

August 2013

AEM/ECON 7670

Topics in International Finance

Fall 2013
Mondays 5:00-7:25 p.m.
Warren Hall 113

Professor Eswar Prasad

This course will provide a selective overview of topics at the cutting-edge of academic research and policy debates about the international financial system. Main areas will include the effects of financial globalization on growth, volatility, and the transmission of business cycles. We will also examine the determinants of the direction and composition of capital flows. We will then discuss the causes and effects of the financial crisis and what implications it has for the research agenda in international finance and macroeconomics, with particular emphasis on the implications for monetary policy and financial regulation.

This course is intended for advanced Ph.D. students, especially those in search of thesis topics, and will require extensive student involvement in preparing research proposals and critiques of existing literature. Students will be expected to have basic graduate-level training in modeling techniques and familiarity with empirical tools (both panel data and time series).

There will be no exams. All registered candidates will be required to write a paper in order to receive a passing grade. The course will be graded S/U only.

Course Support: Carol Thomson (cmt8)
310 Warren Hall

Office Hours: By appointment (through Carol Thomson)

Teaching Assistant: Parul Sharma (ps552)

TA's Office Hours: Wednesdays & Thursdays, 9:00–10:00 a.m.
B-05 Warren Hall

Background Readings

Foundations of International Macroeconomics, Maurice Obstfeld and Kenneth Rogoff, MIT Press. [OK]

Kose, Ayhan M., Eswar Prasad, Shang-Jin Wei, and Kenneth Rogoff, 2009, “Financial Globalization: A Reappraisal,” *IMF Staff Papers*, Vol. 56:1, pp. 8-62. [KPRW]

Structure of Course

Topic 1: Measurement of Financial Openness

A. Measures of Asset Market Integration Based on Price Data

B. Capital Controls

C. De Facto Measures of Integration Based on Quantities—Flows, Stocks

D. Evolution of De Facto Measures

E. Brief Presentation on Sources of International Macro Data

References for this lecture can be found in Section III of KPRW. For a different approach to construction of capital control indexes and for detailed chronologies of capital controls in specific emerging markets, see the relevant chapters in: *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences*, 2007, Sebastian Edwards, ed. Chicago, IL: University of Chicago Press.

Chinn, Menzie, and Hiro Ito, 2006, “What Matters for Financial Development? Capital Controls, Institutions, and Interactions,” *Journal of Development Economics*, Vol. 61, No. 1, pp. 163-192.

Lane, Philip R., and Gian Maria Milesi-Ferretti, 2007, “The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004,” *Journal of International Economics*, Vol. 73: 2, pp. 223-250.

Lane, Philip R., and Gian Maria Milesi-Ferretti, 2008, “The Drivers of Financial Globalization,” *American Economic Review*, Vol. 98:2, pp. 327-332.

Schindler, Martin, 2009, “Measuring Financial Integration: A New Data Set,” *IMF Staff Papers*, Vol. 56:1, pp. 222-238.

Prasad, Eswar, 2011, “Role Reversal in Global Finance,” Cornell University Manuscript

Topic 2: Financial Integration and Growth

A. Macro Evidence

B. FDI and Growth

C. Equity Market Liberalizations and Growth

D. New Thinking on Capital Controls

References for this lecture can be found in Sections V and VI of KPRW. Additional readings:

Bekaert, Geert, Campbell R. Harvey and Christian Lundblad, 2005, “Does Financial Liberalization Spur Economic Growth,” *Journal of Financial Economics*, Vol. 77, pp. 3-55.

Forbes, Kristin J., 2007, “The Microeconomic Evidence on Capital Controls: No Free Lunch,” in *International Capital Flows*, ed. Sebastian Edwards (Chicago, IL: University of Chicago Press).

Gourinchas, Pierre-Olivier, and Olivier Jeanne, 2006, “The Elusive Gains from International Financial Integration,” *Review of Economic Studies*, Vol. 73:3, pp. 715-41.

Henry, Peter Blair, 2007, “Capital Account Liberalization: Theory, Evidence, and Speculation.” *Journal of Economic Literature*, Vol. 45:4, pp. 887-935.

Magud, Nicolas, Carmen Reinhart, and Kenneth Rogoff, 2011, “Capital Controls: Myth and Reality – A Portfolio Balance Approach.” Peterson Institute of International Economics. WP 11-7.

Ostry, Jonathan, Atish Ghosh, Karl Habermeier, Marcos Chamon, Mahvash Qureshi, and Dennis Reinhardt, 2010, “Capital Inflows: The Role of Controls.” IMF Staff Position Note 10/04.

