The Future of International Finance

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Outline

- International finance and domestic finance started far apart.

- Important convergence over past two decades.

- Common future? Specific futures?

International vs. Domestic Finance

- ▶ Key equation for domestic finance (one agent, one good):

$$\frac{P_t}{D_t} = \mathbb{E}_t \left[X_{t.t+1} \frac{D_{t+1}}{D_t} \right].$$

- ▶ Key equation for international finance (two agents, two goods):

$$\frac{E_{t+1}}{E_t} = \frac{X^*_{t,t+1}}{X_{t,t+1}}.$$

Distinguishing Features of International Finance

- ▶ Heterogeneity.

- ▶ Frictions.

- ▶ Numeraires/currencies.

- ▶ Governments.

- ▶ Data/observability.

Common Long-Standing Problems

- ▶ Economic determinants of beliefs $\mathbb{E}_t[\cdot]$.

- ▶ Economic determinants of risk premia $X_{t,t+1}$ and $X_{t,t+1}^*$.

- ▶ Economic determinants of portfolios and balance sheets.

- ▶ Economic "disconnect" and transmission:

$$1 \neq \mathbb{E}_t[X_{t,t+1} MPK_{t+1}], \quad X_{t,t+1} \neq MRS_{t,t+1}, \quad \frac{E_t P_{F,t}^*}{P_{H,t}} \neq MRS_{F,H}.$$

- ▶ Externalities and market failures.

- ▶ Role and transmission of policy.

Specific Long-Standing Problems

- Mussa puzzle on fixed vs. flexible regimes:

$$vol(\frac{E_t P_t^*}{P_t}) \approx vol(E_t).$$

- CIP (arbitrage) violation:

$$\frac{F_{t,t+1}}{E_t} \neq i_t - i_t^*.$$

- Home bias in portfolios.

- "Destabilizing" capital flows in emerging markets.

- Economic determinants of government behavior.

Specific Long-Standing Problems

▶ Determinants and implications of exchange rate regimes.

▶ IMS and special role of the U.S.:

  ▶ reserve/safe assets/invoicing/issuance currency;

  ▶ global imbalances/exorbitant privilege/world banker view;

  ▶ international financial architecture;

  ▶ Triffin dilemma/transition to multipolar world?

Resolutions and Theories

- ▶ Segmentation/intermediary asset pricing, noise traders/speculators, financial constraints, liquidity, regulation, inattention, runs...

- ▶ Sticky prices, limited commitment...

- ▶ Specific vs. common, local vs. global?

Micro Data

- ▶ Heterogeneity and frictions.

- ▶ Disaggregated capital flows, portfolios, balance sheets...derivatives.

- ▶ Disaggregated beliefs.

- ▶ Disaggregated prices, rigidity, invoicing.

- ▶ Reduced-form empiricism vs. structural link with theories?