

GRAD-C8-104: Economics II: Economic and Financial Market Policy**Hans Peter Grüner****1. General Information**

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| Class Time | Selected Thursdays, 09.00 - 12.00h February 11, 18, 25, March 11, 18, April 15, 29, May 6 |
| Course Format | Initially (February and March), the Economics II lecture will be taught online, in real time, via the platform Clickmeeting or Teams. The lecture may move back to the classroom at a later stage. Small participatory labs will accompany the lecture and will be taught onsite at the Hertie School, or online via the platform Clickmeeting or Teams, depending upon your location. |
| Convener | Prof. Hans Peter Grüner |
| Office | - |
| E-Mail | gruener@hertie-school.org |
| Telephone | |
| Assistant | Email: adjunctsupport@hertie-school.org |
| Office Hours | Online office hours will be available. |

Link to Module Handbook [MIA](#) and [MPP](#)Link to [Study, Examination and Admission Rules](#)**Instructor Info:**

Hans Peter Grüner is a Professor of Economics at the University Mannheim (since 1999) and, since 2006, an adjunct professor at the Hertie School. He studied economics and mathematics at Heidelberg University. 1994 Docteur de l'Ecole des Hautes Etudes en Sciences Sociales in Paris (dissertation on "Central bank credibility and wage setting in Europe").

Grüner's research focuses on the design of political and economic institutions. He has published widely on political economy, applied mechanism design theory, economic and monetary policy, capital market theory, labor market reform and the theory of income and wealth distribution.

Grüner has also been a consultant and advisor to several companies and institutions including UBS, BMW, Deutscher Bundestag, Auswärtiges Amt, the European Commission and the European Central Bank. He was awarded fellowships from the EU-Commission and the European Central Bank, is a Research Fellow of CEPR, London, a member of the Royal Economic Society, and serves on the editorial board of the European Journal of Political Economy. Academic visits to Northwestern University,

Oxford University, University of Pennsylvania, London Business School, the Toyota Center at the LSE, UCL, and the Hebrew University Jerusalem.

2. Course Contents and Learning Objectives

Course contents:

The proper functioning of financial markets is essential for the functioning of any developing or advanced market economy. This course deals with important challenges to (economic) policymakers. In the first session, we lay the groundwork and refresh basic analytical instruments in economics. We introduce and discuss a modern view of the role of economics and provide an overview of fundamental results from general equilibrium theory, and welfare economics. In the second session, we provide a thorough introduction to game theory and mechanism design. On this basis, we discuss why financial markets are important in practice. We analyze the role of financial intermediaries and the risks that are associated with financial intermediation. We compare traditional financial intermediation with recent innovations (peer to peer funding). Moreover, we study cases in which financial markets fail to work properly and we discuss appropriate policy responses. Sessions 4 and 5 are devoted to the analysis of fiscal and monetary policy measures that affect financial markets. In Session 6 students present their casework on the design of a new financial and economic order in Europe.

Main learning objectives:

Students learn to

- understand incentive problems in financial relationships,
- deal with allocation problems on financial markets,
- analyse and address related policy problems.

Target group:

This course is offered as **an Economics II course for first year MPP/MIA students**. The course is designed for students who would like to get a broad overview of advanced analytical methods in order to apply them to practical political problems. Formal concepts that we use will be explained in detail along the way. Applications and experiments will play a prominent role during the first two sessions.

Teaching style:

Teaching by instructor, continuous discussion of content and casework.

Prerequisites:

Some prior knowledge in economics and minimal mathematical skills (taking derivatives and solving equations with two unknowns) is very helpful.

3. Grading and Assignments

Composition of Final Grade:

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| Assignment 1: Take home test | March 5 | Submit via Moodle | 25% |
| Assignment 2: Midterm exam | Mid-Term Exam Week | TBD | 30% |

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| Assignment 3 (if applicable): Final exam | Final exam week | TBD | 45% |
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Assignment Details

Assignment 1

The take home test covers the most fundamental analytical concepts from the first two course sessions.

Assignment 2

The midterm exam covers basic insights from session 1 - 4 the course. While a large part of the course relies on formal arguments, the exam will mostly verify whether students have a basic intuitive understanding of the basic insights and results.

Assignment 3

The final exam covers the main insights from the entire course. While a large part of the course relies on formal arguments, the exam will mostly verify whether students have a basic intuitive understanding of the basic insights and results.

Late submission of assignments: For each day the assignment is turned in late, the grade will be reduced by 10% (e.g. submission two days after the deadline would result in 20% grade deduction).

