

The Economics of Past, Present, and Future Financial Collapse

KHC EC 101

Fall 2011

Tuesdays/Thursdays

11:00 AM – 12:30 PM

Room: KHC 107

Laurence Kotlikoff

Boston University, Department of Economics

Office hours: Mondays 2:00-3:00 PM, Wednesdays 4:00 – 5:00 PM, Thursdays 10:00-11:00 AM

Office location: 264 Bay State Road, Room 300

kotlikoff@gmail.com

(617) 353-4002

Course Description and Objectives

This course examines the history, causes, and potential cures for financial collapse. It will combine many elements of a traditional money and banking course, but integrate financial history and the history of financial thought.

The course begins with a description of the 2008 and 1929 financial collapses and their economic impacts. You'll read parts of the Financial Crisis Inquiry Commission report and the Percora Commission report as well as hear from John Maynard Keynes and John Kenneth Galbraith. We'll then take a tour, with Charles Kindleberger, of financial collapse through the centuries and examine the extent to which they have been accompanied by economic downturns.

With this background, we'll spend several lectures understanding financial intermediation, the nature and types of modern financial intermediaries, and the nature and types of ancient and modern financial securities. You'll learn about the Tontine, developed in 1653, and Parimutuel Betting, developed in 1867. You also learn about modern derivative securities, including the Credit Default Swap and tranching CDOs. And you'll consider the emergence and scope of Shadow Banks in the financial system.

To see more precisely the roles financial intermediaries play in the economy, we'll start with a simple dynamic economy that features no financial system or money. This presentation will be based on the simple life-cycle growth model developed in chapters 1, 2, and 3 of Auerbach and Kotlikoff's *Intermediate Macroeconomics: An Integrated Approach*. (These chapters will be available on line.)

We'll then examine the role of money and the need for financial intermediaries relying on chapters from Steven Cecchetti's text book, *Money, Banking, and Financial Institutions*. Next we'll look at the different types of financial intermediaries, including commercial banks, investment banks, hedge funds, and insurance companies that fulfill this need. We'll then

consider the instability of financial institutions. You'll view *It's a Wonderful Life*, read Minsky's views, and consider the role that lack of transparency and disclosure leading to financial fraud plays in financial collapse. In this regard, we'll study the great Ponzi schemes of Charles Ponzi, Bernard Madoff, and Uncle Sam.

The built-in fragility of the financial system and its susceptibility to fraud requires central banks and other government agencies to stabilize and regulate the financial system. Hence, we'll consider these responsibilities and how well they've been carried out. We'll read the classic work by Walter Bagehot on central banking, learn from Perry Merhling how Bagehot's principals are being extended in modern times, consider Milton Friedman's and Anna Schwartz's critique of Federal Reserve policy during the Great Depression, and contrast Fed actions in the 1930s with those in the Great Recession.

With this background, we'll examine recent actual and proposed financial reforms, including the Dodd-Frank reform, the British Banking Commission's Report, the Squam Lake Report, Simon Johnson's proposal to break up the banks, and Limited Purpose Banking.

Finally, we'll consider the potential for another, even larger financial crisis arising because of the interconnection between fiscal and financial fragility.

Required Readings and Texts

Texts:

1. Steve Cecchetti, *Money, Banking, and Financial Institutions*
2. Alan Auerbach and Laurence Kotlikoff, *Macroeconomics – An Integrated Approach* (several chapters, which will be made available on line)
3. John Kenneth Galbraith *The Great Crash 1929*
4. Charles Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*
5. Laurence Kotlikoff, *Jimmy Stewart Is Dead*
6. Perry Mehrling, *The New Lombard Street*

Course Blackboard Site:

Course materials (including homework and some readings) will be posted on Blackboard.

Group Book-Reviews

You'll be grouped with other members of the class into a book-reading club to read and report to the class, per the date indicated on the calendar, on your group's assigned book. As part of this assignment, you'll each separately write a critical review of the book you choose.

Books Options:

1. John Maynard Keynes, *The General Theory*
2. Walter Bagehot, *Lombard Street*
3. Harry Markopolous, *No One Would Listen*

4. Ferdinand Pecora, Wall Street Under Oath
5. Nassim Taleb, The Black Swan

Attendance

Classroom attendance is not optional and is taken very seriously. If you have a medical problem or a family emergency, please inform me via email. Failure to attend 5 or more classes not due to medical problems or family emergencies will lead to a reduction by one letter grade in your final grade.

Academic Dishonesty

You are to act with the highest academic standards. It is your responsibility to read and understand the provisions of the Academic Conduct Code posted at <http://www.bu.edu/academics/resources/academic-conduct-code/>. Hard copies are available in CAS room 105. Cases of suspected misconduct will be referred to the Dean's office.

Grading

- Problem Sets: 20%
- Midterm Exam: 30%
- Final Exam: 40%
- Group Presentation: 10%

Missed Work: Homework is due as assigned. Homework more than two weeks late will be treated as not completed.

Make Up Exams: Missed exams due to medical problems or family emergencies will be rescheduled. Please contact me in such circumstances to arrange a make up exam.

-Please Note: you are responsible to plan your travel ahead around exam dates. The data of the final is set by the registrar and cannot be changed.

Course Outline & Readings

Lecture 1. Introduction to the Course

Lecture 2. The Crash of 2008 - The Looming Crisis

Readings:

- The Financial Crisis Inquiry Commission, Parts I, II, and III.
<http://www.fcic.gov/report>.

Lecture 3. The Crash of 2008 – The Unraveling and Aftershocks

Readings:

- The Financial Crisis Inquiry Commission, Parts III and IV.
<http://www.fcic.gov/report>.

