

ECON 670: Financial Economics
Course Information and Syllabus
Spring 2017

Instructor: Dr. Somasree Dasgupta

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Office hours: Thursdays, 6:00-6:30 pm, or by appointment

Lecture: Thursdays, 6:45-9:30 pm, with a 15 minute break in between

Lecture Location: 1400 16th Street N.W, Washington DC

Teaching Assistant: Hide Matsumoto

E-mail: DCmastersTA@econ.umd.edu

Office Hours: Announced on ELMS site at the beginning of the term and weekly reminders via email

Course Overview

The objective of this course is to introduce the students to the different aspects of the financial system in the US and some other developed countries, with detailed discussions of financial institutions, financial instruments and roles played by financial regulators like the Fed. We will be using microeconomic and applied econometric techniques to study financial markets as well as the pricing of financial assets. This course will enable the students to better understand the causes behind financial crises such as the Great Recession of the late 2000s and the Euro-zone crisis.

Course Objectives

Our program has 7 general learning outcomes for students:

1. Ability to understand, evaluate and analyze economic data
- 2: Ability to understand and interpret statistical evidence from economic data
- 3: Ability to apply empirical evidence to assessing economic arguments
- 4: Ability to apply macroeconomic theories to policy discussions
- 5: Ability to apply microeconomic theories to policy discussions
- 6: Ability to communicate economic ideas to a broader audience
- 7: Ability to evaluate the effectiveness of policy programs using sound economic techniques

The learning outcomes that pertain to this course are: 1,2,3,4, 5 and 6

At the end of the semester, you should be able to:

1. Understand the different aspects of the financial system in the US and other developed countries.
2. Use microeconomic theoretical tools to analyze financial markets and financial instruments.
3. Use macroeconomic theoretical tools to analyze monetary policy in developed countries.
4. Use basic econometric techniques to analyze and interpret financial data.
5. Understand how the theoretical concepts learned in class apply to the real world through interpretation of real world events like the financial crisis of the late 2000s.
6. Make presentations in class to communicate ideas of financial economics to a broader audience.

Course Prerequisites

Econ 641, Econ 644 (co-requisite)

Required Text and Additional Readings:

The required textbook for this class is:

Hubbard and O'Brien, Money, Banking, and the Financial System, 2nd Edition.

ISBN-13: 978-0-13-299491-0

ISBN-10: 0-13-299491-7

Additional academic papers and book chapters will be assigned as readings. There will be some required additional readings, and some recommended ones. Note that the recommended readings are beyond the scope of this class. But, you are supposed to know the material from the required readings for assignments and exams.

Course Requirements:

Assignments: 10%

Online Discussion: 5%

Presentation: 15% (first draft: 3%, in-class presentation: 12%)

Midterm: 35%

Final Exam: 35%

Assignments

Five problem sets will be assigned to you during the semester. The problem sets will be due at the beginning of class on the dates mentioned in the syllabus below. Group discussion in solving the assignments is encouraged, but each student is expected to write their own answers in their own words. Students are encouraged to meet with the TA to discuss any questions regarding problem sets, noting that the exams would closely relate to the problem sets.

Online Discussions

We will hold a weekly online discussion under the "Discussion" tab on the class ELMS site. Discussions will generally occur on Friday and stay open for 24 to 48 hours. Details regarding discussions will be posted on the ELMS site.

All assignments and online discussions are subject to late penalties. The penalties are as follows: 20% for the first day, 50% for the second day. Assignments are not accepted after the second day. Late penalties apply except when prior approval is obtained, or when valid documentation is presented for being late.

Presentations

The presentation will be in groups of 2 or 3 students at the end of the semester. Please note the presentation dates in the list of important dates below. Each group must submit the names of their members to me by March 16. Each group should discuss the topic of their presentation with me before the

first draft is due. The first draft of your presentation, worth 3% of the course grade, will be due on April 13. Details regarding the presentation will be available on the ELMS website, and discussed in class.

Exams

There will be one midterm exam and one final exam in class, each counting towards 35% of your course grade. The midterm will be 90 minutes long, followed by lecture. The final exam will be 2 hours long held in the last class session and will be comprehensive. The dates for the midterm and final exams are on the list of important dates below. You must take the final exam to get a letter grade in this course.

Final Course Grades:

Final letter grades are based on the weighted score and performance relative to the class. I generally do not grade on the curve unless the exam averages are very low for the whole class. Numerical course grades will be translated into letter grades as follows:

Percent	Letter Grades
93-100	A
90-92	A-
80-89	B+
70-79	B
60-69	B-
50-59	C+
40-49	C
30-39	C-
20-29	D+
10-19	D
0-9	F

Tentative Schedule:

This schedule is tentative and may be changed as needed.

