

SYLLABUS
ECON 230 Financial Markets and Institutions
Prof. Miles Cahill
Spring 2010

CONTACT INFORMATION

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Course meeting time: Tuesdays and Thursdays, 9:30-10:45, Stein 307

Office Hours: Tues.: 2-3:30, Wed.:10-12, 2-3, Thurs.: 2:00-3:30 and by appointment and drop-in

Important web resources:

Moodle: <http://www.holycross.edu/login/>; *login:* your Novell logon ID

Reserve articles (ERes): <http://eres.holycross.edu/coursepage.asp?cid=877>; *password:* fim

Text web site: http://wps.prenhall.com/bp_fabozzi_finmkt_4/108/27865/7133612.cw/index.html

WHO MAY TAKE THIS COURSE?

The course is open to all students who have taken the prerequisites. It counts as a lower-level elective for economics majors and an elective for economics-accounting majors. This course satisfies the finance elective requirement for taking the CPA exam in New York and some other states. The prerequisites are ECON 111 *Principles of Macroeconomics*, ECON 112 *Principles of Microeconomics*, and high school mathematics. You are expected to understand basic concepts from these courses, like economic modeling, the supply and demand model, the meaning of interest rates, solving linear equations and using graphs.

EXAM AND PROJECT DATES, POINTS

Midterm 1: Thursday, February 25, in class, 100 points (20%)

Midterm 2: Thursday, April 8, in class, 100 points (20%)

Final Exam: Monday, May 10, 2:30 p.m., 150 points (30%)

Quizzes (6): Announced one class ahead of time, 15 points (3%) each

Project overview: Tuesday, March 30 in class, 10 points (2%)

Presentation: Tuesday April 27 or Thursday April 29, 25 points (5%)

Written report: Tuesday, May 4 at 2:00, 25 points (5%)

Attendance: Every day, 5 bonus points total (1%)

COURSE OVERVIEW

This course gives a basic introduction to the main features of financial institutions and markets in the United States, focusing on markets and institutions that failed during the recent turmoil. The first part of the course covers interest rates and securities pricing, including rate of return calculations, how markets determine the overall level of interest rates, and why different securities pay different interest rates. The second part of the course covers financial markets, related financial institutions and the assets that are traded on these markets, including the money, bond, stock, and derivatives markets. Throughout the course, we will try to understand how the “Great Panic” evolved.

COURSE MATERIALS

Required materials:

Text: Fabozzi, Modigliani and Jones, *Foundations of Financial Markets and Institutions*, 4th ed., Prentice Hall, 2010.

Newspaper: *New York Times* or *Wall Street Journal* (print or on-line)

Readings: There are several articles for you to read on ERes, including appendices to the text

Text web site: Contains some extra book chapters; practice questions may be added later.

Office hours: You are very strongly encouraged to meet with me during my office hours if you need any assistance understanding material covered in class or the readings; if you would like to go over exams, quizzes or other questions; have any questions about the economics major or economics courses; or if you would like to ask about and/or discuss any economic issue. The biggest mistake many students make at college is not using office hours, especially early in the semester. So, stop by early and often!

Homework problem sets: Throughout the year, your homework usually in the form of problem sets will be posted on Moodle. These assignments are a combination of textbook problems and my own. I will not collect or grade these assignments, though you will find it very difficult to do well on quizzes and exams if you do not complete them on time. A few days after the homework sets are distributed (and always before relevant exams and quizzes), answers will be posted on Moodle.

e-mail: It is your responsibility to regularly check e-mails and respond as appropriate.

GRADING

Exams: There will be two midterm exams and one final exam. Each of the midterms will be 75 minutes, and the second exam will not be cumulative. Specific content on the exams will be announced at least one week ahead of time. Expect the midterm exams to take the entire period to finish, even for those who understand the material well. At least one of the questions on each midterm will have you use the material you learned in class to answer a real-world question you likely have not previously considered. These should work as incentives to learn the material well, follow current events, and to test your ability to use the material learned in this course. The final exam will be cumulative. In contrast to the midterms, do not expect to need the entire (three hour) period to finish the final exam.

Quizzes: Six quizzes will be given during the course of the semester. The quizzes will be short, 10-15 minutes each, covering limited material announced ahead one class ahead of time. Quizzes will usually cover important or difficult topics to keep you studying and completing homework assignments and are designed to get you ready for exams.

Presentation and report: The class will be divided into 6 groups of 4 students. Each group will be assigned a financial regulator upon which to present a twenty minute report. The report must consist of the following elements: a concise description of the duties of the regulatory body, a short history of why it was created, and a description of how the regulator acted during the recent financial crisis. The written report should be approximately 10 pages with sources fully cited. All members of the group will receive the same base grade based on the presentation and the report, adjusted by a peer review by the other members of the group.

