

# International Finance for MSc

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August 27, 2012

## 1 Course Description

This class addresses the following main topics: exchange rate determination in open economy models, failures of the law of one price and pricing to market, international business cycles transmission in general equilibrium models, exporter dynamics, short and long run adjustments of trade flows, determinants of international capital flows and multinational production. The readings for the class will be equally split between theory and empirical papers. We will discuss stylized facts and the empirical performance of the models on these facts as well as major theoretical puzzles. We will also discuss topics for new research questions on the empirical and theoretical front.

## 2 Support Material

There will not be a particular reference for the course. However, a good book is Obstfeld and Rogoff, 1996, "Foundations of International Macroeconomics," MIT Press.

Useful notes can also be found in the following websites:

L. Drozd: <http://www.ssc.wisc.edu/~ldrozd/871.htm>

A. Ramanarayanan <http://sites.google.com/site/ananthramanarayanan/9613a>

M. Uribe: <http://www.columbia.edu/~mu2166/GIM/GIM.html>

& <http://www.columbia.edu/~mu2166/UIM/notes.pdf>

<http://econ.sciences-po.fr/nicolas-coeurdacier/test>

<http://www-personal.umich.edu/~jzhang/Syllabus642.pdf>

<http://www.kellogg.northwestern.edu/faculty/rebelo/htm/SYLphd99.pdf>

Class notes will also be distributed

## 3 Assessments

There will be a 100% final exam.

## 4 Syllabus

### 4.1 Empirical: International Accounting, Risk Sharing and Business Cycles (Lectures 1-2)

#### 4.1.1 Topic Overview

Here we will look at the basics of national accounting for open economies and examine stylized facts about the world economy. These lectures will provide a motivation for the theoretical frameworks that will follow.

#### 4.1.2 Additional Reading

Mendoza, E., 1991, "Real Business Cycles in a Small Open Economy," *American Economic Review*, 81, 797-818. Backus, D., P. Kehoe, and F. Kydland, 1992, "International Real Business Cycles," *Journal of Political Economy*, 100, 745-775. Backus, D., P. Kehoe and F. Kydland, 1994, "Dynamics of the Trade Balance and the Terms of Trade: The J-Curve?" *American Economic Review*. Stockman, A., and Linda L. Tesar, 1995, "Tastes and Technology in a Two-Country Model of the Business Cycle: Explaining International Comovements," *American Economic Review*, 85, 168-85. Drosz, L., and J. Nosal, 2010, "Understanding International Prices: Customers as Capital," forthcoming *American Economic Review*.

#### 4.1.3 Other Readings

Backus, D., and G. Smith, 1993, "Consumption and Real Exchange Rates in Dynamic Economies with Nontraded Goods," *Journal of International Economics*, 297-316. Baxter, M., 1993, "International Trade and Business Cycles," in G. Grossman and K. Rogoff (eds.) *Handbook of International Economics* vol. 3, 1995. Obstfeld, M., and K. Rogoff, 1995, "The Intertemporal Approach to the Current Account," in G. Grossman and K. Rogoff (eds.) *Handbook of International Economics* vol. 3.

### 4.2 Theory: International Exchange Economies, Risk Sharing and Incomplete Markets (Lectures 3-6)

#### 4.2.1 Topic Overview

We will first extend the basic asset pricing result of Arrow-Debreu to an international context and examine the predictions for risk sharing. We will extend this analysis first to International CAPM and then see how market incompleteness and default affect the results.

#### 4.2.2 Additional Reading

Baxter, M., and U. Jermann, 1997, "The International Diversification Puzzle is Worse than You Think," *American Economic Review*, 87, 170-180. Bekaert, G., Harvey, C.R.,

1995. Time-varying world market integration. *Journal of Finance* 50, 403-444. Bekaert, G., Harvey, C.R., Lundblad C. and S. Siegel, 2007. Global Growth Opportunities and Market Integration, *Journal of Finance*, 62, 1081-1137. Heathcote, J. and F. Perri, 2007 "International diversification is not as bad as you think," manuscript. University of Minnesota. Martin, F., and C. Horioka, 1980, "Domestic Saving and International Capital Flows," *The Economic Journal*, vol 90, No. 358, pp. 314-329. Bai, Y., and J. Zhang, "Can Financial Frictions Account for the Cross-Section FeldsteinHorioka Puzzle?" forthcoming *Econometrica*. Kehoe, P., and F. Perri 2000 "International Business Cycles with Endogenous Incomplete Markets," *Econometrica*. Heathcote, J., and F. Perri, 2002, "Financial Autarky and International Real Business Cycles," *Journal of Monetary Economics*, 49, 601-627. Solnik, B., 1974, An Equilibrium Model of the International Capital Market, *Journal of Economic Theory*, 500-524.

