

# FINANCIAL CRISES, BUBBLES AND CRASHES

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## *Description:*

Financial crises are a recurrent feature in modern economies. They were as common in the 19<sup>th</sup> century as they are today. This course examines financial crises, banking collapses, and credit crunches over the last 200 years. Starting with the subprime crisis, it analyses underlying factors that generate instability in financial markets. Using a mix of recent and historical episodes, the course examines the causes and consequences of banking crises and of asset price bubbles, and concludes with a discussion of policy implications.

\* starred readings will receive particular emphasis in class.

## **Background Readings**

Jean Tirole, Financial Crises, Liquidity, and the International Monetary System. Princeton: Princeton University Press. 2002.

Charles P. Kindleberger, Manias, Panics and Crashes: A History of Financial Crises, New York: John Wiley, 1996.

Barry Eichengreen, Financial Crises: and what to do about them. New York: Oxford University Press, 2002.

Michael D. Bordo, Currency crises (And Banking Crises) in Historical Perspective. Stockholm School of Economic Research Report No. 10 1998.

Maury Obstfeld, Alan Taylor, Global Capital Markets: Integration, Crisis, and Growth. Cambridge: Cambridge University Press 2003.

## **1 Introduction and Overview: Financial Crises, Crashes and Bubbles**

\* Reinhart, Carmen and Ken Rogoff, 2008. "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises", NBER working paper 13882.

Bordo, Michael et al., 2001. "Financial Crises. Lessons from the last 120 years". Economic Policy.

## **2 Banking crises and credit booms gone wrong**

### *Theory and stylized facts*

Douglas Diamond, Philip Dybvig, "Bank Runs, Deposit Insurance, and Liquidity", *Journal of Political Economy* 91, 1983.

Franklin Allen, Douglas Gale, 1998, "Optimal Financial Crises", *Journal of Finance*.

Arteta, C. and B. Eichengreen, 2002, "Banking Crises in Emerging Markets: Presumptions and Evidence", In M. Blejer and M. Skreb (eds.), *Financial Policies in Emerging Markets*, MIT Press.

Cormac O Grada, Eugene N. White, 2000, "Who Panics During Panics? Evidence from a Nineteenth Century Savings Bank", *American Economic Review*.  
 Gary Gorton, Lixin Huang, 2002, "Banking Panics and the Origin of Central Banking", NBER wp 9137.

### *The Subprime Crisis*

\* Greenlaw, Michael, Jan Hatzius, Anil Kashyap, and Hyun Shin, 2008. "Leveraged Losses: Lessons from the Mortgage Market Meltdown". US Monetary Policy Forum Conference Draft.  
 Mian, Atif R. and Sufi, Amir, 2008. "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis". U Chicago wp.  
 Reinhart, Carmen M. and Rogoff, Kenneth S., 2008. "Is the 2007 U.S. Sub-Prime Financial Crisis so Different? An International Historical Comparison". NBER wp.

### *The Great Depression and Financial Instability*

Bernanke, Ben, 1983. "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression", *The American Economic Review*, 73: 257-276.  
 Bernanke, Ben, and Harold James, 1991. "The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison," in R. Glenn Hubbard, *Financial Markets and Financial Crises*, Chicago: University of Chicago Press.  
 Calomiris, Charles and Joseph R. Mason, 2003. "Fundamentals, Panics, and Bank Distress During the Depression", *American Economic Review* 93.  
 Cole, Harold and Lee Ohanian, 2000, "Re-Examining the Contributions of Money and Banking Shocks to the US Depression", *NBER Macroeconomics Annual*, Ben Bernanke and Kenneth Rogoff, eds., Cambridge, MA.  
 Eichengreen, Barry, and Kris Mitchener, 2003. "The Great Depression as a credit boom gone wrong", BIS conference paper.  
 \* Grossman, Richard S. "The Shoe That Didn't Drop: Explaining Banking Stability during the Great Depression." *Journal of Economic History* 54, no. 3 (1994)  
 Schnabel, Isabel, 2004. "The German Twin Crisis of 1931", *Journal of Economic History*.

### *The East Asian Crisis*

\* Krugman, Paul, 1999. "Balance Sheets, the Transfer Problem, and Financial Crises", *International Tax and Public Finance* 6: 459-72.  
 Paul Krugman, 1998, "What Happened to Asia?" mimeo, January 1998.  
 Corsetti, Giancarlo, P. Pesenti, and N. Roubini, 1999. "Paper tigers? A model of the Asian crisis", *European Economic Review*.  
 Frederic Mishkin, 1999, "Global Financial Instability: Framework, Events, Issues", *Journal of Economic Perspectives*, 13(4), pp. 3-20.

