

PG Course Outline
EC5360: The Economics of Banking
2017/18

Spring: The Economics of Banking (20 credits)

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Aims

The course's aim is to provide a theoretical economic analysis of the economics of banking and the potential fragility of the financial system. The course will include analysis of why banks exist and why bank runs may occur, with reference to the most recent global financial crisis of 2007-2008. The course's textbook will be Freixas and Rochet "Microeconomics of Banking", but will also use "Understanding Financial Crises", Clarendon Lectures in Finance by Franklin Allen and Douglas Gale.

Learning Outcomes

Upon completion of this course students should:

- Understand the economic meaning of the terms liquidity and solvency in the context of financial intermediaries and understand simplified frameworks for analysing these concepts and be able to answer problems based on these frameworks
- Have an understanding of some explanations for why banks exist and the role that they play in the modern economy.
- Understand models of equilibrium bank runs and be able to answer problems based on these frameworks
- Understand some models of the implications of imposing capital requirements on financial intermediaries

Course Delivery

There will be one two-hour lecture per week and one seminar per week. The lectures will be used primarily for expounding the economic theory and the seminars for going through problem sets although there may be some reversal of this demarcation between lectures and seminars in some weeks. You are advised that solving the homework problems will be of enormous help in preparing for the examinations, although they will not be part of the formal method of evaluation. You should prepare answers to the problems before the weekly seminars and expect to present them to the rest of the group. Note that lecture notes and homework answer sheets are NOT given out or placed on Moodle in this course. This is because I have found that students engage more with the course and learn more when handouts are not available. This benefits everyone attending lectures and seminars. This has been a successful policy in previous years and will not be changing this year. Please note that while seminar attendance is compulsory and is monitored by the department, attendance at lectures is also an essential part of the course.

Communication and Office Hours



I will endeavour to answer emails within three working days during term time. Most questions will be answered by going over the material at the start of the next lecture or seminar so that all students can benefit. However if you do want to go through something directly with me then you can email to arrange a slot during my office hours. Please note that I do not answer homework questions directly by email.

Textbooks

Microeconomics of Banking, Xavier Freixas and Jean-Charles Rochet, MIT Press (2008)
Understanding Financial Crises, Clarendon Lectures in Finance by Franklin Allen and Douglas Gale
OUP (2009)

Assessment

A Mid-Term exam during one of the lecture periods will comprise 25% of the final mark. An unseen examination in the summer term will contribute the remaining 75% to the final mark. Please refer to the student handbook for the scheduling of these exams.

Timetable

Note that the following timetable is indicative and that not all topics may be covered

Week 1 Introductory Concepts and Why Banks Exist

At the end of this part of the course you should understand the concepts of solvency and liquidity.

Readings

Admati, Anat R. & Martin F. Hellwig (2013). *The Bankers' New Clothes*, Princeton University Press
Admati, Anat R. , Peter M. DeMarzo, Martin F. Hellwig & Paul Pfleiderer. (2013) "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive" Stanford Graduate School of Business Working Paper.
Freixas and Rochet, Chapter 1 and 2

Homeworks

Week 2 The Choice Between Market Debt and Bank Debt

At the end of this part of the course you should understand some explanations for why some firms borrow from banks as opposed to issuing bonds.

Readings

Freixas and Rochet, Chapter 2

Homeworks

Week 3 The Diamond and Dybvig Model of Bank Runs

At the end of this part of the course you should understand a model of bank runs based on the analysis of Diamond and Dybvig and demonstrate an ability to solve problems based on this model

Readings

Freixas and Rochet, Chapter 7
Diamond, D. W. and P. Dybvig (1983). "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* 91, 401-419.

Homeworks

Week 4 The Allen and Gale Model of Bank Runs

At the end of this part of the course you should understand a model of bank runs based on the analysis of Allen and Gale and demonstrate an ability to solve problems based on this model.

Readings

Freixas and Rochet, Chapter 7
Allen and Gale, chapter 3.
Allen, F. and D. Gale. "Optimal Financial Crises," *Journal of Finance* 53, 1245-1284.

Homeworks

Week 5 Policy Responses for dealing with Financial Crises

At the end of this part of the course you should understand and be able to answer questions based on deposit insurance, suspension of convertibility and the problem of moral hazard

Readings

Freixas and Rochet , chapter 7 and 9

Homeworks

READING WEEK

Week 6 MID-TERM EXAM

Week 7 Asset Price Bubbles and Financial Crisis

At the end of this part of the course you should understand a model of asset price bubbles and financial crises and demonstrate an ability to solve problems based on this model.

Readings

Allen and Gale, chapter 10.

Allen, F. and D. Gale (1999). "Bubbles, Crises and Policy," *Oxford Review of Econ.Policy*, 15, 9-18

Homeworks

Week 8 and 9 Contagion and Financial Stability and the crisis of 2007-8

At the end of this part of the course you should understand a model of contagion and financial stability and the broad facts about the 2007-8 financial crisis including the growth of securitization and demonstrate an ability to solve problems based on this model.

Readings

Freixas and Rochet, Chapter 7

Allen and Gale, chapter 11.

Admati, A & M. Hellwig (2013). *The Bankers' New Clothes*, Princeton University Press

Brunnermeier, Markus (2009). *Deciphering the Liquidity and Credit*

Crunch 2007–2008. *Journal of Economic Perspectives*—Vol(23), No.1—Winter 2009—p 77–100

Gorton, G. (2009). *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007*

Prepared for the Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference: *Financial Innovation and Crisis*

Kaminsky, G. and C. Reinhart (1999). "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems," *American Economic Review* 89, 473-500.

Homeworks and Revision

Week 10 Revision