Topics in Economics Economics of Financial Crises ECON 3090-001/FINN 3000-002

Spring 2017

Professor: Fred R. Becker, Jr. Classroom Location: Friday 107

E-mail: <u>fbecker1@uncc.edu</u> Class Time: T&TH: 9:30 AM - 10:45 AM

Office: 218C Friday (and by appointment)

Office Hours: T & Th - 11:00 AM - 1:00 PM

(and by appointment)

Telephone: (704) 687-7031 (Note: This telephone number is shared with other adjunct professors, as a result I may not receive your message. Accordingly, e-mail is the preferred method of communication.)









IT'S IN THE SYLLABUS

This message brought to you by every instructor that ever lived.

WWW.PHDCOMICS.COM

"The four most dangerous words in investing are 'This time it's different.'"

Sir John Templeton

"The global financial crisis - missed by most analysts - shows that most forecasters are poor at pricing in economic/financial risks, let alone geopolitical ones."

Nouriel Roubini

"Managing and navigating through a financial crisis is no fun at all."

Howard Schultz

"Millions of Americans were duped by the federal government and the Federal Reserve into buying homes they could not afford and failed to count the cost. When the financial crisis of 2008 hit, they could not keep up the monthly mortgage payments and defaulted."

Mark Skousen

"At this juncture, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."

Ben Bernanke, March, 2007

"Why is it possible to rescue S&L buccaneers in the early '90s and provide guidance to levered Wall Street investment bankers during the 1998 long-term capital management crisis, yet throw 2 million homeowners to the wolves in 2007?"

Bill Gross

"Imagine the big rating agencies as three competitive saloons standing side by side, with each free to set its own drinking age. Before long, nine-year-olds would be downing bourbon"

Roger Lowenstein

I do believe that the worst is likely to be behind us."

Henry Paulson, May 2008

"If money isn't loosened up, this sucker could go down."

George W. Bush, September 2008

"Anyone who says we're in a recession, or heading into one — especially the worst one since the Great Depression — is making up his own private definition of "`recession.""

Donald Luskin, the day before Lehman Brothers filed for bankruptcy

"We have an excessive degree of concern right now about housing and its role in the economy. Obviously speculation is never a good thing. What those who argue housing is now at a bubble seem to be missing a very important point. ... we are talking about homes where there is not the leverage we have seen elsewhere. This is not the dot.com situation ... you are not going to see a collapse that you see with a bubble..."

Barney Frank, June, 2015

"It was obviously a big meeting. I had no idea we were going to hear what we heard. Sitting in that room with Hank Paulson, saying in a very measured tone, "Unless you act the financial system of this country and the world will collapse in a number of days."

Senator Chris Dodd, commenting on the September 2008 meeting with Ben Bernanke and Hank Paulson

"Your money is safe in Bear Stearns"

Jim Cramer, March 2009

Important Dates & Times

Class Meetings:

Tuesday and Thursday, 9:30 AM - 10:45 AM

Belk College of Business, Friday Building, Room 107

Examinations

Substantive Exam: Class 24 (Tuesday, April 11, 2017) (Closed Book, Closed Notes)

Note: This examination s comprehensive (may include material from the first day of class forward) and will test your knowledge of, and ability to apply the concepts in this course. It will <u>not</u> be multiple choice, true false or fill-in the blank. In contrast, questions are along the line of, "Compare and contrast the Deposit Insurance Fund (DIF) to the

National Credit Union Share Insurance Fund (NCUSIF)."

Final Exam: (Tentative) Thursday, May 11, 2017 8:00AM - 10:30 AM

Note: Questions on this exam will be essay type and policy related. An

example will be provided the first day of class.

Deliverables

Note:

All written assignments must be typed, double spaced, using Times New Roman font (size 12), with one-inch margins on all sides; citations and references must follow APA format. Include:

- (1) A cover page containing the title of the assignment, your name, my name, the course title and date
- (2) A one-page executive summary.

(The cover page, one-page executive summary and the reference page(s) are <u>not</u> included in any required assignment page length.)

Homework assignments and the briefing paper are to be <u>solely</u> your own work product, without assistance of other classmates/friends, etc.

All written assignments are to be submitted in person to me and are due at the beginning of class - before I begin the day's discussion - any assignment submitted to me by any other means will not be considered for any credit!

Homework

Homework Assignment One: Handed into me by the start of Class 6, on Thursday, January 26, 2017

Research and provide a comprehensive listing and brief summary of <u>all</u> the specific laws enacted during, and immediately following, the Great Depression to facilitate the nation's recovery and/or improve the nation's financial system and financial health.

Your paper should include:

- (1) A cover page
- (2) A brief one paragraph executive summary of your conclusions.
- (3) A 1 3 page listing of the laws enacted that you believe were beneficial or may have inhibited and/or delayed the nation's recovery, along with a sentence or two describing the purpose of each law.
- (4) 2 -- 3 pages of your assessment of the laws enacted which do you believe were helpful to the nation's recovery, which inhibited the nation's recovery? Why?

Be prepared to discuss in class.

Note: President Roosevelt's "New Deal" was not legislation - the term was a political catchphrase for a set of federal programs proposed by President Roosevelt after taking office in 1933 in response to the Great Depression.

Grading will be based on (Note: particular emphasis will be given to criteria (3)):

- (1) The number of laws identified,
- (2) The summary provided of each law, and
- (3) Your 2 3 page assessment of the law's impact in facilitating or inhibiting/delaying the nation's economic recovery.

Homework Assignment Two: Handed into me by the start of Class 11, on Tuesday, February 14, 2017

You work for a newly elected Congressman/Congresswoman who has just been appointed to the House Financial Services Committee. The

Congressman/Congresswoman, comes from a small farming family and has only limited knowledge of the financial regulatory system. The Chief of Staff has asked that you write a short (8 - 10 page maximum) briefing paper for the Congressman/Congresswoman explaining the financial regulatory system in the United States. The

Congressman/Congressman wants to know what regulatory agencies are responsible for overseeing the financial system. He/she wants to know why each particular agency was created, what function its performs, what entities it regulate and if there is duplication in their oversight.

Finally, the Congressman/Congresswoman has read that Senator Rand Paul (R-KY) and others have raised concerns regarding the Federal Reserve system. He/she wants to know what concerns have been recently raised (following the Great Recession) and why. He/she wants to know if any of these concerns have\merit and why.

Your paper should include:

- (1) A cover page
- (2) A brief one page executive summary of your conclusions.
- (3) A 2 3 page listing of the current financial regulators in the U.S., a brief description of their function(s).
- (4) A 2 3 page discussion of the concerns Senator Paul and others have raised regarding the Fed and your assessment of the merits of these concerns.

Grading will be based on (Note: particular emphasis will be given to criteria (3)):

- (1) Your identification, and the quality of your explanation of the functions of the various regulatory bodies overseeing the financial services industry in the United States, to include the entities overseen and the identification of any duplication in oversight.
- (2) Your identification of the concerns Senator Paul and others have raised regarding the Federal Reserve.
- (3) Your discussion of your views on the concerns expressed by Senator Paul and others regarding the Federal Reserve.

Congressional Briefing Paper: Handed into me by the start of Class 17, on Tuesday, March 14, 2017

You are a staff member of a first term Senator who has been appointed to the Senate Banking Committee. The Senator is an independent self-made small businessman from a moderate state where political ideology must be carefully balanced against the needs and interests of the states populous. The Senator ran for office on the platform of compromise and doing what is truly best for his/her state and the nation and wants to do everything in his/her power to live up to that promise. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act") (Pub.L. 111-203, H.R. 4173, found at https://www.govtrack.us/congress/bills/111/hr4173/text) is now approaching its 7th anniversary. Dodd-Frank has been amended only once (to relax the "swap push out rules") and remains very controversial.

The Trump Administration and Senate Banking and House Financial Services Committees are:

- 1) Actively considering further changes to the Act (changes to the Act were contained in the Consolidated and Further Continuing Appropriations Act, 2015, Public Law No: 113-235 (December 16, 2014))
- 2) Conducting oversight hearings over the Act's implementation by the cognizant regulatory agency(s).

The Senator wants to be "up to speed and ready to go" as changes to the Act are considered by the new Administration and cognizant Congressional oversight committees.

The Staff Director has assigned you write a paper on a <u>specific</u> assigned national financial policy subject area that arguably was a factor in the creation of the "perfect storm" that led to the Great Recession.

The paper (8 - 10 pages in length) must include:

- 1) Cover page,
- 2) One page executive summary of your conclusions.
- 3) A full discussion of the assigned national financial policy subject area,
 - a) How did the assigned national policy area contribute to the Great Recession?
 - b) The provisions, if any, in the Dodd-Frank Act regarding the assigned national financial policy subject area.
 - c) The specific actions, if any, that the cognizant regulator(s) have taken to implement the Dodd-Frank Acts' provisions on the assigned national financial policy subject area.
 - d) What changes, if any, are being actively considered by the Senate Banking and/or House Financial Committees regarding the assigned national financial policy subject area.
- 4) Your assessment of the effectiveness of the provision in the Act and any regulatory action taken in preventing a future economic crisis. (If regulations have not been issued, your specific recommendation(s) as to what regulatory action should be taken.)
- 5) Any changes, and the reasons therefor, that you recommend to the Dodd-Frank Act or to the regulatory action taken with regard to the assigned national financial policy subject area to include whether the legislative provision and/or the regulatory action(s) taken should be modified (and if so how), or removed from law.

Do <u>not</u> discuss Dodd-Frank other than as it relates to the specific subject area you are assigned.

Should you have any questions regarding this assignment, please do not hesitate to discuss it with me.

Grading Criteria (Note: particular emphasis will be given to criteria (3) and (4)):

- 1) The quality of the executive summary
- 2) The quality and accuracy of your discussion of the assigned national policy subject area.
- 3) The quality of your assessment of the effectiveness of the provision and any regulatory action taken in preventing a future economic crisis, to include, if regulatory action has not been taken, your specific recommendation(s) as to what action should be taken.
- 4) The quality of your assessment of any changes, and the reasons therefor, that you might recommend to the Act or the regulatory action taken.

Team Presentation

Handed Into me by the Beginning of Class 22, on Tuesday, April 4, 2017

Posted on Canvas by the Beginning of Class 23 on Thursday, April 6, 2017

Groups 1 - 3: Class 25, on Thursday, April 13, 2017

Groups 4 - 6: Class 26 on Tuesday, April 18, 2017 Groups 7 - 9 Class 27, on Thursday, April 20, 2017

NOTE: YOU MUST BE PRESENT FOR YOUR GROUP PRESENTATION. PRESENTATIONS MAY RUN BEHIND AS WE MAY NOT BE ABLE TO HAVE THREE PRESENTATIONS IN ONE DAY. PLEASE REMAIN FLEXIBLE.

Imagine that the Senator's staff director assigned more than one staff member to independently examine the same specific policy area. Now, having received and reviewed each staff member's paper, the Chief of Staff has asked you and your fellow staff members to share each other's work, meet, discuss and evaluate each other's views, and develop a presentation for the Senator, comparing and contrasting any differing views, making a recommendation where there is consensus, or otherwise calling for the Senator's decision.

To facilitate the team presentation, I will be placing you in a group with several of your fellow classmates who were assigned to write a paper on the same specific national policy subject area. To the extent possible I will be pairing those of you who consider yourself to be of the Chicago or Austrian school of economists (Friedman) with Keynesians. In addition, I will be paring finance majors with economic majors.

You must be present for your team presentation.

The team presentation must follow the format of the paper set forth above, excluding the Executive Summary.

Grading will be based on (**Note: particular emphasis will be given to criteria (3) and (4)**):

- 1) The quality and accuracy of the team's discussion of the assigned national policy subject area.
- 2) The quality of the team's assessment of the effectiveness of the provision and any regulatory action taken in preventing a future economic crisis, to include, if regulatory action has not been taken, the team's specific recommendation(s) as to what action should be taken.
- 3) The quality of your assessment of the effectiveness of the provision and any regulatory action taken in preventing a future economic crisis, to include, if regulatory action has not been taken, your specific recommendation(s) as to what action should be taken.
- 4) The quality of the team's assessment of any changes, and the reasons therefor, that the team might recommend to the Act or the regulatory action taken.

General Information

Course Description:

ECON 3090. Financial crises have unfortunately been regular occurrences of market economies throughout world history, including bubbles, bank failures, and liquidity crises. This class will examine multiple crises and the governmental policy responses to them, ranging from Tulipmania, to

the South Sea Bubble, to the Great Depression, to the S&L crisis, to the 1987 stock market crash, to Dot.com bubble, to the Great Recession, with a focus on the actions the federal government has taken to prevent another financial crisis (Dodd-Frank). We will examine topics including securitization, credit regulation, banking regulation, and the role of financial market actors such as hedge funds. Prerequisites: ECON 2101 and ECON 2102.

