Economics of Capital Markets
220:394:01
Prof. Paczkowski

Spring, 2008
January 20, 2008

My office hours are:
Thursday 3:00 PM - 4:00 PM
and by appointment

Office Location:
Room 108, New Jersey Hall - CAC
732-932-7077

Otherwise, the best place to find me is before class in the classroom. I can also be reached by email at

paczkows@economics.rutgers.edu

Please feel free to call me with any questions or see me before or after class. Do not wait until the end of the semester!

A final way to reach me is via the Economics Department’s secretary in New Jersey Hall. Just leave a message for my mail box although this is the most ineffective way.
1  Course Objectives

Capital traditionally has been a major factor of production - along with labor - both in micro and macro theory. But because of capital’s inherent properties, using capital involves risk. Firms try to minimize their risk exposure by sharing this risk. The terms for holding capital, and thus sharing its attendant risk, are determined in the capital markets which are one facet of the overall financial market. In addition, consumers, as a way of smoothing consumption in the face of incomplete markets, invest in securities and build portfolios to minimize their risk exposure. An understanding of how the capital markets operate to set prices and share risk is vital for understanding how the economy functions.

General objectives for this intense course are to provide you with an understanding of:

1. the operation of the capital markets and their relation to the overall, general financial market;
2. the pricing of capital instruments in the presence of risk;
3. the sharing of risk by the capital markets;
4. issues in capital market analysis.

Specific objectives are to instruct you in:

1. the various types of risk and the premiums demanded by investors as compensation for holding or sharing risk;
2. the importance of the Efficient Market Theory;
3. how arbitrage leads to the Law of One Price and its use in pricing assets;
4. the nature and determination of real interest rates and the term structure of interest rates;
5. the general movements and time patterns of asset prices and interest rates, especially with respect to the Business Cycle;
6. the Capital Asset Pricing Model (CAPM);
7. Operations of futures and options markets and the pricing of these assets.

2  What the Course Is and Is Not

The two operative words in the title for this course are Economics and Markets. This course focuses on the setting of prices for financial assets such as stocks and bonds in various markets and the efficiency of these markets for allocating risks and returns. Monetary policy issues will also be addressed since they are so prominent in the news. Above all, this is not a Personal Investment, Corporate Finance, Money & Banking, International Finance, or Macroeconomics course.
3 Relation to Other Economics Courses

Because of the general nature of the topic (i.e., financial markets), there is some overlap with other economics courses. In particular, Money & Banking, Financial Economics, Macroeconomic Theory and Microeconomic Theory cover similar or related material. This course differs by its emphasis on the pricing of long-term claims in which risk and uncertainty are dominate factors influencing choices.

4 Prerequisites

The prerequisites are listed in the course description.

5 Math/Stat Requirement

Some calculus will be used but we will usually rely on algebra bordering on pre-calculus. This pre-calculus material becomes heavy at times, however, explanations are given in class when a concept is presented. After that, it is assumed that you understand the concept if questions are not asked; it is your responsibility to ask questions. Probability and statistical concepts are heavily used and are reviewed in class when necessary.

Econometric results will be presented and you are expected to know and understand these results.

6 Textbooks

There is one book:

A Random Walk Down Wall Street.
B. Malkiel (W.W. Norton & Co.)

Handouts will be provided as necessary to supplement lectures but not to replace your responsibility to attend class and take notes.

7 Reading Assignments

Read Random Walk for the first half of the course. Other reading assignments will be provided as the course progresses. The assignments cover some of the lecture material and will give a better exposure to the subject. Suggestions for how to read articles are given below.

You are urged to read as much of the optional material as possible. In addition, reading the Wall Street Journal regularly (daily!) is highly recommended to relate course material to actual, real world events.

You are expected to read assigned articles and be prepared for class discussions. You are responsible for both the readings and the lectures.
8 How to Read Articles

Approach each article looking for central ideas and concepts, not detail. Almost all articles are well structured with a literature review in the beginning, a general outline of the author’s argument, the analytical detail, and then a summary. Concentrate on the literature review and summary. Look for how the general ideas relate to other concepts you already know. Some of the articles are very mathematical; skip the mathematics.

9 Current Markets Discussions

We will try to spend the first 10 - 15 minutes of each class discussing the major market news and interpreting events within the context of the theory learned in class. Your readings from the Wall Street Journal will provide you with the background. The purpose for these discussions is two-fold:

1. to relate the theory to reality or to identify those things that we do not understand;
2. to encourage you to keep abreast of economic developments.

