COURSE DESCRIPTION

Please complete the following information:

<table>
<thead>
<tr>
<th>Course Number and Title</th>
<th>ECO 395L Financial and economic crises, exchange rate regimes, and monetary and fiscal policy</th>
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<tbody>
<tr>
<td>Semester and Year</td>
<td>Fall 2022</td>
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<tr>
<td>Instructor’s Name and Academic Rank</td>
<td>Valerie R Bencivenga, Senior Lecturer (or Professor of Instruction)</td>
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<tr>
<td>Cross Listing Information</td>
<td>NA</td>
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<tr>
<td>Previous Title and/or Course #</td>
<td>NA</td>
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Description (one to three paragraph description of course content):

The overarching objective is for students to understand why sound macroeconomic policies (financial market regulation and interest rate/exchange rate and fiscal policies) are important for a set of interrelated outcomes: investment (including capital flows); productivity (and therefore incomes and growth); exchange rate and price level stability, stability of interest rates, government debt, and foreign exchange reserves; and financial sector depth and development. The approach will be to discuss financial and economic crises jointly with the economic theory needed to understand why the crises happened and how well-designed policies could have prevented them or better handled them. The crises we’ll consider are listed below. Relevant economic theory will include aspects of international finance, monetary theory, growth theory, and the theory of banking and financial intermediation. The crises will serve as “laboratories” that reveal the characteristics of well-designed policies.

We’ll cover a short-run model of the exchange rate based on uncovered interest parity; a long-run model of the exchange rate based on differential real growth rates and trend inflation rates; and how an exchange rate is "defended" (the capacity to do so is limited, which is what can lead to crises). We’ll discuss why a country might give up a flexible exchange rate in favor of a fixed exchange rate, currency board, or common currency such as the euro, and the relationship between a country's exchange rate regime and its monetary and fiscal policy options. We’ll cover a limited set of topics in growth theory in order to understand why internationally (and within a country) funds flow to where their marginal productivity is highest; why international capital flows are not sufficient to equalize output per worker; and how freely-flowing capital can actually increase the output gap between poor and rich countries (when labor is not mobile and there are externalities in the process of capital accumulation that result in increasing returns to scale in the aggregate production function). We’ll cover the basics of the theory of financial intermediation (banking) in order to understand how a drop in the value of government bonds (due to a fiscal crisis) or a drop in house prices (when a house price bubble bursts) can lead to a financial crisis. Banking theory also shows us the importance of regulators shutting down almost-insolvent banks, because of moral hazard. All of the above will be taught in an analytical way, using models that are exposited mathematically and/or graphically. Each element will be motivated by a specific policy question in the context of one of the crises we are studying. The course is designed to value regardless of whether or not a student has had prior courses in macroeconomics, international finance, and growth theory. If a student has not had these courses previously, they’ll learn self-contained pieces of economic reasoning and theory. If a student has had one or more of these courses previously, this course will show connections between different courses and models, and how to apply them.

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The course will cover a number of crises:

- **European sovereign debt crisis and the Eurozone economic crisis (2010-present):** This crisis is still simmering, despite rescues and reforms that have made the underlying situation more robust. Italy's huge government debt could lead to a resurgence of the crisis. Financial markets are still segmented. It is still important to understand how the design of the European Union and the euro contributed to the crisis. The Eurozone lets us easily see the pros and cons of currency unions, fixed exchange rates (and how a currency union differs from a fixed exchange rate regime), and flexible exchange rates.

- **Iceland (2008)** shows that you don't need a fixed exchange rate or a big government budget deficit to have an exchange rate crisis and banking crisis. Poor monetary policy and poor banking regulation set Iceland up as a destination for the “carry trade” (capital flows that take advantage of departures from “uncovered interest parity”). Banks were allowed to grow explosively via expansion of euro-denominated deposits, although Iceland’s central bank did not have enough euros in reserve to bail out Iceland’s banks.

- **Argentina** instituted a currency board in 1991 to tie the government’s hands with respect to “printing money” to finance big government budget deficits, which had caused hyperinflation, and to enhance Argentina’s credibility in global financial markets. The currency board “broke” in 2001 and arguably should have been abandoned five years earlier. We will use this case study to understand the conditions for a fixed exchange rate regime (or currency board) to be credible and speculative attacks on a fixed exchange rate.

- **Mexican peso crisis (1994-95):** In Mexico, a poorly-regulated banking system, a fixed exchange rate, and a big government budget deficit led to financial (banking) and economic crises.

- **Asian economic crisis (1997-98):** Several Asian countries had currency crises as a result of a “sudden stop” in capital inflows. Understanding why “sudden stops” occur is important for good monetary policy and financial market regulation.

- **Chile (late 1970’s and early 1980’s):** This crisis presaged the Mexican peso crisis and the Asian economic crisis. It gives us a stark illustration of the importance of financial market regulation, sound fiscal policy, and appropriate monetary policy for a small open economy.

- **US financial crisis of 2008-09:** At the time, I gave a number of talks on the US financial crisis (inside and outside of UT). Students may be interested in why the crisis occurred, and whether it could happen again. Recently, I have been asked whether the US is likely to have a financial crisis due to events in the crypto/"decentralized finance" (DEFI) sector. Not yet, but over the longer run good regulation would help. We can cover this topic if students are interested.

- **India, Sri Lanka, Turkey, Japan:** If students are interested, we can discuss recent developments concerning key currencies.

- **Hyperinflations:** If students are interested, we can cover why hyperinflations happen. This would be easy to incorporate.