Course Objectives:

To develop an understanding of:

- 1) The causes of, governmental actions taken in response to, and parallels between Tulipmania, the South Sea Bubble, the Great Depression, the S&L crisis, the 1987 stock market crash, the Dot.com, bubble, and the Great Recession, with a focus on the actions the federal government has taken to prevent another financial crisis (Dodd-Frank).
- 2) The financial regulatory system in the United States
- 3) The Federal Reserve and its tools to stabilize the economy
- 4) How banks balance sheets are impacted by changes in the economy.

Your responsibilities:

- 1) This is <u>not</u> a lecture-format class you must read the assigned material before class. Further, you must be prepared to participate actively in the class discussion of the reading assignments by having thought about the questions provided following each assignment as set forth below.
- 2) Hand in assigned homework on time. Further details on the homework assignments are set forth below.
- 3) Write an 8 10 page "briefing" paper with a one-page executive summary on an assigned specific national financial policy subject area that arguably was a factor in the creation of the "perfect storm" that lead to the Great Recession and any legislative and/or regulatory actions subsequently taken in, or as a result of, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub,L. 111-203, H.R. 4173, found at https://www.govtrack.us/congress/bills/111/hr4173/text), or by subsequent legislation. Further details on the paper are set forth below.
- 4) Prepare and present to the class as part of an assigned team an oral 15-20 minute PowerPoint presentation with other students who have been assigned the same specific national financial policy subject area. **Further details on the team presentation are set forth below.**
- 5) Take a substantive examination and a final (policy) examination.

Grading:

15%
25%
10%
20%
30%

As noted in "Attendance" (below) class attendance is mandatory and grades will be adjusted based on class attendance.

Each assignment is graded on a curve with numerical distributions, approximately as follows:

Percent of Students Grade

Top 35%	A
Next 40%	В
Next 20%	C
Next 2.5%	D
Lowest 2.5%	F

A curve of this nature ensures that the best students (in the highest percentiles) will receive an A. That said. I have no difficulty giving all "A's" on any assignment, if all are exemplary. F's may be given to those whose performance falls significantly below that of other members of the class or who fail to achieve a minimum performance level of 60%.

I will hand back each written assignment to you with a numerical grade.

Attendance:

Class attendance is mandatory! Be on time and stay for the duration of the class.

I will provide an attendance sign-in sheet for each class.

As I have learned over my three careers, 95% of life is just "showing-up." With that in mind if, from the time of your enrollment in the class, you attend <u>all</u> classes you will have 40 (4%) points added to your final grade.

You may miss three (3) classes without penalty from the time of your enrollment in the class. You do not need to provide an excuse for these first three (3) absences.

If, from the time of your enrollment in the class, you miss more than three (3) classes that are not "excused absences," you will lose 30 points (3%) from your final grade!

If you miss more than seven (7) classes (one-fourth of the course) that are not excused, there will be a one letter deduction in your final grade (i.e., A to B; B to C; C to D; D to F).

"Excused absences" are those in which you provide written documentation, in a "timely manner," of a genuine "valid rationale," for failing to attend class. For example, if you are ill, a note from the doctor; if you are participating in a university sanctioned activity, a note from the faculty advisor; if an immediate family member (nuclear family; grandparents) dies, the obituary notice, etc.

"Valid rationales" are those that are beyond your control and that absolutely prohibit you from attending class - including, but not limited to death of an immediate relative (nuclear family;

grandparents), physical injury or illness, participation in a university sponsored/sanctioned event that conflicts with the class period. Invalid rationales include: oversleeping; non-emergency medical appointments that could only be scheduled during class; parking problems; speeding tickets; work requirements; previously scheduled social events, including family reunions and concerts. A "timely manner" generally means you contacted me via email (using the contact information listed above) at least 24-hours prior to the missed class (exceptions will be made for absences arising from events that occurred within the 24-hour period with documentation after that fact that clearly establishes that you were physically and/or mentally incapable of providing adequate prior notice).

The UNC Charlotte Code of Student Academic Integrity applies.

Class structure:

This is not a lecture-format class and the course requires your active participation. You must come to class having read the assigned material and fully prepared to discuss it in response to the questions posed during class. Cogent, articulate, and informed contributions are expected as part of your class participation grade. Active participation also includes actively listening to me and your fellow classmates. In other words, when you are not actively participating in the class discussion, you must be taking notes and/or listening to the recognized speaker (not the person sitting next to you). This also assumes that you will not create any disturbances that might interfere with your classmates' abilities to listen and discuss.

Also note that this is not a class where you can succeed by memorizing the material and simply regurgitating it back on a paper or exam. It is a course where you are expected to think about the material you have read and that we have discussed in class and form and convey to your colleagues your own opinions as part of the class discussion.

Students who have succeeded in this course have:

- (1) Read the reading the material prior to class,
- (2) Regularly attended class,
- (2) Asked questions and actively participated, and
- (3) Taken notes during class (although I will be teaching from PowerPoint slides, students who have attempted to rely solely on those slides (which are numerous) have experienced considerable difficulty in the examinations).

As economic and finance majors you are probably used to "numbers." While there will be some "numbers," calculations, and concepts that you must understand and will be tested on (in the substantive exam), a large portion of the class discussion will be devoted to policy in the financial services arena. We will be discussing a number of financial terms and concepts (duration, beta, CDO's, CDS's, securitization, trances, is synchronization risk, arbitrage, etc.) with which you might not be familiar, but <u>must</u> become part of your vernacular in order to do well on the substantive exam (the substantive exam will test your knowledge and ability to apply these terms and concepts to various factual situations). I will be making every effort to ensure these terms and concepts become part of your vernacular during the class period and if you have read the material, attended class, taken notes and listened to and participated in the discussion, the substantive exam should not be difficult.

Finally, as a large portion of the class time devoted to "policy" discussions, there will generally be on "right" answer - in fact I expect fully some disagreement among you in the class discussions and within the team groups.

Course Resources:

This course does <u>not</u> require a textbook. I have included a listing of required readings for each class period below. For ease of reference I have provided a hyperlink to the document wherever possible (**if the hyperlink does not work, Google the title of the article**). Also note that some readings may only be available through the library.

Readings:

Because academic research and literature on the Great Recession continues to actively evolve, I have not been able to find a single text that is authoritative and objective (over two decades passed before an authoritative text was written on the Great Depression). As many of the assigned readings have a distinct point of view, multiple sources have been included to ensure more than one point of view is presented.

The number and extent of the readings are somewhat longer in pages per class than many other economic or finance classes. Note, however, that the readings and discussion questions in some instances cover two class periods. Also, somewhat mitigating is that many readings:

- 1) Are in many cases small articles,
- 2) Are often of relatively large type face,
- 3) May be double-spaced,
- 4) May contain numerous graphs,
- 5) Need not be read with the same intensity you would read a textbook, and
- 6) Are logically written.

Also note that for some reading that are particularly lengthy I have asked that you read only certain portions.

The entire syllabus has been provided at course inception in recognition of your personal schedule and to enable reading in advance. I am aware that many of you work. I reserve the right and privilege of changing and/or modifying the syllabus as we proceed through the semester and I welcome your comments and suggestions as to particular areas you would like to focus on.

General Rules

Communication:

Communication with those outside of class while class is in progress is not acceptable. (In other words, turn off all communication devices prior to the start of class.) Check your UNC Charlotte e-mail (username@uncc.edu) for correspondence and updates.

Note Taking:

Although I will be using PowerPoint slides, I strongly encourage you to take notes as there are too many PowerPoint slides for you to substitute the slides for notes. Simply put, why waste the time in class by not taking notes?

After prolonged consideration, I have decided to ban laptops from this class. The reason is that a 2003 study found that laptops make it harder for students to remember what they had just learned in lecture. A 2014 study showed that students are less likely to understand complex ideas when they take notes by computer instead of by hand. In a big, new experiment from economists at West Point, who randomly banned computers from some sections of a popular economics course the students who were allowed to use laptops scored worse on the final exam. The smartest students seemed to be harmed the most! https://www.washingtonpost.com/news/wonk/wp/2016/05/16/why-smart-kids-shouldnt-use-laptops-in-class/.

Questions:

Your first source of reference on dates, deliverables, rules and procedures is the syllabus and the material posted on Canvas. As to academics, if you have a question, ask it! When it comes to comprehending the material, there is no such thing as a stupid question or said another way, "the only dumb question is the one you did not ask." If you find that I am going too fast for you to take notes, do not hesitate to ask me to slow down.

Academic Integrity:

Academic misconduct (cheating) will NOT be tolerated. In addition, you have the responsibility to know and observe the requirements of University Policy 40 (The Code of Student Academic Integrity). This code forbids cheating, fabrication or falsification of information, multiple submissions of academic work, plagiarism, abuse of academic materials, and complicity in academic dishonesty. Academic evaluations in this course include a judgment that your work is free from academic dishonesty of any type; and grades in this course therefore should be and will be adversely affected by academic dishonesty. Students who violate the code can be expelled from UNC Charlotte. The normal penalty for a first offense is zero credit on the work involving dishonesty and further substantial reduction of the course grade. In almost all cases, the course grade is reduced to U. Copies of the code can be obtained from the Dean of Students Office. Standards of academic integrity will be enforced in this course. You are expected to report cases of academic dishonesty to me.

Statement on Diversity:

The Belk College of Business strives to create an inclusive academic climate in which the dignity of all individuals is respected and maintained. Therefore, we celebrate diversity that includes, but is not limited to ability/disability, age, culture, ethnicity, gender, language, race, religion, sexual orientation, and socio-economic status.

Disability Services:

UNCC is committed to access to education. If you have a disability and need academic accommodations, please provide a letter of accommodation from Disability Services early in the semester. For more information on accommodations, contact the Office of Disability Services at 704-687-0040 or visit their office at Fretwell 230.

Tentative Course Schedule

Note: We are very likely to run behind. If we do run behind the due dates for papers, the substantive exam and class presentations will <u>not</u> change. We will use class 29, if necessary, to complete our discussions.

Below is a tentative schedule (as noted, there is no guarantee that we follow the schedule precisely). We may deviate from the schedule as the course progresses depending on time and it is your responsibility to keep up with adjustments made throughout the course.

Classes 1 & 2 (Tuesday, January 10 & Thursday, January 12) - **Introduction - Impact of the Great Recession**

Our first priority is to get organized. I want to learn about you and your career goals and I will give you the opportunity to learn about me. I will be handing out index cards asking for some information about you, your career goals, etc. From the information you provide I will be making team assignments and a seating chart (I know some would prefer not to have assigned seating, but I think assigned seating will be beneficial).

As you will learn, as a CEO of a Washington, D.C. financial trade association, I experienced the great recession first hand - it had a momentous impact on the industry my staff and I were hired to represent. I will spend a class session going through that with you. It was an experience I would never want to repeat or wish upon anyone else. It is hoped that my discussion of the real world impact on the segment of the financial services industry that my staff and I represented will serve as not only as an introduction to the course, but also heighten your interest in this course.

Class 3 (Tuesday, January 17) - Financial Crises - A Historical Perspective – Tulipmania

Readings:

Knight, T.

Peculiar Facts From 500 Years of Finance American Association of Individual Investors Journal, (May, 2014), pp. 27 - 33 Available at Canvas

C.W and A.J.K. D. (2014)
Was tulipmania irrational?

The Economist, (2014)

http://www.economist.com/blogs/freeexchange/2013/10/economic-history

Frehen, R.G.P., Goetzmann, W.N., and Rouwenhorst, K.G.

New Evidence of the First Financial Bubble

Yale International Center for Finance, Working Paper No. 09-04, as Revised: July 27, 2012

 $\underline{http://depot.som.yale.edu/icf/papers/fileuploads/2542/original/2008_ICF_WPS_09-04_Goetzmann_Bubble.pdf}$

Note: Read only Sections 1, 2, and 6.

Garber, P.M.

Tulipmania

The Journal of Political Economy, Vol. 97, No. 3 (June, 1989), pp. 535 - 560 http://ms.mcmaster.ca/~grasselli/Garber89.pdf

Thompson, E.A.

The tulipmania: Fact or artifact?

University of California, Los Angeles, (2006)

http://www.dklevine.com/archive/thompson-tulips.pdf

Note: Read only Sections 1 - 4.

As a foundation, we will spend several class sessions discussing the financial crises that have occurred throughout history. As we do so, think about what a crisis is – is it a set of economic conditions? A failure of governance? The result of bad choices, or of uncontrollable forces? Can such events ever be prevented? If so, what are the consequences from a business perspective? Look for parallels throughout the course.

