

Financial Booms and Busts

AEA Continuing Education Program

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Overview

This 12-hour lecture on Financial Economics for the AEA Continuing Education Program, entitled "Financial Booms and Busts", is divided into two 6-hour lectures. The first part (taught by Harrison Hong) covers recent research developments in the economics of speculative asset price bubbles. The second part (taught by Hyun Shin) covers recent developments in the frameworks used to analyze financial crises, with a focus on the role of banks and other financial intermediaries.

If participants would like to do some preliminary reading before the course, we list references that are non-technical introductions to the issues. A more detailed reading list and syllabus will be distributed at the beginning of the course.

Part I: Bubble Economics

What drives speculative asset price bubbles? As financial markets have become more liquid, more sophisticated and less regulated over the last half-century, asset price bubbles appear, at least anecdotally, to be occurring more frequently. A brief history of bubble episodes includes the Japanese stock and housing markets of the mid-to-late eighties, the internet stocks of the mid-to-late nineties, the US/European housing (subprime) experience, and (with debate) commodity prices from 2004-2008. Significant economic recessions and/or financial crises seem to follow the bursting of bubbles. The most recent subprime and commodity episodes have led many policy makers, including Lawrence Summers and Chairman Bernanke, to wonder aloud about the need to deal with asset price bubbles either through regulation and/or monetary policy.

This part of the lecture course looks to developments in behavioral finance for some answers. First, we establish key stylized facts regarding bubbles and trading volume and the inability of neoclassical models to fully explain the trading behavior of investors and aggregate volume patterns. Second, we present a model based on disagreement (or divergence of opinion) among investors and short-sales constraints that can account for these stylized facts. Third, we focus on how sophisticated investors' incentives and risk-taking influence the formation of asset price bubbles. Finally, we apply these lessons to analyze the recent housing/subprime and commodity price episodes and examine the role of incentives and regulation in these experiences.

Pre-Course Reading List

Hong, Harrison and Jeremy C. Stein, 2007, Disagreement and the stock market, *Journal of Economic Perspectives* 21, 109-128.

Lamont, Owen, and Richard Thaler, 2003, Can the market add and subtract? Mispricing in tech stock carve-outs, *Journal of Political Economy* 111, 227-268.

Odean, Terrance, 1999, Do Investors Trade Too Much?, *American Economic Review* 89, 1279-1298.

Shleifer, Andrei, and Robert Vishny, 1997, The limits of arbitrage, *Journal of Finance* 52, 35-55.

Part II: Financial Intermediation and Crises

Financial contagion is often viewed through the lens of cascading defaults, where if A has borrowed from B and B has borrowed from C, then the default of A impacts B, which then impacts C, etc. However, in a modern market-based financial system where assets have been securitized and traded widely in the financial system, a more important channel is through the fluctuations in the price of risk and the associated balance sheet changes of leveraged financial intermediaries. The global financial crisis of 2007 – 2008 has been a laboratory for such effects.

This part of the lecture course reviews recent developments in the frameworks used for the analysis of financial market liquidity and financial crises. The main organizing theme is the balance sheet management of banks and other financial intermediaries. The lectures cover some initial theoretical ground but their goal is to understand the events of 2007-2008 and inform practical policy concerns on financial stability and financial crises. The lectures offer an interpretation of the events surrounding the financial crisis of 2007-8 and show how the theoretical framework sheds light both on the timing and sequence of contagion and the quantification of its impact. The lectures conclude with a discussion of policy implications for financial regulation, accounting rules for financial institutions, and monetary policy.

Pre-Course Reading List

Adrian, Tobias and Hyun Song Shin, 2009, "Money, Liquidity and Monetary Policy" American Economic Review Papers and Proceedings

Brunnermeier, Markus, 2009, "De-Ciphering the Credit Crisis of 2007" Journal of Economic Perspectives, 23(1), 77-100

Shin, Hyun Song, 2009, "Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis" Journal of Economic Perspectives, 23(1),