

Financial Markets and Public Policy: Woodrow Wilson 582f

Woodrow Wilson 582f Spring 2009 Robertson 20 9:00 AM – 12:00 Noon	Edward L. Golding Edward_golding@freddiemac.com 703-903-2370
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- “We are in the midst of a once-in-a century credit tsunami. Central banks and governments are being required to take unprecedented measures.”
- “I still do not fully understand why it happened and obviously to the extent that I figure where it happened and why I will change my views.”

Alan Greenspan appearing before Committee of Government Oversight and Reform on October 23, 2008. He went on to testify that he had “found a flaw” in his ideology and “that’s precisely the reason I was shocked.”

Purpose:

The rule book on regulation of financial markets has been thrown out over the last two months. The purpose of this class will be to explore what needs to be discarded and what can be saved.

Class will be a mixture of finance and public policy. For example, when we discuss the excess leverage in the financial system, we will study the Modigliani-Miller Theorem and when we discuss deposit insurance we will explore the Black-Scholes option valuation model. I will try to bring in a few guest speakers (formerly) from Wall Street.

Requirements:

3 short papers (3 pages) analyzing current issues: 30% of grade
1 longer paper (10 pages) to be presented in class: 40% of grade
Class participation: 30% of grade

Week	Topic
1. 2/6	Introduction, objectives, what is special about financial markets Review of basic financial concepts/jargon
2. 2/13	Banks: Are banks and financial intermediaries special and does this explain financial regulation? Why were banks rescued so quickly, but not the auto industry (at least not yet)? Does the Fed want 5 large “universal” banks or is there a place for community banks? Prior to the current crisis, why did the US provide explicit guarantees only to deposits? Now that this guarantee has been extended to all bank liabilities is this a permanent change? How should we regulate banks?
3. 2/20	Housing finance and Bubbles: Recent experience in the housing market. Did the housing market cause this mess? Where were the regulators? Where was market discipline? Is more “transparency” the answer?
4. 2/27	Systemic Risk and Contagion: Case studies of Freddie Mac and Fannie Mae, Lehman, Bear Stearns and LTCM? Why did regulators think that they had the problem managed? Can we restructure mortgage market to reduce systemic risk? Role of credit default swaps in transferring risk. Will the TARP stop the contagion?
5. 3/6	Corporate Governance: Enron, Sarbanes-Oxley In whose interest are companies run? Where are the externalities and why regulate the public securities market? US approach vs. other countries?
6. 3/13	Rating agencies, accounting firms and the role of third parties in providing information Who watches the watchers? Why did the rating agencies do such a bad job? Will the rating industry make a comeback? What do we expect from the accounting profession? In whose interest are they operating?
7. 3/20	SPRING BREAK
8. 3/27	Executive Compensation: Excessive pay, shareholder say and options Why did we pay executives millions to lose billions? How do options work and do they align incentives?
9. 4/3	Regulation of asset management and hedge funds Do professional managers add value? Value funds vs. index funds. Why regulate hedge funds? Are households saving enough? Should we privatize social security? Should the US Treasury invest in the stock market?
10. 4/17	Financial innovation, derivatives, and complete markets What drives innovation in financial markets? Efficiencies, regulatory and accounting arbitrage, or deception? How do we regulate these markets?
11. 4/24	Presentation of student papers
12. 5/1	Wrap up

Reference Readings :

On Reserve:

Saunders, Anthony and Cornett, Marcia, *Financial Markets and Institutions*. (FMI) McGraw-Hill.

Handbook of the Economics of Finance: Corporate Finance Volume 1A (HEF) ed. by Constantinides, Harris, and Stulz, North Holland 2003.

Bodie, Kane, and Markus, *Essentials of Investments*, McGraw-Hill, 2005

Selected articles (to be updated)