The first documented financial crisis ('Tulipmania') occurred in the early 1660's in Holland. Knight attempts to provide history's lesson as a template to investors. (Note that the Knight article is from the *American Association of Individual Investors Journal*). Garber presents a relatively comprehensive look at Tulipmania, discussing the traditional view of its causes, and suggesting that the pricing for rare bulbs reflected normal pricing behavior while offering no explanation for the speculation in common bulbs. Thompson takes a different approach. In a rather densely written, but precise account he argues that the market for tulips was an efficient response to changing financial regulation. In a more recent paper, Frehen, Goetzmann and Rouwenhorst suggest that innovation was the key driver.

- 1) What is a "financial crisis"? Is it any crisis involving money? A crisis involving regulatory failures? When GDP drops by some percentage? Is it something that we can only define as, "We know it when we see it?"
- 2) How, if at all, would you distinguish a crisis from a bubble? Is it necessary we come to joiner on a formal definition?
- 3) What do you believe was/were the cause(s) of Tulipmania?
- 4) Do you believe irrationality can ever be employed to describe the basis for a financial crisis or is there always some rational explanation?
- 5) Is the "irrationality" explanation "one of laziness" as asserted in *The Economist*?
- 6) What is an options contract? A futures contract? A margin requirement?
- 7) How, if at all, do options and futures contracts, and margin requirements relate to

Tulipmania?

- 8) Who is right, Gardner or Thompson?
- 9) Do you agree with Knight is there a history lesson to be learned? If so, why haven't we learned it, or have we?
- 10) Was innovation a factor in Tulipmania? If so, from your basic knowledge of the Great Recession can you draw any parallels?
- 11) Does "Peculiar Facts From 500 Years of Finance" provide a template to enable one to identify a bubble?

Class 4 (Thursday, January 19) - **Financial Crises - A Historical Perspective – the South Sea Bubble.**

Readings:

Temin, P. and Toth, H.J. (2004)

Riding the South Sea Bubble

Massachusetts Institute of Technology, Department of Economics, Working Paper 04-02, Dec. 21, 2003

http://ssrn.com/abstract=485482

Walsh, P.

Writing the History of the Financial Crisis: Lessons from the South Sea Bubble, School of History and Archives, University College Dublin, Working Papers in History and Policy, No. 3, 2012

file:///C:/Users/Fred/Downloads/Patrick_Walsh_South_Sea%20(1).pdf

Understanding Asset Bubble and How to React to Them An Interview with Robert Shiller American Association of Individual Investors Journal, (June, 2015), pp. 6 - 9 Available at Canvas

Temin and Toth provide a case study of a well-informed investor in the South Sea bubble, arguing that from the perspective of a sophisticated investor, it was profitable to ride the bubble. Drawing on his research on Ireland and the South Sea Bubble, Walsh seeks to explore how historians have dealt with past economic and financial crises and where possible glean any lessons learned. The interview with Robert Shiller, a Nobel Prize winning economist, addresses stock and bond bubbles. (Note that the Shiller interview is from the *American Association of Individual Investors Journal*).

- 1) How does Shiller define a bubble?
- 2) Shiller says, "most economists are not sociologists." Do you agree?
- 3) If true, what impact does that have on economy theory and predictions? What is the CAPE ratio?
- 4) What was the South Sea Company?

- 5) Why did the British government offer it exclusive trading rights with entities in the South Seas?
- 6) What did the British government give to the shareholders in addition to a monopoly in the South Seas?
- 7) How did the British government intend to obtain the funds to repay the South Sea shareholders?
- 8) By what percent did South Sea stock decrease when the bubble burst?
- 9) What do you believe was the cause or causes of the South Sea Bubble?
- 10) Is an understanding of the human impact of financial crisis, as asserted by Walsh important?
- 12) Do you believe, as postulated by Temin and Toth, that investors in many cases knew that The South Sea Stock was overvalued? If so, why did they continue to buy shares in the stock?
- 13) What is arbitrage?
- 14) Why did some investor's fail at arbitrage during the South Sea bubble?
- 15) What is synchronization risk and how, if at all, did it lead, or contribute, to the crisis?
- 16) Did Hoare's bank have any advantage in trading on the South Sea Company?
- 17) What world famous person lost money?
- 18) What was the legacy of the South Sea bubble?
- 19) Do you agree with Walsh that the global financial crisis of 2007 ("The Great Recession") was not as unprecedented as some have postulated?
- 20) Why would politicians and policy makes find it attractive to take the position that the Great Recession was unprecedented and could not be foreseen?
- 21) Can you draw any parallels to Tulipmania?
- 22) Were the innovative forms of banking and finance (expansion of the stock market, the ubiquity of paper money, the development of a national debt and the emergence of new forms of short-term credit instruments) 'financial capitalism' or a 'financial revolution'?
- 23) Might a bubble be defined as, "any unsound commercial undertaking accompanied by a high degree of speculation."
- 24) If the investment appeared sound at the start and only foolish in hindsight would economists classify the event as being driven by market fundamentals?

Class 5 (Tuesday, January 24) - Financial Crises - Historical Perspective - The Bank Panic of 1907

Readings:

Bernanke, B.

Origins and Mission of the Federal Reserve, Lecture 1

George Washington University School of Business

March 20, 2012

http://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture1-20120320.pdf

Note: Slides to accompany the lecture are available at:

http://www.federalreserve.gov/newsevents/files/bernanke-lecture-one-20120320.pdf

Tallman, E. and Moen, J.
Lessons from the Panic of 1907

Economic Review, (May/June 1990), pp. 2 - 13

http://www.frbatlanta.org/filelegacydocs/ern390_tallman.pdf

Tallman, E.W. The Panic of 1907

Federal Reserve Bank of Cleveland, Working Paper 12-29, (November 2012) file:///C:/Users/Fred/Downloads/wp%201228%20the%20panic%20of%201907%20pdf.pdf

Watch the video: The Panic of 1907: Lessons Learned from the Market's Perfect Storm Skip Introduction, Watch Only Bruner and Carr Remarks (20 minutes) (October 17, 2007)

Dean Robert Bruner and Professor Sean Carr

Miller Center, University of Virginia

http://millercenter.org/scripps/archive/forum/detail/3838

Tallman summarizes the academic literature on the panic, noting that despite the fact the panic occurred over 100 years ago, research continues to uncover data and underexploited connections between institutions. Tallman and Moen examine the circumstances leading to, and the intervention measures taken during the panic. In the video Robert Bruner, Dean of the University of Virginia's Darden Graduate School of Business Administration and Sean Carr, Director of Corporate Innovation Programs at the Darden School's Business Institute, discuss the panic of 1907 and the financial crisis of 2008.

- 1) What caused the crisis of 1907?
- 2) Do you agree that failure in financial markets is like a vortex in a sink a pernicious reinforcing downward cycle that gains in momentum and force the longer it runs with ever increasing velocity? If so, how can they be stopped?
- 3) Drawing on your basic knowledge of the Great Recession, what are the differences between the panic of 1907 and the Great Recession?
- 4) Do you agree that investors and depositors get with they deserve? If so, from your basic knowledge, was that the case in the Great Recession?
- 5) What role did financial intermediaries play in the 1907 panic?
- 6) Did the lack of regulation of some entities contribute to the panic?
- 7) What intervention measures were taken? How effective were the intervention measures?
- 8) What role did any unequal regulation of financial institution play in the panic?
- 9) What role did trust companies play in the panic?
- 10) Why did the panic of 1907 lead to the creation of the Federal Reserve?
- 11) What regulatory failures, if any, can be attributed to the crisis?
- 12) What is the mission of a central bank?
- 13) What is the difference between the economic stability and the financial stability parts of the mission of a central bank?

- 14) Explain and give examples of how those missions are related to each other.
- 15) What are the policy tools that central banks have?
- 16) Explain how monetary policy can function to achieve economic stability. What is the role of interest rates? Explain the process of how the Fed changes interest rates and how those changes encourage an appropriate increase or decrease in spending in the economy?
- 17) Analyze how a second tool, the provision of liquidity, can help to promote financial stability.
- 18) Describe how the lender-of-last-resort function of a central bank can reduce runs on banks.
- 19) Discuss the regulatory role of a central bank. What is its purpose?
- 20) Why were the first central banks established?
- 21) How would long-term illiquid assets and short-term liquid liabilities contribute to conditions for a financial panic?
- 22) Why is a bank run so difficult to stop?
- 23) What is a financial panic and what can cause a financial panic?
- 24) Describe how a financial panic can lead to loss of income and employment in sectors of the economy seemingly unrelated to the financial sector.
- 25) What does "lender of last resort" mean?
- 26) Analyze why liquidity is such an important issue.
- 27) What is the difference between illiquid banks and insolvent banks? How does that difference affect the lender-of-last-resort role of central banks?
- 28) How does the lender of last resort help prevent bank runs? And by doing so, the chances of a broader financial panic?
- 29) Why might a bank run worsen if a bank has to sell assets in response to depositors' withdrawals?
- 30) Describe the need for financial and economic stability that led to the establishment of the Federal Reserve in 1914.
- 31) Summarize the role of monetary policy in affecting short-term interest rates.
- 32) What is a gold standard?
- 33) Identify two possible problems with a gold standard and explain why those problems are created by a gold standard.
- 34) Explain how shocks can spread among countries under an international gold standard.
- 35) If interest rates are different in two countries that are both on an international gold standard, what will likely happen?
- 36) What might cause a run on gold in a country? What are the consequences of a run?
- 37) How can a gold standard create stable prices over a long-run period?
- 38) How can a gold standard cause a deflationary period? What is undesirable about falling prices?
- 39) Compare the costs and the benefits of a gold standard.
- 40) What economic conditions led to the establishment of the Fed in 1913?]
- 41) How would you describe the economic and financial stability mission of the Fed?
- 42) What is the decentralized structure of the Fed and why was it designed in that fashion? Has this made the Fed a more stable, longer-lasting institution? Why or why not?

Classes 6 & 7 (Thursday, January 26 & Tuesday, January 31) - **Financial Crises - A Historical Perspective - The Great Depression**

Homework Assignment One Due at the Beginning of Class 6 on Thursday, January 26

Readings:

Barrow, R.

An Interview With Robert Barrow on The Lessons from the Great Depression Five Books, (2012)

http://fivebooks.com/interviews/robert-barro-on-lessons-great-depression

Bernanke, B.

Origins and Mission of the Federal Reserve, Lecture 1

George Washington University School of Business

March 20, 2012

Read the remaining - on the Great Depression.

http://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture1-20120320.pdf

Note: Slides to accompany the lecture are available at:

http://www.federalreserve.gov/newsevents/files/bernanke-lecture-one-20120320.pdf

Bernanke, B.

Money, Gold and the Great Depression

Remarks at the H. Parker Willis Lecture on Economic Policy

Washington and Lee University (March 2, 2004)

http://www.federalreserve.gov/boardDocs/speeches/2004/200403022/default.htm

Bernanke, B.

On Milton Freedman's Ninth Birthday

Remarks at the Conference to Honor Milton Friedman

University of Chicago, (November 8, 2002)

http://www.federalreserve.gov/boarddocs/Speeches/2002/20021108/default.htm

Butkiewicz, J.

Reconstruction Finance Corporation

EH.Net Encyclopedia, (2012)

https://eh.net/encyclopedia/reconstruction-finance-corporation/

Roosevelt. T.R.

Fireside Chat, (March 12, 1933)

http://www.mhric.org/fdr/chat1.html

Roosevelt and Predatory Wealth

Kalgoorlie Western Argus, (August 27, 1907)

http://trove.nla.gov.au/ndp/del/article/33091827

Romer, C.

An interview with Christina Romer on Learning from the Great Depression Five Books, (2012)

http://fivebooks.com/interviews/christina-romer-on-learning-great-depression

Romer, C.

The Nation in Depression

Journal of Economic Perspectives, Vol. 7, No. 2, (Spring 1993), pp. 19 - 39 http://eml.berkeley.edu/~cromer/The%20Nation%20in%20Depression.pdf

Romer, C.

What Ended the Great Depression

The Journal of Economic History 52(4), (1992), pp. 757 - 784 http://eml.berkeley.edu/~cromer/What%20Ended%20the%20Great%20Depression.pdf

Whaples, R. (1995).

Where Is There Consensus among American Economic Historians? *Journal of Economic History, Vol.* 55, No. 1, (March, 1995). pp. 139-154 http://employees.csbsju.edu/jolson/econ315/whaples2123771.pdf

White, E.

The Stock Market Boom and Crash of 1929 Revisited
Journal of Economic Perspectives, Vol. 4, No. 2, (Spring 1980), pp. 67 - 83.
http://www.econ.ku.dk/okocg/Students%20Seminars%C3%98kon-
%C3%98velser/%C3%98velse%202007/artikler/White-1929Crash-JEP1990.pdf

There is a plethora of material on the Great Depression. Former Federal Reserve Board Chairman Ben Bernanke wrote his doctorial thesis on it. Unfortunately, our time to discuss it is limited. A portion of the FDR fireside chat is also available in an audio file at http://www.presidency.ucsb.edu/mediaplay.php?id=14540&admin=32 and is interesting as an example of an initial response to a crisis. Listen to it as well as read it – the tone of FDR's voice is an important part of its effectiveness.

