Economics 916

Bubbles, Busts, and Bailouts:
Market and Regulatory Failures in the Financial Crisis

Spring 2013

Prof. John Kwoka

Course Description
The financial crisis of five years ago was a massive collapse or near-collapse of major financial institutions in this country. It spilled over into the “real” economy and then to other countries. Its effects remain with us today and are likely to persist for some time. But this was hardly the first such crisis. Bubbles (and the inevitable busts) in housing, currency, stocks, and other commodities have a long history in the U.S. and elsewhere, raising a number of questions such as how the recent financial bubble compares to other bubbles, whether policies have successfully dealt with the bust and its effects, and whether we face risks of future dangerous bubbles.

This course investigates bubbles, busts, and bailouts, focusing on the U.S. crisis of 2008. We analyze the specific problems with markets that caused or contributed to the crisis—problems that center on the key economic issues of information and incentives. We then examine the failures of regulatory policies that were supposed to protect us—failures due to complacency, ideology, and politics. And finally, we examine the lasting effects of this crisis and ask whether its lessons have been learned.

This course draws on microeconomics, finance, and public policy. These perspectives will be combined to create a comprehensive analysis of the crisis—its causes, aftermath, and implications.

Readings and Blackboard
This course will use four books quite extensively. We will read most of the Financial Crisis Inquiry Report, which is downloadable for free at http://www.gpoaccess.gov/fcic/fcic.pdf or can be purchased from the bookstore. We will read a lot from each of the following—enough that you should buy them either from the bookstore or online:

Acharya and Richardson, Restoring Financial Stability
Shiller, Irrational Exuberance
Zandi, Financial Shock (updated version)

Much has now been written about the crisis, and we will make use of many additional sources. All those listed on the syllabus are posted on blackboard. In addition, links to most journal and newspaper articles are provided. The books we will use are as follows:

Acharya, et al (ARCRW), Regulating Wall Street
Baer, Bull by the Horns
Cassidy, How Markets Fail
Dash, *Tulipomania*
Ferguson, *Predator Nation*
Friedman, *What Caused the Financial Crisis*
Johnson and Kwak, *13 Bankers*
Kindleberger, *Manias, Panics, and Crashes*
Lowenstein, *The End of Wall Street*
Mankiw and Ball, *Macroeconomics and the Financial System*
Mansharamani, *BoomBustOlogy*
Porter et al, *New Directions in Financial Services Regulation*
Rapp, *Bubbles, Booms, and Busts*
Reinhart and Rogoff, *This Time Is Different*
Rubini, *Crisis Economics*
Stiglitz, *Freefall*

All of the readings are required, and they should be read in advance of the class in which they will be discussed. Approximate number of class periods for each topic are indicated in parentheses after major headings. Assignments, materials, and notices will be posted periodically on blackboard. You are responsible for checking blackboard for those updates.

**Exams and Grading**

There will be one midterm exam plus a final in this course. The midterm will cover material up through Sections 5A on this syllabus and will be given on February 18. The final exam will cover the entire course, with some emphasis on material in the last five sections. In addition, a few homework exercises will be assigned and graded, and there will be a short paper to be assigned later in the course.

Your overall grade will be made up of 30% for the midterm, 40% for the final, 15% for the paper and 15% for all the homeworks.

Unexcused absences from any exam or late submission of any assignment will be graded F—no exceptions.

**Prerequisites**

The prerequisite for this course is principles of economics. Readings and lectures will presume you have a good grasp of that material. We will introduce and use some intermediate level economics, as well as some mathematics and statistics along the way. If you are not ready for this, this would be the right time to bow out of the course.

**Speakers**

We will have some guest speakers come to our class. I will let you know the particular assignments for those classes.
I. INTRODUCTION

1. Bubbles—Past and Present (3)
   A. Overview
      Kindleberger, ch. 1 (pp. 1-16)

   B. Tulipmania (1634-7)
      Mansharamani, ch. 6
      Dash, ch. 10, 12 (pp. 155-161)

      Mankiw, ch. 16 (pp. 432-450)
      Shiller, ch. 1, 3, 4 (56-68)
      Rapp, pp. 175-204
      Mollenkamp and Lundegaard, “How Internet Fever Sent Shares of a Firm on a 3
      Day Joy Ride,” WSJ, Dec. 9, 1998

   D. The Housing Bubble (2002-07)
      Zandi, ch. 8, 10
      Shiller, ch. 2

2. Theories of Bubbles (3)
   A. Efficient Market Hypothesis
      Malkiel, “The Efficient Market Hypothesis and Its Critics,” Journal of Economic
      Perspectives (2003), pp. 59-64, 72-80
      Shiller, ch. 4 (68-81), 10, 11
      Norsted, “Mean Reversion, Forecasting, and Market Timing”
      Fox, “Is the Market Rational?”