Please be prepared.

10 The Wall Street Journal

You are strongly encouraged to read The Wall Street Journal regularly. A special student subscription is available but a subscription is not a requirement for the course. The important thing is that you keep abreast of market and economy news. You can use whatever information source you like.

11 Exams

There will be a midterm and a final. The final is already scheduled by the University:

May 14, 8 - 11 AM

Above all, please check the University website for exam dates and times:

http://scheduling.rutgers.edu/springfinals.htm

It is your responsibility to verify the date and time. The midterm will be on  

March 13
The exams are comprehensive, including the final, and will focus on grand themes and issues. They are meant to synthesize the material. Your exam answers are graded on completeness (just having a key word does not suffice), relevancy to the question I asked (many students do not answer my question), and neatness (points are deducted if I cannot read an answer). Short ESSAY answers are required. Essays consist of whole sentences and paragraphs correctly worded and written. Anything else is a zero. Points are deducted if the answers are not in acceptable essay form. In short, it’s not only what you say, but how you say it that counts.

There are no makeups for missed exams due to tardiness or being absent - no excuses. A make-up exam is allowed only after prior permission is granted to miss that exam (rarely given!!) or there is a note from the Dean’s Office and appropriate documentation (e.g., medical, court order). It is your responsibility to notify the Dean’s Office of a medical or personal problem (e.g., death in the family) resulting in a missed exam. Excuses are not accepted; only a note from the Dean’s Office will be accepted - maybe! A make-up exam is not necessarily the same as the regular exam. Obviously, a make-up is not given for the final.

12 Presentations

An important aspect of learning is being able to present to a wide audience. You will be asked to give two presentations during the semester. One will be on current capital market news and events, the other on a reading assignment. It is important that you take notes on these presentations because there will be questions on the exams relating to them. Failure to show for an assigned presentation will result in a zero for that presentation with no make-up possible. Details for the presentations will be given in class.

13 Grades

All assignments, exams and presentations/participation have points. For exams, the points are:

<table>
<thead>
<tr>
<th>Points</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Very well written; to the point; correct; shows deep understanding</td>
</tr>
<tr>
<td>3</td>
<td>Minor errors; some minor writing issues; displays deep understanding</td>
</tr>
<tr>
<td>2</td>
<td>Major errors; major writing issues; displays understanding but without depth</td>
</tr>
<tr>
<td>1</td>
<td>Major errors; major writing issues; insufficient; displays only minor understanding</td>
</tr>
<tr>
<td>0</td>
<td>No answer or work; displays complete lack of understanding</td>
</tr>
</tbody>
</table>

Grades are determined on a points-earned basis with the following importance weights:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Midterm</td>
<td>33%</td>
</tr>
<tr>
<td>Presentations</td>
<td>33%</td>
</tr>
<tr>
<td>Final</td>
<td>34%</td>
</tr>
</tbody>
</table>
A straight curve is used:

<table>
<thead>
<tr>
<th>Percentage Range</th>
<th>Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>90% to 100%</td>
<td>A</td>
</tr>
<tr>
<td>88% to less than 90%</td>
<td>B+</td>
</tr>
<tr>
<td>80% to less than 88%</td>
<td>B</td>
</tr>
<tr>
<td>78% to less than 80%</td>
<td>C+</td>
</tr>
<tr>
<td>70% to less than 78%</td>
<td>C</td>
</tr>
<tr>
<td>60% to less than 70%</td>
<td>D</td>
</tr>
<tr>
<td>Less than 60%</td>
<td>F</td>
</tr>
</tbody>
</table>

14 Appeals

Students occasionally feel that a grade is too low. In such a case, an appeal consisting of one (1) double spaced, typed page plus a copy of the exam or paper with my comments on it may be submitted at any time up to and including the last class, but not beyond.

The appeal should contain an argument as to why a particular grade should be changed. Not all appeals are accepted. An appeal that says, for instance, "But I studied hard" or "I worked all semester and just got a C - I deserve better" or "You graded me unfairly" are not acceptable.

Appeals are reviewed only at the end of the semester and only when it is believed that a grade may be changed. Do not ask if I reviewed an appeal at any point in the semester - the answer is "No". Appeals are only reviewed at the end of the semester to determine borderline cases.

15 Final Course Grades

Final course grades will be available in the usual way.

16 Attendance Policy

Attendance is taken at the beginning of each class.

17 Frequently Asked Questions

See the web site. These FAQs give answers to most class policy questions.