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*American University*  
*Department of Economics*

*Policy Issues in Financial Economics, Economics 639,*  
Spring 2008, Mondays, 8:10-10:40 PM, Ward 201

Modern financial economics provides the tools relevant to examining a range of central public policy issues. Recently, the use of modern finance has been applied to international financial instability, including explanations of crises in Asia and Latin America. Economists and policymakers often focus on the macroeconomic and fiscal policy aspects of these crises and pay little attention to critical financial structure issues. Applying the modern finance perspective offers guidance about public policy issues affecting pensions, the banking system, housing policy, education finance, environmental markets, and health policy. The tools in modern finance for the treatment of risk and uncertainty help us understand these issues and analyze which policies are likely to prove most effective.

This course will examine the application of modern finance to such questions as:

- What are the essential ways a financial system can guarantee loans and deposits?
- How are financial imbalances linked to the global financial crises?
- Should the international financial system develop bankruptcy for governments?
- What should governments do to encourage pensions and to help people assure themselves of an adequate retirement income?
- How can the tools of modern finance be used effectively to deal with environmental risks and with reducing the costs of environmental clean-up?
- Can the tools of modern finance improve our understanding of how to evaluate government investments?

My goal is that students learn not only about specific policy issues, but also about how to approach issues likely to emerge over time. The class will involve some lectures, but will rely heavily on class discussions, student presentations, and guest speakers. Readings will mostly be available through the class blackboard site. There is no text for the course.

I will base student grades on the following four components:

1. Class participation, 20%
2. Student project (paper and presentation), 50%
3. Exam, 30%

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**Topics, Readings, Assignments**

January 14 **Course Overview: Underlying Issues in Applying Finance Tools to Public Policy**

Robert Merton and Zvi Bodie. "On the Management of Financial Guarantees." *Financial Management*. Vol. 21 (4). p 87-109. Winter 1992.

Todd Groome et al. "The Limits of Market-Based Risk Transfer and Implications for Managing Systemic Risk." IMF Working Paper. WP/06/17. September 2006.

David Rule. "Risk transfer between banks, insurance companies and capital markets" *Financial Stability Review*. 2001..

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January 28 **International Financial Crises: Causes**

Michael Pettis, *The Volatility Machine*. Oxford University Press. 2001. Chapters 1-2, 6.

Dale Gray, Robert Merton, and Zvi Bodie, "A New Framework For Analyzing and Managing Macroeconomic Risks of an Economy," National Bureau of Economic Research, Working Paper 12637.

Mark Allen, Christoph Rosenberg, Christian Keller, Brad Setser, and Nuriel Rubini, "A Balance Sheet Approach to Financial Crises." IMF Working Paper 02-210, 2002.

Recommended: Jack Boorman, et al. "Managing Financial Crises: The Experience in East Asia." *Carnegie- Rochester Conference Series on Public Policy*. Vol. 53 (0). p 1-67. December 2000; and comments by Thomas Willett. 67-79.

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February 4 **No class**

February 11 **International Financial Crises: Solutions**

Sections from Lex Rieffel, *Restructuring Foreign Debt: The Case for Ad Hoc Machinery*. Brookings Institution Press. 2004.

Jeremy Bulow. "First World Governments and Third World Debt." *Brookings Papers on Economic Activity*. 2001 and Comment by .

Nuriel Roubini. "Do We Need a New Bankruptcy Regime?" *Brookings Papers on Economic Activity*. 2001.

Edward Borensztein and Paulo Mauro, "Reviving the Case for GDP-Linked Bonds." IMF Working Paper PDP 02/10. 2002.

Marcos Chamon and Paulo Mauro. "Pricing Growth-Indexed Bonds." IMF Working Paper WP/05/216. November 2005.

Erwin Quirin and Jose Joaquin Lopex. "Mexico's Financial Vulnerability: Then and Now." *Economic Letter*. Federal Reserve Bank of Dallas. 2006.

Garry Schinasi, Burkhead Drees, and William Lee. "Managing Global Finance and Risk" *Finance and Development*, December 1999. 36:4. 1-4.

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February 18    **Conceptual Issues in Pension Finance**

Zvi Bodie. "Pensions" in *The New Palgrave Dictionary of Money and Finance*. The McMillan Press Limited. 1992.

Zvi Bodie. "Financial Engineering and Social Security Reform." Delivered at NBER Conference on Pensions, 1999.

Bruce Jurin and William Margrabe, "The JP Morgan Framework for Measuring (and Managing the Risk of) Overfunding and Underfunding in a Defined Benefit Pension Plan"

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February 25    **Pension Policy Issues and Annuities in the US and Other Countries**

Zvi Bodie. "On Asset-Liability Management and Federal Deposit and Pension Insurance." And Deborah Lucas. "Commentary". *The Federal Reserve Bank of St. Louis Review*, July/August 2006. 323-336.

Zvi Bodie and Robert Merton. "International Pension Swaps." *Journal of Pension Economics and Finance*. March 2002.

Douglas Elliot. *PBGC Policy Options*. Center on Federal Financial Institutions. 2005.

Robert Holtmann. "Toward a Reformed and Coordinated Pension System in Europe: Rationale and Potential Structure." The World Bank. 2004.

George A. Mackenzie, *Annuity Markets and Pension Reform*. Chapters 3 and 4. Cambridge University Press. 2006.

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March 4    **Insuring Deposits in Banking Systems**

Merton, Robert C and Zvi Bodie. "Deposit Insurance Reform: A Functional Approach" and "Reply." *Carnegie-Rochester Conference Series on Public Policy*. p 1-34 and 51-55. June 1993. Also see comments by George J. Benston and George G Kaufman and by Mark J. Flannery, pp 35-39 and 41-49.

