Studies* 72, 707-734.

### ***Section 3: Major Empirical Puzzles (and related theory)***

Obstfeld, M. and K. Rogoff, "The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?" *NBER Macro Annual*, 2000 With comments by C. Engel

#### *a. Home bias in trade and Feldstein Horioka puzzle*

Feldstein, M. and C. Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, 1980

#### *b. Home bias in financial holdings and lack of risk sharing*

French, K. and J. Poterba, "Investor Diversification and International Equity Markets," *American Economic Review* 1991

Backus, David and Gregor Smith. "Consumption and Real Exchange Rates in Dynamic Economies with Nontraded Goods," *Journal of International Economics*, November 1993.

Lewis, Karen K. "What Can Explain the Apparent Lack of Consumption Risk Sharing?" *Journal of Political Economy*, April 1996.

Karen Lewis (1999) "Trying to Explain Home Bias in Equities and Consumption," *Journal of Economic Literature*, 37 (2): 571-608.

Baxter M. and U. Jerman, "The international diversification puzzle is worse than you think", *American Economic Review*, March 1997, 87(1).

Coeurdacier, Nicolas. "Do Trade Costs in Goods Markets Lead to Home Bias in Equities?" *Journal of International Economics*, February 2009.

Van Wincoop, Eric and Francis E. Warnock. "Is Home Bias in Assets Related to Home Bias in Goods?" *Journal of International Money and Finance*, 2010.

#### *c. Exchange Rate Puzzles (forward premium, failure of UIP, carry trade)*

Engel, Charles. 1996. "The Forward Discount Anomaly and the Risk Premium: A Survey of Recent Evidence." *Journal of Empirical Finance* 3, 123-192.

Lustig, Hanno, and Adrien Verdelhan. 2007. "The Cross Section of Foreign Currency Risk Premia and Consumption Growth Risk." *American Economic Review* 97, 89-117.

Verdelhan, Adrien. 2010. "A Habit Based Explanation of the Exchange Rate Risk Premium." *Journal of Finance* 65, 123-146.

Burnside, Craig; Martin Eichenbaum; Isaac Kleshchelski; and, Sergio Rebelo. 2010. "Do Peso Problems Explain the Return to the Carry Trade?" *Review of Financial Studies*, forthcoming.

*d. PPP (and Pass-through debates)*

K. Rogoff (1996) "The Purchasing Power Parity Puzzle," *Journal of Economic Literature* 34: 647-668.

Imbs, Jean, Haroon Mumtaz, Morten Ravn and Hlne Rey, (2005). "PPP Strikes Back: Aggregation and the Real Exchange Rate," *The Quarterly Journal of Economics*, MIT Press, vol. 120(1), pages 1-43, January.

Carvalho, Carlos, and Fernanda Nechio. 2011. "Aggregation and the PPP Puzzle in a Sticky-Price Model." *American Economic Review*, 101(6): 2391–2424.

Engel, Charles. 1999. "Accounting for U.S. Real Exchange Rate Changes." *Journal of Political Economy*, vol. 107, no. 3, June 1999, pp. 507-538.

Atkeson, Andrew, and Ariel Burstein. 2008. "Pricing to Market, Trade Costs, and International Relative Prices." *American Economic Review* 98, 1998-2031.

G. Gopinath and O. Itskhoki (2010) "Frequency of Price Adjustment and Pass-through," *Quarterly Journal of Economics* 125(2)

Gopinath, Gita; Oleg Itskhoki; Roberto Rigobon. 2010. "Currency Choice and Exchange Rate Pass-Through." *American Economic Review* 100, 304-336.

Engel, Charles, and John H. Rogers. 1996. "How Wide is the Border?" *American Economic Review* 86, 1112-1125.

Gopinath, Gita, and Roberto Rigobon. 2008. "Sticky Borders." *Quarterly Journal of Economics* 123, 531-575.

Gopinath, Gita; Pierre-Olivier Gourinchas; Chang-Tai Hsieh; and, Nicholas Li. 2009. "Estimating the Border Effect: Some New Evidence." *American Economic Review* 101, 2450-2486.

