

Iowa State University
Department of Economics
Econ 657

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Spring 2006
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279 Heady Hall

International Finance

Second Part: Business-Cycle Phenomena in Open Economies

<http://www.econ.iastate.edu/classes/econ657/oviedo>

Class location: Heady 272 Class time: T and TH, 2:10 - 3:30 PM

Office hours: by appointment

Course Description:

This is the second part of the graduate course in International Finance and focuses on business-cycle phenomena in open economies from the perspective of dynamic general equilibrium theory. This part starts with a review of the dynamic general equilibrium approach to study macroeconomics and with a discussion of the empirical evidence on some of the business-cycle phenomena to be studied in the rest of the course. Next, the discussion focuses on workhorse models of business-cycle research and some numerical solution techniques that have been used to solve these models. The rest of the course concentrates on the following topics: exchange rates and stabilization policies; financial frictions; sudden-stops; domestic intermediation of capital inflows; fiscal sustainability; sovereign debt and sovereign default.

Requirements:

The final grade for Econ 657 will be computed weighting equally the final grades in this and professor Singh's part of the course. Requirements for this part follow:

1. Assignment (30% of the final grade). An assignment which is going to be given out during the first week of classes is due on April 28 at 5 PM. The assignment requires computational work, so students are encouraged to review the material taught in Econ 509, specially the mimeos designed to get users familiarized with basic Matlab commands. If time allows, students will be asked to present the results of their assignment to the rest of the class by the end of the semester.
2. Class participation (30% of the final grade). Students are expected to participate in class discussions and to be knowledgeable of the topics that will be covered in each lecture. The instructor will ask questions to the students about the papers to be discussed in class according to the course readings detailed below and students should be prepared to introduce those papers to the rest of the class.
3. Comprehensive final exam (40% of the final grade). Final exam date and time are Monday, May 4, from 7:30 to 9:30 PM. The exam tests the understanding of any class material covered during the six weeks of classes.

Optional Reference texts:

Agénor, P.-R.: *The Economics of Adjustment and Growth*, Harvard University Press 2004, 2nd edition.

Adda J. and R. Cooper: *Dynamic Economics*, MIT Press, 2003.

Calvo, G.: *Money, Exchange Rates and Output*, MIT Press, 1996.

Cooley, T. (Ed.): *Frontiers of Business Cycle Research*, Princeton University Press, 1995.

Grossman G. and K. Rogoff (Eds.): *The Handbook of International Economics*, North Holland - Elsevier Press, 1996.

Ljungqvist, L. and T. Sargent: *Recursive Macroeconomic Theory*, MIT Press, 2004, second edition.

Marimon R. and A. Scott (Editors) (1999): *Computational Methods for the Study of Dynamic Economies*, Oxford University Press.

Miranda M. and P. Fackler: *Applied Numerical Methods in Economics*, MIT Press 2002.

Obstfeld, M. and K. Rogoff: *Foundations of International Macroeconomics*, MIT Press, 1996.

Turnovsky, S.: *International Macroeconomic Dynamics*, MIT Press 1997.

Course Outline and Readings:

Starred readings are required.

1. Business Cycle Phenomena in Open Economies: Stylized Facts

★ Agénor, P.-R., C. McDermott, and E. Prasad (2000): “Macroeconomic Fluctuations in Developing Countries: Some Stylized Facts”, *World Bank Economic Review*, vol 14, No. 2 (May); pp. 251-285.

★ Backus, D., P. Kehoe and F. Kydland (1992): “International Real Business Cycles”, *Journal of Political Economy*, vol. 100, No. 4; pp. 745-775.

★ Calvo G., A. Izquierdo and E. Talvi (2006): “Phoenix Miracles in Emerging Markets: Recovering without Credit from Systemic Financial Crises”, *NBER Working Paper* 12101, March.

Calvo, G. and C. Végh (1999): “Inflation Stabilization and BOP Crises in Developing Countries”, *Handbook of Macroeconomics*, Vol 1C, North-Holland, 1999, edited by J. Taylor and M. Woodford. Available as *NBER working paper* 6925, (February).

★Cooley, T. (1995, see book reference above) chapters 1 and 11.

Hamilton, James (2005): “What’s Real about the Business Cycle?”, *NBER Working Paper* 11161, (February).

★ Kaminsky, G. and C. Reinhart (1999): “The Twin Crises: The Causes of Banking and Balance of Payment Problems”, *American Economic Review*, 89 (June); pp. 473-500.

Kaminsky, G, C. Reinhart, and C. Véh (2004): “When it Rains, it Pours: Procyclical-

cal Capital Inflows and Macroeconomic Policies”, *NBER Working Paper* 10780. (Also published in NBER Macro Annual 2004 (edited by Mark Gertler and Ken Rogoff))

Kiguel, M. and Liviatan N. (1992): “The Business Cycle Associated with Exchange-Rate-Based Stabilization”, *The World Bank Economic Review*, 6; pp. 179:305.