Attendance: Attendance at each class is mandatory. If you have a serious problem that forces you to miss class, it is your responsibility to let me know ahead of time if possible. Furthermore, I reserve the right to request a note from the class dean or other authority. If you miss a quiz or midterm due to an excused absence, your final score will be re-weighted except in extreme circumstances. If you do not miss classes (without an excuse) you will be awarded 5 bonus points on to your final grade.

Distribution of grades: The grade distribution for each assignment will be provided when assignments are turned back to you. Your cumulative point and grade total will be provided when exams are turned back to you. As an insurance policy, you are guaranteed at least the "straight scale," but it is likely that the distribution will be looser than the straight scale. In the past, my courses have tended to have the department average of about 2.8/4.0.

Academic dishonesty: The College policy on academic dishonesty is clear and spelled out in the *College Catalogue*. Academic dishonesty includes cheating on exams and assignments (by using or providing prohibited materials) and plagiarism, which includes the deliberate *or unintentional* use of another's ideas or language without proper attribution. See the presentation assignment handout for specific guidelines on avoiding plagiarism. I am required to report any act of plagiarism (intentional or not) that results in any grade reduction to your Class Dean for academic dishonesty disciplinary proceedings as described in the *Catalogue*.

COURSE OUTLINE AND READINGS

The following is an outline of course content with assigned readings from the textbook (FMJ text) and readings available in ERes. The italicized chapter appendices are available on the textbook's web site and ERes. Readings are coded by number; the list of articles follows the outline. An asterisk (*) denotes significant material not covered in the text.

Topic	FMJ text	Readings
UNIT 1: INTRODUCTION TO COURSE (4 classes)		
Overview of ongoing financial crisis	*	{1}, {2}
Asymmetric information problems (moral hazard/adverse selection)	*	{3}
Overview of financial system	1	{4},{5}
Types of assets, markets	"	
Introduction to derivatives	"	
Regulations and financial innovation	"	
Overview of institutions	2	
Overview of risk	"	
UNIT 2: INTEREST RATES AND ASSET PRICES (4 classes)		
Key characteristics of securities	9(170-6)	
Measuring interest rates		
Present value, yield to maturity, rate of return	9(176-9), 9A	
The discount rate	9(176-7)	
Real vs. nominal interest rates	9(194-5)	
Stock price and return calculations	*	{6}
Determining the level of market interest rates	10(192-5), *	
Asset and loanable funds market models (supply/demand curves, shifts, equilibrium)	*	
UNIT 3: STRUCTURES OF INTEREST RATES, MARKET PRICING MODELS (5½ classes)		
Structures of interest rates	9(180-8), 10(201-13), 11	
Risk structure	10(201-13)	
Spreads and premiums	9(176-7), 10(201-13)	{7},{8}
Interest rate and reinvestment risk	9(180-7)	
Duration	", *	
Term structure and yield curve	11(218, 224-239)	{9}
Theories	11(230-5)	
Calculating forward rates	11(224-230), *	
Interpreting the yield curve	11(236-8), *	
Default risk	12	
Diversification	12(246-8)	
Types of risk, measuring risk with beta	12(249-52)	{10}
CAPM and APT models	12(252-66)	
Conventional risk management	3(40-2)	{11}
The efficient markets hypothesis	14(288-9), 17(357-9)	{12}

Topic	FMJ text	Readings
UNIT 4: DEBT AND EQUITY SECURITIES (4½ classes)		
Overview		
Example: Iowa Electronic Markets	*	{13}
Growth and importance of financial markets	*	{14}
Primary markets	13	
Secondary markets	14	
Money markets	15, 19, 21	
Instruments		
Treasury Bills	15(302-3)	
Commercial Paper	19(401-5)	
Repurchase agreements	15(303-5)	
Instruments issued by banks	21	
Bond capital markets	20	
Treasury securities	15(2954-302, 303, 305-10)	
Federal Agency securities	15(310-3)	
Corporate bonds and preferred stock	20	
Medium-term corporate notes	19(405-8)	
Common Stock markets	17-18	
Overview, types of trades, costs, indexes	17	{15}, {16}
Types of markets	18, 18A	
UNIT 5: DERIVATIVE SECURITIES (3 classes)		
Securitization		{17}
Asset-backed securities	25	
Collateralized debt obligations	31(639-42)	
Credit default swaps	31(634-6)	
Role in recent financial crisis	31(645-8)	
Financial futures		
Overview	26	
Pricing	28(566-8)	
Uses	29(590-4), 29A	
Options		
Overview	27	
Pricing	28(574-9)	{18}
Uses	29(595-6){18}	
Interest rate swaps	30(603-20)	
UNIT 6: FINANCIAL REGULATORS IN FINANCIAL CRISIS (3 classes)		
Student presentations (Text provides some coverage of each regulator)		
Securities and Exchange Commission (SEC)		
Commodity Futures Trading Commission (CFTC)		
Federal Reserve System (Fed)		
Office of the Comptroller of the Currency (OCC)		
Federal Deposit Insurance Corporation (FDIC)		
Office of Thrift Supervision (OTS)		
Summary of recent financial crisis	*	{1},{19},{20}

List of Readings: Readings are listed in course order. They are available for downloading from Eres (password fim) or from original document sites when listed.

