

ECONOMICS 712-007
INTERNATIONAL MACROECONOMICS WITH FINANCIAL FRICTIONS
MONDAYS, 1:45-4:45PM, ROOM 625 PCPSE

This course studies International Macroeconomics from a perspective that emphasizes financial frictions and quantitative analysis. The course blends elements of International Finance, Asset Pricing Theory and Recursive Macroeconomic Theory. A thorough understanding of first-year Ph.D. Macro and Micro material, particularly stochastic dynamic programming, general equilibrium analysis, and Bewley models of heterogeneous agents is critical. Knowledge of computational methods and software used in Macro modeling is also useful, particularly global methods for solving nonlinear models and models with incomplete markets. Familiarity with principles of International Macros is helpful but not required.

The course begins with a review of workhorse perfect-foresight and RBC models of a small open economy, and an analysis of the tradeoffs involved in solving open economy models with incomplete markets using local v. global methods. The course explores then open-economy models of financial crises and sudden reversals of capital inflows. We also study normative issues such as optimal policy to tackle inefficiencies present in a large class of models with credit constraints, interactions between monetary and financial policies, and models in which financial innovation interacts with Bayesian learning. Next, we cover topics related to public debt and fiscal policy, focusing on sovereign default, public debt sustainability, international spillovers of tax policies and global tax competition. The last part of the course relaxes the representative agent assumption so we can study international macroeconomics with heterogeneous agents in multi-country and small-open-economy models. These models yield key new insights on issues like international disparities resulting from financial globalization, the effects of financial repression and capital controls, default on domestic public debt, and financial contagion.

Grading: The course is graded with a final exam (40%), a term paper (35%), and two components of in-class participation (25%), which include (i) a presentation of the work related to the term paper, (ii) and class attendance/participation. The term paper is required, without it the final grade defaults to a D.

Term paper: The term paper is an assignment in which you are asked to compare the quantitative implications of solving open-economy models with financial frictions using local and global methods. The goal is to determine whether the results differ, and if so to provide a rationale for the differences based on the mechanisms driving the models and their quantification. You have discretion to choose which model to use (excluding the three already compared in de Groot, Durdu, and G. Mendoza, 2020), and you are also free to choose the global and local methods to apply. It can be a model already studied in the literature (or a simplified version of one), an extension of an existing model or a new model altogether, with the understanding that more original or more difficult models carry a premium. A two-page (maximum) proposal must be submitted for approval no later than October 15th, 2021. Presentations of term papers will take place at dates to be determined near the end of the term. These presentations include a discussion of what motivated your choice of model and solution methods, the model itself and its analytic properties, and the preliminary quantitative findings. The final draft must not exceed 20 double-spaced pages in a 12-point font and 1.5-inch margins (no exceptions). The due date of the paper itself will be extended beyond the end of the term. Papers are due no later than March 11th, 2022. Following department guidelines, initial course grades will be posted as B- in lieu of “incomplete,” but this B- should be interpreted as identical to an “incomplete,” and not conveying any information about the final grade. Final grades will be issued after the papers are graded.

Reading List

Reference Texts:

- SL** Ljungqvist, L. & Sargent, T. J., *Recursive Macroeconomic Theory*, MIT Press, 2012.
CV Végh, C.A. *Open Economy Macroeconomics in Developing Countries*, MIT Press, 2013
US Uribe, M. and Schmitt-Grohe, S. *Open Economy Macroeconomics*, Princeton Univ. Press, 2017
OR Obstfeld, M. & Rogoff, K. *Foundations of Intl. Macroeconomics*, MIT Press 1996.
RR Reinhart, C. M. & Rogoff, K., *This Time is Different: Eight Centuries of Fin. Folly*, Princeton U. Press.