Lane, P. and G. Milesi-Ferreti (2001): “The External Wealth of Nations: Measures of Foreign Assets and Liabilities for Industrial and Developing Countries”, *Journal of International Economics*, 55, (December); pp. 263-294.

★ Mendoza, E. (1995): “The Terms of Trade, the Real Exchange Rate, and Economic Fluctuations”, *International Economic Review*, vol. 36, No. 1 (February); pp. 101-137.

★ Prescott, E. (1996): “Theory Ahead of Business Cycle Measurement”, *Quarterly Review*, Federal Reserve Bank of Minneapolis, Vol. 10 No. 4.

★ Reinhart C. and K. Rogoff (2004): “Serial Default and the ‘Paradox’ of Rich to Poor Capital Inflows”, *American Economic Review*, 2004, v94 (2, May), 53-58. Available as *NBER Working Paper* 10296, (February).

2. Business Cycles in Open Economies: Workhorse Models and Solution Techniques.

Agénor, P.-R. (2004, see book reference on page 2), Chapter 1, “Budget Constraints and Aggregate Accounts”.

★ Backus, D., P. Kehoe and F. Kydland (1992): “International Real Business Cycles”, *Journal of Political Economy*, vol. 100, No. 4; pp. 745-775.

★Cooley, T. (1995, see book reference above) chapters 1 and 11.

Correia, Neves and Rebelo (1995): “Business Cycles in a Small Open Economy”, *European Economic Review* 39; pp. 1089-1113.

Díaz-Giménez Javier (2000) ”Linear Quadratic Approximations: An Introduction”, published in Marimon and Scott (eds.); see book reference on pg. 2.

King, R., C. Plosser, and S. Rebelo. (1988). ”Production, Growth and Business Cycles I. The Basic Neoclassical Model,” *Journal of Monetary Economics*, 21, 195-232.

King, R. C. Plosser and S. Rebelo (2002): Production, Growth and Business Cycles: Technical Appendix”, *Computational Economics*, vol. 20(1-2), pages 87-116.

Klein, P. (2000): “Using the Generalized Schur Form to Solve a Multivariate Linear Rational Expectations Model”, *Journal of Economic Dynamics & Control*, 24; pp. 1405-1423.

★ Kydland, F. and E. Prescott (1982): “Time to Build and Aggregate Fluctuations,” *Econometrica*, vol. 50(6), pages 1345-70.

★ Lucas, R.E. (2005, Personal Report): “Present at the Creation: Reflections on the 2004 Nobel Prize to Finn Kydland and Edward Prescott”, *Review of Economic Dynamics* 8, (2005) 777-779.

- ★ Mendoza, E. (1991): “Real Business Cycles in a Small Open Economy”, *American Economic Review*, Vol. 81, No. 4, pp. 797-818
- ★ Oviedo, P. (2005): “A Toolbox for the Study of Linear Difference Rational Expectations Models”, forthcoming *Económica*. Vol LI. N1-2 January-December.
- Schmitt-Grohé, S. and Uribe M. (2002): “Solving Dynamic General Equilibrium Models Using a Second-Order Approximation to the Policy Function”, NBER Technical Working Paper No. 282, October. <http://www.nber.com/papers/t0282>.
- Sims, C. (2000): “Solving Linear Rational Expectations Models”, mimeo Yale University; available at: <http://sims.princeton.edu/yftp/gensys/LINRE3A.pdf>
- Söderlind, P. (1999): “Solution and Estimation of RE Macromodels with Optimal Policy”, *European Economic Review*, 43; pp. 813-823.
- ★ Uribe, M (2003): “Closing Small Open Economy Models” *Journal of International Economics*, 61; pp. 163-185.

3. Exchange Rates and Stabilization Policies

- Burstein, A., M. Eichenbaum and S. Rebelo (2003): “Large Devaluations and the Real Exchange Rate”, mimeo, UCLA.
- ★ Burstein, A., J. Neves and S. Rebelo (2003): “Distribution Costs and Real Exchange Rate Dynamics During Exchange-Rate-Based Stabilizations”, *Journal of Monetary Economics*, 50; pp. 1189-1214.
- Calvo G., O. Celasun and M. Kumhof (2003): “Inflation Inertia and Credible Disinflation: The Open Economy Case”, NBER Working Paper 9557.
- Mendoza, E. (1995): “The Terms of Trade, the Real Exchange Rate, and Economic Fluctuations”, *International Economic Review*, vol. 36, No. 1 (February); pp. 101-137.
- ★ Mendoza E. (2005): “Real Exchange Rate Volatility and the Price of Nontradables in Sudden-Stop-Prone Economies”, *NBER Working Paper* No. 11691, October.
- ★ Oviedo P.M. and R. Singh (2005): “Distribution Costs and International Business Cycles”, mimeo, Iowa State University.
- Razin A. and Y. Rubinstein (2005): “Evaluation of Exchange-Rate, Capital Market, and Dollarization Regimes in the Presence of Sudden Stops”, *NBER Working Paper* 11131, (February).
- ★ Uribe, M. (2002): “The Price-Consumption Puzzle of Currency Pegs”, *Journal of Monetary Economics*, 49; pp. 533-569.

