Fall 2011
Econ 3380 – MANIAS, PANICS, CRASHES

Cihan Bilginsoy
E-mail: bilginsoy@economics.utah.edu
Office: OSH 352
Office hours: T 9:00-10:30 or by appt.

Course description and objectives:
This course will present the causes and consequences of financial crises in historical perspective. It will discuss in this context alternative economic views on how markets work and the role of the government in stabilizing the economy. It will introduce basic economic concepts, including resource allocation, rationality, herd behavior, uncertainty, risk, speculation, and regulation.
In this course, students will:

1. Gain knowledge of financial crises in the capitalist economy since the 17th century and identify the common patterns related to their sources, propagation mechanisms, and resolution;
2. Acquire literacy on basic concepts of pricing, resource allocation, efficiency, market failure, risk, uncertainty, information, regulation;
3. Distinguish between two approaches to explaining behavior under uncertainty, probabilistic assumptions underlying each approach, and their implications for financial markets:
   a. The first approach formulates uncertainty in terms of probabilistic distributions and models decision-making behavior as maximizing expected value of an objective function given the probability distribution of odds of the payoffs. Under the assumption of independence of agents, financial outcomes are normally distributed.
   b. The second approach rejects the probabilistic approach to uncertainty on the grounds that there are limitations on information and cognitive abilities of decision-makers; it emphasizes behavior based on norms, custom, heuristics and rules of thumb which lead to interdependent actions of agents, herd behavior, and fat-tailed distributions of financial outcomes.
4. Learn the foundations of two competing modes of economic thought:
   a. The Orthodox view is based on rational decision making by informed economic agents. This behavior leads to optimal allocation of resources and efficient dissemination of information, both through prices. It rules out the possibility of crisis and therefore deems regulation unnecessary and harmful.
   b. The Heterodox view emphasizes uncertainty, herd behavior, and systemic risk. It argues that endogenous crises are endemic to the financial system and regulation is necessary in view of the fragility of the financial system.

Content overview:
The course is divided into three sections:

1. Early history: History of financial crises from the tulip mania to the crash of 1929. This section will give a historical account of crises during this period, emphasizing the common patterns
2. Economics of financial crises: Theoretical content will be added to the course by interpreting the patterns indentified in the first third of the course. Concepts of invisible hand, market mechanism, pricing, credit, risk, uncertainty, speculative behavior, and lender of last resort will be discussed and illustrated.

Other Class Rules:

1. Come to class on time.
2. Read the assigned material in advance and familiarize with the subject before the lecture.
3. This is not a "textbook course." Information comes from disparate sources, some of which can be to challenging to comprehend on your own. Considerable amounts of material are not "strictly" covered in readings but will be discussed in class (e.g. comparisons of alternative interpretations or specific episodes). Class discussions are indispensable to understand the material. Hence, class attendance is very strongly recommended.
4. I will use WebCT for announcements, etc. but it is not a substitute to being in class. It is the responsibility of the student to keep up with the class.
5. I will not allow *any* electronic gadgets (including, but not limited to, computers, cell phones, calculators, dictionaries, i-pods, pagers, …) in class or in the final exam. Remove them from your desk, and turn off the cell phones. If you need to use an electronic device for medical reasons let me know in the first week of the semester.
6. Do not read the newspaper during the lecture.

Students with disabilities:

The University of Utah seeks to provide equal access to its programs, services and activities for people with disabilities. If you will need accommodations in the class, reasonable prior notice needs to be given to the Center for Disability Services, 162 Olpin Union Building, 581-5020 (V/TDD). CDS will work with you and the instructor to make arrangements for accommodations.

Course Plan and Reading List

Timing of lectures is approximate. Over the course of the semester there may be marginal changes in the reading material.