Ostry, Jonathan, Atish Ghosh, Karl Habermeier, Luc Laeven, Marcos Chamon, Mahvash Qureshi, and Annamaria Kokenyne, 2011, “Managing Capital Inflows: What Tools to Use?” IMF Staff Discussion Note SDN/11/06.

Prasad, Eswar, Raghuram Rajan, and Arvind Subramanian, 2007, “Foreign Capital and Economic Growth,” *Brookings Papers on Economic Activity*, Vol. 1:2007, pp. 153-230.

Rodrik, Dani, 2008, “The Real Exchange Rate and Economic Growth,” *Brookings Papers on Economic Activity*, 2008:2, pp. 365-412.

Topic 3: Risk Sharing

A. International Risk Sharing—Patterns and Channels

B. Intrastate Risk Sharing as a Benchmark

C. Risk Sharing, Specialization and Growth

D. Risk Pooling and GDP-Linked Bonds

Asdrubali, Pierfederico, Bent Sorensen and Oved Yosha, 1996, “Channels of Interstate Risk Sharing: United States 1963-1990,” *Quarterly Journal of Economics*, Vol. 111, pp. 1081-1110.

Athanasoulis, Stefano, and Robert Shiller, 2001, “World Income Components: Measuring and Exploiting Risk Sharing Opportunities,” *American Economic Review*, Vol. 91:4, pp. 1031–54.

Gourinchas, Pierre-Olivier, Helene Rey, and Kai Truempler, 2012, “The Financial Crisis and the Geography of Wealth Transfers,” forthcoming, *Journal of International Economics*.

Kalemli-Ozcan, Sebnem, Bent E. Sørensen, and Oved Yosha, 2001a, “Risk Sharing and Industrial Specialization: Regional and International Evidence,” *American Economic Review*, Vol. 93 (3), pp. 903–18.

Kose, M. Ayhan, Eswar Prasad, and Marco Terrones, 2009, “Does Financial Globalization Promote International Risk Sharing,” *Journal of Development Economics*, Vol. 89:2, pp. 258-270.

Lewis, Karen K., 1996, “What Can Explain the Apparent Lack of International Consumption Risksharing?” *Journal of Political Economy*, Vol. 104, No. 2, pp. 267–297.

Obstfeld, Maurice, 1994, “Are Industrial-Country Consumption Risks Globally Diversified?” in *Capital Mobility: The Impact on Consumption, Investment and Growth*, eds. L. Leiderman and A. Razin (Cambridge University Press), pp. 13–47.

Obstfeld, Maurice, 1994, “Risk-Taking, Global Diversification and Growth,” *American Economic Review*, Vol. 84, pp. 1310-29.

Prasad, Eswar, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, 2003, “Effects of Financial Globalization on Developing Countries: Some Empirical Evidence,” *IMF Occasional Paper No. 220*. [Appendix III: Calculating the Potential Welfare Gains from International Risk Sharing]

Topic 4: Volatility, Crises

A. Financial Integration and Macroeconomic Volatility

B. Financial Crises

C. Globalization and the Growth-Volatility Relationship

- Acemoglu, Daron, Simon Johnson, James Robinson and Yonyong Thaicharoen, 2003, "Institutional Causes, Macroeconomic Symptoms: Volatility, Crises and Growth," *Journal of Monetary Economics*, Vol. 50, pp. 49-123.
- Calvo, Guillermo, Alejandro Izquierdo, and Ernesto Talvi, 2006, "Sudden Stops and Phoenix Miracles in Emerging Markets," *American Economic Review*, Vol. 96:2, pp. 405-410.
- Frankel, Jeffrey, and George Saravelos, 2011, "Can Leading Indicators Assess Country Vulnerability? Evidence from the 2008-2009 Global Financial Crisis", Working paper 2011-0007, Weatherhead Center for International Affairs, Harvard University.
- Kose, M. Ayhan, Eswar Prasad, and Marco Terrones, 2003, "Financial Integration and Macroeconomic Volatility," *IMF Staff Papers*, Vol. 50, pp. 119-41.
- Kose, M. Ayhan, Eswar Prasad, and Marco Terrones, 2006, "How Do Trade and Financial Integration Affect the Relationship between Growth and Volatility," *Journal of International Economics*, Vol. 69:1, pp. 176-202.
- Levchenko, Andrei A., Romain Ranciere, and Matthias Thoenig, 2008, "Growth and Risk at the Industry Level: The Real Effects of Financial Liberalization," *Journal of Development Economics*, Vol. 89:2, pp. 210-222.
- Martin, Philippe, and Helene Rey, 2006, "Globalization and Emerging Markets: With or Without Crash?" *American Economic Review*, Vol. 96:5, pp. 1631-1651.
- Ranciere, Romain, Aaron Tornell and Frank Westermann, 2007, "Systemic Crises and Growth," *Quarterly Journal of Economics*, Vol. 123:1, pp. 359-406.
- Rose, K. Andrew and Mark M. Spiegel, 2011, "Cross Country Causes and Consequences of the Crisis: An Update" *European Economic Review*, Vol. 55:3, pp. 309-324.

