Advanced Macroeconomics I
ECON 525a, Fall 2009
Yale University

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Syllabus

Course Description

This course offers a discussion about the importance and fragility of financial markets in macroeconomics. We will start by analyzing the foundations of financial contracts, the justification for the existence of financial intermediaries and the characterization of financial relationships. Then, we will study the role of financial frictions in magnifying aggregate fluctuations and the role of bubbles and panics in fueling financial crises. Finally, we will discuss how regulation and reputation concerns shape incentives in financial markets.

Just as a commitment device (to myself), my office hours are Mondays from 1pm to 3pm. However, my door is always open in case you want to go for a coffee and chat. You are also very welcome to drop me a line so we can schedule a meeting.

Finally, I'm planning this class to be very flexible. We will be discovering new common interests along the way, so I will try to accommodate to them more than following rigorously the contents I'm proposing here. Hence, the reading list is not exhaustive and may change (most likely get longer) during the semester.

Grading

You will be graded on a term paper. You should use this requirement as an opportunity to start exploring a topic of your interest. Ideally this paper will lead to a broader and more ambitious project,… but everything starts from zero! I am eager to discuss your ideas, whether they are theoretical or empirical, and to guide you the best I can towards a relevant question. In terms of evaluation, I will put weight on your efforts and the creativity and quality of the paper, not on its length.

I may also assign some optional exercises along the way…but I will give you details later, depending on how the class evolves.

Reading List

*** indicates papers that I intend to discuss in lectures.
** indicates papers that I may not discuss in lectures but you should read.
* indicates papers that I consider highly recommended additional reading.

1. Foundations of Banks and Financial Contracts (3 weeks)

** Gorton G. and A. Winton, (2002) "Financial Intermediation", Handbook of the Economics of Finance. Eds: George Constantinides, Milt Harris and Rene Stulz. North Holland.

** Modigliani, F. and M. Miller (1958) "The Cost of Capital, Corporation Finance and the Theory of Investment", American Economic Review, 48, 261-297.

a) Liquidity Provision and Consumption Smoothing

*** Diamond D. and P. Dybvig (1983), "Bank Runs, Deposit Insurance and Liquidity", Journal of Political Economy, 91, 401-419.

*** Holmstrom H. and J. Tirole, (1998), "Private and Public Supply of Liquidity", Journal of Political Economy, 106, 1-40.

** Allen, F and D. Gale (2004) "Financial Intermediaries and Markets", Econometrica, 72, 1023-1062.

** Gorton, G and L. Huang (2004) "Liquidity, Efficiency, and Bank Bailouts", American Economic Review, 94, 455-483.

** Green E. and P. Lin (2000) "Diamond and Dybvig's Classical Theory of Financial Intermediation: What's Missing?". Federal Reserve Bank of Minneapolis Quarterly Review, 24.

** Jacklin, C and S. Bhattacharya (1988) "Distinguishing Panics and Information-based Bank Runs: Welfare and Policy Implications", Journal of Political Economy, 96, 568-592.

b) Monitoring Delegation

*** Gale D. and M. Hellwig (1985), "Incentive Compatible Debt Contracts: The One-Period Problem". Review of Economic Studies, 52, 647-663.

*** Diamond D.(1984), "Financial Intermediation and Delegated Monitoring", Review of Economic Studies, 51, 393-414.

** Townsend, R. (1979), "Optimal Contracts and Competitive Markets with Costly State Verification", Journal of Economic Theory, 21, 265-293.

* Bester, H. (1985) “Screening vs. Rationing in Credit Markets with Imperfect Information”, American Economic Review, 71, 393-410.

* Farhi, E. and J. Tirole (2008) “Competing Liquidities: Corporate Securities, Real Bonds and Bubbles”, mimeo, Harvard.

c) Information Production

*** Stiglitz J. and A. Weiss (1981), “Credit Rationing in Markets with Imperfect Information”, American Economic Review, 71, 393-410.

*** Leland H. and D. Pyle (1977) “Informational Asymmetries, Financial Structure, and Financial Intermediation”, Journal of Finance, 31, 371-387.

** Campbell T. and W. Kracow, (1980), “Information Production, Market Signaling and the Theory of Financial Intermediation”, Journal of Finance, 35, 863-881.

* Boyd J. and E. Prescott (1986), “Financial Intermediary Coalitions”, Journal of Economic Theory, 38, 211-232.

d) Incomplete Contracts and Commitment

*** Aghion P. and P. Bolton (1992), “An Incomplete Contracts Approach to Financial Contracting”, Review of Economic Studies, 59, 473-494.

*** Diamond D. and R. Rajan (2001), “Liquidity Risk, Liquidity Creation, and Financial Fragility: A Theory of Banking”, Journal of Political Economy, 94, 691-719.

* Hart, O (1994) “A Theory of Debt Based on the Inalienability of Human Capital”, Quarterly Journal of Economics, 109, 841-879.

