Course Description: This course explores how the financial system interacts with the real side of the economy. Or, how does Wall Street affect Main Street? The course will generally approach matters from an economic perspective and will illustrate how theory helps us deal with real-world problems. Key issues that we will study include the forces shaping the structure of financial markets and institutions; the effects of regulation and deregulation on financial market activity; the sources and costs of financial crises; the virtues and vices of financial innovation; and the role of monetary policy and a central bank in the economy. Though many of these issues will be addressed in the context of the U.S. economy, the course will often take a broader perspective and explore the workings of financial systems and economies throughout the world.

Prerequisites: The course is self-contained, although background in microeconomics and macroeconomics will be helpful.

Readings:

2) Course packet of readings. (All readings except those marked with a are required.)

Supplemental Reading Material: For those who have not taken a macroeconomics course recently, Robert Barro's Macroeconomics provides an excellent review of macroeconomic theory and evidence. Linda Allen's Capital Markets and Institutions: A Global View provides details on financial institutions and securities markets. For a long-term perspective on monetary economics, Friedman and Schwartz's A Monetary History of the United States is a classic.
Grades: The course grade will be based primarily on two closed-book examinations. The final is comprehensive. The weights will be 35 percent for the midterm and 55 percent for the final. There will also be three or four problem sets worth 10 percent. You are encouraged to work in groups on the problem sets, but you must write up your own set of solutions. If you have any questions concerning how your exam was graded, within two weeks you must submit a written explanation of what you believe the problem to be. I reserve the right to regrade the entire exam.

Course Outline

I. The Economics of Financial Markets

   Overview of the financial system
   Mishkin, chapters 1 and 2

   Money, bonds, and the determinants of interest rates
   Mishkin, chapters 3-7

II. The Role of Intermediaries in the Financial System

   Information problems in securities markets and financial intermediation
   Mishkin, chapter 9
   Diamond, A Financial Intermediation as Delegated Monitoring

   Banks = role in the payments system

   Management of banks
   Mishkin, chapter 10
   *Bomfim and Nelson, Profits and Balance Sheet Developments at US Commercial Banks
   (This article is loaded with facts; read it for background information)

   Nonbank financial institutions
   Mishkin, chapter 13

   The changing role of financial intermediaries and bank consolidation
   Mishkin, chapter 11
   Boyd and Gertler Are Banks Dead? Or are the Reports Greatly Exaggerated?
   Berger, Demsetz and Strahan, The consolidation of the financial services industry: Causes, consequences and implications for the future
   *Saidenberg and Strahan, Are Banks Still Important for Financing Large Businesses?
*Mishkin and Strahan, AWhat Will Technology do to Financial Structure?@

III. Regulation and the Financial Safety Net

Overview of financial regulation
Mishkin, chapter 12

The savings and loan crisis and regulatory change
Kane, AThe High Cost of Incompletely Funding the FSLIC Shortage of Explicit Capital@
Benston and Kaufman, ADeposit Insurance reform in the FDIC Improvement Act: The experience to date@

Expansion of bank powers, consolidation, and the regulation of large financial institutions
Benston, AUncial Banking@
Berger, Demsetz and Strahan, AThe consolidation of the financial services industry: causes, consequences and implications for the future@Sections 7 and 8)
Mishkin, AFinancial Consolidation: Dangers and Opportunities@
Edwards, AHedge Funds and the Collapse of Long-Term Capital Management@

Recent changes in bank supervision and regulation
Hendricks and Hirtle, ABank Capital Requirements for Market Risk: The Internal Models Approach@
Marshall and Venkataraman, ABank Capital for Market Risk@

IV. Monetary Theory and Policy

The Federal Reserve and the structure of central banks
Mishkin, chapter 15

Money supply
Mishkin, chapters 16 and 17

Money demand
Mishkin, chapter 21

Monetary policy
Mishkin, chapters 18, 19, 24 and 26
Krugman, ABabysitting the Economy@
Garfinkel, AWhat Is an 'Acceptable' Rate of Inflation?@
Taylor, ATime Inconsistency: A Potential Problem for Policy Makers@
IV. Monetary Theory and Policy (continued)

Why does monetary policy affect the economy?
Mishkin, chapter 25
Bernanke and Gertler *Inside the Black Box: The Credit Channel of Monetary Policy*
Cecchetti, *Legal Structure, Financial Structure and the Monetary Policy Transmission Mechanism*

Rational expectations
Mishkin, chapters 27 and 28