Fall 2011
Econ 3380 – MANIAS, PANICS, CRASHES

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Course description and objectives:

Why did the mortgage-backed securities market and the Wall Street collapse in 2008? 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 S&Ls in the 1980s? Which is 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 financial 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. Distinguish between two approaches to explaining behavior under uncertainty 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.
   b. The second approach rejects the probabilistic approach to uncertainty on 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 and possibly herd behavior.
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 approach implies optimal allocation of resources and efficient dissemination of information, both through prices. It rules out the possibility of crisis and therefore deems regulation of financial markets 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 tulipmania in 1636 to the crash of 1929. This section will give a historical account of crises during this period and introduce elementary economic concepts.
2. Economics of financial crises: Theoretical content will be added to the course by interpreting the patterns identified 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.
3. Contemporary crises: Upon the theoretical foundation of section 2, the sources and mechanisms of financial crises since 1980 will be discussed.

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. The course fulfills the Social and Behavioral Sciences BF requirement.

Readings:

The following books are available at the U bookstore. All other readings will be available on Canvas.

- E. Chancellor, *Devil Take the Hindmost: A History of Financial Speculation* (2000).
- J.K. Galbraith, *The Great Crash: 1929* (2009).
- R. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (2010).

All 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 requirements and grading:

Course grade will be based on two short interpretive essays (60%) and the final exam (40%). Essays will be based on assigned readings and will not require additional research. The length of each essay is expected to be 1,000 to 1,200 words.

Essays are due at the <u>beginning</u> of the class on the day the assignment is due. Work turned in late will <u>not</u> get credit.

The **final exam** is on Friday, December 14, 1:00-3:00 pm.

There will be no make-up exam 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 before the final exam 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.

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 the website frequently.

Collusion and Cheating:

Cheating in essays or the final exam 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 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 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 class.
5. I will not allow *any* electronic gadgets (including, but not limited to, computers, cell phones, dictionaries, i-pods, …) 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)
   a. Tulipomania (Class period 1)
      - E. Chancellor, *Devil Take the Hindmost* (2000) Chapter 1.
      - P. Garber, *Famous First Bubbles* (2000), pp. 19-47.
      - Bilginsoy (Notes 1)
   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.

- Bilginsoy (Notes 2)

c. The South Sea bubble and the early stock markets (Class period 3)
   - E. Chancellor, *Devil Take the Hindmost* (2000) Chapters 3, 4.
   - P. Garber, *Famous First Bubbles* (2000), pp. 109-120.
   - Bilginsoy (Notes 3)

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, *Crisis Economics* (2010) Chapter 2.
   - Bilginsoy (Notes 4)

e. The British railway crisis (Class period 6)
   - E. Chancellor, *Devil Take the Hindmost* (2000) Chapter 5.

f. The 19th century U.S. tradition (Class period 7, 8)
   - E. Chancellor, *Devil Take the Hindmost* (2000) Chapter 6.
   - J.K. Galbraith, *Money* (1975) Chapter 7, 8, 9.
   - S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 1.
   - Bilginsoy (Notes 6,7)

g. The crash of 1929 (Class periods 9, 10)
   - E. Chancellor, *Devil Take the Hindmost* (2000) Chapter 7.
   - J.K. Galbraith, *The Great Crash: 1929*.

First Essay

2. The Economic Theory of Financial Crisis (4 weeks)

a. Markets, rationality, and efficient allocation of resources (Class periods 11, 12)
   - A. Smith, *The Theory of Moral Sentiments* (excerpts).
   - A. 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* (2008) Chapter 3.

d. Minsky's theory of financial fragility (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 (5 weeks)
   a. Junk bonds, leveraged buyouts, S&L debacle, and the crash of 1987 (Class period 19, 20)
      – E. Chancellor, *Devil Take the Hindmost* (2000) Chapter 8, Epilogue.
   b. The roaring nineties: Dot-coms, quants, LTCM (Class period 21, 22)
      – S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 3, 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, 25, 26, 27)
      – R. Rajan, *Fault Lines* (2010) Chapters 1-7.
      – J. Cassidy, *How Markets Fail* (2010), Chapter 18, 19.
      – S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 5, 6.
      – Roubini and Mihm, *Crisis Economics* (2010) Chapters 3, 4.
      – Timeline: http://www.pbs.org/wgbh/pages/frontline/meltdown/cron/)
   d. Lessons (Class periods 28, 29)
      – R.J. Shiller, *Irrational Exuberance* (2005) Chapter 12.
      – R. Rajan *Fault Lines* (2010) Chapters 8, 9.
      – Roubini and Mihm, *Crisis Economics* (2010) Chapters 8, 9.
      – S. Johnson and J. Kwak, *13 Bankers* (2010) Chapter 7.
      – A. Greenspan, *Age of Turbulence* (2008) Chapter 19, Epilogue.

Final exam