Lecture 4. The 1929 Crash -- Prelude

Readings:

- Galbraith, The Great Crash 1929 – Chapters 1-4
- Reference materials: Stock Exchange Practices – The Final Report of the Pecora Commission
http://fraser.stlouisfed.org/publications/sensep/issue/3912/download/59691/19340606_sensep_rpt.pdf

Lecture 5. The 1929 Crash – Black Tuesday and Its Aftermath

Readings:

- Galbraith, The Great Crash 1929. Chapters 5-9
- John Maynard Keynes, The General Theory. Selected chapters.

Lecture 6. Financial Crises Across the Centuries – Pre-1929

Readings:

- Kindleberger, Manias, Panics, and Crashes, Chapters 1-7

Lecture 7. Financial Crises Across the Centuries – Post-1929

Readings:

- A Reading Assignment: Kindleberger, Manias, Panics, and Crashes, Chapters 8-12

Lecture 8. Financial Intermediation- An Economy Without a Financial System

Readings:

- Macroeconomics – An Integrated Approach, Chapters 1-3

Lecture 9. Financial Intermediation and Financial Markets

Readings:

- Money, Banking, and Financial Institutions. Chapters 1-3

Lecture 10. Financial Intermediation and Financial Valuation.

Readings:

- Money, Banking, and Financial Institutions. Chapters 4 and 5.

Lecture 11. Financial Derivatives.

Readings:

- Money, Banking, and Financial Institutions. Chapter 6-9.

Lecture 12. Money as a Means of Financial Intermediation

Readings:

- Macroeconomics – An Integrated Approach. Chapter 7 Nobuhiro Kiyotaki and Randall Wright
- “Acceptability, Means of Payment and Media of Exchange,” in New Palgrave Dictionary of Money & Finance, ed., Newman, et. al., Macmillian, 1992.

Lecture 13. Banks and the Creation of Money

Readings:

- Macroeconomics – An Integrated Approach, Chapter 14

Lecture 14. Financial Institutions

Readings:

Money, Banking, and Financial Institutions, Chapters 11-13

Lecture 15. The Inherent Instability of Financial Institutions and the Economy

Movie Viewing Assignment: Frank Capra, It’s a Wonderful Life

- http://www.feedblitz.com/t.asp?/268315/9874509/http://www.levy.org/pubs/pn_08_2.pdf
- http://www.economist.com/blogs/freeexchange/2010/01/the_fed_discovers_hyman_minsky
- http://www.newyorker.com/talk/comment/2008/02/04/080204taco_talk_casidy

Lecture 16. Financial Fraud

Readings:

- Kotlikoff, Jimmy Stewart Is Dead, Chapters 1-4
- Frankel, Con Artists and Their Victims, selected chapters
- Group Presentation: Harry Markopolous, No One Would Listen
- <http://www.bloomberg.com/opinion/kotlikoff/>

Lecture 17. Financial Collapse and Information Cascades

Guest Lecturer – Christophe Chamley, Boston University Dept. of

Economics

Readings:

- A Quick Introduction to Information Cascades - <http://www.info-cascades.info/>
- Patrick Lemieux -- Following the Herd --
<http://www.cato.org/pubs/regulation/regv26n4/v26n4-2.pdf>
- Lisa R. Anderson and Charles A. Holt, "Information Cascades," Journal of Economic Perspectives, Vol. 10, no. 4, Fall 1996.

Lecture 18. Central Banks as Lenders, Dealers, and Insurers of Last Resort
Guest Lecture – Perry Mehrling

Readings:

- Money, Banking, and Financial Institutions, Chapters 15-17
- Walter Bagehot, Lombard Street. Selected chapters
- Perry Mehrling, The New Lombard Street. Selected chapters

Lecture 19. The Role of the Fed in the Great Depression

Video Viewing Assignment:

- Friedman and Schwartz, A Monetary History of the United States, 1867-1960, selected chapters
- Milton Friedman Videos:
http://www.youtube.com/watch?v=dgyQsIGLt_w
<http://www.youtube.com/watch?v=O7pnjzCuSv8>

Readings:

- Ben Bernanke, "Money, Gold, and the Great Depression,"
<http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm>

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Lecture 20. Financial Regulation

Readings:

- Money, Banking, and Financial Institutions, Chapter 14
- Simon Johnson, Thirteen Bankers, Selected chapters.

Video Viewing Assignment:

- Videos of Simon Johnson
<http://www.google.com/search?q=simon+johnson&hl=en&prmd=ivnso&source=univ&tbs=vid:1&tbo=u&sa=X&ei=MZ1gTbOKHsO78gbo8-CgDA&ved=0CG4QqwQ>

Lecture 21. The Next Financial Crisis? – The Financial--Fiscal Nexus

Readings:

- <http://www.bankofengland.co.uk/publications/speeches/2010/speech455.pdf>
- http://en.wikipedia.org/wiki/2008-2010_Icelandic_financial_crisis
- http://en.wikipedia.org/wiki/2008-2011_Irish_financial_crisis
- <http://www.youtube.com/watch?v=RmRdQUOu0QM>
- <http://www.washingtonpost.com/wp-dyn/content/article/2010/11/12/AR2010111206488.html>
- Nassim Taleb, The Black Swan: The Impact of the Highly Improbable. Group Report.

Lecture 22. Fixing the Financial System – The Squam Lake Report, Dodd Frank, Basel III, and the UK Independent Banking Commission Report

Readings:

- <http://seekingalpha.com/article/232711-book-review-the-squam-lake-report-offers-an-authoritative-look-at-post-crisis-financial-regulation>
- http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf
- <http://www.bis.org/speeches/sp101109a.htm>

Lecture 23. Fixing the Financial System – Limited Purpose Banking

Readings:

- Kotlikoff, Jimmy Stewart Is Dead, chapters 5-8.