Econ 872
Spring 2012
C. Engel

Syllabus

This course covers topics in open-economy macroeconomics and international finance. It introduces topics of current research in the field. There are several topics listed below. We may not cover all of them.

Why study open-economy macroeconomics?
1. What economies are closed? Although American macroeconomics tends to favor closed-economy models, that approach is likely to become outdated soon enough. A closed-economy model may still be a reasonable approximation for the U.S. economy, but for nowhere else. Open economies have significantly different features than close economies, so it is necessary to understand how openness affects the macroeconomy.
2. It is useful to learn the field just to learn the methodologies. Open-economy macro is necessarily general equilibrium, while closed-macro sometimes focuses on partial equilibrium behavior. Open economy models are forced to deal with agents that are not homogenous because there are at least agents in two different countries, while closed models often have representative agents. Understanding the key issues in open economy macro models requires understanding the interaction between financial markets, goods markets, and factor markets, while these interactions are often trivialized in closed macro.
3. Research in open economy macro is driven by empirical anomalies – the behavior of prices, asset pricing puzzles, risk-sharing puzzles, etc. Closed macro often ignores inconvenient empirical facts, but they are impossible to ignore in open macro because they are so prominent in the study of prices, exchange rates, current account balances, etc.

Homework

You may work together on assignments. I only ask that each person turns in his own work – no photocopies of somebody else's work. You should figure out on your own how much to work on your own, and how much to work with others. It is probably not optimal to let somebody else do all the work.

The last homework assignment is to make a 10-minute presentation of one of the empirical papers from the Global Financial Crisis conference, which is the last item on the reading list.

Papers

You will be asked to write two papers, one during the semester and one at the end.

Each time you will choose five papers from the literature (at most two can be from the reading list) and pick a particular question that their set of papers addresses, and write a "review essay" on that topic. The essay should then explain how each paper helps us to understand that topic.

That means, first, you need to develop a question that each of these five papers helps to answer. The papers might not be written specifically about that question, but each paper develops a model that sheds some light on that question. So, the first step is to pick a question that your papers each help us to understand.

State the problem, and why it is interesting. Then proceed to explain what insights each of your papers sheds on these questions. More specific instructions will be given in class.

You should turn in a typed review essay, 1.5 spacing, 12-point type, standard margins, and at least 6 but no more than 10 pages long.

The papers you choose should be significant, and published since 2000. Significant papers are likely to be in major journals. You *must* choose your papers from one of these journals: Journal of Political Economy; American Economic Review; Quarterly Journal of Economics; Review of Economic Studies; Econometrica; Journal of International Economics; Journal of Monetary Economics; Review of Economics and Statistics; Journal of Money, Credit, and Banking; Journal of Finance; International Economic Review; Journal of the European Economics Association.

The topic you work on must be about open-economy macroeconomics.

<u>Grade weights</u>

Homework: 1/3
Exams: 2/3

<u>Readings</u>

1. Dynamic Models

A. Basic models

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

Engel, Charles, and John H. Rogers. 2006. "The U.S. Current Account Deficit and the Expected Share of World Output." <u>Journal of Monetary Economics</u> 53,1053-1093.

B. Real Business Cycle models

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

Engel, Charles, and Jian Wang. 2011. "International Trade in Durable Goods: Understanding Volatility, Cyclicality and Elasticities." <u>Journal of International Economics</u> 83, 37-52.

C. Market incompleteness

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

Kehoe, Patrick J., and Fabrizio Perri. 2002. "International Business Cycles with Endogenous Incomplete Markets." <u>Econometrica</u> 70, 907-928.

D. Real Business Cycle models with sovereign default

Arellano, Cristina. 2008. "Default Risk and Fluctuations in Emerging Economies." <u>American Economic Review</u> 98, 690-712.

Aguiar, Mark, and Gita Gopinath. 2006. "Defaultable Debt, Interest Rates and the Current Account." Journal of International Economics 69, 64-83.

E. Capital Flows to Developing Countries

Gourinchas, Pierre-Olivier, and Olivier Jeanne. 2011. "Capital Flows to Developing Countries: The Allocation Puzzle." Working paper.

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

F. Sudden Stops and Borrowing Constraints

Bianchi, Javier. 2011. "Overborrowing and Systemic Externalities in the Business Cycle." American Economic Review 101, 3400-3426.