Y. Gorodnichenko and L. Tesar (2009) "Border effect or country effect? Seattle may not be so far from Vancouver after all," *AEJ-Macro* 1: 219-241

Devereux, Michael B., and Charles Engel. "Monetary Policy in the Open Economy Revisited: Exchange Rate Flexibility and Price Setting Behavior." *Review of Economic Studies* 70, 765-783.

Margarida Duarte and Maurice Obstfeld, "Monetary policy in the open economy revisited: The case for exchange-rate flexibility restored," *Journal of International Money and Finance* 27 (2008) 949–957

L. Goldberg and J.M. Campa (2010) "The Sensitivity of the CPI to Exchange Rates: Distribution Margins, Imported Inputs, and Trade Exposure," *Review of Economics and Statistics*.

#### ***Section 4: Empirics of Exchange Rates and Exchange Rate Regimes***

##### *a. General empirical issues*

Meese, Richard, and Kenneth Rogoff. 1983. "Empirical Exchange Rate Models of the Seventies: Do They Fit Out of Sample?" *Journal of International Economics* 14, 3-24.

Mark, Nelson C. 1995. "Exchange Rates and Fundamentals: Evidence on Long-Horizon Predictability." *American Economic Review* 85, 201-218.

M. Evans and R. Lyons (2005) "Meese-Rogoff Redux: Micro-Based Exchange Rate Forecasting," *AER P&P*.

Engel, Charles, and Kenneth D. West. 2005. "Exchange Rates and Fundamentals." *Journal of Political Economy* 113, 485-517.

Bacchetta, Philippe, and Eric van Wincoop. 2006. "Can Information Heterogeneity Explain the Exchange Rate Determination Puzzle?" *American Economic Review* 96, 552-576.

Betts, C. and M. Devereux, "Exchange Rate Dynamics in a Model of Pricing-To-Market," *Journal of International Economics* 2000.

##### *b. Empirics of Exchange Rate Regimes*

Mussa, Michael, 1986, "Nominal Exchange Rate Regimes and the Behavior of Real Exchange Rates: Evidence and Implications," *Carnegie-Rochester Conference Series on Public Policy*, Vol. 25 (Autumn), pp. 117–214.

Calvo, G. and C. Reinhart, "Fear of Floating," *Quarterly Journal of Economics*, 2002

Michael Klein and Jay Shambaugh, "The Dynamics of Exchange Rate Regimes: Fixes, Floats, and Flips," *Journal of International Economics* - Volume 75, Issue 1, Pages 70-92 (May 2008)

Shambaugh, Jay, "The Effects of Fixed Exchange Rates on Monetary Policy," *Quarterly Journal of Economics*, Vol. 119 no.1, February 2004, p. 301-352.

Maurice Obstfeld, Jay C. Shambaugh, and Alan M. Taylor, "The Trilemma in History: Tradeoffs among Exchange Rates, Monetary Policies, and Capital Mobility," *Review of Economics and Statistics* –vol 87, issue 3- August 2005, pp. 423-38.

Reinhart, Carmen and Kenneth Rogoff, 2004, "The Modern History of Exchange Rate Arrangements: A Reinterpretation," *Quarterly Journal of Economics*, 119 (1) pp. 1-48.

Joshua Aizenman and Menzie Chinn and Hiro Ito. "Assessing the Emerging Global Financial Architecture: Measuring the Trilemma's Configurations over Time",

Andrew Rose, "One money, one market: the effects of common currencies on trade", *Economic Policy* 30 (2000)

## ***Section 5: Financial flows***

### *a. Financial liberalization and capital flows*

Lucas, Robert E., Jr. "Why Doesn't Capital Flow from Rich to Poor Countries?" *American Economic Review*, May 1990.

Obstfeld, Maurice. "International Finance and Growth in Developing Countries: What Have We Learned?" *IMF Staff Papers*, April 2009. At: <http://www.palgrave-journals.com/imfsp/journal/v56/n1/pdf/imfsp200832a.pdf>

Gourinchas, Pierre-Olivier, and Olivier Jeanne. 2011. "Capital Flows to Developing Countries: The Allocation Puzzle." Working paper. (see WP version on Gourinchas website)

Gourinchas, Pierre-Olivier, and Olivier Jeanne. 2006. "The Elusive Gains from International Financial Integration." *Review of Economic Studies* 73, 715-741.