Week	Topic	Readings
1. 2/6	Introduction, objectives, what is special about financial markets	FMI, Chapters 1&2 Weimer, David L. and Aidan R.Vining, "Landing on Your Feet: How to Confront Policy Problems," <i>Policy Analysis – Concepts and Practice</i> , 1999, Chapter 10, pp. 256-289 White, Lawrence "The Role of Financial Regulation in a World of Deregulation and Market Forces," Presented at International Monetary Fund Conference on Second Generational Reforms, November 8, 1999 Greenspan, Alan, "Remarks before the Society of Business Economists, London, UK", Sept. 25, 2002
2. 2/13	Are banks special and does this explain bank regulation?	FMI, Chapters 11, 12, & 13 Santo, Jao AC. "Bank Capital Regulation on Contemporary Banking Theory: A Review of the Literature", Bank for International Settlements, September 2000 Gorton and Winton "Financial Intermediation" HEF Ch. 8 (technical) Diamond and Dybvig "Bank Runs, Deposit Insurance, and Liquidity" <i>JPE</i> 1983 (technical)
3. 2/20	Bubbles and contagion: Recent experience in housing market	Kindelberger, Charles, "Anatomy of a Typical Crisis", in <i>Manias, Panics, and Crashes: A History of Financial Crises</i> , Wiley, 2000, pp. 13-22 Shiller, Robert J., "The Stock Market Level in Historical Perspective", <i>Irrational Exuberance</i> , Princeton University Press, 2000, pp. 3-14

Week	Topic	Readings
		<p>Bernanke, Ben, "Asset price 'bubbles' and monetary policy", October 2002</p> <p>Rosen, Richard, "Explaining recent changes in home prices", <i>Chicago Fed Letter</i>, July 2005</p>
4. 2/27	Systemic Risk: Case studies of Freddie Mac and Fannie Mae and LTCM	<p>Introduction to "New Directions for Understanding Systemic Risk," <i>Economic Policy Review</i>, Federal Reserve Bank of New York, pp. 3-13</p> <p>Van Order, Robert, "A Microeconomic Analysis of Fannie Mae and Freddie Mac", <i>Regulation</i>, Volume 23, No.2, pp. 27-33.</p> <p>Wallison, Peter. "How to Privatize Fannie, Freddie." <i>American Banker</i>. October 2004.</p> <p>Dunbar, Nicholas (2001) <i>Inventing Money: The Story of Long-Term Capital Management and the Legends Behind It</i>, Wiley</p> <p>Lowenstein, Roger (2000) <i>When Genius Failed</i>, Random House</p>
5. 3/6	Corporate Governance: Enron, Sarbanes-Oxley	<p>Coglianesse, Cary, Healey, Thomas J., Keating, Elizabeth and Michael, Michael, "The Role of Government in Corporate Governance", <i>NYU Journal of Law & Business</i>, Fall 2004, pp.101-120</p> <p>Becht, Bolton, and Roell "Corporate Governance and Control" HEF Ch. 1</p> <p>McLean, Bethany and Peter Elkind, <i>Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron</i></p>
6. 3/13	Rating agencies and the role of third parties in providing information	<p>Smith, Roy, and Ingo Walter (2002) "Ratings Agencies: Is there an Agency Problem?," Chapter 12 in R.M. Levich, G. Mainoni, and C. Reinhart, <i>Ratings, Rating Agencies and the Global Financial System</i>, Springer</p>
7. 3/20	SPRING BREAK	
8. 3/27	Executive Compensation: Excessive pay, shareholder say and options	<p>Hall, Brian, and Murphy, Kevin "The Trouble with Stock Options" <i>The Journal of Economic Perspectives</i>, August 2003, pp. 49-70</p> <p>Bebchuk, Lucian, and Fried, Jesse "Pay without Performance: Overview of the issues" <i>The Academy of Management Perspectives</i>, 2006</p>

Week	Topic	Readings
9. 4/3	Regulation of asset management and hedge funds	<p>Bogle, John, "Fair Shake or Shakedown?", <i>The Wall Street Journal</i>, July 8, 2004</p> <p>Donaldson, William, "Testimony Concerning Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry", Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, U.S. Senate, April 8, 2004</p> <p>Bernanke, Ben S., "Hedge Funds and Systemic Risk", Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, May 16, 2006.</p> <p>Geithner, Timothy, "Hedge Funds and Derivatives and Their Implications for the Financial System," Remarks at the Distinguished Lecture Sept. 2006, sponsored by the Hong Kong Monetary Authority</p>
10. 4/17	Financial innovation, derivatives, and complete markets	<p>Tufano, Peter "Financial Innovation" HEF Ch. 6</p> <p>Das, Satyajit (2006) <i>Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives</i>, Prentice Hall</p> <p>Partnoy, Frank (1997) <i>F.I.A.S.C.O. Blood in the Water on Wall Street</i>, Norton</p>
11. 4/24	Presentation of student papers	
12. 5/1	Wrap up	