Financial Stability
Françoise DRUMETZ and Christian PFISTER (Banque de France, ENSAE)

Syllabus

Number of hours: 24

Language of tuition: English

Teachers: Françoise DRUMETZ and Christian PFISTER (Banque de France, ENSAE)

Pre-requisite: Students will preferably have a basic background in macro- and microeconomics. No mathematical skills will be needed.

Evaluation: Weighted average of (i) assignments during term (2/3), (ii) final exam (1/3).

Course description

The severity of the financial crisis which began in the summer of 2007 continues to surprise not only the general public but also market practitioners, economists and journalists.

Faced with this challenge, the course presents an overview of the main theoretical and empirical knowledge available on the causes and consequences of financial instability. We then discuss the lessons that can be learned so as to avoid repeating past mistakes.

Outline of the course

1. General presentation of the course/Notions (beginning): definition of financial stability; financial fragility, leverage and liquidity; moral hazard and Too Big to Fail (TBTF)

Exposés
- Is there a cost to financial stability?
- Is finance intrinsically instable?
- Market liquidity/Funding liquidity
- Why is moral hazard an issue for financial stability?
- If banks are TBTF, it is because they are too big to start with: Comment on that statement
- Is TBTF an issue for financial stability?
2. Notions (continuation)/ Financial crisis (beginning): bubbles and contagion; systemic risk; what is a financial crisis?

Exposés
- Rational bubbles
- Contagion: what does it mean?
- Can we eliminate systemic risk?
- Do we have a good theoretical explanation of financial crises?

Required reading


3. Crisis (continuation): what were the roots of the crisis?

Exposés
- A historical perspective: is the last financial crisis different?
- A financial crisis or different crises?
- Should we be afraid of the shadow banking system?
- A modern version of “bank runs”?
- Leverage and procyclicality
- Global imbalances and the financial crisis
- International financial linkages and the financial crisis

Required reading


4. Incentivizing (beginning): motivation and modalities of a public intervention; innovation and financial stability; managing moral hazard in financial market infrastructures

Exposés
- Incentives versus constraints: What are the trades-offs?
- Positive versus normative approach to financial regulation: What are the consequences for regulatory reform?
- Should financial innovation be patented?
- Do risk management measures in financial market infrastructures just move risk around? If it does, can it still be useful?

Required reading


5. Incentivizing (continuation): role of rating agencies; securitization; accounting standards; governance; reducing moral hazard (definition of financial contracts; resolution of institutions)

Exposés
- Rating agencies; do we need them to implement financial stability policies?
- Is securitization detrimental to financial stability?
- Mark to market: Should we kill the messenger bringing bad news?
- What is “good governance” from a financial stability point of view?
- What are the best ways to reduce moral hazard in financial activities?
- What is an efficient resolution mechanism?

Required reading


Committee on the Global Financial System, (2009), The role of valuation and leverage in procyclicality, April.


6. Incentivizing (continuation): taxing ; remunerating

**Exposés**
- In which sense can noise trading be dangerous for financial stability?
- Is the TFT useful from a financial stability point of view?
- Regulating the structure of remunerations versus regulating their level
- Are traders overpaid?

**Required reading**


7. Constraining (beginning): institutions (deposit insurance, limitation of activities)

**Exposés**
- Do we need an insurance deposit scheme?
- Should banks activities be limited? If yes, to what extent and how?
- Vickers/Volcker/Liikanen: A comparison
- Should shadow banking be regulated? How?
Required reading


8. Constraining (continuation)/Liquidity and solvency standards (beginning): financial markets (high frequency trading, short sales, use of market infrastructure, dark pools); costs of liquidity and solvency requirements

Exposés
- Is short selling destabilizing?
- Does HFT create risks for financial stability?
- OTC derivatives central clearing: a panacea
- Is bank capital costly? Does it matter?

Required reading:


9. Liquidity and solvency standards (continuation): Basle I, Basle II, shadow banking system and pro-cyclicality; Basle III

**Exposés**
- Why did banks behave pro-cyclically under Basle I/II ?
- How does Basle III improve on Basle II?
- Leverage vs solvency ratios
- Does it make sense to impose liquidity ratios on banks?
- Liquidity ratios: State of play
- Can insurance companies create systemic risk?
- What is a “good” bank supervisor?

**Required reading**
10. Macroprudential policies: objectives, indicators, instruments and implementation issues (communication, coordination, information needs), the Dodd Franck Act

Exposés
- Why do we need macroprudential policies?
- Is the credit/GDP ratio useful for macroprudential policies?
- Stress tests: Are improvements necessary?
- Are indicators of systemic risk useful?
- What instruments does the macroprudential authority have at its disposal?
- Should there be limits to the transparency of the macroprudential authority?
- Micro and macro surveillance of the financial system

Required reading

11. Economic policies and financial stability: monetary policy (lender of last resort, role of financial stability considerations, fiscal dominance); fiscal policy; public (tax, competition, housing) policies

Exposés
- Lender of last resort: classic versus modern
- What is financial repression? Do we need it?
- Fiscal policy and inflation: a tale of two theories?
- Would financial stability be fostered by a pre-emptive strike of the central bank?
- Are inflation targeting strategies undermined by the financial crisis?
- Monetary and macroprudential policies: undesirable Interactions?
- The financial stability-fiscal policy nexus
- A trigger? Tax policy and the real estate bubble
- Are GSEs such as Fannie Mae etc. useful?
- Should bank competition be encouraged?

**Required reading**


**12. Institutions: general, international and European aspects**

**Exposés**

- What role should the central bank have in the institutional architecture of financial stability?
- Is it possible to avoid the capture of the financial regulator?
- Does the IMF have a role to play in the realm of financial stability at the global level?
- Is there a need for an international lender of last resort?
- Private sector involvement: who opposes it and why?
- Should risks be shared in the euro area? If yes, how?
- Are fiscal councils useful?
- Have the flaws in the SGP been corrected with the Treaty on Stability, Coordination and Governance (TSCG)?
- How can a euro area resolution mechanism be created?
**Required reading**