**List of Proposed Texts /Readings (N/A, TBD, and Course Packet are not acceptable responses):**

**OPTIONAL:** The following textbooks are optional but each of them has considerable value. My lecture notes are very comprehensive and you can rely on them (and the assigned articles, discussed below) for the assignments. There is no single book or set of books that will be best for all students – what's best for any one student will depend on their previous courses (including as an undergraduate) and on their interests. Besides the international finance textbook, which also contains some growth theory (Feenstra and Taylor), these books focus on the European debt crisis and the Eurozone economic crisis. Articles

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will be assigned for the other crisis we will study (as well as for the European economic crisis).

Richard Baldwin and Charles Wyplosz, The Economics of European Integration, 6th edition, McGraw Hill (April, 2021). Recommended for students who are interested in the EU and the Eurozone. This book covers the relevant theory of international trade as well as the monetary economics of a currency union. It is a classic reference.

Paul de Grauwe, Economics of Monetary Union, 13th edition, Oxford University Press (2020). This book complements Baldwin and Wyplosz. Students who already have had macroeconomics and monetary economics will get the most of out of book.

Robert C. Feenstra and Alan M. Taylor, International Macroeconomics, 5th edition, Worth Publishers, 2020). Any edition from the 2nd to the 5th will work. Classic international finance textbook. Some parts of some lectures will be based on this book (and again, my lecture notes are very comprehensive). If you are interested in international finance and did not have an undergraduate course, you may enjoy this book.

Markus K. Brunnermeier, Harold James, and Jean-Pierre Landau, The Euro and the Battle of Ideas, Princeton University Press (2017). A political economy treatment of why European countries have differed on their desired design of the European Union and the Eurozone, and on the response the EU and the ECB should have had to the European debt crisis (2010-present).


REQUIRED: Articles from VoxEU, Project Syndicate, Financial Times, Economist, Wall Street Journal, etc., will be assigned (I will provide a link to each). There will be a number of articles for each crisis that we will study. In all, there will be dozens of articles, with most of them being short (several pages each). Parts of your assignments will be based on the articles. It is not possible to list all of the articles here. Here are some of the articles upon which the assignment on the European banking crisis will be based (one assignment), to provide a feeling for the types of articles students will be reading. Also see the section on the assignments that follows.

- “Why coco bonds are worrying investors”, Financial Times, Feb 9, 2016
- “ECB is having second thoughts on ‘coco’ bonds”, Financial Times, April 24, 2016
- “Greeks’ worst fear is run on banks”, Financial Times, Nov 2, 2011
- “Greek bank capital accelerates”, Financial Times, Feb 28, 2017
- “EU banks could shrink to hit capital rules”, Financial Times, Oct 12, 2011
- “IMF sees banks deleveraging by $2.6 trillion”, Financial Times, April 18, 2012
- “In and Out of Each Other’s Wallets”, New York Times, April 30, 2010
- “Is Europe facing a ‘Bear Stearns’ moment?”, Financial Times, May 5, 2010

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- “German, French Banks Vulnerable-- Analysts say a 'severe' blow in store for lenders if Greece defaults on its debt; lack of information roils markets”, Wall Street Journal, April 29, 2010
- “Eurozone – A nightmare scenario”, Financial Times, Sep 16, 2011
- “Signs another Eurozone financial crisis is looming”, Financial Times, Feb 15, 2016
- “Breaking the ‘doom loop’ could take ten years”, Financial Times, June 21, 2016
- “Study says banks in EU stress tests could require 900 bn euros”, Financial Times, July 28, 2016
- “DBRS downgrades Italy in blow to banking system”, Financial Times, Jan 13 2017
- “Defending the Euro Starts with Cleaning Up the Banks – Why European bad loans are more than just an economic burden”, Wall Street Journal, Feb 27, 2017
- “Cleaning up Europe’s Bad Loans”, Wall Street Journal, Aug 8, 2017
- “Completing Banking Union”, VoxEU, Feb 12, 2016
- “Italy resists Brussels’ tough love on banks”, Financial Times, Jan 17, 2017
- “Over-indebtedness and moral hazard in the European Monetary Union”, VoxEU, Sep 7, 2015

Proposed Grading Policy:

Homework assignments (approximately 12): 100%

Attendance and participation: Extra credit (15%). I will not drop any assignments, but good attendance and participation can make up for one or two assignments.

There will be no exams. Evaluation will be based on a set of homework assignments. The assignments will require problem-solving and explanations ranging from one or two sentences to two or three paragraphs. Some problems will require algebraic solutions and/or graphs. Some questions will require several paragraphs laying out economic reasoning based on the lectures and/or reading. Where an explanation is requested, I will be specific about a suggested length (for example, 1-2 sentences, or 2-3 paragraphs). For a couple of the assignments, I’ll ask students to read a sequence of articles and in a parallel fashion work through bank balance sheets or graphs, which illustrate what is described in the articles. One assignment will involve using FRED (the Federal Reserve Bank of St. Louis database with graphing and downloading into Excel) in the context of the European debt crisis. (The assignment will come with step-by-step instructions for using FRED, and at the end of the assignment, students will know how to use FRED, and the coverage of FRED data.)

There is a mix of types of questions in the assignments, but the unifying objective is to understand important mechanisms of economic theory (international finance, growth, macroeconomics, banking, etc.) and to apply them to real-world crises. These assignments will teach you how to apply economic analysis when you read about current events, and will help build connections between your courses. If a student does the work, the student will do well on the assignments, and will learn a lot.

Each assignment (and the links to the associated articles) will be posted at least two weeks before the assignment is due.
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Chair/Associate Chair
Signature: ___________________________  Date: ____________

Associate Dean
Signature: ___________________________  Date: ____________

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