Syllabus for Econ 281: Real Frictions and Financial Frictions

Winter 2013

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In the core Macro sequence, most of the material is devoted to the complete markets, frictionless model. While understanding how the macro economy behaves in the ideal, frictionless setting is indispensible, most of the interesting issues in macro arise as a consequence of some sort of friction or missing market. In this course, we will study some models based on "real frictions" and "financial frictions". While there are other types of real frictions that we could considers, in this course the "real friction" is a lumpy, or nonconvex, adjustment cost on adjusting the quantity of a durable good. In particular, we will look at the basic macro/finance model that is generalized to include housing, and assume that housing is subject to a nonconvex adjustment cost. The second half of the course will focus on financial frictions and their role in the financial crisis.

Lectures: Tuesdays and Thursdays, 2:00 - 3:20, Econ 304 Office Hours: Wednesdays, 1:00 - 3:00, Econ 216

Grading: Your grade for the course will be based on four short written assignments; there will not be a midterm or a final exam. The four written assignments will consist of two referee reports and two short paper proposals, one referee report and one short paper proposal for each of the two components of the course.

For each of the referee reports, you will choose a paper (not covered in class) and write a 2-3 page referee report that provides a critical assessment of the contribution of the paper.

For the "paper topic" assignments, the intent is for students to think through, and write up, the germ of a possible paper related to the material covered in the course. The "paper topic" assignments will be brief sketches (3 - 4 pages) of a potential research topic in the preliminary stage.

Reading list for "Real Frictions and Financial Frictions"

Part I: Housing with nonconvex adjustment costs

Karl E. Case and Robert J. Shiller, "The Efficiency of the Market for Single-Family Homes", American Economic Review, Vol. 79, No. 1 (March 1989), pp. 125-137.

Karl E. Case and Robert J. Shiller, "Forecasting Prices and Excess Returns in the Housing Market", Real Estate Economics, Vol 18, No. 3, (1990), pp 253-273.

John Muellbauer and Anthony Murphy, "Booms and Busts in the UK Housing Market", The Economic Journal, Vol 107, (1997), pp. 1701-1727.

Edward Leamer, "Bubble Trouble? Your Home has a P/E Ratio Too", UCLA Anderson Forecast Report, June 2002.

Delip Abreu and Markus Brunnermeier, "Bubbles and Crashes", Econometrica, Vol.71., No. 1 (Jan., 2003), pp. 173-204.

Manuel Santos and Michael Woodford, "Rational Asset Pricing Bubbles", Econometrica, Vol 65, (1997), pp 19-57.

Karl E. Case and Robert J. Shiller, "Is there a Bubble in the Housing Market?", Brookings Papers on Economic Activity, (2003), No.2, pp 299-363.

Charles Himmelberg, Christopher Mayer, and Todd Sinai, "Assessing High House Prices: Bubbles, Fundamentals and Misperceptions", The Journal of Economic Perspectives:, Vol. 19., No. 4 (Autumn, 2005), pp. 57-92.

Guiseppe Bertola and Ricardo Caballero, "Kinked Adjustment Costs and Aggregate Dynamics", NBER Macroeconomics Annual, Vol. 5 (1990), pp., 237-288.

Ricardo Caballero and Eduardo M R A Engel, "Dynamic (S,s) Economies", Econometrical, Vol. 59, No. 6, (Nov., 1991), pp. 1659-1686.

Ricardo Caballero, "Durable Goods: An Explanation for their Slow Adjustment", Journal of Political Economy, Vol. 101, No. 2 (April 1993), pp. 351-384.

Orazio Attanasio, "Consumer Durables and Inertial Behavior: Estimation and Aggregation of (S,s) Rules for Automobiles", Review of Economic Studies, Vol 67., (2000), pp. 667-696.

Sanford J. Grossman and Guy Laroque, "Asset Pricing and Optimal Portfolio Choice in the Presence of Illiquid Durable Goods", Econometrica, Vol. 58, No. 1 (1990), pp. 25-51.