#### 4.2.3 Other Readings

Baxter, M., and M. Crucini, 1993, "Explaining Saving-Investment Correlations," *American Economic Review*. Corsetti, G., L. Dedola and Sylvain Leduc, 2008, "International Risk Sharing and the Transmission of Productivity Shocks," *Review of Economic Studies*, 75, 443-473. Lewis, K., 1999, "Trying to Explain Home Bias in Equities and Consumption," *Journal of Economic Literature*, 571-608.

### 4.3 Empirical: International investments (Lectures 7-9)

#### 4.3.1 International portfolio diversification in theory and practice

French, K. and J. Poterba 1991, Investor diversification and international equity markets, *American Economic Review* 81, 222-226 Griffin J. and G. A. Karolyi, 1998. Another Look at the Role of the Industrial Structure of Markets for International Diversification Strategies, *Journal of Financial Economics* 50, 351-373. Ahearne, A., W. Grier and F. Warnock, 2004, Information costs and home bias: an analysis of U.S. holdings of foreign equity, *Journal of International Economics* 62, 313-336. Prasad, E., K. Rogoff, S. Wei and M. Kose, 2004. Financial Globalization, Growth and Volatility in Developing Countries, NBER Working Paper 10942.

#### 4.3.2 Equity and Bond Home Bias

Bekaert, G. and X. Wang, 2009, Home bias revisited, working paper, Columbia University. Chan, K.; Covrig, V.; Ng, L., 2005, What Determines the Domestic Bias and Foreign Bias? Evidence from Mutual Fund Equity Allocations Worldwide, *Journal of Finance*, 60, 1495-1534. Cooper, I. and E. Kaplanis, 1994, What Explains the Home Bias in Portfolio Investment? *Review of Financial Studies* 7, 45-60. Ferreira, M. and P. Matos, 2008. The Colours of Investors' Money: the Role of Institutional Investors around the World, *Journal of Financial Economics*, 88, 499-533. Lewis K., 1999. International Home Bias in International Finance and Business Cycles, *Journal of Economic Literature* 37, 571-608.

### 4.3.3 International Portfolio Flows

Bekaert G., C. Harvey and C. Lundblad, 2005. Does Financial Liberalization Spur Growth, *Journal of Financial Economics*, 77, 3–56. Portes, R. and H. Rey 2005. The determinants of cross-border equity flows, *Journal of International Economics* 65, 269-96. Brennan M. and H. Cao, 1997, International portfolio investment flows, *Journal of Finance* 52, 1851-1880. Albuquerque, R., N. Loayza and L. Servén 2005, World Market Integration Through the Lens of Foreign Direct Investors”, *Journal of International Economics* 66, 267-295.

## 4.4 Open Economy Monetary Economics and Exchange Rates (Lectures 10-11)

### 4.4.1 Topic Overview

### 4.4.2 Additional Reading

Engel, C., 1999, “Accounting for U.S. Real Exchange Rate Changes Accounting for U.S. Real Exchange Rate Changes” *The Journal of Political Economy* 107, 507-538. Engel, C., and K. West, 2005, “Exchange Rates and Fundamentals.” *Journal of Political Economy* 113, 485-517. Betts, K., and T. Kehoe, 2006, “U.S. real exchange rate fluctuations and relative price fluctuations,” *Journal of Monetary Economics* 53, 1297-1326. Dornbusch, R., 1976, “Expectations and Exchange Rate Dynamics,” *Journal of Political Economy*, 6. Chari, V.V., P. Kehoe, and E. McGrattan, 2002, “Can Sticky Price Models Generate Volatile and Persistent Real Exchange Rates?” *Review of Economic Studies* 63, 533-563.

