Course Description

The financial crisis of 2007-9 was a massive and dangerous collapse of major financial institutions in this country. It spilled over into the “real” economy and then to other countries. Its effects—both micro and macro—remain with us today and are likely to persist for some time. But what actually happened, and why? Who or what was responsible? Was it predictable and preventable? Have we now fixed the underlying problems?

This course investigates the microeconomic issues underlying this crisis. It focuses on the problems with markets that caused or contributed to the crisis—problems of information and incentives. It then examines the failures of regulatory policies that were supposed to protect us—failures due to ideology and politics. And finally, we ask whether the lessons of this crisis have been learned: Have we made the necessary changes in institutions and in policy to prevent such failures again?

We begin by analyzing “bubbles.” We first discuss several examples of famous bubbles in history and at present, and then examine in some detail economic, financial, and behavioral theories of market pricing and bubbles. This permits us to answer such questions as: What constitutes and causes a bubble? Can we identify a bubble? Should we let a bubble run its course, or should policy intervene to control it?

We then undertake a detailed examination of the 2008 financial crisis. We first discuss the bubble in the housing market that was the proximate cause of the crisis. We will see that this bubble did not have to happen: Any number of market players or policymakers could have reined it in. The analysis will also investigate a series of related issue, such as: What are subprime mortgages and who was responsible for their oversight? What were the roles of compensation, securitization, and the ratings agencies in causing the mortgage market to spin out of control? Where were the regulators throughout all this?

Finally, we consider how policy responded to this crisis, and what has resulted. What is the best way to deal with a bubble that is deflating? Is bankruptcy or bailout or regulation the right approach? Can these markets to be trusted in the future? What have been the broader social and intellectual fallouts from this crisis?
Readings and Blackboard

This course will draw extensively on several books. 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 (total cost for online purchase is about $75):

- Acharya and Richardson, Restoring Financial Stability
- Cassidy, How Markets Fail
- Lowenstein, The End of Wall Street
- Shiller, Irrational Exuberance (2/e; available as an ebook through our library)
- Zandi, Financial Shock (updated)

There are a number of additional readings listed on the syllabus. Links to journal articles are provided. You will be given instructions as to how to access chapters from other books shortly. Those books are as follows:

- Acharya, et al (ARCRW), Regulating Wall Street
- Dash, Tulipomania
- Friedman, What Caused the Financial Crisis
- Johnson, 13 Bankers
- Kindleberger, Manias, Panics, and Crashes
- Lowenstein, Origins of the Crash
- Mankiw and Ball, Macroeconomics and the Financial System
- Mansharamani, BoomBustOlogy
- Rapp, Bubbles, Booms, and Busts
- Roubini, Crisis Economics
- Stiglitz, Freefall
- Vogel, Financial Market Bubbles and Crashes

All of the readings are required, and they should be read in advance for class discussion. 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 two in-class exams plus a final in this course. The first exam will cover Sections 1-4A and will be given on February 13. The second exam will cover Sections 4B-6 and be held on March 21. The final will cover the entire course, with some emphasis on material in the last five sections.

Your overall grade will be made up of 30% for each of these three exams, plus 10% from questions you will prepare for guest speakers. More on that assignment will follow.

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

The prerequisites for this course are 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. If you are not ready for this, this would be the right time to bow out of the course.
I. INTRODUCTION

1. Famous Bubbles (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
      Shiller, ch. 1
      Rapp, pp. 175-185
      Lowenstein ORIGINS, ch 6, 9
   D. The Housing Bubble (2005-8)
      Zandi, ch. 8, 10
      Shiller, ch. 2

2. Theories of Bubbles (3)
   A. Efficient Markets
      Vogel, ch. 3
      Shiller, 10, 11
   B. Minsky Bubbles
      Kindleberger, ch. 2, 3
      Cassidy, ch. 16
   C. Behavioral Finance
      Cassidy, ch. 13-15
      Shiller, ch. 8, 9
II. THE FINANCIAL CRISIS OF 2008