Marjorie Flavin and Shinobu Nakagawa, "A Model of Housing in the Presence of Adjustment Costs: A Structural Interpretation of Habit Persistence", American Economic Review, Vol 98, No. 1, (2008), pp 474-95.

Marjorie Flavin and Takashi Yamashita, "Owner-Occupied Housing and the Composition of the Household Portfolio", American Economic Review, Vol. 92, No. 1 (Mar., 2002), pp. 345-362.

Hanno Lustig, Stijn Van Nieuwerburgh, "Housing Collateral, Consumption Insurance, and Risk Premia: An Empirical Perspective", The Journal of Finance, Vol. LX, No 3, June 2005, pp. 1167-1219.

Todd Sinai and Nicholas Souleles, "Owner-Occupied Housing as a Hedge Against Rent Risk", Quarterly Journal of Economics, Vol. 120, No. 2, pp 763-789.

Karl E. Case, JM Quigley and RJ Shiller, "Comparing Wealth Effects: the Stock Market vs. the Housing Market", Advances in Macroeconomics, Vol 6, Issue 1, (January 2005), pp 1-32.

Willem Buiter, "Housing Wealth Isn't Wealth", NBER working paper W14204, (2008).

Erik Hurst and Frank Stafford, "Home is Where the Equity is: Mortgage Refinancing and Household Consumption", Journal of Money, Credit and Banking, Vol 36, No. 6, (2004), pp. 985-1014.

Edward E. Leamer, "Housing *is* the Business Cycle", NBER Working Paper No. W13428, (2007).

Robert Shiller, "The Subprime Solution: How Today's Global Financial Crisis Happened, and What to do about it." Princeton University Press, (2008).

Francois Ortalo-Magne and Sven Rady, "Housing Transactions and Macroeconomic Fluctuations: A Case Study in England and Wales", Journal of Housing Economics, Vol 13, Issue 4, (2004) pp, 287-303.

Morris Davis and Jonathan Heathcote, "Housing and the Business Cycle", International Economic Review, Vol 46, Issue 3, (2005), pp 751-784.

Part II: Financial Frictions

Markus Brunnermeier, Thomas Eisenbach, and Yuliy Sannikov, "Macroeconomics with Financial Frictions: A Survey", March 2012.

Diamond and Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", JPE, 91(3), 401-419.

Ben Bernanke and Mark Gertler, "Agency Costs, Net Worth, and Business Fluctuations", AER, 79(1), 14-31.

Ben S. Bernanke, Mark Gertler, Simon Gilchrest, "The Financial Accelerator in a Quantitative Business Cycle Framework", Chapter 21, Handbook of Macroeconomics, Volume 1, Part C, 1999, pages 1341-1393.

Nobuhiro Kiyotaki and John Moore, "Credit Cycles", Journal of Political Economy, Vol 105, No. 2 (Apr., 1997), pp. 211-248.

Mark Gertler and Nobuhiro Kiyotaki, "Financial Intermediation and Credit Policy in a Business Cycle Analysis", Handbook of Monetary Economics, 2010.

Vasco Curdia and Michael Woodford, "Credit Frictions and Optimal Monetary Policy" working paper, 2009. <u>http://www.columbia.edu/~mw2230/credit_0709.pdf</u>

Markus Brunnermeier and Yuliy Sannikov, "A Macro model with a Financial Sector", working paper, 2012. <u>http://scholar.princeton.edu/markus/files/macro_finance.pdf</u>

Tobias Adrian, Erkko Etula, and Tyler Muir, "Financial Intermediaries and the Cross-Section of Asset Returns", forthcoming, Journal of Finance. https://fisher.osu.edu/blogs/efa2011/files/APE_7_1.pdf

Gauti B Eggertsson and Paul Krugman, "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach", QJE, 2012, Volume 127, Issue 3, pp. 1469-1513. http://gie.oxfordjournals.org/content/127/3/1469.full+html

Itay Goldstein and Assaf Razin, "Review of Theories of Financial Crises", 2013, NBER Working Paper. <u>http://www.nber.org/papers/w18670.pdf</u>