Romer (The Nation in Depression) examines the ways in which the U.S. experience resembled, and fundamentally differed, from that of other countries. Whaples (p 143 - 144 and 149) presents the results of a survey of American economic historians on causes of the Great Depression. Butkiewicz provides an overview of the activities of the Reconstruction Finance Corporation (RFC).

In his remarks at Washington and Lee University, Bernanke discusses the causes of the Great Depression and offers a number of lessons learned. Romer (What Ended the Great Depression) examines the source(s) of recovery from the Great Depression. The Five Books interviews with Romer and Barrow briefly addresses their differing thoughts on the lessons of the Great Depression and provide their recommendations for five books on the Great Depression. (Note that Romer was a member of President Obama's cabinet, serving as Chair of the White House Council of Economic Advisers.) The interview with Barrow takes issue with some of the common assumptions about the

Great Depression, while also providing his thoughts on the Obama administration's Great Recession stimulus package.

- 1) What is a recession? Who defines it?
- 2) What is a depression? Who defines it?
- 3) What is the difference between a recession and a depression?
- 4) How do economists recognize the difference between a recession and a depression?
- 5) What was the state of the economy in the 1920's?
- 6) How did leading political and economic figures describe the U.S. economy?
- 7) What did the stock market crash of 1929 establish as to the Fed's ability to bring down stock prices?
- 8) What were the problems in returning to the gold standard after World War I?
- 9) What happened to consumer prices during the 1920s? The 1930's?
- 10) How does the Fed control the money supply today?
- 11) What are the competing explanations for the Great Depression? Which do you find most convincing? Why?
- 12) What regulatory failures, if any, can be attributed to the Great Depression?
- 13) What were the errors of U.S. monetary policymakers identified by Friedman and Schwartz?
- 14) What is your personal view on each of the questions Whaples asked?
- 15) Does it matter that economists have not been able to reach consensus on the causes and cure for the Great Depression?
- 16) Some have argued that when a financial crisis occurs, it is important for government to "do something" even if the "something" isn't particularly well thought out or executed. (This is often referred to as the "throw money out of helicopters" theory and why former Federal Reserve Board Chairman Ben Bernanke was nicknamed, "Helicopter Ben.") Was that true in the Great Depression? Why/why not?
- 17) How was the Great Depression being used in the debate over our financial crisis? (No reading on this, just think about what you may have seen/and/or heard/or read.)1
- 18) What laws were passed during the Great Depression? How effective were they? Which, if any, were prospective in nature, i.e., enacted with a view toward preventing a future depression?
- 19) What changes in U.S. federal regulatory structure occurred as a result of the Great Depression?
- 20) What parallels exist to the Great Recession? If you believe there are parallels between the Great Depression and the Great Recession, why didn't we learn from them?
- 21) In the speech in honor of Milton Freidman's birthday closed his remarks by stating, "I would like to say to Milton (Friedman) and Anna (Jacobson Schwartz): regarding the Great Depression, you're right. We did it. We're very sorry." Do you agree the Federal Reserve caused the Great Depression? Why?
- 22) What are your thoughts on Roosevelt's speech on predatory wealth?
- 23) Who is right, Romer or Barrow?
- 24) Did Henry Ford cause, or contribute in any way to, the Great Depression? If so, how?
- 25) What were the sources of recovery from Great Recession?
- 26) Why was the Reconstruction Finance Corporation (RTC) created? What were its functions?

- 27) How effective was RTC lending to banks?
- 28) Why were banks reluctant to use the RTC?
- 29) Why did the RTC fail to prevent the crisis?
- 30) Why did Roosevelt find the RTC advantageous?
- 31) How did the Emergency Banking Act improve the RFC's ability to assist the banks?
- 32) What were the controversial aspects of the Emergency Banking Act?
- 33) What entities did the RTC assist besides banks?
- 34) Why did bank lending not increase following RTC assistance?
- 35) Why did the RTC lend to businesses?
- 36) What was the purpose of the National Housing Act?
- 37) Why was the Federal National Mortgage Association created?
- 38) Why was the Export-Import Bank created?
- 39) Why did Roosevelt want to devalue the dollar? How was the RTC employed to devalue the dollar?
- 40) Why was the Federal Deposit Insurance System created?
- 41) What are the lessons learned that Bernanke puts forward?
- 42) What is the liquidationist thesis?
- 43) How does Bernanke's discussion of standard orthodoxy relate to any of the 7-factors addressed by Bob Brunner?
- 44) How did the Roosevelt Administration respond to the Great Depression? What lessons on how to handle a crisis are there from that response?
- 45) Did Roosevelt's actions help the nation recover or exacerbate the depression? Were Roosevelt's policy actions in combating the Great Depression akin to "throwing spaghetti on the wall and seeing what sticks?
- 46) What were the source(s) of recovery from the Great Depression?
- 47) According to Romer, how important is changing people's expectations to a recovery?
- 48) Imagine you have read these materials and are an aide to President Bush in September 2008. The President asks you what he can do to avoid being thought of as a "second Herbert Hoover" what is your advice?
- 49) Summarize the economic conditions and events during the Great Depression. Discuss the stock market crash, the change in price levels, the fall in output, the rise in unemployment, and the increase in the number of bank failures.
- 44) Describe the major causes of the Great Depression and explain how each of them may have Contributed to the crisis.
- 45) Describe monetary policy during the Great Depression.
- 46) What monetary policy errors were made? Why were those errors committed?
- 47) Summarize the Fed's policy as a lender of last resort during the Great Depression and evaluate its effects.
- 48) Discuss the role of the gold standard during the Depression and the resulting level of interest rates in the economy.
- 49) Summarize the role of deposit insurance in ensuring financial stability.
- 50) Why would the abandonment of a gold standard positively affect economic conditions?
- 51) List the primary monetary and fiscal policies that were used during the Depression. Evaluate the effectiveness of those policies.
- 52) What can we learn about policy today from that experience?
- 53) What would be a more effective set of solutions?

Class 8 (Thursday, February 2) - Financial Crises - A Historical Perspective - The Saving and Loan Crisis

Readings:

Bode, K.

Where the Streets Are Paved With Depositors

New York Times Book Review, May 16, 1993

http://www.nytimes.com/1993/05/16/books/where-the-streets-are-paved-with-depositors.html

Cassak, L.

How Governments React to Financial Crises: The Saving and Loan Crisis as a Test Case The Foundation for Law, Justice and Society in affiliation with The Centre for Socio-Legal Studies, (2011)

University of Oxford

https://www.academia.edu/1328422/How_Governments_React_to_Financial_Crises_The_Savings_and_Loan_Crisis_As_a_Test_Case

Laughlin, R.J.

Causes of the Savings and Loan Debacle

Fordham Law Review Vol. 59, No, (6), (1991), pp. S301 - S321

http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=2920&context=flr

Rothchild, J.

A Wonderful Life: S&L Hell: The people and the politics Behind the \$1 Trillion Savings and Loan Scandal

Los Angeles Times Book Review, (May 9, 1993)

http://articles.latimes.com/1993-05-09/books/bk-33020_1_kathleen-day

Shaffer, S.

Interest Rate Risk: What's a Bank to Do? Federal Reserve Bank of Philadelphia

https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CB8QFjAAah UKEwjX-

rTXu5LHAhUHkQ0KHfuMDrY&url=https%3A%2F%2Fwww.philadelphiafed.org%2Fresearch-and-data%2Fpublications%2Fbusiness-

<u>review%2F1991%2Fbrmj91ss.pdf&ei=uUfCVZe6GoeiNvuZurAL&usg=AFQjCNFIXT-89fii1hJuBi6FEGcAdUcosQ&sig2=E6MJC1sTaww7PrAscVbAzA</u>

Sinkey, J.F.

An Analysis of the Causes of Savings and Loan Association Failures

Book Review

Journals of Money, Credit and Banking, Vol. 21, No (1), (1989), pp. 130 - 133

Obtain at the UNCC Library Website

The S&L Crisis: A Chrono-Bibliography
The Federal Deposit Insurance Corporation
http://www.fdic.gov/bank/historical/s&l/

The Savings and Loan Crisis and Its Relationship to Banking Federal Deposit Insurance Corporation http://www.fdic.gov/bank/historical/history/167 188.pdf

Start with the FDIC's chrono-bibliograpy, it provides a great reference point from an historical perspective. Kathleen Day, a reporter for *The Washington Post*, broke many of the major stories on the S&L crisis. She later took a leave of absence to write *S&L Hell: The People and the politics behind the \$1 Trillion savings and loan scandal. S&L Hell* offers a comprehensive account of the causes of the crisis, spotlighting the role of the regulators, thrift operators, lobbyists, and politicians. Day's book could be a course into itself. The book review gives you a glimpse. Laughlin provides a nice overview of the crisis. Cassak details the regulatory responses as the crisis unfolded. The chapter from the Federal Reserve's *History of the Eighties - Lessons of the Future* entitled "The Savings and Loan Crisis and Its Relationship to Banking," provides an excellent overview of the savings and loan crisis with an emphasis on its relationship to the banking crises of the decade. The Shaffer article, "Interest Rate Risk: What's a Bank to Do?" addresses the importance of determining interest rate risk to banks.

- 1) What did commercial banks do in the 1920s? Does this mix of activates make sense?
- 2) Why do panics occur?
- 3) What do you believe were the causes of the S&L debacle?
- 4) How would you judge the government's reaction to the crisis?
- 5) What role did deposit insurance play in the crisis?
- 6) Should Roosevelt have agreed to deposit insurance? Why not simply maintain the status quo?
- 7) Were there alternative reforms of the banking system that were preferable from an economic point of view? From a political point of view?
- 8) Why did Congressman Glass want to separate commercial and investment banks? Were his arguments compelling? Are there other reasons to do it?
- 9) Why was there a crisis in 1933? How was it solved?
- 10) What is systemic risk? Does deposit insurance (note it is now at \$250,000) create systemic risk? If so, how?
- 11) What regulatory failures, if any, can be attributed to the crisis?
- 12) Do you agree with Laughlin that timely action could have avoided the crisis?

Class 9 (Tuesday, February 7) - Financial Crises - A Historical Perspective - The 1987 Crash

Readings:

Cashin, A.

Black Monday, An Unforgettable Single Day

The Big Picture, (October 19, 2012)

http://www.ritholtz.com/blog/2012/10/art-cashin-black-monday-an-unforgettable-single-day/

Carlson, M.

A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response

Board of Governors of the Federal Reserve, (2007)

http://www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf

Fraim, R.

Revisiting the 1987 Crash

The Big Picture, (October 19, 2012)

http://www.ritholtz.com/blog/2012/10/revisiting-the-1987-crash/

French, K.R.

Crash-Testing the Efficient Market Hypothesis

National Bureau of Economic Research Macroeconomics Annual 1988, Vol. 3, pp. 277-286 http://www.nber.org/chapters/c10957.pdf

Greenwald, B. and Stein, J.

The Task Force Report: The Reasoning Behind the Recommendations *Journal of Economic Perspectives*, Vol. 2, No. 3, (Summer 1988), pp. 3 -23 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.2.3.3

Koning, J.P.

Fama v. Shiller on the 1987 stock market crash

Moneyness Blog

http://jpkoning.blogspot.com/2013/10/fama-vs-shiller-on-1987-stock-market.html

McKeon, R. and Netter, J.

What Caused the 1987 Stock Market Crash and Lessons for the 2008 Crash Social Science Research Network, (2009)

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330220.

Ritholtz, B.

October 19, 1987: Dow Down 22% The Big Picture, (October 19, 2012)

http://www.ritholtz.com/blog/2011/10/october-19-1987-dow-down-22/

Vigna, P. (2012)

Crash of '87 Recollections: "My Singularly Worst-Day Ever"

The Wall Street Journal, (October 19, 2012)

 $\underline{http://blogs.wsj.com/marketbeat/2012/10/19/crash-of-87-recollections-my-singularly-worst-day-ever/}$

Watch either the Nightly Business Report, (Oct.19, 1987) http://www.ritholtz.com/blog/2012/10/1987-crash-as-seen-through-tv/

Of

After the Crash: Louis Rukeyser Wall Street Week, (Oct., 23, 1997)

 $\underline{http://www.ritholtz.com/blog/2012/10/after-the-crash-louis-rukeyser-wall-street-week-oct-23-1987/$

McKeon and Netter assert that the large three-day drop from October 14 to October 16 led to the Monday morning crash of October 19, 1987. The Koneng blog "Moneyness," contrasts the views of Eugene Fama and Robert Shiller. Fama asserts that the crash was attributed to "a change in fundamental values," while Robert Shiller, based on the results of a survey sent to individuals and institutional investors inquiring about their behavior during the crash, concluded the crash was a purely psychological phenomena. Carlson reviews the events surrounding the crashes and discussed the Federal Reserve's response. The videos provide a sense of the public's reaction to the crisis.