4. Financial Frictions, Sudden-Stops, and Domestic Intermediation of Capital Inflows

Cavallero R. and A. Krishnamurthy (2003): “Smoothing Sudden Stops”, forthcoming *Journal of Economic Theory*. Available at: <http://web.mit.edu/caball/www/>.

Calvo G. (1998): “Capital Flows and Capital-Market Crises: The Simple Economics of Sudden Stops”, *Journal of Applied Economics*, Vol. 1, No. 1. Available at: <http://www.bsos.umd.edu/econ/ciecpp.htm>

Calvo G., A. Izquierdo, and E. Talvi (2003): “Sudden Stops, the Real Exchange Rate and Fiscal Sustainability: Argentina’s Lessons”, NBER Working Paper 9828.

★ Calvo G., A. Izquierdo and E. Talvi (2006): “Phoenix Miracles in Emerging Markets: Recovering without Credit from Systemic Financial Crises”, *NBER Working Paper* 12101, March.

Chari V.V., P. Kehoe, and E. McGrattan (2005): “Sudden Stops and Output Drops”, Federal Reserve Bank of Minneapolis, Research Department Staff Report 353, January.

★ Mendoza E. (2002): “Credit, Prices, and Crashes: Business Cycles with a Sudden Stop”, in *Preventing Currency Crises in Emerging Markets*, edited by Sebastian Edwards and Jeffrey A. Frankel; The University of Chicago Press. Available at: <http://www.econ.duke.edu/mendozae/>

★ Mendoza E. (2002): “Margin Calls, Trading Costs, and Asset Prices in Emerging Markets: The Financial Mechanics of the ‘Sudden Stop’ Phenomenon”, *NBER Working Paper* 9286 (October).

Mendoza E. and K. Smith (2004): “Quantitative Implications of a Debt-Deflation Theory of Sudden Stops and Asset Prices”, *NBER Working Paper* 10940, (December).

★ Mendoza E. (2006): “Lessons from the Debt-Deflation Theory of Sudden Stops”, forthcoming *American Economic Review*, May; also available as *NBER Working Paper* No. 11691.

★ Neumeyer, P. and F. Perri (2005): “Business Cycles in Emerging Economies: The Role of Interest Rates”, *Journal of Monetary Economics* vol. 52 (2), pp. 345-380).

★ Oviedo (2005): “World Interest Rate, Business Cycles, and Financial Intermediation in Small Open Economies”, mimeo Iowa State University.

Oviedo (2004): “Macroeconomic Risk and Banking Crises in Emerging Market Countries: Business Cycles with Financial Crashes”, mimeo Iowa State University; available at <http://www.econ.iastate.edu/faculty/oviedo>.

Uribe, M. and V. Yue (2004): “Country Spreads and Emerging Countries: Who Drives Whom?”, forthcoming, *Journal of International Economics*.

5. Fiscal Sustainability, Sovereign Debt and Sovereign Default

Aguiar, M. and G. Gopinath (2004): “Defaultable Debt, Interest Rates and the Current Account”, *NBER Working Paper* No. 10731, September.

Arellano, C. (2003): “Default Risk, the Real Exchange Rate and Income Fluctuations in Emerging Economies”, mimeo Duke University; available at <http://www.duke.edu/ca2/Research.htm>.

Atkinson A. (1991): “International Lending with Moral Hazard and Risk of Repudiation”, *Econometrica*, vol 59, No. 4 (July); pp. 1069-1089.

★ Cole H. and P. Kehoe (1998): “Models of Sovereign Debt: Partial Versus General Reputations”, *International Economic Review*, vol. 39, No. 1 (February).

★ Cole H. and T. Kehoe (2000): “Self-Fulfilling Debt Crises”, *Review of Economic Studies*, vol 67 (1), No. 230; pp. 91-116

Cole H., J. Dow, and W. English (1995): “Default, Settlement, and Signalling: Lending Resumption in a Reputational Model of Sovereign Debt”, *International Economic Review*, vol. 36, No. 2 (May); pp. 365-385.

Eaton, J. and M. Gersovitz (1981): “Debt with Potential Repudiation: Theoretical and Empirical Analysis”, *Review of Economic Studies*, 48; pp. 289-309

★ Mendoza E. and P. Oviedo (2005): “Public Debt, Fiscal Solvency and Macroeconomic Uncertainty in Emerging Markets: The Tale of the Tormented Insurer”, Mimeo, Iowa State University.

Reinhart C. and K. Rogoff (2004): “Serial Default and the ‘Paradox’ of Rich to Poor Capital Inflows”, *American Economic Review*, 2004, v94 (2, May), 53-58. Available as *NBER Working Paper* 10296, (February).

Weinschelbaum F. and J. Wynne (2005): “Renegotiation, Collective Action Clauses and Sovereign Debt Markets”, *Journal of International Economics*, vol 67, pp. 47-72.