Course Description

The objective of this course is to provide a unified overview of how monetary policy interacts with financial markets, with special emphasis on recent events. The course consists of three parts:

1. **Financial markets and risk.** In this part, we study how different financial instruments help market participants dealing with risk and the unique role of financial institutions.

2. **The transmission mechanism of monetary policy.** In this part, we distinguish between monetary policy in normal times and during financial crises.

3. **Topics highlighting the link between monetary policy and financial markets.** In this part, we discuss a number of topics (four or five) at the forefront of the current macroeconomic debate through student presentations and general discussion.

Schedule:

Classes meet on Saturdays, 1-4pm in room KMC 2-90. Tentative outline and calendar are below.

Readings:


Slides and additional material (handouts, articles, papers, data...) will be available on Blackboard, which is also the source of all administrative announcements regarding the course.

Classes will frequently begin with a discussion of current events related to the theme(s) of the week. Regularly reading news sources such as the *Financial Times*, *The Wall Street Journal* or *The Economist* will greatly facilitate the debate.
Grading

The final grade will be a weighted average of the following deliverables:

- **Class participation (10%)**. Your grade will take into account both the frequency and the quality of your contributions. Attendance, punctuality and your overall citizenship in class will matter too.

- **8 Problem sets (25%)**. Qualitative and quantitative applications of principles and tools developed in class. Distributed after each of the first 8 classes. Due at the beginning of the next class. Problem sets are the best preparation for the midterm exams. Feel free to work on problem sets alone or in groups but each student should submit her/his own answers.

- **2 Midterm exams (35%)**. Sixty minute long, at the beginning of the 5th and 9th class (tentative). Questions similar to the problem sets. Exams are closed book but a calculator is allowed. Students are responsible for avoiding any conflicts between midterm exam dates and other commitments.

- **Final presentation (30%)**. Four/five topics (depending on class size). For each topic, two groups will address the same question from a different perspective. The presentation should be the product of group work. All members of each group are expected to equally contribute to the preparation and presentation. A general discussion, in which everyone is expected to participate, will follow the two presentations on each topic.

The detailed course outline provides dates and deadlines for all assignments.

Consistent with the School’s policies, no more than 35% of the class will receive A or A–.

Questions about grading must be made in writing (send me an email and give me the exam with a written note describing the disagreement), no more than a week after the exams are returned.

Assistance & Communication

Email is the best way to get a quick answer from me. For longer discussions, my office hours are right before class (10.30am-12.30pm). Students who cannot make regular office hours and want to meet in person should email me to set up alternative times.

Camila Jiménez Villa, the teaching assistant, can also help with questions. Email her for quick answers or to set up a mutually convenient time to meet.
Students with disabilities

Students with a qualified disability, who require academic accommodation during this course, should contact the Moses Center for Students with Disabilities (CSD, 998-4980) and provide me with a letter from the Center verifying your registration and outlining the recommended accommodations. Students who need to take an exam at the CSD must submit a completed Exam Accommodations Form to the Center at least one week prior to the scheduled exam time to be guaranteed proper accommodation.

Honor Code

The Stern community believes that honesty and integrity are necessary for rewarding academic and professional experiences. These qualities form the basis for the strong trust among members of the academic community (students, faculty, and administrators) that is essential for excellence in education. The Honor Code requires that each student act with integrity in all academic activities and endeavor to hold her/his peers to the same standard.

Tentative Outline and Calendar (Spring 2011)

Note: Please skim through the first three chapters of CS (especially chapter 3).

Part 1: Financial markets and risk

Class 1: February 5, 2011 (CS chapter 5)
- Introduction to the course
- What is risk and how does it affect economic decisions?
- Risk aversion
- Idiosyncratic and systematic risk
- How do financial markets help dealing with risk?
- Problem set 1 distributed

Class 2: February 12, 2011 (CS chapters 6, 7 and 9)
- Problem set 1 due
- Overview of financial instruments with special emphasis on debt instruments
- Is financial sophistication good?
- Financial innovation and the crisis of 2008
- Problem set 2 distributed

February 19, 2011: No class (President’s Day weekend)

Form groups for presentations and choose topics
Class 3: February 26, 2011 (CS chapters 11, 12, 13 and 14)
- Problem set 2 due
- Banks and other financial institutions
- The “Shadow Banking System”
- Leverage
- Regulation
- Problem set 3 distributed

Class 4: March 5, 2011 (CS chapters 11, 12, 13 and 14)
- Problem set 3 due
- The Great Recession of 2008-2009
- The crisis in Europe and in the rest of the world
- This time is different: A comparison with earlier crisis
- Problem set 4 distributed

Part 2: The mechanism of transmission of monetary policy

Class 5: March 12, 2011 (CS chapters 15, 18, 21 and 22)
- Problem set 4 due
- Outline of presentations due
- Midterm 1
- Monetary policy before the crisis
- Interest rate setting and stabilization policies
- Monetary policy and risk
- Problem set 5 distributed

March 19, 2011: No class (Spring break)

Class 6: March 26, 2011 (CS chapters 14 and 23)
- Problem set 5 due
- Did monetary policy cause the housing bubble?
- Alternative explanations of the 2008 financial crisis
- Central banks as regulators
- Problem set 6 distributed

Class 7: April 2, 2011 (CS chapters 17, 18 and 23)
- Problem set 6 due
- First draft of presentations due
- Monetary policy during the financial crisis
- The zero lower bound on nominal interest rates
- Central banks as “Lenders of Last Resort”
- Credit easing vs. Quantitative Easing
- Interest on reserves
- Problem set 7 distributed
Monetary Policy, Banks and Central Banks

Class 8: April 9, 2011 (CS chapters 16, 18 and 19)
- Problem set 7 due
- Final version of presentations due
- The policy response to previous crises
- The Great Depression in the U.S. and the “Lost Decade” in Japan
- IMF interventions
- Problem set 8 distributed

Part 3: Topics and presentations

Class 9: April 16, 2011
- Problem set 8 due
- Midterm 2
- First topic (two presentations)
- General discussion

Class 10: April 23, 2011
- Second topic (two presentations)
- General discussion

Class 11: April 30, 2011
- Third topic (two presentations)
- General discussion

Class 12: May 7, 2011
- Fourth topic (two presentations)
- General discussion

Suggested topics for presentations:

1. Global imbalances: Should policymakers (and central banks in particular) worry?

2. Asset price bubbles: Should monetary policy try to prick bubbles?

3. Exchange rates: Fix or float?

4. Inflation targeting: Should central banks only focus on price stability?

If needed (depending on class size), an additional topic could be

5. U.S. vs. EMU: Did the Euro make the EU financial system more similar to the U.S.?

Students should feel free to suggest alternative topics of greater interest that fit with the broad objective of the class.