Spring 2017
Econ 3380 – MANIAS, PANICS, CRASHES

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Course description and objectives:

Why did the housing and mortgage-backed securities markets collapse in 2007? Did dot-com companies of the 1990s and English railway companies of the 1840s have anything in common that explains the boom and crash of their share prices? What menace scared the Bank of England in 1720, J.P. Morgan in 1907, and the Federal Reserve in 1929? Which was the better course of action for the government: saving Bear-Stearns or letting Lehman Brothers fail? How do supposedly rational and reasonable investors so frequently succumb to euphoria and despair?

This course is an historical introduction to the causes, mechanisms, and consequences of asset price bubbles and banking crises, from tulip bulbs in the 17th century Netherlands to the subprime mortgages in the 21st century U.S. 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. Identify the common patterns in sources, propagation mechanisms, and resolution of financial crises;
2. Acquire literacy on basic concepts of pricing, resource allocation, efficiency, market failure, risk, uncertainty, information, regulation;
3. Develop analytical skills by establishing logical links between the assumptions (concerning decision-making under uncertainty and market structures) and implications of economic models, and making policy inferences;
4. Develop critical thinking skills to evaluate competing theories of financial crises

Towards these ends, we will distinguish between five competing approaches to understanding financial crises:

a. The fundamentals-based approach: asset prices are outcomes of optimizing behavior under conditions of perfect competition and asset price bubbles do not exist.
b. The Austrian approach: financial crisis is a consequence of government actions (monetary policy and regulation) into an otherwise well-functioning market.
c. Imperfect markets approach: due to frictions and imperfections in the financial markets optimizing behavior of economic agents yield sub-optimal outcomes of bubbles and bank runs.
d. The behavioralist approach: Economic behavior is based on norms, custom, heuristics and rules of thumb which lead to interdependent actions of agents and possibly herd behavior that may turn into financial crises

e. Financial fragility approach: Crises are endemic to the capitalist financial system and an outcome of the cyclical changes in the quality of credit.

Pre-requisites:

There are no prerequisites for this course except for having interest in the subject matter and intellectual curiosity to inquire into the questions of why and how (beyond what). If the material described above appeals to you, then you should consider taking this course.

Readings:

The textbook is Cihan Bilginsoy, *A History of Financial Crises: Dreams and Follies of Expectations* (Routledge 2015). Other reading assignments will also be posted on Canvas.

I will post discussion questions in advance in order to provide students guidance in preparation for the next lecture.

I will also post lecture slides on Canvas. Beware that these slides provide only an outline of the material covered in class. Therefore, slides are **not** a substitute for the assigned readings.

Students are encouraged to keep up with current events in the financial markets. *New York Times*, *Financial Times*, and *Wall Street Journal* are excellent sources and they are free on campus. You may also want to peruse *The Economist*.

Course website:

The syllabus, essay questions, reading assignments, economic data, and announcements will be posted on Canvas. It is the student's responsibility to check Canvas regularly. If necessary, make sure that your mail is forwarded from Canvas to an address that you check frequently.

Course requirements and grading:

The course grade will be based on class participation (10%), two mid-term exams (25% each), and the final exam (40%). The format is essay and will include questions that require reflection on course material.

There will be no make-up exams except in the cases of (a) medical emergencies; (b) officially sanctioned University activities; (c) religious obligations. As indicated in PPM 9-7 Sec 15, the appropriate unit should provide a written statement for the reason of absence. In cases (b) and (c), student should get in touch with me at least two weeks in advance and reschedule the exam. These rules will be strictly enforced.

Students will <u>not</u> be assigned extra credit work to improve their grades.

Grading system follows the university standards literally: e.g. A, A- (excellence superior performance), B+, B, B- (good performance), C+, C, C- (standard performance), D+,D,D- (substandard performance), E (unsatisfactory performance). Senior students' work will not be graded differently.

Exam dates:

Midterm exams: Thursday, Feb 14; Thursday, March 30.
Final exam: Tuesday May 2, 1:00–3:00, in regular classroom.

Collusion and cheating:

Cheating in essays or exams and other types of academic misconduct will be dealt with in accordance with the University regulations. For full details on procedures and penalties, see: http://www.admin.utah.edu/ppmanual/8/8-10.html#SECTION%20V. Punishments can be severe, so don't do it. Enough said.

Other class rules:

1. Come to class on time.
2. Read the assigned material, familiarize yourself with the material, and mull over the discussion questions in advance of each lecture.
3. I will use Canvas 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 material.
4. Turn off cell phones and remove them from your desk. This is not the place for messaging.
5. You are allowed to use a computer to take notes. In case you want to use computers for any other purpose, please leave the classroom and do it outside because it is distracting and disrespectful to your classmates (yes it is easy to tell you are surfing, playing solitaire, …).

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 Outline and the Reading List

Over the course of the semester there may be marginal changes in the reading material.
* indicates optional reading.

1. Introduction: Financial markets and crises
   Dreams and Follies, Chapter 1.

2. The classic bubbles – Tulip mania, the Mississippi and the South Sea bubbles
   Dreams and Follies, Chapters 2, 3, 4.
   *Chancellor, *Devil Take the Hindmost* (2000) Chapter 1, 2, 3.
   *Garber, *Famous First Bubbles* (2000), pp. 19-47, 95-103, 109-120.

3. The economics of asset price bubbles
   Dreams and Follies, Chapters 5. 6.
   **Famous First Bubbles* (2000), pp. 3-14, 75-93, 105-107, 121-126.
   *Kindleberger and Aliber, *Manias, Panics, and Crashes* (2005) Chapter 2.

4. Railways, banks, and robber barons in the 19th century Britain and U.S.
   Dreams and Follies, Chapter 7, 8, 9.
   *Chancellor, *Devil Take the Hindmost* (2000) Chapter 5, 6.
   *Smith and Sylla, "The Transformation of Financial Capitalism" (1993) pp. 1-23.

5. The crash of 1929
   Dreams and Follies, Chapter 10
   *Chancellor, *Devil Take the Hindmost* (2000) Chapter 7.
   *Smith and Sylla, "The Transformation of Financial Capitalism" (1993) pp. 23-40.

6. Random walk, market efficiency, market failure and regulation
   Dreams and Follies, Chapters 11, 12.
   J. Levin and J.A. Fox, *Elementary Statistics* (1994) Chapter 5 ("Probability and the Normal Curve" chapter in any *elementary* statistics textbook would do.)
   *Shiller, *Irrational Exuberance* (2005) Chapter 10.
   *Keynes, *General Theory* (1936) Chapter 12.

7. Junk bonds, leveraged buyouts, S&L debacle, and the crash of 1987
   Dreams and Follies, Chapter 13
   *Chancellor, *Devil Take the Hindmost* (2000) Chapter 8, Epilogue.

8. The roaring nineties: Dot-coms, quants, LTCM
   Dreams and Follies, Chapter 14
   *Johnson and Kwak, *13 Bankers* (2010) Chapters 3, 4.
   *Cassidy, *How Markets Fail* (2010), Chapter 14.

9. The sub-prime mortgage crisis
   Dreams and Follies, Chapters 15–17
   *Blinder, *After the Music Stopped* (2013) Chapters 2–6.
   *Cassidy, *How Markets Fail* (2010), Chapter 18, 19.