The Economics of Financial Crises  

Course Syllabus  
Fall Semester 2015

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Course meeting times/places:  
Section 2001: MWF 2, SA 101  
Section 3001: MWF 3, SA 101  
Section 4001: MWF 4, SA 101

“The essence of this-time-is-different syndrome is simple. It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times; crises do not happen to us here and now. We are doing things better, we are smarter, we have learned from our past mistakes. The old rules of valuation no longer apply. Unfortunately, a highly leveraged economy can unwittingly be sitting with its back at the edge of a financial cliff for many years before chance and circumstance provokes a crisis of confidence that pushes it off.” Reinhart & Rogoff (2009)

Course Description:

While many emerging and developing economies had been hit by severe financial crisis in the last several decades, until a few years ago Western economies appeared crisis-proof. Then, starting in 2008, the sub-prime mortgage debacle crippled the U.S. financial markets, many European countries threatened to abandon their common currency, and many financial institutions around the rich world failed on an epic scale. All of this contributed to the largest worldwide economic recession in eighty years. This course explores in depth the causes and consequences of economic and financial crises in general, the contagion of such crises into other countries, and the policies used or proposed to prevent similar crises in the future. To help us gain a broader perspective on the causes and “fixes” of the U.S. crisis of the last couple of years and of the current European crisis, we will examine numerous historical crises in hopes of drawing parallels that may help to guide future economic policy. After completion of this course you will have a fuller understanding of what really happened. Using the tools of economics, you will be able to critically examine comments made by so called "market experts" concerning the crisis and the government's response. And, you will have a framework for understanding future crises when they inevitably occur (those are the goals anyway!).
General Student Learning Objectives:

- Students will apply economic reasoning to understand the causes and consequences of financial crises, specifically using:
  - Standard macroeconomic models
  - Case study analysis
  - Empirical analysis

- Students will use appropriate statistical methods to understand financial crises by:
  - Working hands-on with cross-country panel data set provided by the instructor
  - Generating and understanding descriptive statistics
  - Executing multivariate regression analysis and interpreting results

- Students will understand the key domestic and international institutions that can mitigate or exacerbate financial crises by:
  - Delving into historical case studies
  - Studying the key institutional players of the 2008 Financial Crisis

- Students will hone and demonstrate effective communication skills by:
  - Orally presenting and arguing over an historical financial crisis case
  - Writing a report on the key causes of crises using empirical evidence
  - Writing and presenting reports on historical and contemporary crises cases

Course Outline:  FOUR MODULES

Module I: *Theoretical Foundations for Studying Financial Crises* (6 weeks)

1) Introduction to the Financial System
2) Asset Prices and Interest Rates
3) Securities Markets
4) Banking
5) The IS-LM Model (closed economy)
6) The Mundell-Fleming Model (open economy)
7) The Diamond-Dybvig Banking Model
8) Models of Asset Price “Bubbles”

Much of the material will be synopsized in a series of slides. These slides will be posted on the class website.
After reviewing these theories and supporting material, there will be an exam which will test your knowledge of the theoretical material.

We will first review these theories, and then use them to analyze various crises in history.

**Readings: Refer to website**
**Exam: Covers models presented in class (25% of grade)**

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**Module II: This Time is Different: Historical Study of Financial Crises (3 weeks)**

Your extensive knowledge of the various theories covered in Module I will allow you to better analyze actual crises in history. To that end, you will team up in pairs and prepare a brief (6-7 pages in length) concerning an actual crisis in history. You should address questions like what happened, what country-specific institutions helped or hindered economic recovery, and what you as a policy-maker would have done differently.

**Readings: Refer to website**
**Group presentation and paper: Analyze the causes and consequences of “Crisis X.”**
**Details to follow. (15% of grade)**

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**Module III: This Time is Different: Empirical Study of Financial Crises (3 weeks)**

Here we will do what economists love to do – bring our ideas to the data. You will get down and dirty with a panel dataset, spanning 200 years and over 80 countries. Again in groups of two, you and a partner will develop an empirical model, test the model, create estimates and write up your results in a brief (6-8 pages). Some of our tasks include:

1) Gathering and organizing data
2) A quick primer on panel regression analysis
3) Producing and interpreting results

**Readings: Refer to website**
**Group presentation and paper: Develop an empirical model of the determinants of financial crises (20% of grade)**
Module IV: All Together Now - The 2008 Financial Crisis and Beyond (3 weeks)

The Great Contraction that began in 2008 was the worst since the Great Depression of the 1930s, and for many nations the crisis continues. Why? What policies would you recommend to prevent such a disaster from occurring again? Here you will utilize all your insights garnered from the first three modules to answer these critical and challenging questions. The outline of our approach is as follows:

1) Defining and Sequencing the Crisis:
   a) What happened?
   b) What types of sub-crises occurred (banking, currency, asset, debt, etc.)?
   c) What happened when?
   d) How were these sub-crises linked?

2) The Role of Institutions (the IMF, central banks, governments, etc.)

3) What regulations should be imposed to help us deal with future crises?