- 1) Imagine that your were running the floor for PaineWebber on Monday morning, October 19, how would you have reacted that day?
- 2) Should the crash have been anticipated given the substantial market downturn the Thursday and Friday immediately preceding?
- 3) Who is correct Fama or Shiller? Why?
- 4) Prior to the crash were there any expressions of concern by the press that the market was over-valued?
- 5) What impact did M&A activity have on stock prices before the crash?
- 6) What were dividend yields before, and immediately following, the crash?
- 7) Was there a "trigger" that led to the crash? If so, what was it?
- 8) What is the efficient market hypothesis?
- 9) Do you believe in the efficient market hypothesis? If so, how do you rationalize the October 1987 crash?
- 10) What new news over the weekend before the crash would have changed market fundamentals so as to support the efficient market hypothesis?
- 11) Were the weekend's events, either standing alone or in combination, sufficient to change investors fundamental expectations about the market?
- 12) Do you believe the market has a "life of its own," unrelated to economic fundamentals?
- 13) Was the crash an inevitable collapse of a speculative bubble?
- 14) If the crash was the result of a speculative bubble, why were investors still buying stocks before the stock market began its decline on October 14, 1987

- 15) Was program trading the cause of the crisis?
- 16) How is volatility in the markets measured?
- 17) What do you believe causes volatility in the markets?
- 18) Given that individuals can trade 24-7, why is there increased volatility in the market when the exchanges are open?
- 19) What is a margin call? How did margin calls exacerbate the 1987 crash?
- 20) Why were mutual fund managers forced to sell?
- 21) How did banks respond to the crisis?
- 22) What actions did the Reagan administration take as a result and why?
- 23) What actions did the Fed take as a result and why?
- 24) How do you judge the Federal Reserve's response? Did it save the day?
- 25) How important was the nature of the Fed's public activities?
- 26) What impact did the Fed's statement before the opening of the financial markets on Tuesday have on market sediment?
- 27) How, if at all, was the Administration's and Fed's response different in 1987 from 1929?
- 28) Was the market's performance more important on Tuesday, October 20, than it was on Monday, October 19th? If so, why?
- 29) Could the government have taken regulatory action to prevent the crisis? If so, what regulatory actions might it have taken and should it have done so?
- 30) What explanations are there for the 1987 crash? Which explanation to find most compelling?
- 31) Why wasn't the 1987 crash a repeat of 1929?
- 32) What impact did computerized trading have?
- 33) Why do you think the Brady Commission's recommendations were limited to market mechanisms as opposed to fundamental economic issues?
- 34) What are circuit breakers and why were they imposed following the 1987 crash?
- 35) What are the arguments for and against circuit breakers?
- 36) Contrast the market crash of 1987 to that of 2008.
- 37) How, if at all, would you distinguish, if at all, 1987's stock market from today's?
- 38) Where was Peter Lynch, the portfolio manager of Fidelity Magellan, on October 19, 1987?

Class 10 (Thursday, February 9) - **Financial Crises - A Historical Perspective - The Dot.com Bubble**

Readings:

Goodnight, T. and Green, S. Rhetoric, Risk and Markets: The Dot-Com Bubble *Quarterly Journal of Speech*, Vol. 96, No. 2, (May 2010), pp. 115 - 140 Available at UNCC Library

Mills, D.Q. Who's to Blame for the Bubble? *Harvard Business Review*, May 2001 https://hbr.org/2001/05/whos-to-blame-for-the-bubble

Morris, J.J. and Alam, P. Analysis of the Dot-com Bubble of the 1990s CFA Institute, (2008)

http://www.cfainstitute.org/learning/products/publications/contributed/Pages/analysis_of_the_dot -com_bubble_of_the_1990s.aspx

Note: Read only Sections 1, 2 and 6.

Here's Why the Dot Com Bubble Began and why it Popped *Business Insider*, December 15, 2010

http://www.businessinsider.com/heres-why-the-dot-com-bubble-began-and-why-it-popped-2010-12

Morris and Alam document the decline in the relationship between market value and traditional accounting information during the bubble, while recognizing irrational exuberance and the aggressiveness of financial analysis forecasts as possible explanations for the Dot.com bubble. Goodnight and Green assert that economics and rhetoric should switch places. Mills suggests responsibility for the bubble lies with the capital markets, investment banks, brokerage house, and the Fed. The *Business Insider* article suggest that a change in tax policy not only caused the bubble, but ended it.

- 1) Was the dot.com phenomenon a bubble or a crash? What "triggered" the Dot.com bubble?
- 2) If a company added Dot.com or dot.net to its name, what impact did that have on its stock price?
- 3) Was the Federal Reserve's monetary policy responsible for the Dot.com bubble? If so, to what extent?
- 4) Did the Fed see, or should the Fed have seen, the Dot.com bubble coming? If so, what action should they have taken, if any, and why? Said another way, can bubbles be managed? If so, should they be and how?
- 5) What impact did Chairman Greenspan's statement of "irrational exuberance" have?
- 6) Does the crash of the Dot.com's mean that as a group these stock lacked economic potential or were badly managed?
- 7) In 1997 Congress passed the Taxpayer Relief Act of 1997, lowering the maximum tax on capital gains for individual investors from 28 percent to 20 percent for assets held more than 18 months. The dividend tax rate was left unchanged. Might this have impacted the desire for, and volatility of, growth stocks?
- 8) Are psychology and sociology as important as finance and economics in explaining events such as the Dot.com bubble and crash?

- 9) To what extent can the Dot.com bubble attributed to the decline in market value and traditional accounting? To the irrational exuberance theory? To the aggressiveness of financial analysts' forecasts? Should economics and rhetoric switch places as postulated by Goodnight and Green?
- 10) What regulatory failures, if any, can be attributed to the crisis?
- 11) What is momentum investing? Does it make sense?
- 12) What action(s) did Congress take following the Dot.com bubble?
- 13) What rationale could investors have used in ignoring traditional financial evaluation methods?
- 14) Was the Federal Reserve's monetary policy responsible for the Dot.com bubble? To what extent?
- 15) Are psychology and sociology as important as finance and economics in explaining events such as the Dot.com Bubble and crash?

Class 11 (Tuesday, February 14) - The Financial Regulatory System

Homework Assignment Two Due at the Beginning of Class

Readings:

Dodaro, G.

Acting Comptroller General of the United States

Statement, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System

Testimony Before he Congressional Oversight Panel, GAO-09-310T, (2009)

http://digitl.library.unt.edu/ark:/67531/metadc291487/m2/1/high_res_d/121456.pdf

Jickling, M. and Murphy, E

Who Regulates Whom? An Overview of U.S. Financial Supervision

Congressional Research Service, (December 8, 2010)

http://www.fas.org/sgp/crs/misc/R40249.pdf

Kaplan, T.

The Federal Reserve: What the Hell Is It?

Vanity Fair Politics and Power Blog, (August 31.2009)

http://www.vanityfair.com/online/daily/2009/08/the-federal-reserve-what-the-hell-is-it

Teslik, H

The U.S. Financial Regulatory System

Council on Foreign Relations, (October 2, 2008)

http://www.cfr.org/financial-regulation/us-financial-regulatory-system/p17417

Voakes, G. and Cooege, C.

Info graphic: Uncovering The Fed *Business Insider*, (July 18, 2012_

http://www.businessinsider.com/infographic-uncovering-the-federal-reserve-2012-7

Kaplan provides a capsule overviews of the Federal Reserve. In his infographic, Voakes explores the controversy over the Federal Reserve, including some interesting facts. Dodaro's statement provides a suggested framework for modernizing the U.S. financial regulatory system.

Discussion Questions:

- 1) What is the Federal Reserve? Why does it exist? Imagine you work for a Member of Congress who asks you, "setting aside the politics, is there any substance to Rand Paul's concerns?" How do you answer?
- 2) Think about the different regulatory agencies described by Jickling and Murphy. Why do we have so many regulators? Are there too many? Does the number of over-lapping regulators provide the opportunity for regulatory arbitrage? What is different about the various agencies? Which ones, if any, failed (and how), based on your current understanding of the economic events and policies leading to Great Recession?
- 3) What changes, if any, would you make in the U.S. financial regulatory system and why?
- 4) Why not allow financial institutions to self-regulate?
- 5) What should be the functions of financial regulators?
- 6) How was the U.S. financial regulatory system developed?
- 7) How do you measure economic power in government?
- 8) What are the four components to U.S. banking regulation?
- 9) What goals does the GAO articulate for a financial regulatory system?
- 10) What gaps existed in the system that the GAO indicted contributed to the Great Recession? Are there any gaps today?
- 11) What are the advantages of a federal charter? Of a state charter?
- 12) Should there be only a federal charter?
- 13) How many times has regulatory restructuring been proposed in the United States?
- 14) Why has regulatory restructuring of financial services failed?
- 15) Why do you think Dodd-Frank eliminated the Office of Thrift Supervision (OTS)?
- 16) Why did Dodd-Frank create the Financial Stability Oversight Council (FSOC)?
- 17) Why did Dodd-Frank create the Consumer Financial Protection Board (CFPB)?
- 18) What changes did Dodd-Frank make to the Federal Reserve's powers and authorities and why?
- 19) What are Senator's Paul's concerns about the Fed? Do you agree? What changes, if any, would you make in the U.S. financial regulatory system and why?

Class 12 (Thursday, February 16) - **Background on derivatives, hedge funds, short selling and collateralized mortgage obligations**

Readings:

Adelson, M. and Bernmelen, M. CDOs in Plain English: A Summer Inters' Letter Home Nomura Securities International, Inc, (September 13, 2004) http://www.markadelson.com/pubs/CDOs in Plain English.pdf

Eichengreen, B. and Mathieson, D.

Hedge Funds: What Do We Really Know?

International Monetary Fund, Economic Issue No. 19, (September 1999)

http://www.imf.org/external/pubs/ft/issues/issues19/

Hawkesby, C.

A primer on derivatives market

Reserve Bank of New Zealand, Bulletin No. 62, No. 2

 $\underline{http://reservebank.govt.nz/research_and_publications/reserve_bank_bulletin/1999/1999jun62_2H\\ awkesby.pdf*$

Shadab, H.B.

Guilty by Association? Regulating Credit Default Swaps

http://moritzlaw.osu.edu/students/groups/oseblj/files/2013/04/4-16.pdf

Note: Read pages 407-425

Whetten, M., Adelson, M, and Bernmelen, M Credit Default Swaps (CDS) Primer Nomura Securities International, Inc, (May 12, 2004) http://down.cenet.org.cn/upfile/10/200589151828114.pdf

Some argue that hedge funds, derivatives and short selling played a role in the Great Recession. These readings introduce some of the crucial financial instruments arguably involved in the financial crisis. Our goal is for you to have an understanding of (1) why these instruments appeared; (2) why their use may have become problematic; and, (3) what regulatory steps might be appropriate and which ones might not be. The Whitten and Adelson articles are clear, concise explanations of what CDO and CDS instruments are. Note that these were written *before* the crisis by a firm that sold CDS and CDO products. (How does that affect how you read these articles?) The Hawkesby piece endeavors to describe derivatives in simple terms. The Shadab article is a post-crisis, skeptical analysis of regulatory efforts plus a good description of how the CDO-CDS market works. (Shadab is one of the best writers on financial regulation around.)

- 1) What is a derivative? Why would one purchase a derivative? Why would want sell a derivative?
- 2) What is a credit default swap (CDS)? Why would one purchase a CDS? Why would one want sell a CDS?
- 3) What is the size of the derivatives market today? The CDS market?
- 4) Who are the largest players in the CDS market?
- 5) Who sells CDS?
- 6) How are CDS premiums calculated?
- 7) What are the "trigger events" for payment of a CDS?
- 8) What is a synthetic CDO?

- 9) Why did problems with the junk bond market in 2001 and 2002 cause problems with CDOs?
- 10) What is credit trenching?
- 11) Why diversify?
- 12) What is correlation? How important are predictions to correlation estimation?
- 13) What problems should regulators being trying to solve with respect to CDS/CDO and derivatives markets? What problems should they leave to market mechanisms? Who should regulators protect in regulating CDS/CDO and derivatives markets?
- 14) Why and when were Over-The-Counter derivatives exempted from capital adequacy requirements, disclosure and regulatory rules?
- 15) What was the value of the Over-The-Counter derivatives market at the time it was deregulated?
- 16) How much had AIG underwritten in CDS and how much did it place in reserves?
- 17) Given the global nature of financial markets, can one country effectively regulate such instruments? Even if most countries cannot, can the United States?
- 18) Should a key principle of financial regulation be, "to supervise financial products based on the actual data and how people make financial decisions?"
- 19) What is a hedge fund?
- 20) Were hedge funds totally unregulated?
- 21) If hedge funds investors must be high net worth individuals with investment sophistication, why should they be regulated?
- 22) Should governments supervise and regulate all investment vehicles? If so, to what should be the goals of such regulation and to what extent should investment vehicles be regulated? Given the need for risk management described by Stowe, what new problems might regulating CDS/CDO markets create?