Ash Demirgüt-Kunt and Edward Kane. "Deposit Insurance Around the Globe: Where Does it Work?" *Journal of Economic Perspectives*. Spring 2002. 175-196.

James R. Barth, Gerard. Caprio, and Ross. Levine, *Rethinking Bank Regulation: Till Angels Govern*. Cambridge University Press. 2006. Various chapters.

Garry J. Schinasi, *Safeguarding Financial Stability: Theory and Practice*. International Monetary Fund. Chapters 8, 9, and 10.

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March 11    **Spring break**

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March 18

**Regulating Banking and Securities Trading**

*Implications of the Growth of Hedge Funds.* Staff Report of the Securities and Exchange Commission. Executive Summary. 2004. Also

William Fung and David Hsieh. "Hedge Funds: An Industry in Adolescence." And Franklin Edwards. "Hedge Funds and Investor Protection Requirements." In *Federal Reserve of Atlanta Economic Review*. Fourth Quarter 2006. 1-49.

Frank Partnoy, "ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?" *Brookings-Wharton Papers on Financial Services*. 2002. 213-252

Stign Claessens, Daniela Klingebiel, and Sergio Schmuckler. "The Future of Stock Exchanges in Emerging Economies: Evolution and Prospects." *Brookings-Wharton Papers on Financial Services*. 2002. 167-212

Charles Calomiris and Robert Litan. "Financial Regulation in a Global Marketplace." *Brookings-Wharton Papers on Financial Services*. 2000. 283-339.

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March 25

**Structure of Housing Finance and Regulation**

Allen Frankel, Jacob Gyntelberg, Kristian Kjeldsen, and Mattias Persson, "The Danish Mortgage Market." *BIS Quarterly Review*. March 2004, 95-109.

Richard Greene and Susan Wachter. "The American Mortgage in Historic and International Context." *Journal of Economic Perspectives*. Fall 2005.

Judith Hardt and David Manning. "European mortgage markets: structure, funding and future development." OECD. June 2000.

Edward Skelton. "Laying the Foundation for a Mortgage Industry in Mexico." *Economic Letter*. Federal Reserve Bank of Dallas. 2006.

**Role of Government-Sponsored Enterprises in Secondary Mortgage Market**

Jay Cochrane and Catherine England. "Neither Fish nor Fowl: An Overview of the Big-Three Government Sponsored Enterprises in the U.S. Housing Finance Markets." November 2001. Mercatus Center Working Papers in Regulatory Studies.

John M. Quigley. "Federal Credit and Insurance Programs: Housing." And John Weicher. "Commentary." *The Federal Reserve Bank of St. Louis Review*, July/August 2006. 281-322.

Eugene Ludwig. "Systemic Risk: A Regulator's Perspective." *Fannie Mae Papers*, Issue 2, Volume 1. February 2003.

Alex Pollack. "The Housing GSEs: Through Competition to Privatization." American Enterprise Institute. *Financial Services Outlook*. August 2004.

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April 1	<p><b>Other Housing Finance Issues and the Community Reinvestment Act</b></p> <p>Souphala Chomsisengphet and Anthony Pennington-Cross. “The Evolution of the Subprime Mortgage Market.” <i>The Federal Reserve Bank of St. Louis Review</i>, January-February 2006. 31-56.</p> <p><i>The 25<sup>th</sup> Anniversary of the Community Reinvestment Act: Access to Capital in a Revolving Financial Services System.</i> Joint Center for Housing Studies, Harvard University. Sections 2-5. <a href="http://www.jchs.harvard.edu/crareport.html">http://www.jchs.harvard.edu/crareport.html</a></p> <p>Additional readings to be assigned</p>
April 8	<p><b>Uses of Financial Economics in Education, Training, Loan Guarantees, and Environmental Policies</b></p> <p>Robert Lerman and David Nickerson. “Uncertainty, Cost-Benefit Analysis and the Design of Social Experiments.” Unpublished mimeo.</p> <p>Douglas Elliot. “On the Importance of the Plumber: The Intersection of Theory and Practice in Policymaking for Federal Financial Institutions.” <i>The Federal Reserve Bank of St. Louis Review</i>, July/August 2006. 259-272.</p> <p>Deborah Lucas, Marvin Phaup, and Ravi Prasad. “Valuing Government Loan Guarantees: The Effect of Risk.” Congressional Budget Office. October 2003.</p> <p>Robert Pindyck, “Uncertainty in Environmental Economics.” National Bureau of Economic Research Working Paper No. 12752. December 2006.</p>
April 15	<p><b>Credit Issues in Consumer Markets: Usury Laws and Other Regulatory Policies</b></p> <p>Selections from <i>The Impact of Public Policy on Consumer Credit</i>, edited by Thomas A. Durkin (Editor), Michael E. Staten (Editor)</p> <p>James Lacko, Signe-Mary McKernan, and Manoj Hastak. “Customer Experience with Rent-to-Own Transactions.” <i>Journal of Public Policy and Marketing</i>, Spring 2002.</p> <p>Wenli Li. “To Forgive or Not to Forgive: An Analysis of U.S. Consumer Bankruptcy Choices.” <i>Economic Quarterly</i>. Federal Reserve Bank of Richmond. Spring 2001.</p> <p>Michael S. Barr. “Banking the Poor: Policies to Bring Low-Income Americans Into the Financial Mainstream.” The Brookings Institution. Research Brief. 2004.</p>
April 22	<p><b>Student Reports</b></p>
May 5	<p><b>Final Exam: Term Paper Due</b></p>