* Hart, O (1995) “Firms, Contacts and Financial Structure”, Clarendon Lectures in Economics, Oxford University Press.

2. Financial Frictions and Aggregate Fluctuations (1week)

*** Carlstrom C. and T. Fuerst (1997) “Agency Costs, Net Worth and Business Fluctuations: A Computable General Equilibrium Analysis”, American Economic Review, 87, 893-910.

** Kiyotaki N. and J. Moore (1997), “Credit Cycles” Journal of Political Economy, 105, 211-248.

** Ordonez, G (2009) “Larger Crises, Slower Recoveries: The Asymmetric Effects of Financial Frictions”, mimeo, Yale.

** Chari V.V. and P. Kehoe (2009). “Confronting Models of Financial Frictions with the Data”, Mimeo, Minnesota.

* Lorenzoni, G (2008) “Inefficient Credit Booms”, Review of Economic Studies, 75, 809-833.

* Aiyagari, R (1994) “Uninsured Idiosyncratic Risk and Aggregate Saving”, Quarterly Journal of Economics, 109, 659-684.

* Krusell, P. and A. Smith (1998), “Income and Wealth Heterogeneity in Macroeconomics”, Journal of Political Economy, 106, 867-896.

* Angeletos G.M. and L. Calvet (2006), “Idiosyncratic Production Risk, Growth and the Business Cycle”, Journal of Monetary Economics, 53, 1095-1115.

3. Financial Crises (2 weeks)

a) Bubbles

*** Tirole J. (1982), “On the Possibility of Speculation under Rational Expectations”, Econometrica, 50, 1163-1181.

** Allen, Morris and Shin (2006), “Beauty Contests and Iterated Expectations in Asset Markets”, Journal of Financial Studies, 19, 719-752.

* Tirole, J (1985) “Asset Bubbles and Overlapping Generations”, Econometrica, 53, 1499-1528.

* Abreu, D and M. Brunnermeier (2003) “Bubbles and Crashes” Econometrica, 71, 173-204.

* Harrison J. and D. Kreps, (1978), “Speculative Investor Behavior in a Stock Market with Heterogeneous Expectations”, Quarterly Journal of Economics, 92, 323-336.

* Angeletos G.M. and I. Werning (2006) “Crises and Prices: Information Aggregation, Multiplicity and Volatility” American Economic Review, 96, 1720-1736.

* Hellwig, C and G. Lorenzoni (2009), “Bubbles and Self-Enforcing Debt”, Econometrica, 77, 1137-1164.

* Allen, F. and G. Gorton (1993), “Churning Bubbles”, Review of Economic Studies, 60, 813-836.

b) Panics

*** Allen F. and D. Gale (1998), “Optimal Financial Crises”, Journal of Finance, Papers and Proceedings, 53, 1245-1284.

*** Morris, S. and H.S. Shin (1998) “Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks”, American Economic Review, 88, 587-597.

*** Morris, S. and H.S. Shin (2000) “Rethinking Multiple Equilibria in Macroeconomics”, NBER Macroeconomics Annual, 139-161. (See also de discussions by Andy Atkeson and Helene Rey).

* Gorton G. and L. Huang, (2006) “Bank Panics and the Endogeneity of Central Banking”, Journal of Monetary Economics, 53, 1613-1629.

* Williamson, S (1988), “Liquidity Banking and Bank Failures”, International Economic Review, 29, 25-43.

* Banerjee, A. (1992) “A Simple Model of Herd Behavior” Quarterly Journal of Economics, 107, 797-817.

* Caplin, A. and J. Leahy (1994) “Business as Usual, Market Crashes, and Wisdom After the Fact”, American Economic Review, 84, 548-565.

4. Regulation and Reputation in Financial Markets (1 week)

*** Diamond, D. (1991) “Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt”, Journal of Political Economy, 99, 689-721.

*** Ordonez, G. (2009) “Fragility of Reputation and Clustering of Risk Taking”, mimeo, Yale.

** Farhi, E., M. Golosov and A. Tsyvinski (2009) “A Theory of Liquidity and Regulation of Financial Intermediation”, Review of Economic Studies, 76, 973-992.

** Atkeson, A., C. Hellwig and G. Ordonez (2009), “Optimal Regulation in the Presence of Reputation Concerns”, mimeo, Yale.

** Caballero, R; T. Hoshi and A. Kashyap (2008), “Zombie Lending and Depressed Restructuring in Japan”, American Economic Review, 98, 1943-1977.

* Diamond, D. (1989) “Reputation Acquisition in Debt Markets”, Journal of Political Economy, 97, 828-862.

* Gorton, G. (1996) “Reputation Formation in Early Bank Note Markets”, Journal of Political Economy, 104, 346-397.

* Gorton, G. (1996) “Reputation Formation in Early Bank Note Markets”, Journal of Political Economy, 104, 346-397.