1. Early History (5 weeks, 10 class periods)
   a. Tulipomania (Class period 1)
      - Chancellor, Chapter 1.
      - P. Garber, *Famous First Bubbles* (2000), pp. 19-47.
   b. John Law, Banque Royale, and the Mississippi Company (Class period 2)
      - P. Garber, *Famous First Bubbles* (2000), pp. 95-103.
      - J.K. Galbraith, *Money* (1975) Chapter 3.
   c. The South Sea bubble and the early stock markets (Class period 3)
      - E. Chancellor, Chapters 3, 4.
      - P. Garber, *Famous First Bubbles* (2000), pp. 109-120.
   d. Taking stock of early bubbles (Class periods 4, 5)
      - P. Garber, *Famous First Bubbles* (2000), pp. 3-14, 75-93, 105-107, 121-126.
      - Roubini and Mihm, Chapter 2.
   e. The British railway crisis (Class period 6)
      - Chancellor, Chapter 5.
   f. Speculative activity in the U.S. and the panic of 1907 (Class period 7,8)
      - Chancellor, Chapter 6.
      - J.K. Galbraith, *Money*, (1975) Chapter 7, 8, 9.
      - S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 1.

g. The crash of 1929(Class periods 9, 10)
   - Chancellor, Chapter 7.
   - J.K. Galbraith, *The Great Crash: 1929.*

First Essay

2. Economic Theory of Financial Crash (5 weeks, 10 class periods)
   a. Markets, rationality, and efficient allocation of resources (Class periods 11, 12)
      - Smith, *The Theory of Moral Sentiments* (excerpts).
      - Smith, *Wealth of Nations* (Book 4, Chapter 2, excerpts).
      - J. Cassidy, *How Markets Fail* (2010), Chapter 2.
   b. Efficient market hypothesis (EMH) (Class periods 13, 14, 15)
      - E. Fama, The Behavior of Stock Market Prices," Journal of Business, 1965, pp. 34-40.
      - J. Levin and J.A. Fox, *Elementary Statistics*, (1994) Chapter 5. (This book happens to be on my shelf. "Probability and the Normal Curve" chapter in any other *elementary* statistics textbook would do.)
      - J. Fox, *The Myth of the Rational Market* (2009), Chapters 4, 6.
      - J. Cassidy, *How Markets Fail* (2010), Chapter 7.
      - R.J. Shiller, *Irrational Exuberance* (2005), Chapter 10.
   c. Behavioral economics (Class periods 16, 17)
      - J.M. Keynes, *General Theory*, (1936) Chapter 12.
      - J. Cassidy, *How Markets Fail* (2010), Chapter 15.
      - R.J. Shiller, *The Subprime Solution*, Chapter 3.
   d. Minsky's theory of financial crisis (Class period 18)
      - C.P. Kindleberger and R. Aliber, *Manias, Panics, and Crashes* (2005) Chapter 2.
      - J. Cassidy, *How Markets Fail* (2010), Chapter 16.

Second Essay

3. Recent Financial Debacles (4 weeks, 9 class periods)
   a. Junk bonds, leveraged buyouts, S&L debacle, and the crash of 1987 (Class period 19, 20)
      - Chancellor, Chapter 8, Epilogue.
      - S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 5.
   b. The roaring nineties: Dot-coms, quants, LTCM (Class period 21, 22)
      - Johnson and Kwak, Chapter 4.
      - A. Greenspan, *Age of Turbulence*, (2008) Chapters 8, 9.
      - J. Cassidy, *How Markets Fail* (2010), Chapter 14.
      - NOVA, *Trillion Dollar Bet*, WGBH Boston Videorecording (2000).
   c. Sub-prime mortgage crisis (Class periods 23, 24)
      - S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 5, 6.
      - J. Cassidy, *How Markets Fail* (2010), Chapter 18, 19.
      - Roubini and Mihm, Chapters 3, 4.
      - Timeline: http://www.pbs.org/wgbh/pages/frontline/meltdown/cron/)
   d. International experience (Class periods 25, 26)
      - Chancellor, Chapter 9.