3/2: Introduction to the Financial System & the Money Market

Required Reading: Hubbard & O'Brien Chapters 1 & 2

Recommended Readings:

- Allen, F. (2001). Do Financial Institutions Matter? *The Journal of Finance*, 56(4), 1165-1175.
- Chemmanur, T., & Fulghieri, P. (1994). Investment Bank Reputation, Information Production, and Financial Intermediation. *The Journal of Finance*, 49(1), 57-79.
- Hubbard, R., Koehn, M., Ornstein, S., Van Audenrode, M., & Royer, J. (2010). Mutual Funds' Organizational Form and Conflicts of Interest. In *The Mutual Fund Industry: Competition and Investor Welfare* (pp. 130-149). Columbia University Press.
- Sornette, D. (2003). Financial Crashes: what, how, why, and when? In *Why Stock Markets Crash: Critical Events in Complex Financial Systems* (pp. 3-25). Princeton University Press.

3/9: Determination of Interest Rates and the Rates of Return, Present Value

Required Reading: Hubbard & O'Brien Chapter 3

The Bond Market

Required Reading: Hubbard & O'Brien Chapter 4

Recommended Readings:

- Bauman, W. (1969). Investment Returns and Present Values. *Financial Analysts Journal*, 25(6), 107-120.
- Eck, J. (1996). Calculating The Present Value Of An Increasing Flow Of Funds. *Journal of Financial Education*, 22, 69-72.

3/16: The Bond Market

Required Reading: Hubbard & O'Brien Chapter 4

Risk Structure of Interest Rates

Required Reading: Hubbard & O'Brien Chapter 5

Recommended Readings:

- Merton, R. (1974). On the Pricing of Corporate Debt: The Risk Structure of Interest Rates. *The Journal of Finance*, 29(2), 449-470.
- Sarig, O., & Warga, A. (1989). Some Empirical Estimates of the Risk Structure of Interest Rates. *The Journal of Finance*, 44(5), 1351-1360.

3/23: Term Structure of Interest Rates

Required Reading: Hubbard & O'Brien Chapter 5

Recommended Readings:

- Cox, J., Ingersoll, J., & Ross, S. (1981). A Re-Examination of Traditional Hypotheses about the Term Structure of Interest Rates. *The Journal of Finance*, 36(4), 769-799.
- Jarrow, R. (2009). The Term Structure of Interest Rates. *Annual Review of Financial Economics*, 1, 69-96.
- Malkiel, B. (1964). The Term Structure of Interest Rates. *The American Economic Review*, 54(3), 532-543.

3/30: The Stock Market & Efficient Markets Hypothesis

Required Reading: Hubbard & O'Brien Chapter 6

Derivatives: Forward & Futures

Required Reading: Hubbard & O'Brien Chapter 7

Recommended Readings:

- Bodie, Kane and Marcus, Investments, 10th edition, New York: McGraw-Hill.
- Jordan, J. (1983). On the Efficient Markets Hypothesis. *Econometrica*, 51(5), 1325-1343.

- Malkiel, B., 1996, A Random Walk Down Wall Street. New York: W. W. Norton and Company
- Malkiel, B. (2003). The Efficient Market Hypothesis and Its Critics. *The Journal of Economic Perspectives*, 17(1), 59-82.

4/6: Derivatives: Forward & Futures

Required Reading: Hubbard & O'Brien Chapter 7

Recommended Readings:

- Hill, J., & Schneeweis, T. (1984). Reducing Volatility with Financial Futures. *Financial Analysts Journal*, 40(6), 34-40.
- Merrick, J. (1988). Hedging with Mispriced Futures. *The Journal of Financial and Quantitative Analysis*, 23(4), 451-464.
- Polinsky, A. (1987). Fixed Price versus Spot Price Contracts: A Study in Risk Allocation. *Journal of Law, Economics, & Organization*, 3(1), 27-46.

Derivatives: Options & Swaps

Required Reading: Hubbard & O'Brien Chapter 7

Required additional Reading:

- Wallison, P. (2011). Credit-Default Swaps and the Crisis. In Posner R. (Author) & Friedman J. (Ed.), *What Caused the Financial Crisis* (pp. 238-248). University of Pennsylvania Press.

Recommended Readings:

- Black, F., & Scholes, M. (1972). The Valuation of Option Contracts and a Test of Market Efficiency. *The Journal of Finance*, 27(2), 399-417.
- Stulz, R. (2010). Credit Default Swaps and the Credit Crisis. *The Journal of Economic Perspectives*, 24(1), 73-92.