### 3 Bubbles

#### *Theoretical background*

- Blanchard, Olivier J. and Mark W. Watson, 1982. "Bubbles, Rational Expectations and Financial Markets." *Crises in the Economic and Financial Structure*, Paul Wachtel, editor, pp. 295-316. Lexington, MA: D.C. Heath and Company.
- Franklin Allen, Stephen Morris and Hyun S. Shin, 2002. "Beauty Contests, Bubbles and Iterated Expectations in Asset Markets", LSE working paper.
- Abreu, Dilip and Brunnermeier, Markus, 2002. "Synchronization Risk and Delayed Arbitrage". *Journal of Financial Economics* 66.
- DeLong, Bradford, Shleifer, Andrei, Summers, Lawrence and Waldmann, Robert, 1990. "Noise Trader Risk in Financial Markets." *Journal of Political Economy* 98: 703-38.
- \* Allen, F. and D. Gale (2000), "Bubbles and Crises", *Economic Journal* **110**: 236-256.

#### *Bubbles and Liquidity*

- Hong, Harrison, Jose Scheinkman and Wei Xiong, 2006, "Asset Float and Speculative Bubbles", *Journal of Finance*.
- \_\_\_\_\_, 2005, "Advisors and Asset Prices: A Model of the Origins of Bubbles", Princeton U working paper.
- Brunnermeier, Markus and L. Pedersen (2004), "Predatory trading", *Journal of Finance*.
- Carlin, B., M. Sousa Lobo and S. Viswanathan (2004), "Episodic Liquidity Crises. The Effect of Predatory and Cooperative Trading". *Duke University working paper*.

#### *Dotcom Mania*

- Brunnermeier, Markus and Stefan Nagel, 2004. "Hedge Funds and the Technology Bubble". *Journal of Finance* 59. 2004.
- \* Eli Ofek and M. Richardson, 2003. 'Dotcom Mania: The Rise and Fall of Internet Stocks', *Journal of Finance*.
- John Cochrane, 2002. 'Stocks as Money: Convenience Yield and the Tech-Stock Bubble', U Chicago manuscript.
- Pastor, Lubos and Veronesi, Pietro, 2006. "Was There a Nasdaq Bubble in the Late 1990s?" *Journal of Financial Economics* 81: 61 – 100.
- Lamont, Owen and Richard Thaler, (2003), "Can the Market Add and Subtract? Mispricing in Tech Stock Carve-Outs", *Journal of Political Economy* 111(2): 227-268.

#### *The South Sea Bubble*

- Temin, Peter and Hans-Joachim Voth. "Riding the South Sea Bubble". *American Economic Review* 94, 2004.
- Dale, R.S., Johnson, J.E.V. and L. Tang (May 2005). "Financial Markets can go mad : Evidence of irrational behaviour during the South Sea Bubble." *The Economic History Review*, LVIII, 2, 233-271.

#### *1929 and the 20s boom*

- Tom Nicholas, 2008. "Does Innovation Cause Stock Market Runups? Evidence from the Great Crash", *American Economic Review*, forthcoming.

- Edith McGrattan, and Ed Prescott, 2003, "The 1929 Stock Market: Irving Fisher Was Right", Federal Reserve Bank of Minneapolis, Staff Report 294.
- \* Bradford De Long, and Andrei Shleifer, 1991, "The Stock Market Bubble of 1929: Evidence from Closed-End Mutual Funds." *Journal of Economic History*, 51(3), pp. 675-700.
- Rappoport, Peter and White, Eugene N., 1994, "Was the Crash of 1929 Expected?" *American Economic Review*, 84(1), pp. 271-81.

*Experimental evidence*

- Smith, Vernon, Gerry Suchanek and Arlington Williams, 1988. "Bubbles, Crashes, and Endogenous Expectations in Experimental Spot Asset Markets", *Econometrica* 56.
- Hirota, Shinichi, Shyam Sunder, "Stock Markets as a Beauty Contest: Investor Beliefs and Price Bubbles Sans Dividend Anchors", *Journal of Economic Dynamics and Control* 31, no. 6 (June 2007): 1875-1909.
- Becker, Ralf, Urs Fischbacher and Thorsten Hens, "Soft Landing of a Stock Market Bubble: An Experimental Study", U of Zurich Working paper 2002.
- Ackert, Lucy et al., "Bubbles in Experimental Asset Markets: Irrational Exuberance No More", Fed Atlanta WP 2002.

**4 Policy Implications: Central Banks and Asset Prices**

- \* Bernanke, Ben, and Mark Gertler, 1999. "Monetary Policy and Asset Price Volatility", *Fed Kansas Economic Review*: 17-51.
- Rigobon, Robert, and Brian Sack, 2003. "Measuring The Reaction Of Monetary Policy To The Stock Market", *Quarterly Journal of Economics*".
- Voth, Hans-Joachim, 2001, "With a Bang, Not a Whimper: Pricking the German Stock Market bubble in 1927 and the Slide into Depression". *Journal of Economic History*.
- Bernanke, Ben, and Ken Kuttner, 2005, "What Explains the Stock Market's Reaction to Federal Reserve Policy?", *Journal of Finance*.
- Frederic S. Mishkin and Eugene N. White, 2003. "Stock Market Bubbles: When Does Intervention Work?" *Milken Institute Review*: 44-52.