I.- Workhorse Models & Solution Methods

Main readings:

- Backus, D. "Interpreting Comovements in the Trade Balance and the Terms of Trade," *J. of Intn'l Econ.*, 1993.
de Groot, O., C.B Durdu, and E. G. Mendoza, 2019, "Approximately Right?: Global v. Local Methods for Open-Economy Models with Incomplete Markets," NBER Working Paper WP26426,
<https://www.sas.upenn.edu/~egme/wp/w26426.pdf> .
Mendoza, E. G., "The Terms of Trade, the Real Exchange Rate and Economic Fluctuations," *International Economic Review*, 1995. <http://www.sas.upenn.edu/~egme/pp/IER95.pdf>
Mendoza, E. G, and S. Villalvazo, "FiPit: A Simple, Fast Global Method for Solving Models with Two Endogenous States & Occasionally Binding Constraints," *Review of Economic Dynamics*, 2020, available at <https://www.sas.upenn.edu/~egme/pp/MendozaVillRED.pdf>
Users guide: https://www.sas.upenn.edu/~egme/econ712/files/FPI_Appendix_v6.pdf
Matlab codes: <https://www.sas.upenn.edu/~egme/econ712/files/MendozaVillalvazoFiPitCode.zip>

SL chs. 8, 16 and 17 (indexed from the second edition)

Reference: CV Chs. 1, 3, 4 US Chs. 1-8 OR 1.1, 1.2, 1.3, 2.1, 2.2, and ch. 5

Additional references:

- Aguiar M. and G. Gopinath, 2007, "Emerging Market Business Cycles: The Cycle Is the Trend," *Journal of Political Economy* 115(1): 69-102.
Blanchard, O. and Fischer S. *Lectures on Macroeconomics*, section 2.4 and Ch.2 appendix C
Boz, E., C. Daude, and C. B. Durdu, 2011, "Emerging Market Business Cycles Revisited: Learning about the Trend," *Journal of Monetary Economics*, vol. 58(6), pages 616-631
Cole, H.L. and Obstfeld, M., "Commodity Trade and International Risksharing," *J. of Mon. Economics*, 1991.
Fernandez, A., S. Schmitt-Grohe and M. Uribe, 2017, "World shocks, world prices, and business cycles: An empirical investigation," *J. of International Econ*, vol. 108, pages S2-S14.
Garcia-Cicco, J., R. Pancrazi, and M. Uribe, 2010, "Real Business Cycles in Emerging Countries?" *American Economic Review*, 100(5): 2510-31.
Mendoza, E. "Real Business Cycles in a Small Open Economy," *American Economic Review*, 1991,
<https://www.sas.upenn.edu/~egme/pp/mendoza1991.pdf>
Mendoza, E., "Capital Controls and the Gains from Trade in a Business Cycle Model of a Small Open Economy," *IMF Staff Papers*, 1991, <https://www.sas.upenn.edu/~egme/pp/Capitalcontrols1991.pdf>
Mendoza, E., G. "The Robustness of Macroeconomic Indicators of Capital Mobility," in *Capital Mobility*, L. Leiderman and A. Razin eds., Cambridge Univ. Press., 1994. <http://www.sas.upenn.edu/~egme/pp/sapir.pdf>
Nicolini, J. P., C. Hevia and J. Ayres, 2015, "Real Exchange Rates and Commodity Prices," mimeo, Federal Reserve Bank of Minneapolis.
Neumeyer, P.A. and F. Perri, "Business Cycles in Emerging Economies: The Role of Interest Rates," *JME*, 2005.
Schmitt-Grohe, S., and M. Uribe (2003), "Closing small open economies," *J. of Int. Econ*, 61, 163-185.
Schmitt-Grohe, S., and M. Uribe (2017), "How Important are Terms of Trade Shocks," *Int. Ec. Rev.*
Uribe, M. and Z. V. Yue, "Country Spreads and Emerging Countries: Who Drives Whom?," *JIE*, 2006.

II.- Financial Crises, Sudden Stops and Macroprudential Policy

Main readings:

Bianchi, J. and E.G. Mendoza, 2018, "Optimal, Time-Consistent Macroprudential Policy," *Journal of Political Economy*, <https://www.sas.upenn.edu/~egme/pp/JPE2018.pdf>, see also the Appendix included in the working paper version available here <http://www.sas.upenn.edu/~egme/wp/w19704.pdf>

Bianchi, J. and E.G. Mendoza, 2015, "Phases of Global Liquidity, Fundamentals News, and the Design of Macroprudential Policy," BIS Working Paper No. 505 (<http://www.sas.upenn.edu/~egme/wp/work505.pdf>).

