Incorporating Financial Factors within Macroeconomic Modelling and Policy Analysis

While there has been considerable progress in quantitative macroeconomic modeling, most of the work in this area assumes that financial markets function perfectly and that financial institutions are merely a veil over real activity. To address the current crisis from both a positive and normative perspective, accordingly, it is necessary to integrate the relevant frictions in capital markets within contemporary macroeconomic analysis. The objective of this course is to describe the work that has been done to date in this area and also to characterize what is left to do.

The course will begin by discussing the micro-foundations of capital market frictions that give rise to key phenomena such as the external finance premium, balance sheet constraints on borrowing, and liquidity shortages. We will then move to general equilibrium and describe the financial accelerator, a theory of feedback between the financial and real sectors. Along the way we will discuss how financial institutions fit into the picture. We will then integrate the approach into a contemporary quantitative business cycle model and discuss the implications both for how the model captures the data and for policy analysis. In addition to discussing the implications for conventional monetary policy (i.e. interest rate setting), we will also analyze non-conventional monetary policies, e.g. direct credit market interventions, etc. Finally, we will extend the analysis to the open economy and consider the implications for sudden stops and for the appropriate policy response to these kind of phenomena.
**Topics and Background Readings**

**Topic 1: Basic Concepts**


**Topic 2: Incorporating Financial Frictions in DSGE Models**


**Topic 3: Financial Intermediation, Dynamic Contracting and Unconventional Monetary Policy**


7. Andrea Gerali, Stefano Neri, Luca Sessa, and Federico Signoretti, "Credit and Banking in a DSGE Model of the Euro Area,"


**Topic 4: The Open Economy and Emerging Market Crises**


4. Devereux, Michael and James Yetman, "Financial Deleveraging and the International Transmission of Shocks"

**Topic 5: The Current Crisis: Implications for Research**
