

EC 373
OPEN-ECONOMY MACROECONOMICS
SYLLABUS

Colby College
Department of Economics
Fall 2008

Professor: Guillermo Vuletin (email: gvuletin@colby.edu)

Office: Diamond 359

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Lecture time and location: Tuesdays and Thursdays 11:00-12:15 am, DIAM 342.

Office hours: Tuesdays and Thursdays 3:00-4:30 pm.

TA: Ian Cummins

TA office hours: Wednesdays 6-8pm (DIAM 369). There will be no TA office hours October 8, October 15 and November 12.

Course web page: http://www.colby.edu/academics_cs/courses/EC373

Course Description

The study of international economics is usually divided into two parts: *international trade* and *international finance* (also called *open-economy macroeconomics*, *international monetary economics* or *international macroeconomics*). This course studies the latter. International finance refers to the monetary side of international economics, in contrast to the real side, or real trade. This branch of economics studies, among other topics, price level and income determination in an open economy, capital flows, the choice of exchange rate regime and its impacts on macroeconomic stability, constraints on the formulation and implementation of monetary and fiscal policy in an open economy. Note that international finance is different from *corporate finance*. Corporate finance is an area of finance dealing with the financial decisions corporations make and the tools and analysis used to make these decisions. The primary goal of corporate finance is to maximize corporate value while reducing the firm's financial risks.

The first part of the course (Sections I to II) develops basic concepts, analytical framework and relevant policy issues in an open-economy setting. The second part of the course (Sections III to VI) emphasizes some particular topics on monetary and international capital markets including cyclicity of fiscal and monetary policies, central bank independence, exchange rate regimes and capital flows, and dollarization.

The aim of the course is not only to learn basic and specific topics in open-economy macroeconomics, but also to develop an understanding and critical thinking about the way economists think and do research. For this reason you will find that parallel to the study of each topic we will discuss why the paper analyze that topic in that way and how it differentiates from the approach used by other papers in the reading list. This methodological approach intends to turn you from consumers of knowledge into critical consumers and critical producers of knowledge. This focus will also be emphasized in your assignments, including problem sets and a research paper proposal.

Lectures should only be considered as *supplement* and not substitute for readings. The lectures are design to cover the most fundamental issues and provide foundation for the readings. It is essential that students work carefully their way through the book chapters and the readings.

Prerequisites

Economics 224 and either Mathematics 121 or 161.

Text

Macroeconomics in the Global Economy, by Jeffrey Sachs and Felipe Larrain, Prentice-Hall

Course policies

Course web site: You should frequently access the course web site to find updated course information. There, you will find problem sets and their solutions and postings of important announcements.

Office hours: Tuesdays and Thursdays 3:00-4:30 pm, Diamond 359. If you need to meet with me and cannot make one of those times, please schedule an appointment by email. If you feel that you are not making as good progress in the course as you should, please talk to me as soon as possible. It is my job to help you understand the material and this is the reason why office hours are held, so make use of them. Do not wait until the week before the final exam!

Class and exam attendance: I do not take attendance. However, I expect students to attend all classes and actively participate in class discussions. Please note ahead the scheduled dates of exams. Unexcused absences from exams will result in a zero grade. Acceptable reasons for missing an exam include critical emergencies, athletic trips or illness. If some athletic event overlaps with a course exam please contact me as soon as you know about such event (at least one week in advance) so I can help you to resolve the problem.

Grading policy: The grades for this course will be based on 2 exams (1 midterm and 1 final), problem sets, a paper and class participation. The final exam *will be cumulative*. The midterm will be Thursday, October 9 (during class time). The final exam will Thursday, December 4 (during class time). That is to say, there will be no final during finals week. The paper will be due Wednesday, December 10 at 11:00am. Your final grade will be determined as follows:

| | |
|---------------------|-----|
| Midterm | 20% |
| Final exam | 25% |
| Problem sets | 20% |
| Paper | 25% |
| Class participation | 10% |

Paper: The paper will discuss a topic of your choice. The topic could be related to course material or could discuss other international finance topic (my approval is required in those cases). The paper is expected to describe the major contributions on the topic, the current state of the literature and include at least one possible extension/addition/improvement to that literature. The proposed extension(s) must clearly:

- i) identify why such extension is important. Using considerable motivational detail you should indicate the contribution to the economics literature.
- ii) describe the expected result of your addition. We all know that what we expect to happen is not always equal to what actually happens, but this is not a complete research paper. If your addition is theoretical, explain the transmission mechanisms involved and their expected impact on the variable or subject you are analyzing. If your addition is empirical, specify and justify your research methodology (econometric models, case studies, games, experiments, etc.) and the source and description of the key variables. If you use new variables describe in detail how you would construct this variable.