- {1} Federal Reserve Bank of San Francisco (2010), *The Economy: Crisis and Response*, <http://www.frbsf.org/econanswers/portal.htm>
- {2} Yellen, Janet L. (2009), "A View of the Economic Crisis and the Federal Reserve's Response," *FRBSF Economic Letter*, 2009-22, July 6. <http://www.frbsf.org/publications/economics/letter/2009/el2009-22.html>
- {3} Rosenblum, Harvey, Danielle DiMartino, Jessica J. Renier and Richard Alm (2008), "Fed Intervention: Managing Moral Hazard in Financial Crises," *Economic Letter* (Fed-Dallas) Vol. 3 No. 10 (October). <http://www.dallasfed.org/research/eclett/2008/el0810.html>
- {4} Yunus, Mohammad, (1999) "The Grameen Bank," *Scientific American*, Vol. 281, No. 5, November, pp. 114-9.
- {5} Valderrama, Diego, (2003), "Financial Development, Productivity, and Economic Growth," *FRBSF Economic Letter* (Fed-SF), No. 2003-18, June 27. <http://www.frbsf.org/publications/economics/letter/2003/el2003-18.html>
- {6} Marshall, David and Duffy, Denise, (1998), "Whither the stock market?" *Chicago Fed Letter*, August. <http://www.chicagofed.org/publications/fedletter/1998/cflaug98.pdf>
- {7} Lopez, Jose A. (2008a), "What Is Liquidity Risk?" *FRBSF Economic Letter*, 2008-33, October 24. <http://www.frbsf.org/publications/economics/letter/2008/el2008-33.html>
- {8} Christensen, Jens (2008), "The Corporate Bond Credit Spread Puzzle," *FRBSF Economic Letter* 2008-10, March 14. <http://www.frbsf.org/publications/economics/letter/2008/el2008-10.html>
- {9} Poole, William, (2005), "Understanding the Term Structure of Interest Rates," *Review* (Fed-St. Louis) Vol. 87, No. 5 (Sept./Oct.), pp. 589-596. <http://research.stlouisfed.org/publications/review/05/09/Poole.pdf>
- {10} Lopez, Jose A., (2002), "What is Operational Risk?," *FRBSF Economic Letter*, No. 2002-02, January 25. <http://www.frbsf.org/publications/economics/letter/2002/el2002-02.html>
- {11} Lopez, Jose A., (2003), "How Financial Firms Manage Risk," *FRBSF Economic Letter*, No. 2003-03, February 14, pp. 1-3. <http://www.frbsf.org/publications/economics/letter/2003/el2003-03.html>
- {12} Malkiel, Burton G., (2003), "The Efficient Markets Hypothesis and Its Critics," *Journal of Economic Perspectives*, Vol. 17, No. 1 (Winter): pp. 59-82.
- {13} Gomme, Paul, (2003), "Iowa Electronic Markets," *Economic Commentary* (Fed-Cleveland), April 15. <http://www.clevelandfed.org/Research/Commentary/2003/0415.pdf>
- {14} Duca, John V., (2001), "The Democratization of America's Capital Markets," *Economic and Financial Review* (Fed-Dallas), 2nd quarter: pp. 10-19. <http://dallasfed.org/research/efr/2001/efr0102b.pdf>
- {15} Kwan, Simon, (1996), "On the Relation between Stocks and Bonds - Part I & II," *FRBSF Economic Letter*, June 28 and July 5. (2 articles) <http://www.frbsf.org/econrsrch/wklyltr/el96-19.html>, <http://www.frbsf.org/econrsrch/wklyltr/el96-20.html>
- {16} McAndrews, James J. and Stefanadis, Chris, (2000) "The emergence of electronic communications networks in the U.S. equity markets," *Current Issues in Economics and Finance* (Fed-NY), Vol. 6 No. 12. http://www.newyorkfed.org/research/current_issues/ci6-12.pdf
- {17} Ergungor, O. Emre, (2003), "Securitization," *Economic Commentary* (Fed-Cleveland), August 15. <http://www.clevelandfed.org/research/commentary/2003/0815.pdf>
- {18} Nosal, Ed and Tan Wang, (2004), "Arbitrage: The Key to Pricing Options" *Economic Commentary* (Fed-Cleveland), January 1. <http://www.clevelandfed.org/Research/Commentary/2004/0104.pdf>
- {19} Neely, Christopher J., (2004), "The Federal Reserve Responds to Crises: September 11th Was Not the First," *Review* (Fed-St. Louis), Vol. 86, No. 2 (March/April): pp. 27-42. <http://research.stlouisfed.org/publications/review/04/03/Neely.pdf>
- {20} Yellen, Janet L. (2008), "The Financial Markets, Housing, and the Economy," *FRBSF Economic Letter*, 2008-13-14, April 18. <http://www.frbsf.org/publications/economics/letter/2008/el2008-13-14.html>