Group paper: Analyzing the Financial Crisis of 2008. Details to follow (15% of grade)
Exam: Covers the whole shebang, with particular emphasis on Modules I and IV (25% of grade)

Grades:

Exams: 50% (Total of 2)
Projects: 50% (Total of 3)

6-week grade includes Exam#1
12-week grade includes Projects #1 and #2
Tentative Course Outline and Schedule:

* The following schedule is subject to change at my discretion. I will however notify you immediately of any change to the proposed order of topics or any other potential change.

## Section I: Theoretical Foundations for Understanding Financial Crises

<table>
<thead>
<tr>
<th>Week</th>
<th>Topic</th>
<th>Important Dates</th>
<th>Readings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction: The Macro and Financial System</td>
<td></td>
<td>Slides: Introduction to Financial System</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Miskin: “Understanding Financial Crises”</td>
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<tr>
<td>2</td>
<td>IS-LM Model, Asset Prices and Interest Rates</td>
<td></td>
<td>Slides: Asset Prices and Interest Rates</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Miskin: “Understanding Financial Crises”</td>
</tr>
<tr>
<td>3</td>
<td>Crises in Banking</td>
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<td>Slides: Banking</td>
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<td></td>
<td></td>
<td></td>
<td>Slides: Diamond-Dybvig Model</td>
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<tr>
<td>4</td>
<td>Crises in Currencies</td>
<td>Selection of Historical Crisis Case - September 18th</td>
<td>Slides: Mundell-Fleming Model</td>
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<td></td>
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<td>Pill and DiTella: “Financial Crisis in Asia”</td>
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<td>5</td>
<td>Crisis in Sovereign Debt</td>
<td></td>
<td>Reinhart and Rogoff: “Financial and Sovereign Debt Crises: Some Lessons”</td>
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<tr>
<td>6</td>
<td>Two Big Cases: The Great Depression and The Great Contraction</td>
<td>Exam: Friday, October 2nd</td>
<td>Slides: Financial Crises Summary</td>
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## Section II: Historical Episodes of Crises

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<tr>
<th>Topic</th>
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</thead>
</table>
| Week 7: Developing an Historical Case Study | “Library Day” – Monday October 5th  
“Data Day” – Wednesday October 7th |                                                                                       |
| Week 8: Historical Crisis Presentations |                                                                                  |                                                                         |
| Week 9: Historical Crisis Presentations |                                                                                  |                                                                         |

## Section III: Empirical Analysis

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<tr>
<th>Topic</th>
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<th>Readings</th>
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<tbody>
<tr>
<td>Week 10: Cross-Country Panel Empirical Methods</td>
<td><strong>Historical Case Study Due – Wednesday October 28th</strong></td>
<td>Wooldridge: Simple Panel and Limited Dependent Variable Models</td>
</tr>
<tr>
<td>Week 12: Data Analysis</td>
<td><strong>Empirical Paper Due – Friday</strong></td>
<td>Reinhart and Rogoff: “Panoramic View of 8 Centuries of Crises”</td>
</tr>
</tbody>
</table>
# Section IV: Contemporary Crises

|             |                                           | Stewart: “Eight Days”                  |
| Week 14:    | Crisis of 2008 (cont)                      | Cecchetti: “Monetary Policy and the Crisis”  
|             |                                           | Krugman: “How Did Economists Get It So Wrong?”  
|             |                                           | Cochrane: “How Did Paul Krugman Get It So Wrong?” |
| Week 15:    | Crisis Management                          | Blanchard et al.: “Rethinking Macro Policy” |
| Week 16 & 17| Finals                                     | Paper on Contemporary Crisis Due: Final Class Day. Final Exam: TBA |
Examples of Global or Multi-country Economic Crises in History

<table>
<thead>
<tr>
<th>Episode</th>
<th>Type</th>
<th>Global financial center(s) most affected</th>
<th>At least two distinct regions</th>
<th>What happened?</th>
</tr>
</thead>
<tbody>
<tr>
<td>The crisis of 1825-1826</td>
<td>Global</td>
<td>United Kingdom</td>
<td>Europe and Latin America</td>
<td>Greece and Portugal defaulted, as did practically all of newly independent Latin America</td>
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<tr>
<td>The panic of 1907</td>
<td>Global</td>
<td>United States</td>
<td>Europe, Asia, and Latin America</td>
<td>Notably France, Italy, Japan, Mexico, and Chile suffered from banking panics</td>
</tr>
<tr>
<td>The Great Depression, 1929-1938</td>
<td>Global</td>
<td>United States and France</td>
<td>All regions</td>
<td>With the exception of high inflation, all crisis manifestations were present</td>
</tr>
<tr>
<td>Debt crisis of the 1980s</td>
<td>Multi-country</td>
<td>United States (affected, but crisis was not systemic)</td>
<td>Developing countries in Africa, Latin America, and to a lesser extent Asia</td>
<td>Sovereign default, currency crashes, and high inflation were rampant</td>
</tr>
<tr>
<td>The Asian crisis of 1997-1998</td>
<td>Multi-country</td>
<td>Japan (affected, but by then it was five years into the resolution of its own systemic banking crisis)</td>
<td>Asia, Europe, and Latin America</td>
<td>Affected Southeast Asia initially. By 1998, Russia, Ukraine, Columbia, and Brazil were affected</td>
</tr>
</tbody>
</table>

*source: Reinhart and Rogoff (2009)*