4/13:

Asymmetric Information, Adverse Selection and Moral Hazard in the Financial System

Required Reading: Hubbard & O'Brien Chapter 9

Recommended Readings:

- Akerlof, G. (1970). The Market for "Lemons": Quality Uncertainty and the Market Mechanism. *The Quarterly Journal of Economics*, 84(3), 488-500.
- Friedman, J., & Kraus, W. (2011). Bonuses, Irrationality, and Too-Bigness: The Conventional Wisdom About the Financial Crisis and Its Theoretical Implications. In *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (pp. 5-56). University of Pennsylvania Press.

4/20: **Midterm Exam**

Capital Markets & CAPM

Required Reading: Brealey, Myers and Allen/ Staunton and Cornett, Financial Economics, Custom Edition, chapters 7, 8 & 9.

Recommended Readings:

- Fama, E., & French, K. (2004). The Capital Asset Pricing Model: Theory and Evidence. *The Journal of Economic Perspectives*, 18(3), 25-46.
- Modigliani, F., & Miller, M. (1958). The Cost of Capital, Corporation Finance and the Theory of Investment. *The American Economic Review*, 48(3), 261-297.
- Sharpe, W. (1964). Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk. *The Journal of Finance*, 19(3), 425-442.

4/27: The Shadow Banking System, the Financial Crises & Financial Regulation

Required Reading: Hubbard & O'Brien Chapters 11 & 12

Recommended Readings:

- Lewis, M. (2011). Dodd-Frank Financial Reforms Have A Broad Scope, And Will Likely Have A Modest Impact. In Hale D. & Hale L. (Eds.), *What's Next?: Unconventional Wisdom on the Future of the World Economy* (pp. 264-270). Yale University Press.
- Stein, J. (2010). Securitization, shadow banking & financial fragility. *Daedalus*, 139(4), 41-51.

Presentations Day 1

5/4: The Commercial Banking System & the Fed's Monetary Policy

Required Reading: Hubbard & O'Brien Chapters 10, 13 (selected pages) & 14

Required Additional Reading: Mishkin, F. (2009). Is Monetary Policy Effective during Financial Crises? *The American Economic Review*, 99(2), 573-577.

Recommended Readings:

- Larson, R. (2012). Fed Up: The Desperation of Quantitative Easing. In *Bleakonomics: A Heartwarming Introduction to Financial Catastrophe, the Jobs Crisis and Environmental Destruction* (pp. 175-184). Pluto Books.
- Mishkin, F. (2011). Monetary Policy Strategy: Lessons from the Crisis. *National Bureau of Economic Research*, Working paper 16755.
- Tempelman, J. (2012). Guest Editorial: Against Quantitative Easing by the European Central Bank. *Financial Analysts Journal*, 68(4), 4-6.

Presentations Day 2

5/11: Fed's Monetary Policy

Required Reading: Hubbard & O'Brien Chapters 13 (selected pages) & 14

Presentations Day 3

5/18: **Final Exam**

Important Dates for Assignment Submission/Exam/Presentation:

Date	Assignment Due/Exam/Presentation
3/2	---
3/9	Assignment 1 due
3/16	Presentation Groups due
3/23	Assignment 2 due
3/30	---
4/6	Assignment 3 due
4/13	First Draft of Presentations Due
4/20	Midterm Exam
4/27	Assignment 4 due, Presentations Day 1
5/4	Presentations Day 2
5/11	Assignment 5 due, Presentations Day 3
5/18	Final Exam

Standard Policies for the Program and the University of Maryland:

Course Website: Copies of the course syllabus, your grades, and other relevant links and documents will be posted on the course’s ELMS/Canvas website. You can access the site via www.elms.umd.edu. You will need to use your University of Maryland “directory ID” and password.

Email: Email is the primary means of communication outside the classroom, and I will use it to inform you of important announcements. Students are responsible for updating their current email address via <http://www.testudo.umd.edu/apps/saddr/> AND for paying attention to messages I send to the class via ELMS. Failure to check email, errors in forwarding email, and returned email due to “mailbox full” or “user unknown” will not excuse a student from missing announcements or deadlines. I will do my best to respond to email within 36 hours.

Contact Hours: Three credit courses at the University of Maryland require a minimum amount of contact between instructors and students. Our courses’ 12 weekly 3-hour meetings only satisfy 80% of the university’s contact requirement. The other 20% is satisfied by weekly mandatory and graded online contact. In principle, the contact hours requirement could be satisfied by scheduling 3 additional 150-minute meetings per term, or 6 additional 75-minute meetings, or 10 additional 45-minute meetings. But in practice the contact hours requirement is satisfied by the weekly online discussions. The weekly online discussions are a more flexible way to ensure that our program’s courses in DC provide the same level of student-instructor contact as the traditional 15-week, face-to-face, version of the same course when it is taught on campus in College Park.

