

## **NBA543, Financial Markets and Institutions**

**Warren Bailey**

**Fall 2002**

**Mondays and Wednesdays, 1:25pm to 2:40pm or 4:25pm to 5:40pm**

This course applies principles of finance to understand modern financial markets. Central themes of the course are the structure of financial markets, the pricing function markets perform, the interaction between financial markets and macroeconomic conditions, and the processes of innovation and regulation in these markets. We will look at the workings of a variety of markets and develop an understanding of the different problems which different types of markets address. We will study the question of market efficiency and the interaction between government policies and financial markets. We will analyze issues in innovation and regulation with basic principles of financial economics. Throughout the course, we will consider the relevance of these issues for the practical corporate, portfolio, or public sector decision-maker.

The course will include ideas and evidence from academic research along with historical, institutional, and international perspectives. Recent events will be used to illustrate concepts and develop analytic skills. Spreadsheet assignments and a term project requiring data analysis will develop your research skills and illustrate academic concepts.

This subject has few clear-cut answers or cookbook solutions. Students should be prepared to confront ambiguity, apply independent thinking, and juggle conflicting concepts and solutions in approaching the course material, lecture style, term project, and exams.

### **Course Materials:**

Course Packet (required).

Other materials to be made available online or to be distributed in class.

### **List of Topics and Readings:**

#### **I. Introduction to Financial Markets**

#### **II. Financial Market Structures**

- A. "Irrelevance" and financial theory:** how market imperfections enrich the economic setting and yield relevance for corporate leverage, dividend policy, diversification, hedging, insurance, leasing

Cornell and Shapiro, 1987, "Corporate Stakeholders and Corporate Finance," *Financial Management* 16, p. 5-14.

#### **B. Workings of selected markets**

Schaede, 1989, "Forwards and Futures in Tokugawa-Period Japan", *Journal of Banking and Finance* 13, p. 487-513.

Blume and Siegel, 1992, "Appendix: The Structure of World Equity Markets" in *Financial Markets, Institutions, and Instruments* 1, p. 43-50.

Stock Exchange of Thailand, 1997, "The Stock Exchange of Thailand Trading System Manual", p. 1-12.

### **C. Illustrations and Evidence**

Diamond and Dybvig, 1983, "Bank Runs, Deposit Insurance, and Liquidity," *Journal of Political Economy* 91, p. 401-19.

James and Wier, 1988, "Are Bank Loans Different? Some Evidence from the Stock Market," *Journal of Applied Corporate Finance* 1, p. 46-54.

James and Smith, 2000, "Are Banks Still Special? New Evidence on their Role in the Corporate Capital Raising Process", *Journal of Applied Corporate Finance* 13, p. 52-63.

Rajan, 1996, "Why Banks have a Future: Toward a New Theory of Commercial Banking", *Journal of Applied Corporate Finance* 9, p. 114-128.

Buckley, 1997, "The Canadian Keiretsu", *Journal of Applied Corporate Finance* 9, p. 46-56.

Koh and Walter, 1989, "A Direct Test of Rock's Model of the Underpricing of Unseasoned Issues," *Journal of Financial Economics* 23, p. 251-72.

Black and Gilson, 1999, "Does Venture Capital Require an Active Stock Market?", *Journal of Applied Corporate Finance* 11, 36-47.

### **III. Pricing of Risky Assets in Financial Markets**

**A. The time value of money:** theories of the term structure of interest rates, determination of corporate and municipal bond yields

**B. Valuing equities:** basic issues, the equilibrium risk/return trade-off

**C. Market efficiency:** theories and illustrations

Buell, Stephen, 1992, "The Accuracy of the Initial Pricing of Junk Bonds", *Journal of Fixed Income* 2, p. 77-83.

Leroy, 1990, "Capital Market Efficiency: An Update," *FRBSF Economic Review*

(Spring) p. 157-168.

Brown, Harlow, and Tinic, 1989, "How Rational Investors Deal with Uncertainty," *Journal of Applied Corporate Finance* 2, p. 45-58.

Lee, Schleifer, and Thaler, 1990, "Closed End Mutual Funds," *Journal of Economic Perspectives* 4, p. 153-64.

Keane, 1991, "Paradox in the Current Crisis in Efficient Market Theory", *Journal of Portfolio Management* 15, 30-34.

Silber, 1994, "Technical Trading: When It Works and When it Doesn't", *Journal of Portfolio Management* 39-44.

**D. Market efficiency:** explaining "bubbles" and "crashes", differing portfolio management styles

Garber, 1989, "Who Put the Mania in Tulipmania?", *Journal of Portfolio Management* 13, 53-60.