Classes 13 & 14 - (Tuesday, February 21 & Thursday, February 23) - **Background on the Great Recession**

Readings:

Acharya, V, Phillppon, T, Richardson, M. and Roubini, N A Birds-Eye View The Financial Crisis of 2007 - 2008, Causes and Remedies

http://dev3.cepr.org/meets/wkcn/1/1716/papers/prol.pdf

Note: Read pages 1 - 25

Bernanke, B.

The Federal Reserve After World War II, Lecture 2

George Washington University School of Business

http://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture2-20120322.pdf

Note: Slides to accompany the lecture are available at:

http://www.federalreserve.gov/newsevents/files/bernanke-lecture-two-20120322.pdf

Gorton, G. and Metrick, A

Getting Up to Speed on the Financial Crisis: A One-Weekend-Reader's Guide Yale University and the National Bureau of Economic Research. (January 15, 2012) http://faculty.som.yale.edu/garygorton/documents/GettingUpToSpeed_Jan-11-2012.pdf

Greenspan, A.

Never Saw It Coming Why the Financial Crisis Took Economists By Surprise https://www.foreignaffairs.com/articles/united-states/2013-10-15/never-saw-it-coming

Kliesen, K.

Book Review: This Time It's Different: Eight Centuries of Financial Folly *The Region*, (September 2010)

https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4540&

Lo, A.W.

What An Economist Learned From Reading 21 Books About The Crisis August 8, 2012

http://www.argentumlux.org/documents/JEL_6.pdf

Ritholz, B.

Barry Ritholz on Causes of the Financial Crisis *Five Books*, (September 17, 2013)

http://www.ritholtz.com/blog/2013/09/five-books-on-causes-of-the-financial-crisis

Temin, P. (2010)

The Great Recession and The Great Depression National Bureau of Economic Research, Working Paper 165645. (January 2010) http://www.nber.org/papers/w15645.pdf

Yandle. B.

Lost Trust

Working Paper No. 9-02 (2009)

Mercatus Center

George Mason University,

http://mercatus.org/sites/default/files/publication/Lost_Trust_-

The Real Cause of the Financial Meltdown (updated).pdf

Let's now turn to the Great Recession. We will be debating the causes for decades (as we are still debating the causes of the Great Depression). Gorton and Metrick cover the key facts and mechanisms in the build-up of risk, the panics in the short-term debt markets, the policy reactions and the real effects of the crisis. Lo reviews a diverse set of twenty-one books, some written by academics, some by journalists and one by a former Treasury Secretary. Temin discusses the parallels between the Great Depression and the Great Recession. The title to Reinhardt and Rogoff's book, *This Time It's Different: Eight Centuries of Financial Folly*, says it all. Ritholz blames regulatory changes and the Fed. Acharya, Philippon, Richardson, and Roubini call for a redesign of

the regulatory overlay of the global financial system. Yandle addresses the importance of trust to the functioning of financial markets.

- 1) What do you believe was (were) the cause(s) of the Great Recession?
- 2) Was there a single spark that lit if off?
- 3) Why can't economists come to joinder on the cause(s)?
- 4) What does the fact economists cannot come to joinder on the cause(s) indicate about the profession?
- 5) Was the Great Recession a case of people losing their fear in the climate of prosperity, there upon becoming more relaxed (like someone who has had a little too much to drink), becoming lulled in a false sense of security, safety and prosperity, thereafter cutting corners and building in the kind of risks that end in financial crisis?
- 6) Was the Great Recession no different than any other financial crisis, or was it truly different?
- 7) To what extent did technology and innovation play in the crisis?
- 8) Why didn't the greatest financial minds in the country (Greenspan, Bernanke) see it coming? Should they have seen the crisis on the horizon and taken action to curtail it? If so, what action(s) should have been taken and why?
- 9) Should Lehman have been saved?
- 10) What parallels, if any, can you draw to the Great Depression?
- 11) Are there any parallels in causation of the financial crises we have been discussing?
- 12) What actions did the government take to restore stability in each instance
- 13) Was Wall Street unfounded in assuming that "this time it is different," i.e., was risk in the housing market diversified away by CDOs and CDS's?
- 14) How important is trust to financial markets? What institutions provide that trust?
- 15) What is a subprime mortgage?
- 16) What is the difference between "originating-to-hold" and originating-to-distribute?
- 17) What percent of loans were subprime in 2006?
- 18) Why did the number of subprime loans increase so dramatically?
- 19) To what extent did "originating-to-distribute" contribute to the crisis?
- 20) What is securitization?
- 21) How much did securitization grow in the years immediately preceding the crises?
- 22) What impact did increased securitization have on the crisis?
- 23) What is a shadow bank?
- 24) What led to the growth of the shadow banking system?
- 25) What impact did shadow banks have on the crisis?
- 26) What is a repo?
- 27) What impact did repos have on the crisis?
- 28) What is "mark-to-market" accounting? How did it become problematic during the crisis?
- 29) Why is high inflation equivalent to default by the government?
- 30) To what extent were large capital inflows to the United States responsible for the crisis?
- 31) Can ever-improving forms of self-mentoring and institutional advance prevent financial crises from occurring?
- 32) What is regulatory capture? Can regulatory capture be blamed for the crisis?
- 33) What about greed? Can it be regulated or prevented?

- 34) Is a "this time it's different syndrome" likely to result in future crises? If so, how do we overcome it?
- 35) Why do banking crises tend to be contagious?
- 36) Did the efficient market hypothesis lead investors astray causing them to ignore the possibility that securitized debt was mispriced and that the real-estate bubble could burst?
- 37) Was the decline in housing prices and the prospect of subprime loan defaults in and of itself sufficient to cause the crisis?
- 38) Were Wall Street compensation contracts too focused on short-term trading profits rather than long-term invectives?
- 39) Why are bubbles asymmetric, i.e., why do so few investors try to take advantage of an obvious bubble and why do even fewer investors manage to profit from bubbles?
- 40) Does an acceleration in economy wide-leverage and debt portend of a financial crisis?
- 41) Why do households, governments, institutions, financial market participants, economists, and business consistently underestimate the fragility of highly leveraged economies?
- 42) What early warning signs would you identify as portending of a future crisis?
- 43) Was there excessive risk-taking because CEOs on Wall Street were betting on other people's money not their own?
- 44) Did investment banks greatly increase their leverage in the years leading to the crisis a result of an SEC rule-change?
- 45) Is evidence of a bubble, "rapid prices increases" or, "a situation in which excessive public expectations of future price increases cause prices to be temporality elevated?"
- 46) Does money market mutual fund performance predominantly increase on the basis of investment manager skill or risk?
- 47) What were the attributes of the money market funds that saw larger runs?
- 48) What event triggered the run on money market mutual funds?
- 49) What stopped the run on money market mutual funds?
- 50) What impact did the Lehman bankruptcy have on money market funds and why?
- 51) What broad based impact did the Lehman bankruptcy have on the money markets and why?
- 52) What happened to liquidity as the crisis continued to unfold?
- 53) What happened to the credit markets as the crisis continued to unfold?
- 54) Is it critical that government support market function and cushion the blow of an economic crisis?
- 55) What is "breaking the buck"?
- 56) How large was the repo market in the years immediately preceding the crisis?
- 57) Was the Great Recession a case of people losing their fear in the climate of prosperity, there upon becoming more relaxed (like someone who has had a little too much to drink), becoming lulled in a false sense of security, safety and prosperity, thereafter cutting corners and building in the kind of risks that end in financial crisis?
- 58) How did the Fed cooperate with the U.S. Treasury during and immediately after World War II?
- 59) What were the economic consequences of keeping interest rates low?
- 60) Describe the Fed-Treasury Accord and evaluate whether it was effective in improving economic conditions. Discuss the implications of the agreement.
- 61) Identify the various ways in which the Federal Reserve is insulated from political influence.
- 62) Compare the costs and benefits to society of central bank independence.
- 63) What was a "lean against the wind" policy? Was it effective in the 1950s and early 1960s?

- 64) Describe monetary policy in the mid-1960s and into the 1970s? What was the rationale of the policy?
- 65) Was the trade-off between inflation and unemployment relevant to the choice of policy? Why or why not?
- 66) Evaluate the appropriateness of policy in the mid-1960s and into the 1970s and explain how policy impacted economic conditions.
- 67) Describe exacerbating factors other than monetary policy that may have contributed to the high rates of inflation and numerous recessions from the mid-1960s through the 1970s.
- 68) Why was the idea of a permanent tradeoff between unemployment and inflation so important in contributing to inflationary conditions? How did that lead to a concept of "fine-tuning"?
- 69) Why were the estimates of full-employment levels of unemployment so important?
- 70) Explain the roles and importance of data collection and forecasting in monetary policy. Why is accuracy in forecasting so important?
- 71) What does "disinflation" mean? Is it desirable? Why or why not?
- 72) What was the role of monetary policy in contributing to disinflation in the late 1970s and early 1980s?
- 73) Describe the conditions leading up to the 1981-82 recession.
- 74) Summarize monetary policy before and during the recession. What were Chairman Volker's goals?
- 75) Why was there significant political pressure against the policy?
- 76) How did this experience affect monetary policy after the recession and even today? Will the U.S. ever have a similar phenomenon to the Great Inflation? Why or why not?
- 77) Define the term "Great Moderation." Give examples of its characteristics?
- 78) What happened to the rate of growth of real GDP? What happened to inflation rates?
- 79) What happened to the length and frequency of recessionary periods?
- 80) What was the role of monetary policy during the Great Moderation?
- 81) How could changes in business practices, such as improved inventory management, make a difference in recessionary pressures and inflation?
- 82) Were there financial crises during the Great Moderation? What were the effects?
- 83) What can we learn from the Great Moderation? How does that period affect monetary and fiscal policy today?
- 84) Compare monetary policy since the Volcker era to monetary policy in the 1960s and 1970s. What are the key differences? Which was the more effective, and why?
- 85) Explain why financial crises became less of a concern during the Great Moderation? Did they disappear?
- 86) How large was the increase in housing prices?
- 87) Describe what caused the rapid rise in housing prices.
- 88) What is a bubble? Why are rising asset prices not necessarily a positive event for everyone?
- 89) What are several possible causes of the bubble?
- 90) Describe the characteristics of the decline in lending standards.
- 91) Explain why lending standards seemed to deteriorate. Give examples of changing incentives.
- 92) How could a deterioration in lending standards be caused by a bubble and at the same time contribute to the housing bubble?
- 93) List several causes of the bursting of the housing bubble. Explain how each could contribute to the decline in housing prices.
- 94) What were the effects of the bursting housing-price bubble on the rest of the economy

- 95) Define a financial crisis trigger and give examples.
- 96) Define a financial crisis vulnerability and give examples.
- 97) How did the triggers and vulnerabilities lead to serious declines in economic conditions? Why was the collapse in housing prices so much more serious than the collapse of dot-com stock prices in 2001? How did the Great Moderation affect the vulnerability of the economy to a serious financial trigger?
- 98) What were the private-sector vulnerabilities that amplified the effects of the triggers?
- 99) Explain how increased leverage, financial institutions' failure to monitor their own risk adequately, increased short-term funding, and new exotic financial instruments amplified the effects of the triggers.
- 100) What were the public-sector vulnerabilities that amplified the effects of the triggers?
- 101) What were the gaps in the regulatory structure? How did those gaps lead to a worsening of the financial crisis?
- 102) What additional failures by regulatory agencies took place during the financial crisis? Explain how each contributed to a worsening of the crisis.
- 103) What are systemic problems?
- 104) How did systemic problems differ from problems with individual banks or small groups of banks? Why did they receive insufficient attention?
- 105) Summarize the evidence about the role of monetary policy in contributing to the crisis.
- 106) Is that evidence convincing one way or another?
- 107) Summarize the effects of the financial crisis on financial markets.
- 108) How did the collapse of the housing bubble affect housing construction? Explain why.
- 109) Describe how and why unemployment changed during the bubble and the subsequent financial crisis.

Class 15 (Tuesday, February 28) - The Housing Bubble, Subprime Mortgages & Securitization

Readings:

Bernanke, B.