Emmanuel Farhi, Ivan Werning, "Dealing with the Trilemma: Optimal Capital Controls with Fixed Exchange Rates," NBER Working Paper No. 18199, June 2012

### *b. Financial flows and valuation*

Lane, P. R. and G. M. Milesi-Ferretti, "The External Wealth of Nations: Measures of Foreign Assets and Liabilities for Industrial and Developing Countries," *Journal of International Economics*, 2001

Cédric Tille, 2003, "The Impact of Exchange Rate Movements on U.S. Foreign Debt," *Current Issues in Economics and Finance*, Vol. 9, No. 1, January 2003

Cédric Tille, 2008, "Financial Integration and the wealth effect of exchange rate fluctuations," *Journal of International Economics*, Volume 75, Issue 2, July 2008, Pages 283–294

Gourinchas P-O. and H. Rey, "International Financial Adjustment", *Journal of Political Economy*, August 2007, 115(4).

Philip Lane and Jay Shambaugh, "Financial Exchange Rates and International Currency Exposures" *American Economic Review* – vol 100, no. 1, March 2010, pp. 518-540

Lane, P. R. and G. M. Milesi-Ferretti, 2003, "International Financial Integration," *IMF Staff Papers*, vol 50 Special Issue.

Devereaux and Sutherland, "Valuation Effects and the Dynamics of Net External Assets," *Journal of International Economics*, Volume 80, Issue 1, January 2010, Pages 129–143

## ***Section 6: New theories of the CA***

### *a. Imbalances debate*

Bernanke, Ben S. "The Global Saving Glut and the U.S. Current Account Deficit." Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia, 2005. At: <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/>

Dooley, M., D. Folkerts-Landau and P. Garber (2004) "The Revived Bretton Woods system," *International Journal of Finance and Economics*, 9(4): 307-313

Caballero, Ricardo; Emmanuel Farhi; and, Pierre-Olivier Gourinchas. 2008. "An Equilibrium Model of 'Global Imbalances' and Low Interest Rates." *American Economic Review* 98, 358-393.

Mendoza, Enrique; Vincenzo Quadrini; and, Victor Rios-Rull. 2009. "Financial Integration, Financial Development, and Global Imbalances." *Journal of Political Economy* 117, 371-416.

Maurice Obstfeld and Kenneth Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes," Federal Reserve Bank of San Francisco Asia Economic Policy Conference October 18-20, 2009

Francesco Giavazzi and Luigi Spaventa, 2011. "Why the current account may matter in a monetary union. Lesson from the Financial crisis in the Euro area, CEPR Discussion Paper No. 8008.

*b. New Theories of the Current Account*

Kraay, Aart and Jaume Ventura. "Current Accounts in Debtor and Creditor Countries," *Quarterly Journal of Economics* , November 2000.

Kraay, A., and J. Ventura (2002) "Current Accounts in the Long and the Short Run" *NBER Macroannual*.

Devereux, Michael B. and Alan Sutherland. "Country Portfolios in Open Economy Macro Models," *Journal of the European Economic Association*, April 2011. At:

Maurice Obstfeld, "Does the Current Account Still Matter?," NBER Working Paper No. 17877, March 2012

Engel, Charles, and John Rogers. "The US Current Account Deficit and the Expected Share of World Output," *Journal of Monetary Economics*, 2006.

*c. CA changes and determinants*

Obstfeld "External Adjustment" *Review of World Economics* 2004, Vol. 140 (4)

Chinn, Menzie and Eswar Prasad. "Medium-term Determinants of Current Accounts in Industrial and Developing Countries: An Empirical Exploration," *Journal of International Economics* , January 2003.

Gian Maria Milesi Ferretti & Assaf Razin, 2000. "Current Account Reversals and Currency Crises, Empirical Regularities," NBER Chapters, in: *Currency Crises*, pages 285-326 National Bureau of Economic Research, also NBER WP 6620.

Sebastian Edwards, "Thirty Years of Current Account Imbalances, Current Account Reversals, and Sudden Stops." IMF Staff Papers Vol. 51, Special Issue 2004