The topic of the paper must be chosen by the first week of November, and a short (one page) draft paper proposal must be turned in at the beginning of *Thursday, November 6 class*. The final paper proposal must have a maximum of 5 double-spaced pages of text (including a list of references). Use times new roman, 12 point font and 1 inch margins.

Academic honesty: Colby's policy on academic honesty can be found in http://www.colby.edu/academics_cs/catalogue/2005_2006/academic_program/aca_procedures.cfm.

I encourage you to work with other classmates; however, all problem sets (and exams!) must be your own.

Electronic device policy: Please turn off all electronic devices during class. If there is a legitimate reason for you to be within reach during class times, please see me prior to using the cell phone.

Tentative course outline

I. Macroeconomic equilibrium in a small open economy without money

- A. The households saving decision
- B. The firm investment-output decisions
- C. The current account
- D. The government sector
 - Sachs and Larrain Chapters 4.1-4.4, 5.1-5.2, 6, 7.1-7.4, 7.6-7.7.
 - Papers:
 - Bernanke (2005), "The global savings glut and the U.S. current account deficit", remarks at the Sandridge Lecture, Virginia Association of Economics, Virginia. <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm>
 - Cletus and Pollard (2001), "What drives large current account deficits?", International Economic Trends, Federal Reserve Bank of St. Louis. <http://research.stlouisfed.org/publications/iet/20010501/cover.pdf>
 - Hussain and Leite (2006), "Guidance note on the exogenous shocks facility", Policy Development and Review Department, International Monetary Fund. <http://imf.org/external/np/pp/eng/2006/012706.pdf>
(Read sections I and II)
 - Tornell and Lane (1994), "Are windfalls a curse? A non-representative agent model of the current account and fiscal policy", NBER working paper No 4839. <http://www.nber.org/papers/w4839.pdf>
(Skip section 3).

II. Macroeconomic equilibrium in a small open economy with money

- A. Interest rates and prices in a monetary economy
- B. Money and the households budget constraint
- C. The demand for money: a transactions costs approach
- D. The money supply process
- E. Money supply and the consolidated government constraint
- F. Equilibrium in the money market
- G. Money, exchange rates and prices
- H. Mundell-Fleming model (review-problem set)

- Sachs and Larrain Chapters 8.1-8.2, 9.1-9.2, 9.4-9.5, 10.

III. Cyclicalities of fiscal and monetary policies

- Kaminsky, Reinhart and Vegh (2004), "When it rains, it pours: procyclical capital flows and policies", NBER working paper No 10780.

<http://www.nber.org/papers/w10780.pdf>

(Skip section IV)

- Jaimovich and Panizza (2007), "Procyclicality or reverse causality?", Inter-American Development Bank working paper No 599.

<http://www.iadb.org/res/publications/pubfiles/pubWP-599.pdf>

(Pay special attention to sections 4, 5 and 5.1)

Discussion about endogeneity and instrumental variables approach.

IV. Inflation, unsustainable policies and central bank independence

- A. Government deficit and inflation
- B. Inflation and central bank independence

- Sachs and Larrain Chapter 11.1

- Cukierman, Webb and Neyapti (1992), "Measuring the independence of central banks and its effects on policy outcomes", The World Bank Economic Review, Vol.6, pp. 353-398.

[http://links.jstor.org/sici?sici=0258-](http://links.jstor.org/sici?sici=0258-6770%28199209%296%3A3%3C353%3AMTIOCB%3E2.0.CO%3B2-I)

[6770%28199209%296%3A3%3C353%3AMTIOCB%3E2.0.CO%3B2-I](http://links.jstor.org/sici?sici=0258-6770%28199209%296%3A3%3C353%3AMTIOCB%3E2.0.CO%3B2-I)

(Skip pages 376-382)

- Zaleski (1992), "Presidential preferences for inflation versus unemployment", Journal of Macroeconomics. Volume 14, Issue 3, Summer 1992, Pages 555-561.