The Federal Reserve' Response to the Financial Crisis, Lecture 3, March 27, 2012 George Washington University School of Business

http://www.federalreserve.gov/newsevents/files/chairman-bernanke-lecture3-20120327.pdf

Note: Slides to accompany the lecture are available at:

http://www.federalreserve.gov/newsevents/files/bernanke-lecture-three-20120327.pdf

Doherty. B

The Housing Boom and Bust

Reason.com, (May 20, 2009)

http://reason.com/archives/2009/05/20/the-housing-boom-and-bust

Jickling, M.

Fannie Mae and Freddie Mac in Conservatorship

Congressional Research Service, (September 15, 2008)

Google search: "Jickling, M. Fannie Mae and Freddie Mac in Conservatorship"

Katz, A.

The Rise and Fall of Fannie Mae: A Timeline AOL Real Estate, Updated December 26, 2010

http://realestate.aol.com/blog/2010/12/24/the-rise-and-fall-of-fannie-mae-a-timeline/

Kosar, K.

Government Sponsored Enterprises (GSEs): An Institutional Overview Congressional Research Service, (April 23, 2007) http://fas.org/sgp/crs/misc/RS21663.pdf

Pickert, K.

A Brief History of Fannie Mae and Freddie Mac *Time Magazine*, (July 14, 2008)

http://content.time.com/time/business/article/0,8599,1822766,00.html

Democrat Barney Frank admits his role in causing the recession (2010) Wintery Knight Blog, (October 15, 2010)

 $\underline{\text{http://winteryknight.wordpress.com/2010/10/15/democrat-barney-frank-admits-his-role-in-causing-the-recession/}$

Watch The You Tube Video: SubPrime Mortgage Mess Explained https://www.youtube.com/watch?v=q8hjUei-Nwo

The CRS studies outline some of the basics issues and facts involved in the subprime housing bubble. The timeline from AOL Real Estate provides a brief history of Fannie and Freddie. The *Time* article, published just before the September 2008 conservatorship of Fannie and Freddie, provides a further historical synopsis and overview of the 2 main government actors. The Doherty interview of Thomas Sowell addresses Sowell's laying blame on government policies for the housing crisis.

- 1) What do Fannie and Freddie do?
- 2) What is a GSE?
- 3) How many GSE's are there?
- 4) What percent of mortgages were purchased by Freddie and Fannie in 2008? What percentage are purchased today?
- 5) Why would a bank (or other lenders) sell a loan to Fannie/Freddie?
- 6) What impact did the implicit federal government guarantee of Fannie and Freddie have on mortgage rates?
- 7) What were the causes of the housing bubble/subprime crisis?
- 8) What role did securitization play in the crisis?
- 9) Did Freddie and Fannie contribute to the problem? If so, what might be done to prevent such problems in the future? What competitive advantages do Fannie and Freddie have?
- 10) What four key characteristic define the U.S., housing market?
- 11) How, if at all, are housing prices related to interest rates?

- 12) Is mortgage securitization good or bad?
- 13) Did all subprime lending go to poor households?
- 14) Why do banks have a closer relationship to the government than other commercial entities?
- 15) How important is if for elected officials to do special things to get re-elected?
- 16) How is the U.S. housing and mortgage market different from that of other countries?
- 17) Should Fannie and Freddie be dissolved? If so, what would be the consequences?
- 18) What is the role of Congressional oversight in supervising GSEs like Freddie and Fannie? Do some research in news archives what sort of complaints do people have about how Congressional oversight was handled? What criticisms have been raised about the role of individual Congressmen and Senators with respect to oversight of Freddie and Fannie?
- 19) What is the role of Executive branch in supervising GSEs? Should GSEs be treated differently than administrative agencies directly responsible to the President (e.g. the Department of Housing and Urban Development)? Was the GSE structure appropriate for Freddie and Fannie?
- 20) Did "politics" contribute to the housing bubble?
- 21) Did the efficient market hypothesis lead investors astray causing them to ignore the possibility that securitized debt was mispriced and that the real-estate bubble could burst?
- 22) Was the decline in housing prices and the prospect of subprime loan defaults in and of itself sufficient to cause a crisis?
- 23) Why did the housing market collapse of the Great Recession have a greater impact on the economy than the Dot.com crash or the 1987 stock market crash?
- 24) Were Wall Street compensation contracts too focused on short term trading profits rather than long term invectives?
- 25) To what extent were large capital inflows to the United States responsible for the crisis?
- 26) What is "regulatory capture?" Can regulatory capture be blamed for the housing crisis?
- 27) Can greed be blamed for the housing crisis?
- 28) Define government-sponsored enterprises (GSEs). What advantages do the GSEs offer borrowers and lenders?
- 29) Define securitization. Why would firms want to engage in securitization?
- 30) Why might securitization become a vulnerability?
- 31) Are bad mortgage products and practices a trigger or a vulnerability? Explain why.
- 32) Explain why housing prices had to keep increasing in order for adjustable-rate mortgages (ARMs) to make sense for borrowers and lenders.
- 33) What were the roles of option ARMs, stated income loans, and no-doc loans? How were they helpful for borrowers? How did they contribute to the housing-price bubble? How did they contribute to the bursting of the bubble?
- 34) What is a "ratings agency?" What is the role of ratings agencies in financial markets?
- 35) What are the incentives for rating agencies? How might those incentives contribute to the creation of a bubble?
- 36) What are the advantages and disadvantages of securitization of subprime mortgages for the borrowers, for the packagers of the securities, and for the buyers of the securities?
- 37) What was the role of insurance of those securities; that is, what was the role of credit default swaps?
- 38) Define a classic financial panic.
- 39) What happens in the short run? In the long run?
- 40) What is the difference between a solvency crisis and a liquidity crisis?

- 41) How can the entire system be endangered if just a few banks or financial institutions have solvency or liquidity problems?
- 42) Describe the various elements of the policy response to the financial crisis.
- 43) What evidence is relevant to determining the success or failure of the policy response? Can you summarize the evidence?
- 44) What is the "discount window?" Describe the role of the traditional tool of the discount window in halting bank runs. Why was additional action needed?
- 45) What are the alternative tools? How were they intended to prevent potential bank runs?
- 46) What are money market funds and the commercial paper market? What is the relationship between the two? Why are they important in this context? What roles did they play in the financial crisis?
- 47) What is the importance of the federal guarantee of money market mutual funds? How is the money market connected to corporate costs of borrowing?
- 48) Why might there be a panic if depositors and lenders believe that there will be some small amount of trouble? Why would a customer want to be the first to withdraw funds? What are the consequences for the system?
- 49) What is a "too-big-to-fail" financial institution?
- 50) Would it be better to let those institutions fail, so as to discourage future risky actions? Why or why not?
- 51) Summarize the effects of the financial crisis on the real economy. Compare and contrast those effects with the effects of financial crises during the Great Depression.
- 52) Summarize the effects on the stock market. Why is that relevant for the average U.S. worker who might not directly or even indirectly own shares of stock?

Class 16 (Tuesday, March 2) - The Financial Crises Inquiry Report

Readings:

The Financial Crisis Inquiry Report, January 2011 http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

Note: Read the preface (pp. xi-xii), the Conclusions of the Commission (pp. xv - xxviii), the dissenting views (pp. 411 - 439 and 443 - 538, and the introduction and summary of Wallison's dissent (485 - 538)).

The Financial Crisis Inquiry Report is over 600 pages in length with appendices. Reviewing the report in its entirety would take a semester. That said, as noted in a January 2011 article by Gretchen Morgenson in the *New York Times*, the report is in and of itself, "A Bank Crisis Whodunit with Laughs and Tears." The commission was created "to examine the causes of the financial and economic crisis in the United States." Its statutory instructions set out twenty-two specific area for inquiry and called for the examination of the collapse of major financial institutions that failed, or world have failed if not for exceptional assistance from the government. The commission was not asked to offer policy recommendations or evaluate federal law (TARP) (evaluation of TARP was undertaken separately by the Congressional Oversight Panel and the Special Inspector General for TARP). The Commission members were appointed to an independent 10-member panel, six members appointed by the Democratic leadership of the Congress and four members by the

Republican leadership. As you might, therefore, surmise, there was disagreement on the final report, with dissenting views. Note that not even the dissenters agreed!

- 1) Why was the Financial Crisis Inquiry Commission formed?
- 2) Who commissioned it?
- 3) Who were its members?
- 4) Who appointed its members?
- 5) What was its statutory mission?
- 6) What were the topics of inquiry?
- 7) What was the central question the commission's majority says it faced?
- 8) There is disagreement among the commissioners as to the extent that the lack of federal regulation and federal regulatory supervision contributed to the crisis. Which side do you take? Why? What was the spark that the commission's majority indicated ignited a string of events, which led to a full-blown crisis in the fall of 2008? What fueled that spark? What magnified those losses? What were the warning signals?
- 9) What changes does the commission's majority indicate occurred in the financial system in the decades preceding the crisis. What about Wallison's assertion, "why have it (the commission) if Congress is going to proceed to enact Dodd-Frank before the commission completes its report?"
- 10) Who does the commission's majority blame for the failure to stem the flow of toxic mortgages?
- 11) What is leverage?
- 12) How high were Fannie and Freddie leveraged?
- 13) Are some firms too big to manage?
- 14) How highly leveraged were the large investment banks?
- 15) What role does the commission's majority indicate the financial industry itself played in weakening regulatory constraints?
- 16) What's was wrong with the short-term borrowing the large investment banks had undertaken? Has short-term borrowing led to other crisis in history?
- 17) What happened to national mortgage debt in the years preceding the crisis?
- 18) To what extent does the commission's majority indicate greed was responsible for the crisis?
- 19) To what extent does the commission's majority conclude excess liquidity was the cause of the crisis?
- 20) What does the commission's majority say about Fannie and Freddie's business model?
- 21) What is the Community Reinvestment Act (CRA)? To what extent was CRA responsible for the crisis?
- 22) What is a credit spread? What happened to credit spreads in the years immediately preceding the crisis?
- 23) What are the factors the minority identifies as contributing to the housing bubble?
- 24) How did Fed Chairman Bernanke sum up the housing bubble?
- 25) What does the minority report indicate as to the contribution of derivatives to the crisis?
- 26) Do you agree with the conclusions of the majority or minority?
- 27) Is the crisis report a political document?

- 28) There is disagreement among the commissioners as to the extent that the lack of federal regulations and federal regulatory supervision contributed to the crisis. Which side do you take? Why?
- 29) Do you believe, as the majority asserts, that with proper federal regulation and supervision the crisis could have been avoided?
- 30) Was the crisis a "perfect storm?" If so, can perfect storms ever be avoided? If so how? Is avoiding a perfect storm tantamount to removing risk from the financial market place?
- 31) What conclusions does the commission's majority make?
- 32) What does the minority indicate were the essential causes of the crisis?
- 33) How in essence does the commission's majority's conclusions differ from that of the minority?
- 34) What does the minority report indicate was the cause of the credit bubble?
- 35) Do you believe, as the majority asserts, that with proper federal regulation and supervision the crisis could have been avoided?
- 36) What do you believe were the essential causes of the crisis? To what extent did each cause contribute to the crisis? Said another way, had any cause or causes been eliminated or mitigated in some way, could the crisis have been avoided?
- 37) Was there a "spark" that lit the crisis? If so what was it?
- 38) Wallison assets that none of the reasons cited by the commission alone, or in combination, caused the crisis? Do you agree? If so, what do you think cause the crisis?
- 39) Why couldn't the commissioners reach an agreement?
- 40) What does the fact the commissioners could not reach agreement portend for the country?
- 41) What role(s) should government play in housing policy?
- 42) Was the government's housing policy a contributing factor to the crisis? If so, to what extent?
- 43) To what extent did the Federal Reserve's monetary policy contribute to the crisis?
- 44) What is a non-traditional mortgage (NTM)? To what extend did NTMs contribute to the crisis? If NTMs had not existed would the crises have been avoided?
- 45) Was the crisis a "perfect storm?" If so, can perfect storms ever be avoided? If so, how? Is avoiding a perfect storm tantamount to removing risk from the financial market place?

STUDENT RECESS - NO CLASSES - MARCH 4 - 12

Class 17 (March 14) - Starr International Company v. the United States (The AIG Lawsuit)

Briefing Paper Due At Beginning of Class

Readings:

Starr International Company v. the United States Download at Canvas

<u>Discussion Questions</u>: Note: For this class I will go around the room asking each student whether they agree or disagree with a particular finding of fact.

Classes 18 and 19 (Thursday, March 16 & Tuesday, March 21) - Economic Stimulus Act of 2008, American Recovery and Reinvestment Act of 2009, and the Troubled Asset Relief Program (TARP)

Readings:

Bernanke, B.

The Aftermath of the Crisis, Lecture 4, March 29, 2012

George Washington University School of Business

http://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture4-20120329.pdf

Note: Slides to accompany the lecture are available at:

http://www.federalreserve.gov/newsevents/files/bernanke-lecture-four-20120329.pdf

Binder, A. and Zandi, M.