Attendance: Students are expected to be present and prepared for every class session. Active participation during lectures and seminar discussions is essential. If unavoidable circumstances arise which prevent attendance or preparation, the instructor should be advised by email with as much advance notice as possible. Please note that students cannot miss more than two out of 12 course sessions. For further information please consult the [Examination Rules](#) §10.

Academic Integrity: The Hertie School is committed to the standards of good academic and ethical conduct. Any violation of these standards shall be subject to disciplinary action. Plagiarism, deceitful actions as well as free-riding in group work are not tolerated. See [Examination Rules](#) §16.

Compensation for Disadvantages: If a student furnishes evidence that he or she is not able to take an examination as required in whole or in part due to disability or permanent illness, the Examination Committee may upon written request approve learning accommodation(s). In this respect, the submission of adequate certificates may be required. See [Examination Rules](#) §14.

Extenuating circumstances: An extension can be granted due to extenuating circumstances (i.e., for reasons like illness, personal loss or hardship, or caring duties). In such cases, please contact the course instructors and the Examination Office *in advance* of the deadline.

4. General Readings

A very good textbook that helps you to refresh and upgrade your microeconomics is

- Jehle Geoffrey A. and Philip J. Reny (2011) *Advanced Microeconomic Theory*, FT Prentice Hall. (JR)

A very interesting book on financial innovation is:

- Palmer, Andrew (2015) *Smart Money*, Basic Books, New York.

Some basics on financial markets can be found in

- Mishkin, Frederic, S., Kent Matthews and Massimo Guiliodori (2013) The Economics of Money Banking and Financial Markets, European Edition. (MMG)

5. Session Overview

| Session | Session Date | Session Title |
|-------------------------------------------------------|-------------------|-------------------------------------------------------------|
| 1 | February 11, 2021 | Analytical instruments and fundamental results in economics |
| 2 | February 18, 2021 | Games, experiments and the design of rules for society |
| 3 | February 25, 2021 | Financial intermediation and financial stability |
| 4 | March 11, 2021 | Financial market imperfections and economic inequality I |
| 5 | March 18, 2021 | Financial market imperfections and economic inequality II |
| 6 | April 15, 2021 | Fiscal sustainability |
| 7 | April 29, 2021 | Monetary policy institutions |
| 8 | May 6, 2021 | Towards a consistent European economic policy framework |
| Final Exam Week: 17.05 - 21.05.2020 – no class | | |

6. Course Sessions and Readings

Required readings are either accessible via a link from this syllabus or uploaded on the Moodle site before semester start. In the case that there is a change in readings, students will be notified by email.

Required readings are to be read and analysed thoroughly. Optional readings are intended to broaden your knowledge in the respective area and it is recommended to skim them at least.

Session 1: February 11, 2021

Analytical instruments and fundamental results in economics

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| Aim | <ul style="list-style-type: none"> • Economics and the use of information in society: Hayek, Hurvic, Myerson • Economic policy and the use of information in society • APPLICATION 1: Goethe: Matching couples • APPLICATION 2: The European refugee crisis and the use of information in society • Economist's analytical framework <ul style="list-style-type: none"> ○ Methodological individualism: Preferences (reading: JR 1.1.-1.2.) ○ Rational choice: Utility functions, budget sets and optimization (JR 1.3.) ○ A minimalistic requirement: Pareto efficiency (JR 5.1.) ○ General equilibrium (JR 5.1.-5.2.) |
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| | <ul style="list-style-type: none"> • Welfare economics <ul style="list-style-type: none"> ○ The invisible hand: The two fundamental theorems of welfare economics JR 5.2. ○ Market failure ○ Asymmetric information: The use of knowledge in society ○ Constrained efficient allocations and government failure • Why financial markets? <ul style="list-style-type: none"> ○ Arrow Debreu Securities (JR 5.4.) ○ Complete vs. incomplete markets ○ What is a financial market? ○ The world without financial markets |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Jehle Geoffrey A. and Philip J. Reny (2011) <i>Advanced Microeconomic Theory</i>, FT Prentice Hall. (JR), chapters are noted above</p> <p>Hayek, F.A. (1945) "The use of knowledge in society", <i>American Economic Review</i>, 35, 519 – 530. https://www.kysq.org/docs/Hayek_45.pdf</p> |
| Optional Readings | Palmer, Andrew (2015) Preface and Chapters 1-3. |