### 4.4.3 Other Readings

Obstfeld, M., and K. Rogoff, 1995, “Exchange Rate Dynamics Redux,” *Journal of Political Economy*, 103, 31. Engel, C., 2000, “Long Run PPP May Not Hold After All,” *Journal of International Economics* 51, 243-273. Crucini, M., C. Telmer, and M. Zachariadis, 2005, “Understanding European Real Exchange Rates,” *American Economic Review*, 95, 724-738.

## 4.5 Puzzles and new directions in international macroeconomics. (Lecture 12)

### 4.5.1 Topic Overview

### 4.5.2 Additional Readings

Obstfeld, M., and K. Rogoff, “Six major puzzles in International Macroeconomics,” NBER Macro Annual, 2000, plus C. Engel “Comment.” Lewis, K., 1995, “Puzzles in International Finance,” *Handbook of International Economics*, Volume 3, Grossman, Gene M., Rogoff, Kenneth, eds. Lucas, R., 1990, “Why doesn’t capital flow from rich to poor countries?” *American Economic Review*, 1990. Rogoff, K., 1996, “The Purchasing Power Parity Puzzle.” *Journal of Economic Literature* 34, 647-668.

### 4.5.3 Other Readings

Gourinchas, P. and O. Jeanne, 2009, “Capital Flows to Developing Countries: The Allocation Puzzle” Aguiar, M. and G. Gopinath, 2007. “Emerging Market Business Cycles: The cycle is the Trend,” *Journal of Political Economy*. Uribe, M. and V. Yue. 2005. “Country Spreads and Emerging Countries: Who Drives Whom?” *Journal of International Economics*. Obstfeld M., and K. Rogoff, 2000, “New Directions for Stochastic Open Economy Models,” *Journal of International Economics*. Bergin, P., R. Glick, and J. Wu, 2009, “The Macro-micro Disconnect of Purchasing Power Parity, NBER working paper 15624.

## 4.6 Global Imbalances (Lectures 13)

### 4.6.1 Topic Overview

### 4.6.2 Additional Readings

Gourinchas, P., 2007, “International Financial Adjustment,” *Journal of Political Economy*, 115, 665-703. Caballero, R., E. Fahri, and P. Gourinchas, 2008, “An Equilibrium Model of ‘Global Imbalances’ and Low Interest Rates,” *American Economic Review*, 98, 358–393. Mendoza, E., V. Quadrini, and V. Rios-Rull. 2009. “Financial Integration, Financial Development, and Global Imbalances.” *Journal of Political Economy* 117, 371-416.

### 4.6.3 Other Readings

Ferrero, A., 2007, “The Long-Run Determinants of the U.S. External Imbalances,” Working Paper, Federal Reserve Bank of New York. Obstfeld, M. and K. Rogoff (2005): “Global Current Account Imbalances and Exchange Rate Adjustments,” *Brookings papers on Economic Activity*, 2005, 67-146.

## 4.7 Systemic Risk, Global Financial Crises, Sovereign Default and International Financial Stability (Lecture 14-16)

### 4.7.1 Topic Overview

### 4.7.2 Additional Readings

Eaton, J., and M. Gerkovitz, 1981, “Debt with Potential Repudiation: Theoretical and Empirical Analysis,” *Review of Economic Studies*, 48, 289-309. Eaton, J., and R. Fernandez, “Sovereign Debt,” *Handbook of International Economics*, ed. Grossman G. and S. Rogoff. Arellano C., 2008, “Default Risk and Fluctuations in Emerging Economies” *American Economic Review*, 98, 690-712.

#### 4.7.3 Other readings

Aguiar, M., and G. Gopinath, 2006, "Defaultable Debt, Interest Rates and the Current Account" *Journal of International Economics*, 69, 64-83. Arellano, C., and A. Ramanarayanan, 2009, Default and Maturity Structure in Sovereign Bonds, mimeo, University of Minnesota. Bulow, J., and K. Rogoff, 1989, "Sovereign Debt: Is to Forgive or Forget," *American Economic Review*, 79, 43-50.