3. Timeline and Overview (1)
   Zandi, ch. 1
   AR, ch. 1 (pp. 1-25)
   Mankiw, ch. 19 (pp. 546-559)
   FCIR, Executive Summary, ch. 1

4. Housing: Information and Incentive Problems (3)
   A. The Housing Market
      Stiglitz, ch. 4 (pp. 77-97)
      Cassidy, ch. 21
      Mansharamani, ch. 2 (pp. 23-30)
      Zandi, ch. 3
   B. Easy Credit
      Zandi, ch. 4- 5
      FCIR, ch. 6
   C. Subprime Mortgages and Lending Standards
      Cassidy, ch. 18, 19
      FCIR, ch. 5, 7
      Zandi, ch. 6
   D. Compensation Issues
      AR, ch. 8
      Lowenstein, ch. 4
      Bebchuk, “How to Fix Bankers’ Pay,” Daedalus, Fall 2010

5. Inflating the Bubble: Financial Innovations (5)
   A. The Banking and Financial Sector
      Mankiw and Ball, ch. 15 (pp. 409-420)
      Ch. 17 (pp. 465-475)
      Ch. 18 (pp. 499-511, 515-532)
   B. Securitization and Derivatives
      Zandi, ch. 7
      AR, ch. 10
      FCIR, ch. 3
      Stulz, “Credit Default Swaps,” JEP Winter 2010
      Mankiw, ch. 17 (pp. 488-493)
C. Structured Finance: CDOs  
FCIR, ch. 8, 10  

C. Shadow Banking System  
AR, ch. 6  
FCIR, ch. 2  

D. Credit Ratings Agencies  
AR, ch. 3  
FCIR, ch. 11  
Lowenstein, “Triple A Failure,” NYT, Apr 27, 2008  
White, “The Credit Ratings Agencies,” JEP, 2010  

6. Enabling the Bubble: Deregulation and Deregulators (2)  
A. Deregulating Banking and Finance  
AR, ch. 5  
Roubini, ch. 3  
FCIR, ch. 4, 9  

B. The Fed: Mortgage Lending Standards  
Zandi, ch. 9  
Cassidy, ch. 17  

C. SEC/CFTC: Actions and Inaction  
Lowenstein ORIGINS, ch. 5  

III. THE BUST AND AFTERMATH  

7. Overview and Timeline (1.5)  
FCIR, ch. 12, 13, 20, 21  
Zandi, ch. 11, 12, 13  
Lowenstein, ch. 19  

8. Dealing with Past Busts and Crises (1)  
A. Tulipmania Again  
Dash, ch. 13, 14  

B. Savings and Loans  
Rapp, ch. 2 (pp. 136-161)
9. Bankruptcy and Bailouts (1.5)
   A. Automobile Industry
      AR, ch. 17
   B. Banks and Financial Institutions
      AR, ch. 15
      Cassidy, ch. 22-23
      Lowenstein, ch. 16-18
   C. Housing and Personal Bankruptcy
      AR, ch. 16
      FCIR, ch. 22

10. Regulation, Again (2)
    A. The Role of Regulation
       Mankiw, ch. 19 (pp. 560-566)
       Roubini, ch. 8, 9
       AR, ch 1 (pp. 25-50)
    B. Bank Size and Systemic Risk
       AR, ch. 13
       Johnson, ch. 6
       Janicki and Prescott, “Changes in the Size Distribution of U.S. Banks,” FRB Richmond, Fall 2006
    C. Dodd-Frank, Volcker Rule, etc.
       ARCRW, Introduction, ch. 1, 7

11. Broader Effects (1.5)
    A. Social and Economic Effects
       Stiglitz, ch. 6
       Johnson, ch. 4, 7
B. Intellectual and Policy Effects
   Friedman, ch. 11, 12
   Stiglitz, ch. 9
   Lowenstein, ch. 20