Bianchi, J. and E.G. Mendoza, 2020, "A Fisherian Approach to Financial Crises: Lessons from the Sudden Stops Literature," *Review of Economic Dynamics*, <https://www.sas.upenn.edu/~egme/pp/BianMendozaRED.pdf>

Boz, E. and E.G. Mendoza, 2014, "Financial Innovation, the Discovery of Risk, and the U.S. Credit Crisis," *Journal of Monetary Economics*, (<http://www.sas.upenn.edu/~egme/pp/BozMendozaJME.pdf>).

Carrillo, J., E.G. Mendoza, V. Nuguer, and J. Roldan-Pena, 2021, "Tight Money-Tight Credit: Coordination Failure in the Conduct of Monetary and Financial Policies," *American Economic Journal: Macroeconomics*, also available as NBER WP no. w23151 (<https://www.sas.upenn.edu/~egme/wp/w23151.pdf>).

Mendoza, E.G. and E. Rojas, 2019, "Positive and Normative Implications of Liability Dollarization for Sudden Stops Models of Macroprudential Policy," *IMF Economic Review*, <https://www.sas.upenn.edu/~egme/pp/MendozaRojas.pdf>

Mendoza, E.G. and K. Smith, 2006, "Quantitative Implications of a Debt-Deflation Theory of Sudden Stops and Asset Prices," *Journal of International Economics*, 2006. <http://www.sas.upenn.edu/~egme/pp/JIE06smith.pdf>

Mendoza, E. and K. Smith 2014, "Financial Globalization, Financial Crises, & the External Portfolio Structure of Emerging Markets," *Scandinavian Journal of Economics*, <http://www.sas.upenn.edu/~egme/wp/w19072.pdf>

Mendoza, E.G., 2008, "Sudden Stops, Financial Crises and Leverage," *American Economic Review*, Dec. 2010, <http://www.sas.upenn.edu/~egme/pp/CompletePaperRevforDistribution.pdf>;

Mendoza, E.G., and M. Terrones, "An Anatomy of Credit Booms and their Demise," NBER Working Paper no. 18379, 2012 Available at <http://www.sas.upenn.edu/~egme/wp/w18379.pdf>.

Reference texts: US Ch. 12 CV Ch. 2, 16, 17, RR

Additional references:

Bengui, J., E. Mendoza and V. Quadrini, (2012), "Capital Mobility and International Sharing of Cyclical Risk," *Journal of Monetary Economics*, <http://www.sas.upenn.edu/~egme/wp/w18372.pdf>

Aoki, K., G. Benigno and N. Kiyotaki, 2016, "Monetary and Financial Policies in Emerging Markets," mimeo, Princeton University.

Ates, S.T. and F. Saffie, 2014, "Fewer but Better: Sudden Stops, Firm Entry and Financial Selection," available at <https://economics.sas.upenn.edu/sites/economics.sas.upenn.edu/files/14-043.pdf>

Adrian, T. and H. S. Shin, 2013, "Procyclical Leverage and Value-at-Risk," *Review of Financial Studies*.

Arellano, C., Y. Bai and P. Kehoe, 2019, "Financial Markets and Fluctuations in Volatility," *Journal of Political Economy*

Benigno, G., H. Chen, C. Otrok, A. Rebucci & E. Young, 2016, "Optimal Capital Controls or Exchange Rate Policies? A Pecuniary Externality Perspective," *Journal of Monetary Economics*, v. 84, 147-165

Bernanke, B., M. Gertler, and S. Gilchrist, 1999, "The financial accelerator in a quantitative business cycle model," in *Handbook of Macroeconomics*, ed. by J. Taylor, and M. Woodford.

Bianchi, J. "Overborrowing and Systemic Externalities in the Business Cycle" *American Economic Review*, 2011.

Bianchi, J., E. Boz and E.G. Mendoza, 2012, "Macroprudential Policy in a Fisherian Model of Financial Innovation," *IMF Economic Review*, <http://www.sas.upenn.edu/~egme/pp/imfer20129a.pdf>

Borio, C., E. Kharroubi, C. Upper and F. Zampolli, 2016, "Labour reallocation and productivity dynamics: financial causes, real consequences," BIS Working Paper 534, <http://www.bis.org/publ/work534.htm>

Caballero, R. and A. Krishnamurthy, "International and Domestic Collateral Constraints in a Model of Emerging Market Crises," *Journal of Monetary Economics*, 2001.