   B. Behavioral Finance and Economics
      Shiller, ch. 8, 9
      Gretchen Morgenstern, “How to Cut Megabanks Down to Size”

   C. Minsky-type Bubbles
      Kindleberger, ch. 2, 3
      Mansharami, Chapter 5 "Epidemiology and Emergence"
      Bichachandani, Hirshleifer and Welch, "Learning from the Behavior of Others,"
      pp. 151-158]
II. THE BUBBLE AND FINANCIAL CRISIS

3. Timeline and Overview (1)
   Zandi, ch. 1
   Mankiw, ch. 19 (pp. 546-559)
   FCIR, ch. 1

4. Housing: Information and Incentive Problems (3)
   A. Housing Fundamentals
      McDonald and Thornton, “A Primer on the Mortgage Market” pp 31-37 only
      Zandi, ch. 4
   
      B. The Housing Boom
      Stiglitz, ch. 4 (pp. 81-91)
      Cassidy, ch. 18
      Zandi, ch. 3
   
      C. Easy Credit
      Cassidy, ch. 17
      FCIR, ch. 6 and 7
      Zandi, ch. 4
   
      D. Easy Lending Standards
      Zandi, ch. 6
      FCIR, pp. 75-80
      Fishbein and Bunce, “Subprime Market Growth and Predatory Lending”
      pp. 273-283
      Knowledge Wharton, “Victimizing the Borrowers” (2008)

5. Deregulation and Financial Innovations (4)
   A. The Banking and Financial Sector
      Mankiw and Ball, ch. 15 (pp. 409-420)
      Ch. 17 (pp. 465-475)
      Ch. 18 (pp. 499-511)
      AR, ch. 1
   
      B. Deregulatory Policy
      FCIR, ch. 4
      Moss, “An Ounce of Prevention,” in Porter et al
      CEPR, A Short History of Financial Deregulation in the U.S.” (2009)
B. Securitization: MBSs, CDOs, and CDSs
   Zandi, ch. 7
   AR, ch. 10 (pp. 69-74)
   FCIR, ch. 3, 8, 10
   Mankiw, ch. 17 (pp. 488-493)

C. Shadow Banking System
   AR, ch. 6
   FCIR, ch. 2
   Lang and Jagtiani, “The Mortgage and Financial Crisis: Risk and Governance”

6. Contributing Factors and Failures (1.5)
   A. Credit Ratings Agencies
      AR, ch. 3
      FCIR, ch. 11
      Lowenstein, “Triple A Failure,” NYT, Apr 27, 2008
      White, “The Credit Ratings Agencies,” JEP, 2010

   B. Compensation and Governance
      AR, ch. 8
      Bebchuk, “How to Fix Bankers’ Pay,” Daedalus, Fall 2010
      Cassidy, ch. 21

III. THE BUST AND ITS AFTERMATH

7. Busts--Past and Present (1.5)
   Dash, ch. 13, 14
   Rapp, ch. 2 (pp. 136-161)
   Reinhart and Rogoff, ch. 13, 14
   Mankiw, ch. 18 (pp. 520-32)
   FCIR, ch. 12, 16 (pp. 298-3008), 18, 21

8. Bankruptcy and Bailouts (2)
   A. Automobile Industry
      AR, ch. 17
      Rattner, “The Auto Bailout: How We Did It,” Fortune

   B. Banks and Financial Institutions
      FCIR, ch. 15, 16
Lowenstein, ch. 16-18

C. Housing Foreclosures and Personal Bankruptcy
   AR, ch. 16
   FCIR, ch. 22

9. Regulation, Again (3)
   A. The New Role for Regulation
      AR, ch 1 (pp. 25-50)
      ARCRW, Prologue, ch. 1
      Stiglitz, ch. 6
      Baer, “How Main Street Can Tame Wall Street”

   B. Bank Size and Systemic Risk
      AR, ch. 13
      Johnson, ch. 6
      Fisher, “Taming the Too Big to Fail”
      Scherer, “A Perplexed Economist Confronts ‘Too Big to Fail’,” KSG Working
      Paper, March 2010
      CCH, “Understanding the Economics of Large Banks,” 2011

10. Lasting Effects (2)
   A. Distortions in Income and Influence
      “The Jobless and Wageless Recovery from the Great Recession,” 2011
      Johnson, ch. 4, 7
      Johnson, “The Quiet Coup”

   B. Distortions in Policy and Thought
      Friedman, ch. 11, 12
      Stiglitz, ch. 9
      Ferguson, “Ivory Tower”

   C. Student Debt: The Next Great Bubble and Bust?
      Pew Research Center, “Record one-in-Five Households Owe Student Loan Debt”