[http://www.sciencedirect.com/science/article/B6X4M-4ND1M0B-](http://www.sciencedirect.com/science/article/B6X4M-4ND1M0B-B/2/2953b08d790a6a4acfd4bb75c4ddcd02)

[B/2/2953b08d790a6a4acfd4bb75c4ddcd02](http://www.sciencedirect.com/science/article/B6X4M-4ND1M0B-B/2/2953b08d790a6a4acfd4bb75c4ddcd02)

- Dreher, Sturm and de Haan (2007), "Does high inflation cause central bankers to lose their job? Evidence based on a new data set", forthcoming European Journal of Political Economy.

http://www.kof.ethz.ch/publications/science/pdf/wp_167.pdf

- Gruben, Welch (1993), "Interpreting central bank independence in Mexico", Federal Reserve Bank of Dallas Historical Library.
<http://www.dallasfed.org/research/swe/1993/swe9304c.pdf>

*Discussion about measurement issues:
De jure vs. de facto measures.
Direct vs. outcome-based measures.*

V. Exchange Rate Regimes and Capital Flows

A. Impossible or unholy trinity

- Fisher (2001), "Exchange rate regimes: Is the bipolar view correct?", Journal of Economic Perspectives, Vol. 15, pp. 3-24.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=273089

B. Taxonomy and classification of exchange rate regimes

- Reinhart and Rogoff (2004), "The modern history of exchange rate arrangements: A reinterpretation", Quarterly Journal of Economics, Vol.119, pp. 1-48.
[ws1.ad.economics.harvard.edu/faculty/rogoff/files/QJE2004.pdf](http://www1.ad.economics.harvard.edu/faculty/rogoff/files/QJE2004.pdf)
(Skip sections III.B, III.C and IV)

- Alesina and Wagner (2003), "Choosing (and renegeing on) exchange rate regimes", NBER working paper N° 9809.
<http://www.nber.org/papers/w9809>

C. Arguments for exchange rate regime selections

- Levy Yeyati, Sturzenegger and Reggio (2006), "On the endogeneity of exchange rate regimes", Kennedy School of Government working paper No RWP06-047.
[http://ksgnotes1.harvard.edu/Research/wpaper.nsf/rwp/RWP06-047/\\$File/rwp_06_047_sturzenegger_SSRN.pdf](http://ksgnotes1.harvard.edu/Research/wpaper.nsf/rwp/RWP06-047/$File/rwp_06_047_sturzenegger_SSRN.pdf)

VI. Dollarization

A. The allocation of US currency

- Porter and Judson (1996), "The location of U.S. currency: How much is abroad?", Federal Reserve Bulletin.
<http://www.federalreserve.gov/paymentsystems/coin/1096lead.pdf>
(Skip pages 889-903)

B. Definitions and measurement

- Reinhart, Rogoff and Savastano (2003), "Addicted to Dollars", NBER working paper No 10015.
<http://www.nber.org/papers/w10015>
(Skip pages 24-67)

- Feige (2003), "Dynamics of currency substitution, asset substitution and de facto dollarisation and euroisation in transition countries", Comparative Economic Studies, Vol. 45, pp. 358-383.
<http://129.3.20.41/eps/mac/papers/0302/0302005.pdf>

C. Implications

- Berg and Borensztein (2000), "The pros and cons of full dollarization", IMF WP/00/50.

<http://www.imf.org/external/pubs/ft/wp/2000/wp0050.pdf>

D. Currency of choice, valuation effect and the future

- Papaioannou, Portes and Siourounis (2006), "Optimal Currency Shares in International Reserves: The Impact of the Euro and the Prospects for the Dollar", NBER working paper No 12333.

<http://papers.nber.org/papers/w12333>

(Read sections 1 and 2)

- Mohapatra, Ratha and Xu (2006), "Migration and Development", Development Prospects Group, World Bank Brief 2

<http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/MigrationDevelopmentBriefingNov2006.pdf>

- Gross (2004), "Euro Trash. Even drug dealers are giving up on the dollar".

<http://www.slate.com/id/2111504/>