Calvo, G.A., "Capital Flows and Capital-Market Crises: The Simple Economics of Sudden Stops," *Journal of Applied Economics*, v. 1, pp. 35-54, 1998

Calvo, G. and Mendoza, E.G. "Capital Markets Crises and Economic Collapse in Emerging Markets: An Informational Frictions Approach," *American Economic Review*, May 2000.

Calvo, G. and E.G. Mendoza "Rational Contagion and the Globalization of Securities Markets," *Journal of International Economics*, June 2000, https://www.sas.upenn.edu/~egme/pp/JIE_last.pdf

Calvo, G., Izquierdo, A. and L. Mejia, "On the Empirics of Sudden Stops: The Relevance of Balance-Sheet Effects," mimeo, Inter-American Development Bank, 2004.

Choi, W. G. and D. Cook, "Liability Dollarization and the Bank Balance Sheet Channel," *JIE*, 2003.

Cook, D. and M. Devereux, "Accounting for the East Asian Crisis: A Quantitative Model of Capital Outflows in Small Open Economies," *JIE* 2006.

Durdu, C.B. and E.G. Mendoza, 2006, "Are Asset Price Guarantees Useful for Preventing Sudden Stops?: A Quantitative Investigation of the Globalization Hazard Moral Hazard Tradeoff," *Journal of International Economics*. Available at <http://www.sas.upenn.edu/~egme/pp/JIE06Durdu.pdf>

Durdu, C.B., Mendoza, E. and Terrones, M., "Precautionary Demand for Foreign Assets in Sudden Stop Economies: An Assessment of the New Mercantilism," *JDE* 2009, available at http://www.sas.upenn.edu/~egme/wp/Precautionary_durdu_terriones.pdf

Farhi, E. and I. Werning, 2016, "A Theory of Macroprudential Policy in the Presence of Nominal Rigidities," *Econometrica*.

Galati, G. and R. Moesnner, 2018, "What do we know about the effects of macroprudential policy?," *Economica*, vol. 85, issue 340, 735-770

Gertler, M., S. Gilchrist, and F. Natalucci, 2007, "External constraints on monetary policy and the financial accelerator," *Journal of Money Credit and Banking*.

Gertler, M. and N. Kiyotaki, 2015, "Banking, Liquidity and Bank Runs in an Infinite Horizon Economy," *American Economic Review*

Gertler, M. and P. Karadi, 2012, "A Model of Unconventional Monetary Policy," *Journal of Monetary Economics*

Gertler, M. and N. Kiyotaki, 2010, "Financial Intermediation and Credit Policy in Business Cycle Analysis," in *Handbook of Monetary Economics*, B. Friedman and M. Woodford eds., Elsevier, vol. 3, no. 3.

Hernandez, J. and E.G. Mendoza, 2017, "Optimal v. Simple Financial Policy Rules in a Production Economy with "Liability Dollarization"," *Ensayos sobre Politica Economica*, <https://www.sas.upenn.edu/~egme/pp/HernandezMendoza.pdf>

Jermann, U. & V. Quadrini, 2012. "Macroeconomic Effects of Financial Shocks," *AER*, v. 102, no. 1, 238-271.

Korinek A. and Mendoza, E.G., (2014), "From Sudden Stops to Fisherian Deflation: Quantitative Theory and Policy Implications. *Annual Review of Economics*, <http://www.sas.upenn.edu/~egme/wp/w19362.pdf>

Lorenzoni, G. (2008), "Inefficient Credit Booms," *Review of Economic Studies*, 75, 809-833.

Mendoza, E.G., 2016, "Macroprudential Policy: Promise and Challenges," NBER WP no. 22868, <http://www.nber.org/papers/w22868>

Mendoza, E.G. "Real Exchange Rate Volatility and the Price of Nontradables in Sudden-Stop Prone Economies," *Economia*, vol. 6, no. 1, Fall 2005., <https://www.sas.upenn.edu/~egme/pp/EconomiaFall05.pdf>

Mendoza, E.G. "The Benefits of Dollarization when Stabilization Policy Lacks Credibility and Financial Markets are Imperfect," *Journal of Money, Credit, and Banking*, 2001. https://www.sas.upenn.edu/~egme/pp/draft_jmcb.pdf