Topic 5: A New Framework: Collateral Benefits and Thresholds

The framework is summarized in Section VII of KPRW. We will go over the specifics of this framework in detail, and critically examine its theoretical basis and empirical relevance. Sections VIII and IX of KPRW contain the key references.

For some evidence and more detailed discussion of a key collateral benefit, see:

- Goldberg, Linda S., 2007, "Financial Sector FDI and Host Countries: New and Old Lessons," *Federal Reserve Bank of New York Economic Policy Review*, Vol. 13, No. 1, pp. 1-17.

Mishkin, Frederic S., 2006, *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich* (Princeton, N.J.: Princeton University Press).

For a detailed literature survey and related evidence on threshold effects, see:

Kose, M. Ayhan, Eswar Prasad, and Ashley D. Taylor, 2011, “Thresholds in the Process of International Financial Integration,” *Journal of International Money and Finance*, Vol 30:1, pp. 147-179.

Topic 6: International Business Cycle Transmission

A. Properties of Business Cycles in Emerging Markets

B. How Does Financial Integration Affect Domestic Business Cycles

C. Implications of Financial Integration for Business Cycle Transmission

D. Decoupling or Convergence of International Business Cycles?

Aguiar, Mark, and Gita Gopinath, 2007, “Emerging Market Business Cycles: The Cycle is the Trend,” *Journal of Political Economy*, Vol. 115(1), pp. 69-102.

Heathcote, Jonathan, and Fabrizio Perri, 2004, “Financial Globalization and Real Regionalization,” *Journal of Economic Theory*, Vol. 119:1, pp. 207-243

Kose, M. Ayhan, Eswar Prasad, and Marco Terrones, 2003, “How Does Globalization Affect the Synchronization of Business Cycles,” *American Economic Review*, Vol. 93:2, pp. 57-62.

Kose, M. Ayhan, Christopher Otrok, and Eswar Prasad, 2012, “Global Business Cycles: Convergence or Decoupling?” *International Economic Review*, Vol. 53:2, pp. 511-538.

Kose, M. Ayhan, Christopher Otrok, and Charles Whiteman, 2003, “International Business Cycles: World, Region, and Country Specific Factors,” *American Economic Review*, Vol. 93, pp. 1216–39.

Topic 7. Understanding the Causes and Dynamics of the Global Financial Crisis

Basu, Kaushik, 2009, “A Simple Model of the Financial Crisis of 2007-09 with Implications for the Design of a Stimulus Package,” CAE Working Paper # 09-11

Boz, Emine and Enrique, G. Mendoza, 2010, “Financial Innovation, the Discovery of Risk, and the U.S. Credit Crisis,” NBER working paper 16020.

Caballero, Ricardo J., and Pablo D. Kurlat, 2009, “The Surprising Origin and Nature of Financial Crises: A Macroeconomic Policy Proposal,” MIT Department of Economics Working Paper No. 09-24.

- Caballero, Ricardo J., 2009 “The ‘Other’ Imbalance and the Financial Crisis,” NBER Working Paper Series 15636.
- Claessens, Stijn, M. Ayhan Kose and Marco Terrones, 2008, “What Happens During Recessions, Crunches, and Busts?,” IMF Working Paper 08/274.
- Claessens, Stijn, M. Ayhan Kose and Marco Terrones, 2009, “Global Financial Crisis: Similar, Yet Different,” IMF Working Paper.
- Gourinchas, Pierre-Olivier and Maurice Obstfeld, 2012, “Stories of the Twentieth Century for the Twenty-First,” *American Economic Journal: Macroeconomics*, Vol. 4:1, pp. 226-265.
- Kose, M. Ayhan, and Eswar Prasad, 2010, *Emerging Markets: Resilience and Growth Amidst Global Turmoil*, Brookings Institution Press.
- Krugman, Paul, 2008, “The International Financial Multiplier” Manuscript, Princeton University.
- Mendoza, Enrique G., Jose-Victor Rios-Rull and Vincenzo Quadrini, 2009, “Financial Integration, Financial Deepness and Global Imbalances,” *Journal of Political Economy*, Vol. 117:3, pp. 371-410.