Work Load: Mastering the material covered in this course requires a significant amount of work outside of class. Students should expect to spend more time outside of class than in class – typically at least twice as much time. The courses in our DC program are 12-week courses that cover all the same material as a traditional semester-long 3-credit course (15 weeks). The compressed schedule makes it possible to complete our degree in just 15 months if you take 2 courses each term. But the compressed schedule also implies an accelerated pace with an average of 25% more work per week in a given course ($15/12 = 1.25$). The normal full-time load in a master’s program is 3 courses per semester, or 6 courses

per year. Students who take 2 courses per quarter in our program complete 8 courses per year. So taking 2 courses per quarter in our program is equivalent to 133% of a full-time load ($8/6 = 1.33$).

Academic Integrity: The University of Maryland has a nationally recognized Code of Academic Integrity, administered by the Student Honor Council. This Code sets standards applicable to all undergraduate and graduate students, and you are responsible for upholding these standards as you complete assignments and take exams in this course. Please make yourself aware of the consequences of cheating, fabrication, facilitation, and plagiarism. For more information see www.studenthonorcouncil.umd.edu.

Student Conduct: Students are expected to treat each other with respect. Disruptive behavior of any kind will not be tolerated. Students who are unable to show civility to one another or myself will be referred to the Office of Student Conduct. You are expected to adhere to the Code of Student Conduct.

Excused Absences: The University of Maryland's policy on excused absences is posted here:

<http://www.president.umd.edu/administration/policies/section-v-student-affairs/v-100g>

Please note:

If you miss any class meetings for any reason, you are still responsible for all material covered during the meeting you missed. It is your responsibility – not the instructor's – to get yourself caught up in the course. Instructors routinely facilitate things by posting lecture notes, etc.

If you need to miss an exam or other graded course requirement because of illness, injury, or some other emergency: Follow doctor's orders and get documentation. Get in touch with the instructor as soon as you're able – preferably prior to missing the exam or deadline. Communicate with the instructor to make up the course requirement as soon as possible. You are entitled to recover before you make up the course requirement, but you are not entitled to extra days to study beyond the time the doctor's note says you're incapacitated. If you are incapacitated for more than a week or so beyond the end of the term, your grade in the course will be an "Incomplete". In such cases you must negotiate a plan with your instructor for completing the course requirements. Once you make up the course requirement the instructor will change your "I" to the appropriate letter grade.

School Closings and Delays: Information regarding official University closing and delays can be found on the campus website and the snow phone line: (301) 405-SNOW (405-7669). Since our program is an evening program in downtown Washington, DC, rather than a day program in College Park, we do not always cancel classes on the same days as the College Park campus. The program director will always announce cancellation information to the program as an announcement on the program's ELMS/Canvas site. This will generally be done by 1:00 p.m. on days when weather or other factors are an issue.

Students with Disabilities: The University of Maryland does not discriminate based on differences in age, race, ethnicity, sex, religion, disability, sexual orientation, class, political affiliation, and national origin. Reasonable accommodations will be made to students with documented disabilities. I will make every effort to accommodate students who are registered with the Disability Support Services (DSS) Office and who provide me with a University of Maryland DSS Accommodation form.

Academic Progress: The graduate school requires that students maintain a GPA of at least 3.0. Students whose cumulative GPA falls below 3.0 will be placed on academic probation by the graduate school. Students on academic probation must ask the program's director to petition the graduate school if they want to remain in the program. The petition must include a plan for getting the student's GPA up to at

least 3.0. Students who do not live up to their plan can be forced to leave the program without having earned the degree. Note: a grade of "B" corresponds to a GPA of 3.0. A grade of "B-" corresponds to a GPA of 2.7.

Building Access: The door to the building at 1400 16th Street is unlocked on weekdays until 7:00 p.m. Students who arrive after 7:00 p.m. or on weekends will find the door locked. The building's security guard is stationed at a desk just inside the door until 11:00 p.m. and will let you in. You can also call the phone on the security guard's desk by dialing (202) 328-5158. If the security guard happens to be away from his or her desk when you arrive, you can pick up the black phone to the right of the door at 1400 16th Street. You will be connected to the company that handles security for our building. If you tell them you are with the University of Maryland, they should ask you for a password. The password is "Drawbridge". When you tell them the password, they will be able to unlock the door for you.