

# ECON 8872: International Finance

## Syllabus

Time: MW 10:30 am  
Location: Maloney Hall 330

Professor: Rosen Valchev  
Office: 396 Maloney Hall  
E-mail: valchev@bc.edu  
Office Hours: MW 9:30am-10:30

### Course Description

This is the first of a two-part second year, field course sequence for Ph.D. students on International Finance and Macroeconomics. The course will provide a broad overview of the field, and discuss the classic puzzles and the seminal questions that underpin this literature, but also explore in more detail the frontier and some of the most active current areas of research. The goal is two-fold. First, introduce you to the modern models, tools and topics of International Macro and Finance. Second, give you the necessary background on the literature to help you navigate amongst possible dissertation topics. This course omits discussion of certain topics, such as sovereign default, which will be covered in the second semester.

### Course Materials

There is no textbook for this course, and we will focus entirely on reading journal articles. However, you might find the following textbooks to be useful background readings for some of the topics:

Ljungqvist and Sargent (2004), *Recursive Macroeconomic Theory*  
Obstfeld and Rogoff (1996), *Foundations of International Macroeconomics*  
Woodford (2003), *Interest and Prices: Foundations of a Theory of Monetary Policy*  
Uribe and Schmitt-Grohe, *Open Economy Macroeconomics* (manuscript available at: <http://www.columbia.edu/~mu2166/book>)

For an extensive list of references we will cover in class, please refer to the Course Outline below.

### Course Evaluation

Problem Sets:	30%
Presentations:	40%
Research Proposal:	30%

The goal for this course is to prepare you and help you to do interesting original research in the field. As such we will not have tests, but focus instead on presentations (two of them) and writing a research proposal.

**Problem Sets:** Problem sets will be graded on a check, check plus and check minus basis. There will be about 3 of them, and each will roughly correspond to the conclusion of one of our main topics.

**Presentation 1:** Each student will pick one paper from the readings list and will give a 40-minute, research presentation to the class. The idea is to simulate the typical experience at a conference presentation, where you need to concisely and clearly communicate the main message of the paper. Two important pieces of advice on presentations (in general, not just for this class) are:

- (i) Practicing your slides is incredibly important. The typical rule of thumb should be that you have the slides ready a week before the presentation, and then practice it fully several times. Do not work to make your slides absolutely perfect until the last moment, but instead practice the slides you have.
  
- (ii) Get to the main point quickly. As a rule of thumb, you should motivate the paper in the first 1-2 slides, and then communicate the main contributions and message of the paper in the next 1-2 slides. In a 60mins presentation, you should aim to have told the audience what is the main question, why they should care about it, and what it is that the paper does within the first 5 to 10 minutes.

You should pick which paper you want to present and let me know your choice by the end of our third week of class – **Wednesday Sep 13**. See below for the list of papers. You can pick any paper from Section 3 “Exchange Rates” onwards. The paper can be either one of the papers listed as “main reading” or one of the “additional readings”, whatever catches your fancy (it could also be a paper not on our reading list, but you need to get it approved by me first). However, it has to be a relatively recent paper – so it must be written after year 2000.

**Presentation 2 (Discussion):** Each student would also do a discussion style presentation, where instead of presenting the main findings of the paper, they will act as a conference discussant. This presentation will be shorter (20 minutes), and you will be discussing one of the papers being presented by another student. So on a presentation day, we’ll first have one person present the paper, and then one person discuss it.

The role of a discussant is two-fold. First, to summarize the paper, highlight and explain the main results and briefly describe its position in the literature – this should be about one third of the presentation. Second, to provide some detailed critical feedback to both the author and the audience. This should be constructive criticism, where you point out assumptions that are too strong to you, or other places the argument seems a bit weak, or counter-factual. However,

do not only poke holes at the paper, try to also provide some suggestions on how to improve the paper and potentially answer the issues you have raised. And lastly, not all your comments need to be critical – if you think the paper actually makes a very good point that the author has not emphasized, you should point it out. So to summarize, spend about a third of your time explaining the main result of the paper and highlighting its strong and appealing features. Then spend the rest of the time pointing out what can be done better, extended and etc.

