ECON: 4389-1: Economics of Financial Crises
Spring 2017

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Time and Location

Tuesdays and Thursdays, 1.00-2.30pm, M-122

Prerequisites

Intermediate Macro (ECON 3334) and Micro (ECON 3332), as well as basic knowledge of calculus and statistics. In case of doubt, please consult with instructor.

Communication

Email is the preferred means of communication, please allow up to 24 hours to get a response.

Course materials and current grades will be posted on Blackboard. Blackboard will also be used to make general course announcements.

Office hours are on Thursday afternoons, starting at 5pm. Questions and discussions of all kinds are encouraged. In case of a time conflict, alternative appointment may be arranged by email.

Course Description

Financial crises have been a recurring element of world economic history, from the ancient times until the latest Great Recession. They are inherently linked to the way asset markets operate. A boom that follows every major wave of financial or technological innovations is transformed into a bubble, and must eventually lead to a bust. Such bubbles are typically accompanied with "this time is different" attitude, a widespread belief that prices will keep increasing indefinitely. While financial crises are natural and can play the role of *catharsis* - correcting biased expectations and linking the markets back to economic fundamentals - they also come with significant costs. Investors lose great wealth, workers lose jobs, countries fall into prolonged depressions, governments declare bankruptcies.

This course will review the historical context of several important crises that have occurred around the world and propose theories to address them. Albeit grounded in history, lectures will emphasize the use of quantitative analysis and formal economic models. Participants are encouraged to actively think about their own research questions and potential answers, in particular with regard to the recent Great Recession of 2008/09 and its aftermath.

The course is split into two main parts. The first part (until around spring break) will mostly focus on the economics of crises. We will use workhorse economic models to measure and analyze great depressions, banking crises, currency and stock market crashes. The second part (after spring break) will focus on financial markets. We will cover sovereign debt crises, international contagion, modern financial frictions and policy responses.

Readings

Required:

- Reinhart, Carmen M. and Kenneth S. Rogoff (2009): *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press.

Useful (but not required):

- Kehoe, Timothy J. and Edward C. Prescott (2007): *Great Depressions of the Twentieth Century*, Federal Reserve Bank of Minneapolis.
- Kindleberger, Charles P. and Robert Aliber (2011): *Manias, Panics, and Crashes: A History of Financial Crises*, Palgrave Macmillan, Sixth Edition, 2011.
- Sturzenegger, Federico and Jeromin Zettelmeyer (2006): *Debt Defaults and Lessons from a Decade of Crises*, MIT Press.
- Williamson, Stephen D. (2014): *Macroeconomics*, Pearson Education, Fifth Edition.

Course Requirements

The course objective is to provide participants with basic knowledge about the history of financial crises, and help them understand the core theories that explain them. To this end, the final grade will consist of two weighted components: the history part (40%) and the analysis part (60%).

- The history part will be tested on the final exam (last class of the semester: Apr 27 2017). In addition, the history part may be completed with full credit by taking weekly quizzes and passing at least 8 out of 10 of them. Passing 6 out of 10 yields 50% credit for the final exam. To pass the quiz, a minimum score of 80% is required. The quizzes are optional and participation is not mandatory. There will be no make-ups or extra credit offered.
- The analysis part will consist of 4 assignments: two problem sets, a midterm (last class before spring break: Mar 9 2017), and a final exam (last class: Apr 27 2017). The grade weight for each assignment is 15%.

All tests and problem sets will be based on the lecture contents, as well as the required readings assigned throughout the semester.

Course Policies

Participants must have a picture ID with them to all exams. The department reserves the right to assign seating.

Collaboration on problem sets in the form of discussions with fellow participants is encouraged. Copying the answers from others' work is not allowed.

All exams and homework will require participants to present their answers in written form in ink. In particular, the use of pencils is not allowed. For full credit, all writings must be legible, mathematical solutions clear with all necessary work shown, and graphs clearly labeled.

Participants with disabilities who require any modification of the seating or testing arrangements are requested to contact the instructor in advance so that the necessary steps can be taken. Such participants are also encouraged to register with the Center for Students with Disabilities (CSD).

This course will strictly observe the University's deadlines regarding withdrawals.

There is no extra credit available in this course beyond the grading schemes described above. In addition, no make-up exams will be offered and unapproved absences will be equivalent to scoring zero points. Participants who have experienced unusual circumstances (such as an accident, crime of other occurrence of *force majeure*) are requested to contact the instructor as soon as possible. An official proof from the doctor or police will be required in order to make special arrangements.

The course will follow the standard grading scale (93-100: A, 90-92: A-, 87-89: B+, and so on), but it may be adjusted to the distribution of scores at the end of the semester.