Mendoza, E.G. "Credit, Prices, and Crashes: Business Cycles with a Sudden Stop," in *Preventing Currency Crises in Emerging Markets*, ed. by S. Edwards and J. Frankel, Univ. of Chicago Press, 2002, also NBER WP no. w8338, 2001., https://www.sas.upenn.edu/~egme/pp/sudden_stops_draft.pdf

Mendoza, E.G. and Uribe, M. "Devaluation Risk and the Business Cycle Implications of Exchange Rate Management," *Journal of Mon. Economics*, 2001. Available at <http://www.sas.upenn.edu/~egme/pp/CRC00.pdf>

Miranda-Agrippino S, & H. Rey, (2015) "World Asset Markets & the Global Fin. Cycle," NBER WP no. 21722

Stein, Jeremy, "Monetary Policy as Financial-Stability Regulation," *Quarterly Journal of Ec.* 127, no. 1: 57-95.

Schimtt-Grohe, S. and M. Uribe, "Currency Pegs, Downward Nominal Wage Rigidity, Unemployment, and Macro Prudential Policy", http://www.columbia.edu/~mu2166/dnwr_pegs_iu/paper.pdf

III.- Fiscal Policy, Public Debt Sustainability & Sovereign Default

Main readings:

- Aguiar, M. and G. Gopinath, "Defaultable Debt and Current Account Sustainability," *JIE*, 2006.
- Arellano, C., "Default Risk and Income Fluctuations in Emerging Economies," *AER*, 2008
- D'Erasmus, P., E. Mendoza, and J. Zhang, "What is a Sustainable Public Debt?," 2016, *Handbook of Macroeconomics*, available at http://www.sas.upenn.edu/~egme/wp/HandbookDraft_0413.pdf
- Eaton, Jonathan, and Mark Gersovitz, "Debt with Potential Repudiation: Theoretical and Empirical Analysis," *Review of Economic Studies*, v. XLVIII, 289-309, 1981.
- Mendoza, E., L. Tesar and J. Zhang, "Saving Europe?: The Unpleasant Arithmetic of Fiscal Austerity in Integrated Economies" available at <http://www.sas.upenn.edu/~egme/wp/w20200.pdf>
- Mendoza, E. and Z. V. Yue, 2012 "A General Equilibrium Model of Sovereign Default and Business Cycles," *Quarterly Journal of Economics*, <http://www.sas.upenn.edu/~egme/wp/w13861.pdf>

Reference texts: US Ch. 13, RR, OR. Ch. 6

Additional references:

- Aguiar, M., S. Chatterjee, H.L. Cole, and Z. R. Stangebye, 2016, "Quantitative Models of Sovereign Debt Crises," *Handbook of Macroeconomics*.
- Aguiar, M., M. Amador, E. Farhi, and G. Gopinath. 2013. "Coordination and Crisis in Monetary Unions," http://scholar.harvard.edu/files/gopinath/files/monetary_union_sep8_2013.pdf
- Bi, R., "'Beneficial' Delays in Debt Restructuring Negotiations," Ph.D Thesis, UMD, 2008.
- Bohn, H. 2014, "Low Altruism, Austerity, & Aversion to Default", mimeo, UC Santa Barbara.
- Chatterjee, S. and B. Eyigungor, 2012. "Maturity, Indebtedness, and Default Risk," *American Economic Review*, vol. 102(6), pages 2674-99, October.
- Chatterjee, S. and B. Eyigungor, 2014. "Debt Dilution and Seniority in a Model of Defaultable Sovereign Debt," mimeo, Research Dept. Federal Reserve Bank of Philadelphia.
- Cole, H.L. and T. Kehoe, "A Self Fulfilling Model of Mexico's 1994-95 Debt Crisis," *JIE*, 1996
- Cuadra, G. and H. Sapriza, 2008, "Sovereign default, interest rates and political uncertainty in emerging markets" *JIE*, vol. 76, issue 1, 78-88
- Cuadra, G. and H. Sapriza, 2010, *Review of Ec. Dynamics*, "Fiscal Policy and Default Risk in Emerging Markets,"
- Dovis, A., M. Golosov and A. Shourideh, 2016, "Political Economy of Sovereign Debt: A Theory of Cycles of Populism and Austerity," NBER wp21948.
- Farhi, E. and I. Werning, 2017, "Fiscal Unions," *American Economic Review* 107 (12): 3788-3834.
- Hatchondo, J.C., L. Martinez and C. Sosa Padilla, 2016, "Debt dilution and sovereign default risk," *Journal of Political Economy*. vol 124, no. 5: 1383-1422.
- Lorenzoni, G. and I. Werning, 2014, "Slow Moving Debt Crises," mimeo, Dept. of Economics, MIT.
- Mendoza, E., L. Tesar and J. Zhang, 2014, "Saving Europe?: The Unpleasant Arithmetic of Fiscal Austerity in Integrated Economies," mimeo, Dept. of Economics, Univ. of Pennsylvania
- Mendoza, E. and J. Ostry, "International Evidence on Fiscal Solvency: Is Fiscal Policy 'Responsible'?", *Journal of Mon. Econ*, 2008. At: <http://www.sas.upenn.edu/~egme/wp/MendozaOstryJME.pdf>
- Mendoza, E. and L. Tesar, "Why Hasn't Tax Competition Triggered a Race to the Bottom? Some Quantitative Lessons from the EU," *JME*, v. 52, no. 1, p. 163-204, 2005.
- Mendoza, E. and L. Tesar, "The International Ramifications of Tax Reforms: Supply-Side Economics in a Global Economy," with L. Tesar, *American Economic Review*, March, 1998.
- Mendoza, E. and P.M. Oviedo, "Public Debt, Fiscal Solvency & Macroeconomic Uncertainty in Latin America: The Cases of Brazil, Colombia, Costa Rica and Mexico," NBER WP No. 10637, 2004.
- Mendoza, E. and P.M. Oviedo, "Fiscal Policy & Macroeconomic Uncertainty in Developing Countries: The Tale of the Tormented Insurer," available at: <http://www.sas.upenn.edu/~egme/wp/w12586.pdf>
- Sosa Padilla, C., 2018, "Sovereign Defaults and Banking Crises," *Journal of Monetary Economics*
- Yue, Z. V. "Sovereign Default and Debt Renegotiation," *JIE*, 2010.

IV.- International Macroeconomics with Heterogeneous Agents

Main readings:

- Andreasen, E., S. Bauducco, E. Dardati and E. Mendoza, 2021, "Beware the Side Effects: Capital Controls Misallocation and Welfare," mimeo, Universidad de Chile.
- D'Erasmus, P. and E. Mendoza, 2021, "History Remembered: Optimal Sovereign Default on Domestic and External Debt," *Journal of Monetary Economics*, also available as NBER WP 25073, <https://www.sas.upenn.edu/~egme/wp/w25073.pdf>
- D'Erasmus, P. and E. Mendoza, 2016, "Distributional Incentives in an Equilibrium Model of Domestic Sovereign Default," *Journal of the Eur. Ec. Assoc.*, <http://www.sas.upenn.edu/~egme/pp/D%27ErasmusMenozaJEEA.pdf>
- Mendoza, E., V. Quadrini, and J. V. Rios-Rull, 2009, "Financial Integration, Financial Development and Global Imbalances," *Journal of Pol. Econ.*, at <http://www.sas.upenn.edu/~egme/pp/JPEreprint.pdf>
- Mendoza, E., V. Quadrini, and J. V. Rios-Rull, 2007 "On the Welfare Implications of Financial Globalization without Financial Development," *International Seminar on Macroeconomics Annual*, R. Clarida & F. G Giavazzi, eds. available at: <http://www.sas.upenn.edu/~egme/pp/Welfarefinancialintegration.pdf>
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Additional references:

- Asriyan, V., L. Laeven, A. Martin, A. Van der Ghote and V. Vanasco, 2021, "Falling Interest Rates and Credit Misallocation: Lessons from General Equilibrium," mimeo, CREI.
- Azzimonti, M., E. de Francisco, and V. Quadrini, 2012, "Financial Globalization, Inequality and the Raising of Public Debt," <http://www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-6.pdf>
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- McGrattan, E. R. and Prescott, E. C. (2007). Technology capital and the U.S. current account. Federal Reserve Bank of Minneapolis, Staff Report 406.
- Sandri, D. 2014, "Growth and Capital Flows with Risky Entrepreneurship," *Am. Ec. Journal: Macroeconomics*.