Session 2: February 18, 2021

Games, experiments and the design of rules for society

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| Aim | <ul style="list-style-type: none"> • Game theory (JR 7.1) <ul style="list-style-type: none"> ○ Normal form (JR 7.2) <ul style="list-style-type: none"> ▪ Players, payoffs, strategies ▪ Strategy profiles ○ Nash equilibrium ○ Mixed strategies equilibrium: Soccer ○ Extensive form (JR 7.3) <ul style="list-style-type: none"> ▪ Elements of a game tree ▪ The allocation of information ○ Subgame perfection ○ Experimental economics <ul style="list-style-type: none"> ▪ The ultimatum game ▪ The trust game • Mechanism design <ul style="list-style-type: none"> ○ Bayesian games ○ Bayesian equilibrium ○ The revenue from four auctions • APPLICATION 3: Designing a school admission mechanism • APPLICATION 4: Designing a scheme for the financing of public goods • APPLICATION 5: Incentivizing the manager of a cafeteria |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Jehle Geoffrey A. and Philip J. Reny (2011) <i>Advanced Microeconomic Theory</i>, FT Prentice Hall. (JR), chapters are noted above</p> |
| Optional Readings | Palmer, Andrew (2015) Preface and Chapters 1-3. |

Session 3: February 25, 2021

Financial intermediation and financial stability

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| Aim | <ul style="list-style-type: none">• Returns to scale in contracting• Returns to scale in information gathering (Informal treatment)• Maturity transformation) (Informal treatment)• Bank runs and deposit insurance<ul style="list-style-type: none">○ The need for deposit insurance○ Deposit insurance and risk taking• Crowdfunding• Financial contagion<ul style="list-style-type: none">○ Financial contagion○ Financial contagion in 2008/9: The emergence of the financial crisis○ The need for bank supervision |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Hellwig, M. (2009) Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis. <i>De Economist</i>, 157 (2), 129-207. https://link.springer.com/content/pdf/10.1007%2Fs10645-009-9110-0.pdf</p> <p>Diamond, D.W. and P. Dybvig "Bank runs, deposit insurance and liquidity", <i>Journal of Political Economy</i>, 91(3) 1983, pp.401-19. https://www.macro-economics.tu-berlin.de/fileadmin/fg124/financial_crises/literature/Diamond_Dybvig_Bank_Runs_Deposit_Insurance_and_Liquidity.pdf</p> |
| Optional Readings | <p>Allen, F. und Gale, D. (2000) Financial Contagion. <i>The Journal of Political Economy</i>, 108/1, 1-33. https://www.journals.uchicago.edu/doi/10.1086/262109</p> <p>Barth, Caprio, and Levine (2008) <i>Till Angels Govern</i>, Cambridge, http://www.cambridge.org/gb/academic/subjects/economics/finance/rethinking-bank-regulation-till-angels-govern.</p> <p>Diamond, D.W. "Financial intermediation as delegated monitoring", <i>Federal Reserve Bank of Richmond Economic Quarterly</i> 82, 51-66 https://notendur.hi.is/ajonsson/kennsla2006/diamond.pdf</p> <p>Diamond, D.W. "Financial intermediation and delegated monitoring", <i>Review of Economic Studies</i>, 51(3) 1984, pp.728-62.</p> <p>Grüner, H. P. and Siemroth, C. (2019) Cutting out the middleman: Crowdfunding, Efficiency, and Inequality. <i>Journal of the European Economic Association</i>, 17, 1393-1427. (https://cepr.org/active/publications/discussion_papers/dp.php?dpno=10488)</p> <p>Mishkin, Matthews and Guiliadori: <i>The Economics of Money, Banking and Financial Markets</i>, Pearson.</p> |

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| | Palmer, Andrew (2015) Chapters 6 and 7. |
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Session 4: March 11, 2021

Financial market imperfections and inequality I

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| Aim | <ul style="list-style-type: none"> Capital market imperfections, inequality and efficiency (Grüner and Schils, 2007) <ul style="list-style-type: none"> Investment decisions Inefficient equilibrium and market failure Government failure Lotteries Capital market imperfections, politics and economic growth (Perotti, 1993) |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Perotti, R. (1993) Political Equilibrium, Income Distribution and Growth, Review of Economic Studies, 755-776.</p> <p>http://www.jstor.org/stable/2298098?seq=1#page_scan_tab_contents</p> |
| Optional Readings | <p>Grüner, H. P. and Schils, R. (2007) The Political Economy of Wealth and Interest. The Economic Journal, 117 (October), 1403-1422.</p> <p>http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0297.2007.02088.x/epdf</p> <p>De Soto, H. The Mystery of Capital.</p> |