Course Outline and Additional References

1. Financial crises: historical overview, classifications, definitions, sequencing
   - Reinhart and Rogoff, ch. 1-3.
   - Kindleberger and Aliber, ch. 2-5.
   - Garber, P.M. (2000): *Famous First Bubbles. The Fundamentals of Early Manias*, MIT
   - *Was tulipmania irrational?*, by C.W. and A.J.K.D., The Economist, October 2013.
   - *Financial crises: The slumps that shaped modern finance right*, The Economist, Apr 2014.

2. Great Depressions and growth accounting
   - Kehoe and Prescott, ch. 1-2, 9
   - Caballero, R., T. Hoshi and A. Kashyap (2008): *Zombie Lending and Depressed Restructuring in Japan*, American Economic Review, 98, pp. 1943-1977.
   - Pensieroso, L. (2007): *Real Business Cycle Models of the Great Depression: A Critical Survey*, Journal of Economic Surveys, 21, pp. 110-142.
   - Friedman, M. and A. Schwartz (2008): *The Great Contraction 1929-1933*, Princeton University Press.
   - Eichengreen, B. (2015): *Hall of Mirrors: The Great Depression, The Great Recession, and the Uses - and Misuses - of History*, Oxford University Press.
   - *What can we learn from the Depression?*, by C.R., The Economist, Nov 2013.

3. Banking crises
   - Reinhart and Rogoff, ch. 10
   - Diamond, D.W. (2007): *Banks and Liquidity Creation: A Simple Exposition of the Diamond-Dybvig Model*, FRB Richmond Economic Quarterly, 93, pp. 189-200.
   - Diamond, D.W. and P.H. Dybvig (1983): *Bank Runs, Deposit Insurance, and Liquidity*, Journal of Political Economy, 91, pp. 401-419.
   - Wallace, N. (1988): *Another Attempt to Explain an Illiquid Banking System: The Dia-*

mond and Dybvig Model With Sequential Service Taken Seriously, Federal Reserve Bank of Minneapolis Quarterly Review, 12, pp. 3-16.

4. Inflation and currency crises
   - Reinhart and Rogoff, ch. 11-12
   - Dornbusch, R., I. Goldfajn, and R. Valdes (1996): *Currency Crises and Collapses*, Brookings Papers on Economic Activity.
   - Obstfeld, M. (1994): *The Logic of Currency Crises*, Cahiers Economiques et Monetaires (Banque de France), 43.
   - Morris, S. and H.S. Shin (2000): *Rethinking Multiple Equilibria in Macroeconomics*, NBER Macroeconomics Annual 2000, pp. 189-228.

5. Sovereign debt crises
   - Reinhart and Rogoff, ch. 4-6
   - Sturzenegger and Zettelmeyer, ch. 1-2, 8
   - Arellano, C. (2008): *Default Risk and Income Fluctuations in Emerging Economies*, American Economic Review.
   - Hatchondo, J.C. and L. Martinez (2007): *The economics of sovereign default*, Federal Reserve Bank of Richmond Economic Quarterly, 93, pp. 163-188.
   - Hatchondo, J.C. and L. Martinez (2010): *The politics of sovereign default*, Federal Reserve Bank of Richmond Economic Quarterly, 96, pp. 291-317.
   - Kehoe, T.J. (1995): '*What happened in Mexico in 1994-95?*, in P.J. Kehoe and T.J. Kehoe (editors), *Modeling North American Economic Integration*, Kluwer Academic Publishers, pp. 131-147.

6. The Great Recession
   - Kindleberger and Aliber, ch.13
   - Reinhart and Rogoff, ch. 13
   - Brunnermeier, M.K. (2009): *Deciphering the liquidity and credit crunch 2007-2008*, Journal of Economic Perspectives, 23, pp.77-100.
   - Mayer, C., K. Pence and S.M. Sherlund (2009): *The rise in mortgage defaults*, Journal of Economic Perspectives, 23, pp. 27-50.
   - Shin, H.S. (2009): *Reflections on Northern Rock: the bank run that heralded the global financial crisis*, 23, pp. 101-119.

7. The European Debt Crisis
   - Brunnermeier, M.K., H. James, and J.-P. Landau (2016): *The Euro and the Battle of Ideas*, Princeton University Press.
   - Bocola, L. and A. Dovis (2016): *Self-Fulfilling Debt Crises: A Quantitative Analysis*, working paper.
   - Lane, P.R. (2012), *The European Sovereign Debt Crisis*, Journal of Economic Perspectives, 26, pp. 49-68.
   - Aguiar, M., S. Chatterjee, H. Cole, and Z. Stangebye (2016): *Self-fulfilling Debt Crises, Revisited: The Art of the Desperate Deal*, working paper.

8. Policy responses and crisis prevention - Claessens, S., M.A. Kose, L. Laeven, and F. Valencia (2013): *Financial Crises. Causes, Consequences and Policy Responses*, International Monetary Fund.
   - *What causes financial crises?*, by S.R., The Economist, Sep 2016.