**Research Proposal:** I would like you to write a short, 5-pages maximum, research proposal that is to be handed in by the official final exam date. Writing both clearly and concisely is very important and it is good to start practicing early. You should think of this research proposal as an expanded Introduction section of a future paper you are proposing to write. I will provide samples of good research proposals from past years.

We will do several iterations on the research proposal. Please submit

1. A title page with an abstract (200 words maximum) by Nov 28.
2. First draft by Dec 8
3. Final Draft by Dec 15

## Students with Disability

If you have a disability and will be requesting accommodations for this course, please register with either Dr. Kathy Duggan (dugganka@bc.edu), Associate Director, Connors Family Learning Center (learning disabilities or AHD) or Dean Paulette Durrett, (paulette.durrett@bc.edu), Assistant Dean for students with disabilities, (all other disabilities).

Advance notice and appropriate documentation are required for accommodations.

## 1 Academic Integrity

Honesty and integrity are integral components of the academic process. Students are expected to be honest and ethical at all time in their pursuit of academic goals, and to a be in accordance with Boston College Academic Integrity standard, which can be found here: <http://www.bc.edu/offices/stserv/academic/integrity.html>.

# Course Outline

## 2 International Real Business Cycles

### 2.1 A Brief Intro to International Macro and Finance

- Kose, Otrok, and Whiteman (2003), “International Business Cycles: World, Region and Country-Specific Factors”, AER

Additional Readings

- Marcet and Ravn (2004), “The HP-filter in Cross-Country Comparisons”, Working Paper

### 2.2 BKK – the Benchmark Two-Country RBC Model

- Backus, Kehoe and Kydland (1992), “International Business Cycles”, JPE
- Backus, Kehoe and Kydland (1994), “Dynamics of the Trade Balance and the Terms of Trade: The J-Curve?”

Additional Readings

- Ambler, Cardia and Zimmermann (2004), “International Business Cycles: What are the facts”, Journal of Monetary Economics
- Backus, Kehoe, and Kydland (1993), “International Business Cycles: Theory and Evidence”, NBER Working Paper 4493
- Feldstein and Horioka (1980), “Domestic Savings and International Capital Flows”, The Economic Journal

### 2.3 Workhorse Extensions of BKK

- Stockman and Tesar (1995), “Tastes and Technology in a Two-Country Model of the Business Cycle: Explaining International Comovements”, AER
- Baxter and Crucini (1993), “Explaining Saving-Investment Correlations”, AER
- Baxter and Crucini (1995), “Business Cycles and the Asset Structure of Foreign Trade”, IER

Additional Readings:

- Baxter (1995), “International Trade and Business Cycles”, NBER Working paper 5025
- Bai and Zhang (2010), “Solving the Feldstein-Horioka Puzzle with Financial Frictions”, Econometrica

- Engel (2001), “Comment: The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?”, NBER Macro Annual
- Obstfeld and Rogoff (2001), “The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?”, NBER Macroeconomics Annual
- Rabanal, Rubio-Ramirez and Tuesta (2011), “Cointegrated TFP processes and international business cycles”

## 3 Exchange Rates

### 3.1 Uncovered Interest Rate Parity (UIP) Puzzle

- Fama (1984), “Forward and Spot Exchange Rates”, JME
- Burnside, Eichenbaum and Rebelo (2008), “Carry Trade: The Gains of Diversification”, JEEA
- Burnside, Eichenbaum, Kleshchelski, and Rebelo (2010), “Do Peso Problems Explain the Returns to the Carry Trade”, RFS
- Froot and Frankel (1989), “Forward Discount Bias: Is it an Exchange Risk Premium”, QJE

#### Additional Readings

- Engel (2013), “Exchange Rates and Interest Parity”, NBER Working Paper 19336
- Jorda and Taylor (2012), “The Carry Trade and Fundamentals: Nothing to Fear but FEER itself”, JIE

### 3.2 Variations/ Subtleties of the UIP Puzzle

- Chinn (2006) “The (partial) rehabilitation of interest parity in the floating rate era: Longer horizons, alternative expectations, and emerging markets”
- Engel (2015), “Exchange Rates, Interest Rates, and the Risk Premium”, forthcoming AER
- Hassan and Mano (2013) , “Forward and Spot Exchange Rates in a Multi-Currency World”, working paper

