Syllabus
Revised: September 3, 2011

The financial crisis that began in 2007 became the deepest and broadest since the Great Depression, and its aftershocks still threaten the global economy. Understanding these developments and the responses of central banks and other authorities will help business decision-makers and investors assess financial opportunities and risks even in “normal” times. This course is an MBA elective that examines lessons from the crisis as viewed by a market practitioner.

Several broad questions will be addressed over the semester:

- Why did the crisis become so severe and prolonged? How are different types of financial crises (e.g. banking, sovereign debt, currency, and inflation) related?
- What are the textbook responses to financial crises? Is there a conflict between the goals of financial stability and economic stabilization?
- How well have central banks and other policy makers functioned since the crisis began in 2007?
- How will this crisis alter the financial system and its oversight? How will those changes affect the evolution of business and the economy?
- Can policymakers mitigate a crisis without fostering new risks?

International comparisons during the crisis (including the ongoing disruptions in the euro area) will be used to illuminate these key issues. Comparison and contrast with past crises and policy actions also will play an important role. Practical challenges from the experience of market participants will be highlighted and examined. Along the way, key concepts like information asymmetries and asset bubbles will be explored. The course will be conducted using a combination of lecture, discussion, and case analysis. The teaching style will be socratic, so active class participation will be key.

The class also will have at least three special discussion sessions with outside participants: (1) former Treasury Secretary Robert Rubin will address fiscal matters and crisis management; (2) Dr. Henry Kaufman (President of Henry Kaufman and Company Inc.) will examine the evolution of market risk-taking; and (3) Stephen Cecchetti (BIS, Head of Monetary and Economic Department) will discuss international aspects of systemic risk.

Schedule. B30.2343 meets on Thursdays beginning September 22 from 6:00pm to 9:00pm in KMC 3-90. Professor Schoenholtz’s office is KMC 7-89 (212-998-0751). Office hours will be on Thursdays between 4:30pm and 5:30pm. Other appointments can be arranged by email (kschoenh@stern.nyu.edu). The teaching assistant is Robert Rosener (rrl400@nyu.edu).
Materials. The course will be conducted using Blackboard. The following book is required for the course: Viral V. Acharya and Matthew Richardson, eds., Restoring Financial Stability, John Wiley and Sons, 2009. This book will be referred to in the syllabus as AR and can be found at Amazon under the following link.

Prior to the course, students should read the policy chapters of a textbook on money and banking to understand the traditional functions and operating mechanisms of central banks. One such textbook (on reserve at Bobst Library) is Cecchetti and Schoenholtz, Money, Banking and Financial Markets (ISBN 978-0073375908), in which the relevant chapters are 15-18 and 21-23. Modules for an earlier edition of this textbook that treat aspects of the financial crisis are posted in Course Documents on Blackboard.

Required readings appear below and (aside from the readings in AR) will be included in the reading packet distributed at the first class. Required readings should be completed before class, including those for the first session. Recommended and supplementary readings are not included in the reading packet. These latter readings provide additional background for interested students and may be useful for final essay assignments. A file with the websites for most supplementary readings will be made available under Course Documents.

Questions for class discussions and written assignments will be posted on Blackboard, so check the site ahead of class. Students should be prepared to participate in each class. Written assignments should be submitted via Blackboard Turnitin. Students are expected to keep abreast of developments in and policy responses to the crisis (including ongoing developments in Europe), using resources like Bloomberg, the FT, and the WSJ.

Requirements and grades. Students should have completed a course (or be able to demonstrate clear proficiency) in macroeconomics. Course grades will be based on the following with percentages indicated in parentheses:

- In the case of outliers, attendance and class participation will matter for the course grade. Every student should expect to make a contribution on the discussion board as part of class participation.

- Most of the course grade will reflect three take-home assignments. Answers are to be completed individually (i.e. no teamwork) and submitted by Blackboard. The first two assignments will call for a three-page memo to a portfolio/liability manager anticipating a policy development and its implications or to a policymaker providing advice on a policy matter. The third assignment, which will account for about 50% of the final grade, will be a take-home final essay (up to 10 pages) that addresses a critical issue raised in the class. Specific topics and instructions will be provided via Blackboard. Expected assignment dates are in this syllabus.

Honor Code. The Stern Honor Code applies in this course. In addition, we hold ourselves to a high standard of professional behavior. Lateness, cellphones, private conversations, browsing the internet, checking your email, and any other behavior that disrupts the class will be considered inappropriate. Repeated violations of this standard will affect your grade.
Course Schedule – Topics, Readings and Assignments

September 22 – First Class
(1) Origin and propagation of the financial crisis
   - Risk mispricing: dangers of extrapolation
   - Information asymmetries: failure of delegated monitors
   - Incentive problems: private and public sources
   - Balance sheet exposure, leverage and fire sale externality
   - Systemic vulnerabilities: From Drexel and LTCM to Bear and Lehman

Required readings:

A crisis timeline is available at: http://timeline.stlouisfed.org/.

