



Critical Finance in a Volatile World

Area: Finance and
Political Economy

IE Brown Executive MBA

Sessions: 10
(5 plus 5 on-line)

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I am Professor of International Political Economy in the Department of Political Science at Brown University and a Faculty Fellow at Brown's Watson Institute for International Studies. I grew up in Dundee, Scotland. I received my PhD in political science from Columbia University in 1999 and taught at the Johns Hopkins University from 1997 until 2009. My research interests lie in the field of international political economy. More specifically, my research trespasses several fields and aims to be as interdisciplinary as possible, drawing from political science, economics, sociology, complexity theory and evolutionary theory. My work falls into several related areas: the politics of ideas, how institutions (and disciplines) change, political parties, and the politics of finance. A slightly dated research statement can be found here:

http://www.watsoninstitute.org/images_news/blythm_research_statement_2010.pdf

Course Rationale: The classic MBA degree stresses core competencies in economics and finance. Regarding the latter, mastery of technologies such as the CAPM, VAR analysis, and the Black-Scholes options pricing model are core objectives; and so they should be. Students become intimately aware of the correlations that underlie such models and the techniques used to manipulate such correlations in order to hedge exposure or take on leverage. What such an approach misses however are three things. First, understanding how such techniques occasionally break down, sometimes at great cost, costs that are oftentimes not borne by those reaping the benefits. Second, examining how many of the assumptions that underpin such approaches; ergodicity, stationarity, correspondence, and statistical independence, may not characterize the world that we actually live in. Third, appreciating how the institutional and sociological context of markets matters for how they perform. The ongoing financial crisis may constitute a secular shift in the international business environment. We will live in a more complex and volatile world going forward. How business adapts to this environment, one where finance is both more central and more fragile, is the focus of this course.

Course Objectives

The objective of the course is to provide you with a basic understanding of why the world blew up in 2008, to discuss what this means for financial and non-financial businesses going forward, and to suggest innovative ways of navigating this new environment. The purpose is to both challenge what you know, and to make you appreciate, in the manner of Donald Rumsfeld's famous 'unknown, unknowns,' what you cannot know. We will discuss, among other topics, why when you are six foot tall you should be very careful crossing a river that is on average four foot deep, and why moral hazard is trust by another name. The course does not assume more than a passing familiarity with the technical aspects of finance. Rather, it uses finance as a general case of understanding how volatility is generated in the business world.

Methodology

The five face-to-face sessions of the course will be complimented by five on-line sessions. There are two sessions in Providence in February and three more in Madrid in May. The format of the face-to-face class is 'short introductory lecture and long discussion.' At this stage of my career I pretty much know everything that an economist or a political scientist can tell me. I am interested in what you can tell me since you know things that I do not. The point is mutual engagement. As such, the materials for the class, which blend text and video, are designed to be provocative. The on-line class is reading/watching ahead of time followed by on-line discussion.

Evaluation Criteria

Since the majority of our time together will come right at the end of your degree (May 29th and 30th 2012) the course will take the following structure. The first two face-to-face classes will deal with two themes: what happened in 2008, on the macro level of outcomes, and the micro level of crisis generators. The purpose of these two sessions is to give us a common set of understandings that the on-line sessions will take apart in a more focused manner. The final three sessions will augment these sessions by looking forward in terms of the future of banking, finance, and what this means for business.

In that regard the major grading component will be a group presentations to be held in the last face-to-face session in Madrid on May 30th. The groups will be constituted via a survey I will ask you to complete before we meet in February. That will help me group you into teams with similar areas of experience. You and your colleagues will then present a proposal on how to deal with a more volatile economy going forward. You will detail strategies for taking on and laying off risk, as well as how to cope with 'unknown, unknowns.'

The rest of the grade will come from participation in class and on-line. Finally, there is a short response paper due to me by March 15th based upon the materials from the first two sessions. Questions for that paper will be given out at the end of session two. In sum, class and on-line participation is 25 percent, the response paper is 25 percent, while the group presentations are 50 percent.

Course Outline

Prework

Complete online Survey from Course homepage (TBP) and watch these videos:

<http://www.pbs.org/wgbh/pages/frontline/meltdown/view/>

Session One: Face-to-Face in Providence, February 9th 2012 - 10:30-11:50

Why the World Changed: Global Causes

Materials (Essential)

Hyun Song Shin “Global Banking Glut and Loan Risk Premium” IMF working paper – available at: <http://www.imf.org/external/np/res/seminars/2011/arc/pdf/hss.pdf>

Brad DeLong and Steven Cohen ‘The End of Influence’ available at

http://www.foreignpolicy.com/articles/2009/12/23/the_end_of_influence?page=0.0

Recommended:

Martin Wolf, *Fixing Global Finance* (Chapter 4).

Questions: Did globalization cause the crisis? If so, what were the roles of banks, savers, and governments respectively? Can a wholly macro perspective account for the crisis? What policy solutions present themselves from these analyses?

Session Two: Face-to-Face in Providence February 10th 2012 - 2:30-3:50

Why the World Changed: What you can’t see can hurt you...

Materials (Essential)

Nassim Taleb *The Black Swan*, Chapter 15 – ‘The Great Intellectual Fraud’ (PDF from me via course website)

Joe Nocera (2008) ‘Value at Risk’ <http://www.nytimes.com/2009/01/04/magazine/04risk-t.html>

Felix Salmon (2008) ‘Recipe for Disaster: The Formula That Killed Wall Street’

http://www.wired.com/techbiz/it/magazine/17-03/wp_quant?currentPage=all

Recommended

Mark Blyth “What if Most Swans are Black?” (PDF from me via course website)

Questions: Is financial risk management an illusion or a necessity? Does increasing complexity lead to stability or fragility? Can we really control the financial world?