#### Additional Readings

- Bansal and Dahlquist (2000), “The forward premium puzzle: different tales from developed and emerging economies”, JIE
- Chaboud and Wright (2005), “Uncovered Interest Parity: It Works, but not for Long”, JIE

- Chinn and Quayyum (2012), “Long Horizon Uncovered Interest Parity Re-Assessed”, NBER Working Paper 18482
- Frankel and Poonawala (2010), “The Forward Market in Emerging Currencies: Less Biased Than in Major Currencies”, JIMF

### 3.3 Models of the UIP Puzzle

#### 3.3.1 Risk-Premia

- Verdelhan (2010) “A Habit-Based Explanation of the Exchange Rate Risk Premium”, Journal of Finance

#### Additional Readings

- Alvarez, Atkeson and Kehoe (2009), “Time-Varying Risk, Interest Rates and Exchange Rates in General Equilibrium”, REStud
- Bansal and Shaliastovich (2012), “A Long-Run Risks Explanation of Predictability Puzzles in Bond and Currency Markets”, RFS
- Backus, Gavazzoni, Telmer and Zin, “Monetary Policy and the Uncovered Interest Parity Puzzle”, working paper
- Bekaert (1996), “The Time Variation of Risk and Return in Foreign Exchange Markets: A General Equilibrium Perspective”, RFS
- Colacito and Croce (2013), “International Asset Pricing with Recursive Preferences”, working paper
- Farhi and Gabaix (2015), “Rare Disasters and Exchange Rates”, Working Paper
- Gabaix and Maggiori (2014), “International Liquidity and Exchange Rate Dynamics”, Working Paper
- Hassan (2013), “Country Size, Currency Unions, and International Asset Returns”, Journal of Finance
- Pavlova and Rigobon (2007), “Asset Prices and Exchange Rates”, RFS

### 3.4 Deviations from Rational Expectations

- Gourinchas and Tournell (2004), “Exchange Rate Puzzles and Distorted Beliefs”, JIE

#### Additional Readings

- Bacchetta and van Wincoop (2010), “Infrequent Portfolio Decisions: A Solution to the Forward Discount Puzzle”, AER

- Burnside, Han, Hirshleifer, and Wang (2013), “Investor Overconfidence and the Forward Premium Puzzle”, REStud
- Ilut (2012), “Ambiguity Aversion: Implications for the Uncovered Interest Rate Parity Puzzle”, AEJ:Macro

### 3.5 Convenience Yields

- Valchev (2017), “Bond Convenience Yields and Exchange Rate Dynamics”, working paper

### 3.6 Evidence on the UIP Models

- Lustig and Verdelhan (2007), “The Cross-Section of Foreign Currency Risk Premia and Consumption Growth Risk”, AER
- Burnside 2010, “The Cross-Section of Foreign Currency Risk Premia and Consumption Growth Risk: Comment”, AER
- Burnside (2011), “Carry Trades and Risk”, NBER Working Paper 17278

#### Additional Readings

- Backus, Foresi and Telmer (2001), “Affine Term Structure Models and the Forward Premium Anomaly”, JF
- Menkhoff, Sarno, Schmeling, and Schrimpf (2012), “Carry Trades and Global Foreign Exchange Volatility”, JF
- Lustig, Roussanov and Verdelhan (2007), “Common Risk Factors in Currency Markets”, RFS
- Burnside (2010), “Identification and Inference in Linear Stochastic Discount Factor Models with Excess Returns”, NBER Working Paper 16634
- Burnside (2013), “Carry Trade Reconsidered”, Working Paper

### 3.7 Forecasting

- Rogoff and Stavrageva (2008), “The Continuing Puzzle of Short Horizon Exchange Rate Forecasting”, working paper

#### Additional Readings:

- Mark (1995), “Exchange Rates and Fundamentals: Evidence on Long-Horizon Predictability”, AER
- Meese Rogoff (1983), “Empirical Exchange Rate Models of the Seventies”, JIE