**IV. The Macroeconomy and Financial Markets**

**A. Current and historical monetary policy**

Bordo, 1981, "The Classical Gold Standard: Some Lessons for Today," *FRB St. Louis Review* (May), p. 2-17.

**B. Evidence from financial market prices**

Beckers, Stan, 1991, "Stocks, Bonds, and Inflation in World Markets", *Journal of Fixed Income* 1, p. 18-30.

Harvey, Campbell, 1991, "The Term Structure and World Economic Growth", *Journal of Fixed Income* 1, p. 7-19.

Bonser-Neal and Morley, 1997, "Does the Yield Spread Predict Real Economic Activity? A Multi-country Analysis", *Economic Review* (FRB Kansas City), 3<sup>rd</sup> quarter, p. 37-53.

Ederington and Lee, 1996, "The Impact of Macroeconomic News on Financial Markets", *Journal of Applied Corporate Finance* 9, p. 41-49.

Bailey, 1989, "The Effect of U.S. Money Supply Announcements on Canadian Stock, Bond, and Currency Prices," *Canadian Journal of Economics* 22, p. 607-18.

**V. Innovation, Regulation, and Crisis**

## **A. Innovations in securities markets**

Miller, Merton, 1992, "Financial Innovation: Achievements and Prospects", *Journal of Applied Corporate Finance* 4, p. 4-11.

Tufano, Peter, 1992, "Financial Innovation and First Mover Advantages", *Journal of Applied Corporate Finance* 5, p. 83-87.

Markowitz, Harry, 1992, "Markets and Morality", *Journal of Portfolio Management* 16, p. 84-93.

## **B. Crises in the financial industry**

Kaufman, 2000, "Banking and Currency Crises and Systemic Risk: Lessons from Recent Events", *Economic Perspectives* (FRB Chicago), 3<sup>rd</sup> quarter, p. 9-28.

Rolnick and Weber, 1982, "Free Banking, Wildcat Banking, and Shinplasters," *FRB Minneapolis Quarterly Review* (Fall) 10-19.

## **Office Hours:**

Ordinarily, I am available often on an "open door" basis. If you are having difficulty finding me, please email or call. Furthermore, fixed office hours may be used at busy times of the semester.

## **Homework Exercises:**

Several spreadsheet exercises are based on data stored in Excel files. They are intended to enhance and reinforce the lectures and strengthen your computing and data analysis skills. Each student is required to upload an electronic copy of his or her work on each such assignment to the campus-wide system, <http://courseinfo.cit.cornell.edu/courses>. Furthermore:

1. Each homework file must be named with course number, family name, given name, and assignment identifier. For example, NBA543\_Castro\_Fidel\_A.xls. The "subject" line (which appears in courseinfo's uploading dialog box) must also contain this filename.
2. I cannot accept spreadsheet assignments emailed to me directly.

## **Exams:**

Exams are closed book and consist of computational, short answer, and short essay questions. The following rules and procedures govern the examinations:

1. The midterm exam will be held in class on **Monday 21<sup>st</sup> October 2002**.
2. Copies of old midterms are included in the course packet.
3. The final exam will be held during finals week and at the time set by the Johnson School Registrar.
4. Copies of old finals are **not** supplied.
5. For both the midterm and the final, there will be **no** specially scheduled exams, make-up exams, or other special arrangements under any circumstances other than those prescribed by Johnson School or University rules.

### **Term Project:**

Each student must independently complete and submit a term project. The paper is due by the end of class on **Monday 2<sup>nd</sup> December 2002**. Papers received substantially before the deadline will earn extra credit. The following rules govern the submission of the term paper:

1. Term papers must be submitted in hard copy (that is, paper) form only.
2. Submission on a diskette, by email, or by uploading to the "Courseinfo" system is not acceptable.
3. Late papers will not be accepted under any circumstances. Any paper received after the date and time indicated for the deadline will receive zero points.

A handout detailing term paper requirements, suggesting topics, and grading will be supplied. Each term project must be based on collection and statistical analysis of an original data set.

### **Final Letter Grades:**

A rough guide to how final grades will be determined is as follows: midterm 30%, term project 30%, final 30%, and homework 10%. The instructor reserves the right to determine the final letter grade assigned to each student.

### **Two sections:**

You must attend the section for which you are registered. In particular, you must write exams for the specific section you are registered for and submit the term paper by the deadline for the specific section you are registered for.

## **Warning:**

**If you register for this class, you agree to accept all course requirements, deadlines, exam dates,**

**and other procedures outlined in this syllabus and in the term paper description handout. There will be no discussions, pleas, or arguments about these aspects of the administration of the course under any circumstances.**