

# FINANCIAL CRISES, BUBBLES AND CRASHES

Hans-Joachim Voth

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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.

[Problem Sets](#)

[Links](#)

\* 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.

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

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

[lecture notes]

\* 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 Bubbles [lecture notes]

### Theoretical background

\*Allen, F. and D. Gale (2000), "[Bubbles and Crises](#)", *Economic Journal* 110: 236-256.

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. Heathand Company.

Allen, Franklin, Stephen Morris and Hyun S. Shin, 2006, "[Beauty Contests, Bubbles and Iterated Expectations in Asset Markets](#)", *Review of Financial*

*Studies* 19(3): 719-752.

Abreu, Dilip and Brunnermeier, Markus. ["Synchronization Risk and Delayed Arbitrage"](#). *Journal of Financial Economics* 66, 2002.

DeLong, Bradford; Shleifer, Andrei; Summers, Lawrence and Waldmann, Robert, 1990, ["Noise Trader Risk in Financial Markets."](#) *Journal of Political Economy* 98: 703-738.

#### *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"](#), NBER wp. 13504.

Brunnermeier, Markus and L. Pedersen (2004), ["Predatory trading"](#), *Journal of Finance*.

Adrian, Tobias and Hyun Shin, 2007, ["Liquidity and Leverage"](#), Federal Reserve of NY wp.

#### *Dotcom Mania*

Brunnermeier, Markus and Stefan Nagel, 2004. ["Hedge Funds and the Technology Bubble"](#). *Journal of Finance* 59(5): 2013-2040

\* Eli Ofek and M. Richardson, 2003, ["Dotcom Mania: The Rise and Fall of Internet Stocks"](#), *Journal of Finance* 58(3): 1113-1138

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*

Edith McGrattan, and Ed Prescott, 2004, ["The 1929 Stock Market: Irving Fisher Was Right"](#), *International Economic Review* 45(4): 991-1009

\* 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.

Nicholas, Tom, 2008. ["Do Intangibles Cause Stock Market Bubbles? Evidence from the Great Crash,"](#) *American Economic Review*.

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.

**3 Banking Crises and Credit Booms gone wrong [lecture notes]***Theory and stylized facts*

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

Bernanke, Ben, and Mark Gertler, 1989. "[Agency Costs, Net Worth, and Business Fluctuations.](#)" *American Economic Review*, 79, 14-31.

Allen, Franklin and Douglas Gale, 1998, "[Optimal Financial Crises](#)", *Journal of Finance*.

\*Matsuyama, Kiminori, 2007. "[Credit Traps and Credit Cycles](#)". *American Economic Review* 97, 503-516.

Lorenzoni, Guido, 2007. "[Inefficient Credit Booms](#)". MIT wp.

O Grada, Cormac and Eugene N. White, 2002, "[Who Panics During Panics? Evidence from a Nineteenth Century Savings Bank](#)", *American Economic Review*.

*The Subprime Crisis* [for a light-hearted but well-researched look, watch [Bird+Fortune 1](#) or [B+F2](#)]

\* 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](#)". NBER wp 13936.

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. 13761

Dell'Ariccia, Giovanni, Deniz Igan, and Luc Laeven, 2008. "[Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market](#)". IMF wp.

*The Great Depression and Financial Stability*

Bernanke, Ben, 1983. "[Nonmonetary Effects of the Financial Crisis in](#)

[Propagation of the Great Depression](#)", *American Economic Review* 73: 257-276

Calomiris, Charles and Joseph R. Mason, 2003, [Fundamentals, Panics, and Bank Distress During the Depression](#), *American Economic Review* 93: 1615-1647

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* 64: 822-871

#### 4 Sovereign Debt Crises, Exchange Rates, and Contagion [[lecture notes](#)]

##### *Contagion*

[Kristin Forbes, Roberto Rigobon, "No Contagion, Only Interdependence: Measuring Stock Market Co-Movements", \*Journal of Finance\* LVII \(5, October\), pgs. 2223-2261.](#)

[Isabel Schnabel, Hyun Shin, "Liquidity and Contagion: The Crisis of 1763", \*Journal of the European Economic Association\*.](#)

##### *Globalization and Financial Crises in Emerging Markets*

\* [Graciela Kaminsky and C. Reinhart, 1999, "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems", \*American Economic Review\*.](#)

[Guillermo Calvo and Carmen Reinhart, 2000, "Fear of Floating," \*NBER Working Paper No. 7993\*.](#)

[Heinemann, Frank, Rosemarie Nagel and Peter Ockenfels, \*The Theory of Global Games on Test: Experimental Analysis of Coordination Games with Public and Private Information\*, \*Econometrica\* 2005.](#)

[Mitchener, K. and M. Weidenmier, "Supersanctions and Sovereign Debt Repayment", \*NBER working paper\* 2005.](#)

[Sachs, J., "Managing the LDC Debt Crisis", \*Brookings Papers on Economic Activity\* 1986.](#)

##### *East Asia, Argentina and Brazil*

\* [Paul Krugman, 1999, "Analytical Afterthoughts on the Asian Crisis," mimeo.](#)

[Paul Krugman, 1998, "What Happened to Asia?" mimeo, January 1998.](#)

[Olivier Blanchard, \*Fiscal Dominance and Inflation Targeting\*, \*NBER\*.](#)

## 5 Policy Implications: Central Banks and Asset Prices [lecture notes]

Alexandros Kontonikias and Alberto Montagnolinn, 2006. "[Monetary Policy and Asset Price Volatility](#)", *Scottish Journal of Political Economy* 53(5): 636-654

Ben Bernanke and Mark Gertler, "[Monetary Policy and Asset Price Volatility](#)", *Federal Reserve Bank of Kansas Economic Review* 1999.

Rigobon, Robert, and Brian Sack, 2003. "[Measuring The Reaction Of Monetary Policy To The Stock Market](#)", *Quarterly Journal of Economics* 118(2): 639-669

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* 63.

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. [requires creation of an online account with Milken, which is free of charge]

### Problem Sets

No	Question	Deadline
1	How can bubbles exist? Contrast the Brunnermeier- Abreu view with the Allen- Gale one. Are they compatible?	23.2.
2	How rational were stock	

- ← prices in 1929?  
In the Diamond-Dybvig
- 3 setup, can you have a safe bank that is still useful?  
Did bank instability simply reflect poor economic performance during the
- 4 Great Depression? Pick two papers from the reading list, and use them to maximum effect to argue your case  
What are the main similarities and differences
- 5 between the Asian financial crisis and the Great Depression?

## Links

This is just a collection of links that I find useful in tracking the current crisis. It's not meant to be comprehensive. Check them out and let me know if you have other ideas:

- [Econbrowser](#)
- [Brad deLong's webpage](#)
- [St. Louis Fed recession tracker](#)
- [Survey of Consumer Finances](#)
- [CEPR](#) (a mixed bag, but some policy-relevant stuff)
- [Krugman](#)

