INTERNATIONAL FINANCE

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Spring 2014 (Econ 281B)

This course will cover four areas

I. Financial Crises, Regulation and Growth
II. The Eurozone Crisis and Political Economy Models
III. Exchange Rate Anomalies
IV. Microstructure and Exchange Rate Forecasting

In part I we will analyze the stylized facts associated with financial liberalization, as well as the lending booms and financial crises that typically follow. We will compare the financial crises of emerging markets in the 1990s with the recent US crisis. We will then survey the theoretical crisis literature (the third generation crisis models). We will study models with bailout guarantees and with financial frictions, and analyze how their interaction helps account for the stylized facts. We will address the issue of financial regulation by analyzing the trade-off between systemic risk taking, production efficiency and growth. Finally, we will discuss recent empirical papers that use micro-level data sets to analyze macroeconomic transmission mechanisms.

In part II we will analyze the recent Eurozone crisis. We will link the events in Europe to the Balance of Payments crises experienced by Latin American countries in the 1970s and 1980s (the so-called first generation crises). Unsustainable fiscal imbalances are at the root of the Eurozone crisis. We will use political economy models to account for the anomalous procyclical fiscal policy and the tendency to overspend windfalls observed in several European countries--as well as in many developing countries. We will also analyze the link between structural reforms and economic crises.

In part III we will analyze three important anomalies of the foreign exchange market: (i) the forward premium puzzle according to which high interest rate currencies tend puzzlingly to appreciate over time; (ii) the “carry trade” by which real world investors exploit the excess returns generated by the FPP; (iii) momentum and trendiness, as exchange rates follow very persistent trends. We will then analyze whether asset pricing models with a representative agent can account for these anomalies. We will start with the standard rational expectations equilibrium. Then introduce learning via the Kalman filter. We will see that either a large time-varying risk premium or expectational distortions are needed. We will then use the recent literature on robust control to generate these distortions in beliefs. We will learn how a desire for robustness against model uncertainty is transformed into distorted probability distributions in equilibrium.

In part IV we will analyze the predictive power of microstructure indicators such as order flow, the Commitment-of-Traders report and put-call ratios. To interpret these facts we will consider models with heterogeneous agents.

GRADING
The grade will be determined by a referee report on a paper that will be assigned in class (20%) and a term paper (80%).
I. Financial Liberalization, Financial Crises and Regulation

1. The link between Liberalization, systemic risk and growth
   - How to measure financial fragility: skewness, variance or kurtosis?
   - One-sector growth & crisis model with a financial accelerator
   - Agency Problems and Borrowing Constraints
   - Bailout Guarantees and Insolvency Risk Taking

2. Boom-bust cycles and Balance of Payments crises.
   - Stylized facts
   - Third generation models
     - Lending Booms and Real Exchange Rate Appreciation
     - Credit Crunches, Firesales and Real Depreciation
   - Two-sector growth & crisis model with a financial accelerator
     - Balance sheet effect
     - Feedback-loop mechanism (self feeding appreciation )

3. Financial Regulation, growth and misallocation of resources.

4. The 2008 Crisis and financial black-holes
   - Currency Mismatch in Eastern Europe
   - The US housing Crisis

5. Evidence on Credit Market Imperfections
   - Micro-level data sets and evidence of balance sheet effects
   - Currency Mismatch
   - Bailout Guarantees
   - Case studies: Mexico, Turkey, China, Peru

II. The Eurozone Crisis and Political Economy Models

1. Models of the current account:
   - The intertemporal approach
   - Common access models and “voracity”
   - Foreign Aid

2. First generation Balance-of-Payments crisis models.
   - Representative Agent models
   - Political economy models

3. Crises, Economic Reform and Political transition

4. The 1920s Hyperinflation in Germany
III. Exchange Rate Anomalies

1. The Anomalies;
   - Forward Premium Puzzle
   - Delayed Overshooting.
   - The Carry Trade

2. Rational expectations equilibria
   - Representative agent equilibria.
   - Exchange Rate Determination: the Dornbusch Model and ‘new open economy’ models.
   - Learning and the Kalman filter

3. Behavioral Finance and the anomalies
   - Cognitive biases
   - Warping probability distributions in pricing models

4. Robust Control and the anomalies
   - Unstructured uncertainty and H-infinity control
   - Structured Uncertainty and pricing models
   - Link with behavioral economics

IV. Microstructure and Trading Patterns

   - Order flow and exchange rate forecasting
   - Momentum and Trending Prices
   - The Commitment of Traders Report and exchange rate forecasting
   - Put-Call ratios