

Monetary Economics

Econ 8702 Spring 2006 12:20PM- 2:15PM MW Hubert H. Humphrey Center 20 (01/17/2006-03/12/2006)

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Office Hours: 10:00-12:00 W or send me an e-mail to schedule an appointment.

This course is about financial contracts and the aggregate implications of financial imperfections. In the first part we will discuss papers on the foundations of financial contracts. Then we will review recent papers on the implications of financial imperfections on business cycles, asset prices, government policies, firms and open economy issues. I plan to cover the papers that are marked with an asterisk * (tentative).

Reference Texts

Ljungqvist and Sargent, *Recursive Macroeconomic Theory*, 2nd Edition, MIT Press 2004.

Grading

The grading will be based on three parts: two referee reports (50%), e-mails with summary of papers (30%), and class participation (20%).

1. Two referee reports should be based on articles that are in the syllabus or some other articles we agree upon. You should contact me if you have additional papers in mind. The format should be the one in the handout.
2. You have to write me an e-mail before we start covering a new paper in the class with your assesment of the paper. The e-mail should cover the following points:
 - (a) A description of the main features of the paper.
 - (b) An assesment of why this paper is important or interesting (or not).
3. I expect you to participate in class discussions actively.

1 Foundations of Contracts

Monitoring

* Townsend, R. (1979), "Optimal Contracts and Competitive Markets with Costly State Verification," *Journal of Economic Theory*, 21 , 265-293

Gale D. and M. Hellwig (1985), "Incentive-Compatible Debt Contracts: The One-Period Problem" *Review of Economic Studies*, 52, 647 - 663

Limited Commitment

* Kocherlakota , N. (1996), "Implications of Efficient Risk Sharing without Commitment", *Review of Economic Studies* 63 , 595-605

Kehoe, T. and D. Levine (1993), "Debt-Constrained Asset Markets," *Review of Economic Studies*, 60, 865-888

Marcet, A. and R. Marimon (1997), "Recursive contracts", manuscript, Pompeu Fabra University.

Thomas J. and T. Worrall (1988), "Self Enforcing Wage Contracts", *Review of Economic Studies*, 55, 541-554.

Incomplete Contracts

Aghion, P., and Bolton, P. (1992) "An Incomplete contracts Approach to Financial Contracting," *Review of Economic Studies*, 59:473-94

Diamond, D. and R. Rajan, (2001), "Liquidity Risk, Liquidity Creation, and Financial Fragility: a Theory of Banking", *Journal of Political Economy*, 109 , 287-327

Hart, O. (1995), *Firms, Contracts, and Financial Structure*. Oxford University Press 1995.

Hart, O. and J. Moore (1995), "Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management," *American Economic Review* 85: 567-585

* Hart, O. and J. Moore (1998), "Default and Renegotiation: A Dynamic Model of Debt," *Quarterly Journal of Economics*.

2 Aggregate Implications of Financial Imperfections

Business Cycles

* Bernanke, B. S., and M. Gertler (1989), "Agency Costs, Net Worth, and Business Fluctuations," *American Economic Review* 79: 14-31

Bernanke, B. S., M. Gertler, and S. Gilchrist (1999), "The Financial Accelerator in a Quantitative Business Cycle Framework," in John B. Taylor and Michael Woodford (eds.), *Handbook of Macroeconomics*, Amsterdam: North-Holland

Carlstrom, C. and T. Fuerst (1997), "Agency Costs, Net Worth and Business Fluctuations: A Computable General Equilibrium Analysis", *American Economic Review*, 87, 893-910

* Cooley T. R. Marimon and V Quadrini, "Aggregate Consequences of Limited Contract Enforceability", forthcoming *Journal of Political Economy*.

Kehoe, P. and F. Perri, (2002) "International Business Cycles with Endogenous Incomplete Markets," *Econometrica* 70/3, p. 907-928

Kiyotaki N., and J. H. Moore, (1997) "Credit Cycles," *Journal of Political Economy*, 105 , 211-248

Kocherlachota, N. (2000), "Creating business cycles through credit constraints," *Federal Reserve Bank of Minneapolis Quarterly Review* 24 (3), 2–10.

Asset Prices

* Alvarez, F. and U. Jermann (2000), "Efficiency, Equilibrium and Asset Pricing with Risk of Default", *Econometrica*, 68, 775-797

Alvarez, F. and U. Jermann (2001), "Quantitative Asset Pricing Implications of Endogenous Solvency Constraints", *Review of Financial Studies*, Winter, 1117-1152

Aiyagari, S. R., and M. Gertler (1991) "Asset Returns with Transaction Costs and Uninsured Individual Risk," *Journal of Monetary Economics*, 27, 311- 331

Heaton, J., and D. J. Lucas (1996), "Evaluating the Effects of Incomplete Markets on Risk Sharing and Asset Pricing," *Journal of Political Economy*, 104, 668-712

* Lustig, H. (2004) "The Market Price of Aggregate Risk and the Wealth Distribution", working paper, UCLA

Government Policy

* Athey, S. A. Atkeson, and P. Kehoe (2004), "The Optimal Degree of Discretion in Monetary Policy," *Federal Reserve Bank of Minneapolis Staff Report* 326.

* Arellano, C. and J. Heathcote (2005), "Rules, discretion and international risk sharing without enforcement", University of Minnesota working paper.

Chari, V. V., and P. Kehoe (1990), "Sustainable Plans," *Journal of Political Economy* 98, 783—802.

Krueger, D. and F. Perri, (2001) "Risk Sharing: Private Insurance Markets or Redistributive Taxes?" NYU working paper

Sleet, Chris (2003), "Optimal Taxation with Private Government Information," *Review of Economic Studies*, 71:1217-1239.

Firms

*Albuquerque, R. and H. Hopenhayn (2004), "Optimal Lending Contracts and Firm Dynamics", *The Review of Economic Studies*, Vol.71(2): 285-315.

* Atkeson, A. and H. Cole, H. 2005. A Dynamic Theory of Optimal Capital Structure and Executive Compensation? NBER working paper #11083

Cooley, T. and V. Quadrini (2001), "Financial Markets and Firm Dynamics", *American Economic Review*, 91, December

Monge, A. (2001), "Financial Markets, Creation and Liquidation of Firms and Aggregate Dynamics", mimeo, Northwestern University

Open Economy

Antras, Pol, (2003), "Firms, Contracts, and Trade Structure," *Quarterly Journal of Economics*, Vol. 118, No. 4, November , pp. 1375-1418

* Arellano, C. and J. Heathcote (2004), "Dollarization and Financial Integration", University of Minnesota working paper.

Atkeson, A. (1991), "International Lending with Moral Hazard and Risk of Repudiation", *Econometrica*, 59, 1069-89.

Broner, F. and J. Ventura (2005), "Globalization and Risk Sharing", Working paper CREI

Kletzer, K. and B. D. Wright (2000), "Sovereign Debt as Intertemporal Barter", *American Economic Review*, (90): 621-39, June.

Kovrijnykh, N. and B. Szentes (2005), "Competition for Default", University of Chicago Working Paper.