Topic 8: Implications of Financial Globalization (and the Crisis) for Monetary Policy Frameworks in Emerging Markets

- A. Monetary Policy: The New Neoclassical Synthesis
- B. Does Financial Openness Make Monetary Policy Less/More Effective, Less/More Relevant
- C. Optimal Monetary and Exchange Rate Policies for Emerging Markets
- Anand, Rahul and Eswar Prasad, 2010, “Optimal Price Indices for Inflation Targeting Under Incomplete Markets”, NBER working paper No. 16290.
- Brunnermeier, Marcus K., and Yuliy Sannikov, 2012, “Redistributive Monetary Policy,” paper presented at the Federal Reserve Bank of Kansas City's Jackson Hole Economic Policy Symposium on “The Changing Policy Landscape”
- Eggersston, B. Gauti and Paul Krugman, 2012, “Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach,” *Quarterly Journal of Economics*, Vol. 127:3, pp. 1469-1513.
- Goodfriend, Marvin, 2007, “How the World Achieved Consensus on Monetary Policy,” *Journal of Economic Perspectives*, Vol.21:4, pp. 47-68.

- Goodfriend, Marvin, 2004, "Monetary Policy in the New Neoclassical Synthesis: A Primer," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 90:3, pp. 21-45.
- Goodfriend, Marvin, and Eswar Prasad, 2007, "A Framework for Independent Monetary Policy in China," *CESifo Economic Studies*, Vol. 53:1, pp. 2-41.
- Schmitt-Grohe, Stephanie, and Martin Uribe, 2011, "Pegs and Pain," Manuscript, Columbia University.
- Rose, Andrew, 2007, "A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods, Reversed," *Journal of International Money and Finance*, Vol. 26:5, pp. 663-81.
- Woodford, Michael, 2007, "Globalization and Monetary Control," in J. Gali and M. Gertler, eds., *International Dimensions of Monetary Policy*, Chicago: University of Chicago Press, 2010.
- Woodford, Michael, 2012, "Methods of Policy Accommodation at the Interest-Rate Lower Bound," paper presented at the Federal Reserve Bank of Kansas City's Jackson Hole Economic Policy Symposium on "The Changing Policy Landscape".

Topic 9: Integrating Macroeconomics and Finance

- Brunnermeier, Markus K., and Yuliy Sannikov, 2012, "A Macroeconomic Model with a Financial Sector," Manuscript, Princeton University.
- Buiter, Willem, 2008, "Central Banks and Financial Crises", paper presented at the Federal Reserve Bank of Kansas City's Jackson Hole Symposium on "Maintaining Stability in a Changing Financial System."
- Farhi, Emmanuel and Ivan Werning, 2012, "Dealing with the Trilemma: Optimal Capital Controls with Fixed Exchange Rates," NBER working paper 18199.
- Brunnermeier, Markus K., Thomas M. Eisenbach and Yuliy Sannikov, 2012, "Macroeconomics with Financial Frictions: A Survey," NBER working paper 18102.
- Wincoop, Eric van, 2011, "International Contagion through Leveraged Financial Institutions," NBER working paper 17686.

Key Dates

Friday, October 18:	Paper proposals due @ noon
Monday, October 21:	Presentations of paper proposals
Friday, November 15:	First drafts of papers due @ noon
Friday, December 6:	Final drafts of papers due @ noon

Please adhere strictly to deadlines. I will not provide detailed feedback if you do not get your assignment in on time.

Research Proposals

Maximum length of proposal: 10 pages of double-spaced text including cover page and appendixes but excluding references, charts and tables (use 12 point font, at least 1 inch margin on all sides).

Preliminary Drafts of Papers

Maximum length of draft: 20 pages of double-spaced text including cover page and appendixes but excluding references, charts and tables (use 12 point font, at least 1 inch margin on all sides).

Structure, Format for Research Paper

Final draft of paper is due on **Friday, December 6 at 12 noon**. No exceptions.

Maximum length of final draft: 25 pages of double-spaced text including cover page and appendixes but excluding references, charts and tables (use 12 point font, at least 1 inch margin on all sides). Cover page should contain an abstract—maximum of 150 words.

Introduction should clearly convey the objective of your paper, provide a clear motivation (why the questions you are addressing are of interest), what the main original contribution of your paper is, and the key results.

Do not include an extensive literature survey. In the text, discuss only a few key papers that you are building on. Footnote the remaining papers.

Tables and figures should have self-explanatory titles and footnotes, with axes labeled clearly and showing relevant units.

Empirical work should be described clearly (dataset, variable transformations, exact specifications etc.) in a manner that allows for easy replication by other researchers. Theoretical work should have clear and consistent notation.

Email all documents to me (eswar.prasad), with cc to Parul Sharma (ps552) and Carol Thomson (cmt8), with the subject line indicating “7670: Proposal” (or whatever the relevant document is).