Mid-term Exam Week: 22 – 26.03.2021 – no class

Session 5: March 18, 2021

Financial market imperfections and inequality II

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| Aim | <ul style="list-style-type: none"> Persistent inequalities in society and across societies (Galor and Zeira, 1993) |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Galor, O. und Zeira, J. (1993) Income Distribution and Macroeconomics. Review of Economic Studies, 60, 35-52.</p> <p>http://www.jstor.org/stable/2297811?seq=1#page_scan_tab_contents</p> |
| Optional Readings | |

Session 6: April 15, 2021

Fiscal sustainability

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| Aim | <ul style="list-style-type: none"> The dynamics of debt The war of attrition explanation for excessive deficits (Fudenberg and Tirole, 1991) Redistribution and Public Debt (Lizzeri, 1999) |
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| | <ul style="list-style-type: none"> • Political uncertainty and excessive deficits (Tabellini and Alesina 1990) • Constitutional choices (Grüner, 2018) |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Tabellini, G. and Alesina, A. (1990) Voting on the Budget Deficit. American Economic Review, 80, 37-49. http://www.jstor.org/stable/2006732?seq=1#page_scan_tab_contents or http://www.nber.org/papers/w2759</p> <p>Alesina, A. and Drazen, A. (1989) Why are Stabilizations Delayed? American Economic Review, 79, 1170-1189. http://www.jstor.org/stable/2006912?seq=1#page_scan_tab_contents or https://dash.harvard.edu/bitstream/handle/1/4553028/alesina_why_stabilization_s.pdf?sequence=2</p> <p>Fudenberg, D. and J. Tirole (1991) Game Theory, (for the simple war of attrition) MIT Press.</p> <p>Lizzeri, Alessandro (1999) "Budget Deficits and Redistributive Politics," Review of Economic Studies, 66, 909-928. http://www.jstor.org/stable/2566925?seq=1#page_scan_tab_contents</p> |
| Optional Readings | <p>Grüner, H.P. (2017) „Mechanisms for the Control of Fiscal Deficits“, Journal of Economic Behaviour & Organization, 144, 133-152.</p> |

Session 7: April 29, 2021

Monetary policy institutions

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| Aim | <ul style="list-style-type: none"> • Time consistency in monetary policy <ul style="list-style-type: none"> ○ The independent and conservative central bank ○ Credibility vs. flexibility • Monetary policy and labor markets • Monetary and fiscal policy interaction • The central bank as a lender of last resort • Separation of supervision and monetary policy |
| Required Readings | <p>Main insights paper and set of questions</p> <p>Barro, R. J. and Gordon, D. B. (1983) Rules, discretion and reputation in a model of monetary policy. Journal of Monetary Economics, 12(1), 101-121. http://www.sciencedirect.com/science/article/pii/030439328390051X#</p> <p>Rogoff, K. (1985) The Optimal Degree of Commitment to an Intermediate Monetary Target. Quarterly Journal of Economics, 100, 1169-1190. http://www.jstor.org/stable/1885679?seq=1#page_scan_tab_contents</p> |

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| Optional Readings | Hellwig, M. (2014) Financial Stability, Monetary Policy, Banking Stability and Central Banking. Max Planck Institute for Research on Collective Goods, 2014/9. http://www.coll.mpg.de/pdf_dat/2014_09online.pdf |
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Session 8: May 6, 2021

Towards a consistent European economic policy framework

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| Aim | <ul style="list-style-type: none"> • The European economic policy framework before 2010 • The developments and institutional innovations after 2010 <ul style="list-style-type: none"> • The Maastricht experience and 2005 • Sanctioning mechanisms • European government debt after 2009 • The ESM • What happens if a country leaves the European currency union? Develop different scenarios. Explain the role of target balances. • Who benefits from a common deposit insurance in Europe? • How should the single resolution mechanism of the European banking union perform? How does it perform (Italy). • What should be the future role of the ESM? What does a European Monetary Fund add relative to existing structures? • Would Europe benefit from a fiscal capacity that finances incentives for reforms? How would you construct the corresponding decision mechanism? • Does Europe benefit from having a common finance minister? Does centralization of fiscal policy prevent excessive deficits? • Is the OMT program illegal? • Does Big-Tech banking require a new regulatory approach? |
| Required Readings | Main insights paper and set of questions |
| Optional Readings | <p>Grüner, H.P. (2013) "The Political Economy of Structural Reform and Fiscal Consolidation Revisited", European Economy, Economic Papers 487.</p> <p>Grüner, H. P. (2017) Optimal Mechanisms for the Control of Fiscal Deficits. Journal of Economic Behaviour & Organization, 144, 133-152.</p> |

Final Exam Week: 17 - 21.05.2021 – no class