September 29 – No Class

October 6
(2) Compare and contrast: past crises and policies
   - Long history of financial crises
   - Key financial and policy developments in the Great Depression
   - Japan’s asset bubbles: what policy did (and did not) do

Required readings: Reinhart and Rogoff, “From Financial Crash to Debt Crisis,” March 2010. Please read pages 1-34 (including sections I through IV). For NBER papers, you must provide a Stern email address to which NBER can send a link for the paper.

October 13
(3) Understanding the euro-area crisis (first half)
   - Maastricht Treaty and the ECB: Independence + “one size fits all”
   - Fiscal incentives (“no bailout” clause)
   - Structural differences, competitiveness and growth
   - Financial linkages

Costs of financial crises (second half)
   - Public absorption of intermediaries’ balance sheet losses
   - Fiscal sustainability and threats to long-run growth
   - Cyclical shortfalls

Elliott, “Why Can’t Europe Get it Right the First Time… or the Second… or the Third?,” Brookings, August 22, 2011.
Recommended Reading: Reinhart and Reinhart, “After the Fall” (August 2010). Read pages 1-17 and 37-40.

Assignment A distributed.
October 20
(3) Financial conditions and monetary policy
- Why do financial conditions matter?
- What can a central bank do?
- Did the Fed create the housing bubble?
- Understanding financial conditions: the Greenspan “conundrum”


October 27
(4) Lender of last resort
- Past liquidity crises (19th century, 1907, 1929-33)
- Classical response: Bagehot
- Automatic mechanisms: Lombard penalty window – did it work in the crisis?
- Issues: maturity, collateral, counterparties
- Is liquidity policy separable from conventional monetary policy?
- Convener of last resort – the LTCM episode

Required Readings: Testimony of Fed Chairman Alan Greenspan (October 1, 1998)

Assignment A due before class.

November 3
(5) Policy rules and discretion
- Price stability, policy predictability and rule-like behavior (Taylor rule)
- Credibility and independence: Steadying expectations
- Conventional policy transmission: interest rates
- What guides such deviations?
- Inflation vs. deflation: sources of instability
- Does the policy target depend on the state of price developments?

Special Session: Dr. Henry Kaufman will join a class discussion on the evolution of market risk-taking.

Assignment B distributed.
November 10
(6) Policy at zero rates
  - Managing expectations (e.g. leaving Gold Standard, policy commitments)
  - Quantitative easing
  - Credit easing: quasi-fiscal actions
  - Cooperation with fiscal authority: promise and pitfalls
  - Exit strategies – preserving independence and the role of interest payments on reserves
  - Discretionary fiscal policy

Required readings: Mishkin, “Is Monetary Policy Effective During Financial Crises?”

November 17

(7) Regulation I
  - Goals and means: role of policy predictability
  - Crisis prevention vs. crisis management
  - Role of capital regulation
  - Micro- vs. macro-prudential regulation


Special Session: BIS Monetary Department Head Stephen Cecchetti will discuss international aspects of systemic risk.

Assignment B due before class.

November 24 – No Class

December 1
(8) Regulation II
  - Workout rules for financial intermediaries and TBTR
  - Other sources of instability: regulation, guarantees, incentives
  - Common exposure and pro-cyclicality

Required reading:
Acharya et al., “Regulating Systemic Risk,” Chapter 13 in AR.

Special Session: Former Treasury Secretary Robert Rubin will join a class discussion on the relationship between the fiscal and monetary authorities.

Final essay topic distributed.
December 8
(10) Future of regulation and the financial system
- What is systemic? Who should have access to the LOLR?
- Reducing vulnerability
- Strengthening market mechanisms
- Pricing systemic risks: capital, leverage and liquidity requirements
- Reducing pro-cyclicality
- International considerations
- Dodd-Frank

Recommended reading: Michael Barr, “Ending Too Big to Fail,” Testimony to House Financial Services Committee, June 14, 2011.

December 15
(11) Possible long-term economic and policy implications
- Reduced intermediation
  - Higher equilibrium spreads
  - Lower risk-free policy rate
  - Reduced debt intensity?
- Debt and economic growth
- Debt and economic volatility
- Should policymakers respond to asset bubbles apart from implications for price stability?


December 22
(12) Contemporary challenges and wrap-up
- Topical issues of the day
- Review

Final essay due before class.