Session Three: On-Line Week of February 27th

Why do we keep doing this and is it really different this time?

Materials (Essential)

Moritz Schularick and Alan Taylor ‘Credit Booms Gone Bust’ available at

<http://ideas.repec.org/p/cpr/ceprdp/7570.html>

Recommended

Carmen Rienhardt and Kenneth Rogoff, “The Aftermath of Financial Crises” available at <http://www.nber.org/papers/w14656>

Questions: Is it really different this time? If it is, how can business continue to grow in a deflationary environment? What is the upside if you know its coming?

Session Four: On-Line Week of March 12th

An Austere Future for Business?

Materials (Essential)

The *Financial Times* Austerity Debate – available at:

[http://www.ft.com/intl/cms/s/0/dc3ac844-9010-11df-91b6-](http://www.ft.com/intl/cms/s/0/dc3ac844-9010-11df-91b6-00144feab49a,s01=1.html#axzz1gG8Lk58Q)

[00144feab49a,s01=1.html#axzz1gG8Lk58Q](http://www.ft.com/intl/cms/s/0/dc3ac844-9010-11df-91b6-00144feab49a,s01=1.html#axzz1gG8Lk58Q) and from me as a PDF via Course website

And this short video <http://vimeo.com/15061570>

Recommended

Mark Blyth, ‘The G20’s Dead Ideas’ available at

<http://www.foreignaffairs.com/articles/66490/mark-blyth-and-neil-k-shenai/the-g-20s-dead-ideas?page=show>

Questions: Is austerity the correct policy response to the crisis? Is stimulus?

Session Five: On-Line Week of April 9th

A Decade (or more) of Deleveraging?

Materials (Essential)

McKinsey Report ‘Debt and Deleveraging’ available at:

[http://www.mckinsey.com/Insights/MGI/Research/Financial Markets/Debt and deleveraging The global credit bubble Update](http://www.mckinsey.com/Insights/MGI/Research/Financial_Markets/Debt_and_deleveraging_The_global_credit_bubble_Update)

(Download and read Executive Summary and listen to podcast on same page)

Questions: How does stimulus work when consumers are in debt? Is there such a thing as growth friendly fiscal consolidation?

Session Six: On-Line Week of April 30th

The European Future (1)

Materials (Essential)

On-Line seminar – “What’s the Deal with Deutschland?” available at

<http://crookedtimber.org/2011/01/18/seminar-whats-the-deal-with-deutschland-the-european-consequences-of-changes-in-germanys-political-economy/>

Recommended

Simon Tilford “Reaching the Endgame” available at

<http://centreforeuropeanreform.blogspot.com/2011/09/euro-reaching-endgame.html>

Mark Blyth “How to Turn a Continent into a Subprime CDO” available at <http://triplecrisis.com/how-to-turn-a-continent-into-a-subprime-cdo/>

Questions: What explains the European response to the crisis? Will more and better rules work? Can the EU as a whole become more like Germany? What are the consequences for European business?

Session Seven: On-Line Week of May 15th

The European Future (2)

Materials

Mark Blyth and Matthias Matthijs, “Only Germany can Save the Euro” available at <http://www.foreignaffairs.com/articles/136685/matthias-matthijs-and-mark-blyth/why-only-germany-can-fix-the-euro>

Mark Blyth “Greece, Lehman and the Politics of Too Big to Fail” available at <http://www.dw-world.de/dw/article/0,,15465183,00.html>

Vivien Schmidt “Saving the Euro” available at <http://www.foreignaffairs.com/articles/136694/vivien-a-schmidt/saving-the-euro-will-mean-worse-trouble-for-europe>

Questions: Is the Euro a sustainable project? Will the cost of saving the Euro be a polarized Europe?

Session Eight Madrid: Face-to-Face May 29th times TBA

The Future of Finance (1)

Materials (Essential)

‘The Future of Finance – the LSE Report,’ Chapter Two (Haldane et al.), available at <http://www.financialregulationforum.com/wpmember/book-choice-the-future-of-finance-the-lse-report-4722/>

John Cassidy “What Good is Wall Street?” available at http://www.newyorker.com/reporting/2010/11/29/101129fa_fact_cassidy?printable=true

Recommended

Mark Blyth “Economist Magazine Buttonwood Video” available at http://fora.tv/2011/10/26/Mark_Blyth_Leading_Indicator#fullprogram (Login needed – will provide)

Session Nine Madrid: Face-to-Face May 30th Noon

The Future of Finance (2)

Materials (Essential)

Andrew Haldane “The \$100 Billion Question” Available at <http://www.bis.org/review/r100406d.pdf?frames=0>

Recommended

Andrew Haldane “Why Banks Failed the Stress Test” Available at
<http://www.bis.org/review/r090219d.pdf?frames=0>

Andrew Haldane “Small lessons from a Big Crisis” Available at
<http://www.bis.org/review/r090710e.pdf?frames=0>

Questions for Sessions Eight and Nine: Is the business model of investment banking broken? Can finance be reformed? What are the regulatory and practical lessons of the crisis for business?

Session Ten Madrid: Face-to-Face May 30th time TBA
Group project presentations