ECON: 4389-1: Economics of Financial Crises
Spring 2019

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Time and Location

Tuesdays and Thursdays, 11.30am-1.00pm, M-116

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 Tuesdays 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 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 three main parts. The first part will consider the microeconomic aspects of investor behavior, motivated by the early history of financial crises. The second part will focus on the Great Depression and use workhorse economic models to measure and analyze similar episodes. In the final part of the course we will shift attention to financial markets to study banking crises, currency and stock market crashes, sovereign debt defaults and the interdependencies between them.

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.
- Jones, Charles I. (2016): *Macroeconomics*, W.W. Norton & Company Inc., Fourth Edition.

Course Requirements

The course objective is to expose participants to the methods of modern economic analysis in a learning-by-doing environment. The history of financial crises will provide an interesting context and motivation for using them. To this end, grades will be determined by the following requirements:

- Three homework projects, evenly spaced throughout the semester, each carrying a 25% weight in the final score. These projects will ask you to use the research methods presented in class, find relevant economic data, conduct your own analysis, and write a brief report.
- Weekly quizzes, together worth 25% of the final score, which review the history of financial crises and data patterns discussed in the last two classes. There will be a total of ten quizzes, each earning a Pass or a Fail. The total score for this part is equal to the number of Passes times 10. Passing at least 8/10 quizzes automatically results in a maximum score.

Course Policies

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

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

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.

There is no extra credit available in this course beyond the grading schemes described above.

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).

Counseling and Psychological Services: Counseling and Psychological Services (CAPS) can help students who are having difficulties managing stress, adjusting to college, or feeling sad and hopeless. You can reach CAPS (www.uh.edu/caps) by calling 713-743-5454 during and after business hours for routine appointments or if you or somebody you know is in crisis. No appointment is necessary for the "Let's Talk" program, a drop-in consultation service at convenient locations and hours around campus. http://www.uh.edu/caps/outreach/lets_talk.html

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.

2. Early crises
   - *Was tulipmania irrational?*, by C.W. and A.J.K.D., *The Economist*, October 2013.
   - *Financial crises: The slumps that shaped modern finance*, The Economist, April 2014
   - *The Federal Reserve system*, *The Economist*, Jun 2016

3. Herd behavior and overconfidence
   - *Herd behavior in Financial Markets: A Review*, IMF Working Paper 00/48, March 2000.
   - Dubra J., and J.P. Benoit (2011): *Apparent Overconfidence*, Econometrica, 79.

4. Great Depressions
   - Kehoe and Prescott, ch. 1-2, 9
   - *What can we learn from the Depression?*, The Economist, Nov 2013.

5. Growth accounting and the neoclassical growth model
   - Cole, H.L. and L.E. Ohanian (1999): *The Great Depression in the United States From a Neoclassical Perspective*, Federal Reserve Bank of Minneapolis Quarterly Review, 23, 2-24.
   - Conesa, J.C., T.J. Kehoe, and K.J. Ruhl (2007): *Modeling Great Depressions: The Depression in Finland in the 1990s*, manuscript.
   - Bergoeing, R., P.J. Kehoe, T.J. Kehoe, and R. Soto (2007): *A Decade Lost and Found: Mexico and Chile in the 1980s*, manuscript.

6. 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.

7. Inflation and currency crises
   - Reinhart and Rogoff, ch. 11-12

8. Sovereign debt crises
   - Reinhart and Rogoff, ch. 4-6

- Kehoe, T.J. (1995): *What happened in Mexico in 1994-95?*, in P.J. Kehoe and T.J. Kehoe, *Modeling North American Economic Integration*, Kluwer Academic Publishers, 131-147.

9. The Great Recession
   - Kindleberger and Aliber, ch.13
   - Reinhart and Rogoff, ch. 13-14
   - 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.

10. The European Debt Crisis
   - Lane, P.R. (2012), *The European Sovereign Debt Crisis*, Journal of Economic Perspectives, 26, pp. 49-68.