- Meese and Rogoff (1991), “An Empirical Assessment of Non-Linearities in Models of Exchange Rate Determination”, REStud
- Rossi (2013), “Exchange Rate Predictability”, Handbook Chapter
- Diebold and Mariano (1995), “Comparing Predictive Accuracy, JBES
- Clark and West (2006), “Using out-of-sample mean squared prediction errors to test the martingale difference hypothesis”, Journal of Econometrics
- Clark and West (2007), “Approximately normal tests for equal predictive accuracy in nested models”, Journal of Econometrics

### 3.8 The Exchange Rate Determination Puzzle (Optional)

- Engel and West (2005), “Exchange Rates and Fundamentals”, JPE
- Evans and Lyons (2002), “Order Flow and Exchange Rate Dynamics”, JPE
- Bacchetta and van Wincoop (2013), “On the Unstable Relationship Between Exchange Rates and Macroeconomic Fundamentals”, JIE

Additional Readings:

- Evans and Rime (2011), Micro Approaches to Foreign Exchange Determination, Working Paper (survey paper)
- Berger, Chaboud, Chernenko, Howorka, and Wright (2005), “Order Flow and Exchange Rate Dynamics in Electronic Brokerage System Data”, JIE
- Irrarrazabal, Rime and Valchev (2015?), “A Structural Estimation of Dispersed Information Model of Exchange Rates and Order Flow: What are the main drivers?”, draft (hopefully) coming soon

## 4 International Risk-Sharing

### 4.1 The Backus-Smith Puzzle

- Backus and Smith (1993), “Consumption and Real Exchange Rates in Dynamic Economies with Non-Traded Goods”, JIE
- Corsetti, Dedola and Leduc (2008), “International Risk-Sharing and the Transmission of Productivity Shocks”, REStud
- Brandt, Cochrane, Santa-Clara, “International Risk-Sharing is Better than You Think, or Exchange Rates are too Smooth”, JME
- Burnside and Gaveline (2012), “Exchange Rate Determination, Risk Sharing and the Asset Market View”, Working Paper



## 4.2 The Home Bias Puzzle and Portfolio Underdiversification: Introduction

- Baxter and Jermann (1997), “The International Diversification Puzzle is Worse Than You Think”, AER
- French and Poterba (1991), “Investor Diversification and International Equity Markets”, AER

### Additional Readings

- Ahearne, Grier and Warnock (2004), “Information Costs and Home Bias: An Analysis of US Holdings of Foreign Equities”, JIE
- Bekaert, Hodrick and Zhang (2009), “International Stock Return Comovements”, Journal of Finance
- Wincoop and Warnock (2010), “Can Trade Costs in Goods Explain Home Bias in Assets?”, JIMF
- Massa and Simonov (2006), “Hedging, Familiarity and Portfolio Choice”, RFS
- Kang and Stulz (1997), “Why is There a Home Bias? An Analysis of Foreign Portfolio Equity Ownership in Japan”, JFE

## 4.3 The Home Bias Puzzle and Portfolio Underdiversification: Analysis

- van Nieuwerburgh and Veldkamp (2010), “Information Acquisition and Under-Diversification”, REStud
- Valchev (2017), “Dynamic Information Acquisition and Portfolio Bias”, Working Paper

### Additional Readings

- Coeurdacier and Rey (2012), “Home Bias in Open Economy Financial Macroeconomics”, JEL
- Coeurdacier and Gourinchas (2011), “When Bonds Matter: Home Bias in Goods and Assets”, NBER Working Paper 17560
- Lewis (1999), “Trying to Explain Home Bias in Equities and Consumption”, JEL
- Devereux and Sutherland (2010), “Country Portfolio Dynamics”, JIE
- Brennan and Cao (1997), “International Portfolio Investment Flows”, Journal of Finance
- Berriel and Bhattarai (2014), “Hedging Against the Government: A Solution to the Home Asset Bias Puzzle”, Working Paper

- van Nieuwerburgh and Veldkamp (2009), “Information Immobility and the Home Bias Puzzle”, Journal of Finance
- Pesenti and van Wincoop, “Can Nontradables Generate Substantial Home Bias?”, JMCB
- Heathcote and Perri, “The International Diversification Puzzle is Not as Bad as You Think”,