Korinek, Anton. 2011. "Excessive Dollar Borrowing in Emerging Markets: Balance Sheet Effects and Macroeconomic Externalities." Working paper, Department of Economics, University of Maryland.

G. Current account adjustment

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.

2. Foreign Exchange Risk Premium

A. Basic readings

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

Backus, David K.; Silverio Foresi; and, Chris I. Telmer. 2001. "Affine Term Structure Models and the Forward Premium Anomaly." Journal of Finance 56, 279-304.

B. Recent studies

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.

Bansal, Ravi, and Ivan Shaliastovich. 2009. "A Long-Run Risks Explanation of Predictability Puzzles in Bond and Currency Markets." Working paper.

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.

Bacchetta, Philippe, and Eric van Wincoop. 2010. "Infrequent Portfolio Decisions: A Solution to the Forward Discount Puzzle." American Economic Review 100, 870-904.

Engel, Charles. 2012. "The Real Exchange Rate, Real Interest Rates, and the Risk Premium." Working paper.

3. International Price Setting

A. Basic readings

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

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

B. Models with distribution sector

Burstein, Ariel; Martin Eichenbaum; Sergio Rebelo. 2005. "Large Devaluations and the Real Exchange Rate." Journal of Political Economy 113, 742-784.

Corsetti, Giancarlo, and Luca Dedola. 2005. "A Macroeconomic Model of International Price Discrimination." Journal of International Economics 67, 129-155.

C. General Equilibrium models of pricing to market

Atkeson, Andrew, and Ariel Burstein. 2007. "Pricing to Market in a Ricardian Model of International Trade." American Economic Review: Papers and Proceedings 97, 362-367.

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

D. Sticky prices

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

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

E. Borders

Burstein, Ariel, and Nir Jaimovich. 2009. "Understanding Movements in Aggregate and Product-Level Real Exchange Rates." Working paper.

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.

4. Nominal Exchange Rates

A. Basic readings

Dornbusch, Rudiger. 1976. "Expectations and Exchange Rate Dynamics." Journal of Political Economy 6, 1161-1176.

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.

B. Exchange rate forecasting

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

Mark, Nelson C., and Donggyu Sul. 2001. "Nominal Exchange Rates and Monetary Fundamentals: Evidence from a Small Post-Bretton Woods Sample." Journal of International Economics 53, 29-52.

C. Exchange rate disconnect

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.

D. Taylor rule models

Engel, Charles, and Kenneth D. West. 2006. "Taylor Rules and the Deutschemark-Dollar Real Exchange Rate." Journal of Money, Credit and Banking 38, 1175-1194.

Clarida, Richard, and Daniel Waldman. 2008. "Is Bad News about Inflation Good News for the Exchange Rate?" In Asset Prices and Monetary Policy, John Y. Campbell, ed., National Bureau of Economic Research, 371-396.

5. New Open Economy Macro

A. Basic readings

Corsetti, Giancarlo, and Paolo Pesenti. 2001. "Welfare and Macroeconomic Interdependence." Quarterly Journal of Economics 116, 421-445.

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.

B. Inflation targeting

Clarida, Richard; Jordi Galí; and, Mark Gertler. 2002. "A Simple Framework for International Monetary Policy Analysis." Journal of Monetary Economics 49, 879-904.

Engel, Charles. 2011. "Currency Misalignment and Optimal Monetary Policy: A Reexamination." American Economic Review 101, 2796-2822.

C. Small open economy

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

de Paoli, Bianca. 2009. "Monetary Policy and Welfare in a Small Open Economy." Journal of International Economics 77, 11-22.

D. Real exchange rate adjustment and sticky prices

Chari V.V.; Patrick J. Kehoe; and, Ellen R. McGrattan. 2002. "Can Sticky Price Models Generate Volatile and Persistent Real Exchange Rates?" Review of Economic Studies 63, 533-563.

Benigno, Gianluca, 2004. "Real Exchange Rate Persistence and Monetary Policy Rules." Journal of Monetary Economics, vol. 51, no. 3, pp. 473-502.

6. Global Financial Crisis – Empirical Facts

Papers from conference on the "Global Financial Crisis"
Website with links to conference version of papers:
http://www.nber.org/confer/2011/GFC11/summary.html
Revised versions should be available by April.