

Course Code: IE 505

Course title: Balance of Payments

Type of course: Core for MA (Economics)

Number of credits: 4

Number of lecture/tutorial/class presentation hours: 56

Instructor: Professor Meeta K. Mehra

This course will cover key themes in international macroeconomics with focus on the underlying theories that have evolved to understand these, and the applications in real economies. The course will comprise topics such as global imbalances, the static Mundell-Fleming model, an intertemporal approach to open economy macroeconomics, including government budgetary policy and current account, real and nominal exchange rate determination. At the end, the course will include a module on exchange rate regimes and currency crises models.

Pre-requisites: Basic *Microeconomics*, *Macroeconomics* and *Mathematical Economics*.

The **main texts** for the course are:

1. Obstfeld, Maurice and Rogoff, Kenneth (1996), *Foundations of International Macroeconomics*, MIT Press – henceforth O&R
2. Nelson, C. Mark (2001), *International Macroeconomics and Finance: Theory and Econometric Methods*, Blackwell Publishers–henceforth NM
3. Schmitt-Grohe, Stephanie, Uribe, Martin, Woodford, Michael (2016), *International Macroeconomics*, Columbia University - henceforth SGU&W
4. Heijdra, Ben, *Foundations of Modern Macroeconomics*, Second Edition

Module I: Introduction

1. Balance of Payments Accounting and Global Imbalances
SGU&W, Chp 1
2. Static Mundell-Fleming Model
NM, Chp 8, Heijdra, Ch 10

Additional readings

- Lawrence H. Summers (2006), "Reflections on Global Account Imbalances and Emerging Market Reserve Accumulation". L K Jha Memorial Lecture, Reserve Bank of India.
https://www.harvard.edu/president/speeches/summers_2006/0324_rbi.php
- Obstfeld, Maurice, and Kenneth Rogoff (2005), "Global Current Account Imbalances and Exchange Rate Adjustment", *Brookings papers on Economic Activity*, No 1, 67-123.
- Obstfeld, Maurice, Jay Shambaugh, and Alan Taylor (2009), "Financial Stability, the Trilemma, and International Reserves", NBER Working paper 14217.
<https://www.nber.org/papers/w14217.pdf>

Module II: Intertemporal Open Economy Macroeconomics

1. Intertemporal Approach to Current Account Balance
 - a. A small two-period endowment economy
 - b. Role of investment: defining the current account
 - c. A two-region world economy

O&R, Chp 1

2. Dynamics of a Small Open Economy
 - a. A small open economy with many periods and finite time
 - b. An infinite-horizon stochastic model both for endowment economy and with investment
 - c. A stochastic small-country current account model
 - d. Extending the intertemporal model by incorporating shocks in interest rates and relative prices

O&R, Chp 2

3. The Life Cycle, Tax Policy, and the Current Account
 - a. Government budget policy in the absence of overlapping generations
 - b. Government budget deficits in an overlapping generations model: government saving, private saving and current account balance; timing of taxes and implications for current account deficit
 - c. Output fluctuations, demographic changes and life cycle savings.
 - d. Investment and growth

O&R, Chp 3

Additional readings

- Obstfeld, M. and K. Rogoff (2000), The Six Major Puzzles in International Macroeconomics, in NBER Macroeconomics Annual 2000.
- Bergin, P. R. and S. M. Sheffrin (2001), Interest Rates, Exchange Rates and Present Value Models of the Current Account, *The Economic Journal*, 110 (463): 535–558.
- Glick, R. and K. Rogoff (1995), Global versus Country-specific Productivity Shocks and the Current Account, *Journal of Monetary Economics*, 35(1): 159–192.
- Feldstein, M. and C. Horioka (1980), Domestic Saving and International Capital Flows, *Economic Journal*, 90(358): 314-329.

Module III: Real and Nominal Exchange Rates

1. The Determinants of Real Exchange Rates
 - a. Law of one price
 - b. Purchasing power parity
 - c. Productivity differentials and real exchange rates: The Balassa-Samuelson model

NM, Chp 7; SGU&W, Chp 1

2. Monetary Model and Nominal Exchange Rate Determination
 - a. The monetary model of the balance of payments under flexible exchange rates
 - b. Monetary approach to nominal exchange rate determination – the one money economy and the Lucas' two-money monetary economy

NM, Chps 3 & 4; SGU&W, Chp 13

3. Dornbusch's Dynamic Mundell-Fleming Model
 - a. Sticky domestic prices and exchange rates
 - b. Deterministic and stochastic versions of the Dornbusch's Mundell-Fleming model

NM, Chp 8, O&R, Chp 9

Additional readings

- Rogoff, Kenneth (1996), The Purchasing Power Parity Puzzle, *Journal of Economic Literature*, 34, 647-668.
- Goldberg, Pinelopi, and Michael Knetter (1997), Goods Prices and Exchange Rates: What Have We Learned, *Journal of Economic Literature*, 35(3), 1243-1272.
- Engel, Charles, Nelson, C, Mark, and Kenneth D. West (2007), Exchange Rate Models Are Not As Bad As You Think, *NBER Macroeconomics Annual 2007*, 381-441
- Evans, Martin, and Richard Lyons (2005), Meese-Rogoff Redux, *Micro-Based Exchange Rate Forecasting, American Economic Review Papers and Proceedings*, 95(2), 405-416.
- Rogoff, Kenneth (2002), Dornbusch's Overshooting Model After Twenty-Five Years, *The Mundell-Fleming Lecture, IMF Working Paper 02/39*.
<https://www.imf.org/external/pubs/ft/wp/2002/wp0239.pdf>

Module IV: Exchange Rate Regimes and Currency Crises Models

1. Recent History of Exchange Rate Arrangements

Reinhart, Carment and Rogoff, Kenneth (2004), "The Modern History of Exchange Rate Arrangements: A Reinterpretation", *Quarterly Journal of Economics*, 119(1), 1-48.

2. Fixed versus Floating Exchange Rate Crises: A First-Generation Model

NM, Chp 11; O&R, Chps 8 (pages 554-569), 9 (pages 648-653)

3. The Second-Generation Currency Crisis Model

- Obstfeld, Maurice (1996), "Models of Currency Crises with Self-Fulfilling Features", *European Economic Review*, 40, 1037-1047

- Krugman, Paul (1996), “Are Currency Crises Self-Fulfilling?”, NBER Macroeconomic Annual 1996, with comments from Maurice Obstfeld
4. Currency Crises and Monetary Policy in an Economy with Credit Constraints
- Aghion, P, Bacchetta P, and Banerjee A. (2000), “A Simple Model of Monetary Policy and Currency Crises”, European Economic Review, 44, 728-738
 - Aghion, P, Bacchetta P, and Banerjee A. (2000), “Currency Crises and Monetary Policy in an Economy with Credit Constraints”, European Economic Review, 45, 1121-1150.