How the Great Recession Was Brought to an End, (July 27, 2010)

https://www.economy.com/mark-zandi/documents/End-of-Great-Recession.pdf

Haskins, R.

Economic Stimulus Act: Hard to Kill Two Birds with One Stone

Pathways Magazine, Sumer 2008

Brookings

http://www.brookings.edu/research/papers/2008/08/summer-stimulus-package-haskins

Reuter, T.

Bad Economics And Bank Bailouts Were The Norm Long Before TARP: A Retrospective On The East India Company

Forbes, April 14, 2013

http://www.forbes.com/sites/realspin/2013/04/14/bad-economics-and-bank-bailouts-were-the-norm-long-before-tarp-a-retrospective-on-the-east-india-company/

Smith. B.

TARP: A success none dare to mention

Politico, September 14, 2010

http://www.politico.com/news/stories/0910/42135.html

Did the Stimulus Package Work?

Economist's View, March 4, 2012

http://economistsview.typepad.com/economistsview/2012/03/did-the-stimuus-package-work.html

How effective was TARP, really?

The Economist, October 8, 2010

http://www.economist.com/blogs/democracyinamerica/2010/10/public opinion and bailouts

The Final Report of the Congressional Oversight Panel on TARP, (2011)

http://www.gpo.gov/fdsys/pkg/CHRG-112shrg64832/pdf/CHRG-112shrg64832.pdf

Note: Read the Executive Summary (pp. 1-4), the Introduction (pp. 5-21), the lessons learned under each subsection, and the Conclusions and Lesson Learned (pp. 151-160).

In an effort to bring the country out of the Great Recession, two pieces of major legislation were passed by Congress and signed into law by Presidents Bush and Obama: the Economic Stimulus Act

of 2008 and the American Recovery and Reinvestment Act of 2009 (the Troubled Asset Relief Program (TARP) was contained within the Economic Stimulus Act of 2008. Questions regarding the effectiveness of the stimulus plans remain, TARP was very controversial. While not a lengthy as the Financial Crisis Inquiry Report, the Final Report of the Congressional Oversight Panel on TARP (196 pages), is a lot to digest (the commission held over 20 hearings across the country). The study by Alan Binder and Mark Zandi provides a unique analytical insight into TARPs effectiveness.

- 1) How did Fed Chairman Bernanke describe the course the nation was on?
- 2) How did Chairman Bernanke describe the magnitude of actions the Fed would take?
- 3) What were the broad goals of the government in confronting the Great Recession?
- 4) What was the problem with the banking system in 2008, i.e., was it that banks lacked enough capital or that they held so many sub-prime mortgage loans?
- 5) What traditional central bank actions did the Federal Reserve take to stave-off the unfolding crisis? Compare those actions to those taken during the Great Depression and the 1987 stock market crash?
- 6) What is the discount window?
- 7) Why was there a stigma in borrowing from the discount window?
- 8) What did the Fed and the Treasury Department due to mitigate the stigma from borrowing from the discount window?
- 9) What non-traditional central bank actions did the Federal Reserve take to stave-off the unfolding crisis?
- 10) What legislation was passed to accomplish the government's broad goals in confronting the Great Recession?
- 11) How did Secretary Paulson and Chairman Bernanke initially propose using TARP funds?
- 12) What happened on September 29th following the introduction of TARP?
- 13) What was the reaction of the stock market when ARP's passage originally failed?
- 14) Does the stock market set federal government policy?
- 15) How long did it take to pass TARP?
- 16) Why did the Treasury Department choose not to buy troubled assets under TARP as Secretary Paulson and Chairman Bernanke had initially proposed? What alternative action was taken?
- 17) What impact did the change in use of TARP funds have from a public perspective?
- 18) What was the broad based intent of the Fed and the Treasury in the capital infusion to banks?
- 19) What restrictions were initially placed on the banks that took TARP funds? What problems did that cause? What was HAMP and why did if fail?
- 20 To what extent did the commission indicate TARP helped the American homeowner?
- 21) What Treasury action did the commission indicate played the greatest role in calming the makers and halting the financial panic?
- 22) What has happened to the size of the big banks since the crisis?
- 23) To what extent did TARP create "moral hazard" and why?
- 24) Did TARP exacerbate the too big to fail concept?
- 25) What actions did Treasury take that the commission indicates further increased moral hazard and why?
- 26) What actions does the commission indicate Treasury and the Fed could have taken to reduce the likelihood of increased moral hazard?

- 27) How did the commission indicate Treasury's implementation made things worse?
- 28) What does the commission indicate about transparency?
- 29) To what extent and why did the commission indicate TARP distorted the financial market place?
- 30) How many times is the word "unpopular" used in the report?
- 31) Did TARP make things better or worse?
- 32) Did TARP achieve its stated purpose?
- 33) Is the government becoming better at managing a financial crisis?
- 34) What do you believe were TARPs successes and failures?
- 35) For how long was TARP in place?
- 36) To what extent does the commission indicated TARP deserved credit for preventing the Recession from becoming the Great Depression?
- 37) Was TARP necessary?
- 38) In a crisis, is it always necessary for the government to be seen as doing something?
- 39) Think about each of lesson learned subsections what are your thoughts on each?
- 40) Did TARP prevent another Great Depression? Why or why not?
- 41) Does TARP deserve the public stigma that exists when the "four letter acronym is mentioned?
- 42) How important is communication to the public when legislation such as TARP is created?
- 43) Did TARP only benefit Wall Street or where there also benefits to main street?
- 44) Think back to the South Sea Bubble and to the Frehen, Goetzmann and Rouwenhorst paper, New Evidence of the First Financial Bubble. To what extent was innovation in the securities market a contributor to the Great Recession?
- 45) Does the report by Alan Binder and Mark Zandi change your view of TARP? Said another way, knowing what you know now would you defend TARP?
- 46) Summarize the effects of the special lender-of-last-resort programs.
- 47) What were the strengths of the lender-of-last-resort programs? Why were they not continued on a permanent basis?
- 48) Give a brief overview of the purposes of the Federal Open Market Committee (FOMC).
- 49) Who serves on the FOMC?
- 50) Summarize the FOMC traditional monetary policy actions during the crisis.
- 51) Under what circumstances would the FOMC raise the federal funds rate? Why would the FOMC lower the rate? What does the Federal Reserve do to influence the federal funds rate?
- 52) Why can't the federal funds rate be lowered to below zero? What does it mean to say that "the effectiveness of the federal funds rate was exhausted"?
- 53) What are large-scale asset purchases (LSAPs), also sometimes called quantitative easing? What is the purpose?
- 54) How are bond prices and interest rates related?
- 55) Explain the effects of LSAPs on interest rates. Explain the relationship between housing prices and interest rates.
- 56) How does the Federal Reserve pay for LSAPs? Does the Federal Reserve print money to buy the assets?
- 57) What were the effects of the LSAPs on Federal Reserve assets? On Federal Reserve liabilities?
- 58) What is the effect of LSAPs on the money supply? What are the risks of LSAPs?
- 59) What is the difference between monetary and fiscal policy? What did Chairman Bernanke mean by saying the federal government actually made a profit on LSAPs?
- 60) Summarize the steps that were taken by the Fed to improve communication.

- 61) How can improved communication make monetary policy more effective?
- 62) Explain how each of the following may contribute to the effectiveness of monetary policy: establishing news conferences following some FOMC meetings; announcing that the FOMC has an inflation goal of 2 percent in the medium term; and projecting the future path for the federal funds rate.
- 63) Define a recession.
- 64) If the recession ended so long ago, why has the recovery not been stronger?
- 65) Compare the length of the recovery to the length of the recession.
- 66) How can low prices of housing slow the economy's recovery?
- 67) What is the relationship between current housing prices, expected housing prices, interest rates, and overall economic conditions?
- 68) Why are credit markets so slow to recover? What are examples of continuing weaknesses in credit markets?
- 69) What are the limits of monetary policy in promoting economic recovery?
- 70) Explain how conditions in Europe can slow the U.S. recovery.
- 71) What are some examples of "headwinds" faced by the U.S. economy?
- 72) Chairman Bernanke showed a graph of real GDP over the last century. What stands out as its most important feature?
- 73) Describe the determinants of long-term economic growth. Can the continuing sluggish economic conditions affect long-term growth in the economy?
- 74) How have past recessions affected long-term growth?
- 75) Summarize the primary vulnerabilities that contributed to the financial crisis.
- 76) How does the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 approach the following issues?
 - a. Regulators tracking and evaluating the entire financial system
 - b. Key financial institutions
 - c. Too-big-to-fail institutions
 - d. Inefficiencies in markets of relatively new instruments (such as new forms of derivatives)
 - e. Insufficient and ineffective consumer protection in some markets
- 77) How has the crisis affected Federal Reserve policy? What changes are we likely to see in the future? Explain why those changes are being made.
- 78) Are there other changes that are not being made, but should be? Explain your position.

Classes 20 and 21 (Thursday, March 23 & Tuesday, March 28) - The Enactment of Dodd-Frank

Readings:

Kaiser, Robert G.

'Act of Congress': How Barney Frank foiled the banking lobby to form a new financial watchdog. *The Washington Post*, May 5, 2013

 $\frac{https://www.washingtonpost.com/business/economy/act-of-congress-how-barney-frank-foiled-the-banking-lobby-to-form-a-new-financial-watchdog/2013/05/05/94d93ed2-b0eb-11e2-9a98-4be1688d7d84_story.html$

U.S. Senate Floor Debate on Dodd-Frank Conference Report

Congressional Record, (July 14, 2010)

Proceedings and Debates of the 11th Congress, Second Session

https://www.sullcrom.com/files/upload/Senate%20floor%20debate%20on%20Dodd-

Frank%20Conference%20Rpt.pdf

Note: Interspersed among the Dodd-Frank debate are numerous other items - skip those.

Before we dive into the substance of Dodd-Frank itself, we should review the Senate floor debate on Dodd-Frank. Illuminating of the political process is the book by Robert Kaiser, 'Act of Congress:' How America's Essential Institution Works, and How It Doesn't. We do not have time to read the book, but it does provide an interesting account of how "sausage was made" in the passage of Dodd-Frank. The Congressional Record is long (over one-hundred pages). Note, however, that interspersed among the debate on Dodd-Frank are numerous other items - skip those in your reading.

- 1) Is, as former Federal Reserve Chairman Alan Greenspan states, the, "financial system far more complex than lawmakers, and even most regulators apparently contemplate? If so, can it effectively be regulated? 2)
- 2) What does Dodd-Frank do?
- 3) What is the purpose of the Financial Stability Oversight Council (FOSC)?
- 4) What is the purpose of the Office of Financial Research (OFR)?
- 5) What is the purpose of the stress tests? To what entities are the stress tests applied? What are the criteria for the stress tests?
- 6) Was Dodd-Frank necessary?
- 7) Should Dodd-Frank be repealed?
- 8) Should Dodd-Frank have gone further in overhauling the financial regulatory system?
- 9) If you were Senator Scott Brown would you have voted against Dodd-Frank?
- 10) What does the fact that nearly half of the rule-making remains say about the regulatory agencies?
- 11) What is the orderly liquidation authority? Is a Consumer Financial Protection Board (CFPB), akin to the Consumer Products Safety Commission necessary?
- 12) What does Senator Durbin indicate the CFPB will accomplish?
- 13) Does Dodd-Frank, as asserted by Senator Tester, "end once and for all taxpayer funded bailouts of Wall Street banks and investment firms," and "get rid of any notion that any private company can somehow be "too big to fail?" and, as asserted by Senator Murray, guarantee that American taxpayers will never again have to pay to bail our Wall Street or to clean up after big bank's messes?"
- 14) How does the bill protect individuals such as Devin Glaser (Senator Murray) who put twenty percent down on a condo, is now unemployed, and faces foreclosure?
- 15) Is financial literacy the key to keeping consumers financially stable?
- 16) Does the bill as asserted by Senator Bond, ignore the 800-pound gorilla in the room (Fannie and Freddie)?
- 17) How important was it for members of Congress to be perceived by the public as bashing Wall Street?
- 18) Should the CFPB have been governed by a Board?

- 19) What does Senator Corker indicate the bill does to the cost of capital?
- 20) Why did Dodd-Frank need 60 votes to pass in the Senate?
- 21) To what extent does the bill accomplish the objectives set forth by Senator Dodd "to end too big to fail and to end … bailouts" "to grow jobs and create wealth," "to empower consumers and investors?"
- 22) Does Senator Dodd indicate that the bill will stop another economic crisis?
- 23) Did the regulators have the capacity and the ability to indentify, to spot early on, and the tools to prevent the crisis and just not employ them, as asserted by Senator Corker, or not have the tools as asserted by Senator Dodd?
- 24) Should the bill have included an outright ban on too big to fail bailouts?
- 25) How does Senator Levin describe the relationship between Washington Mutual and the Office of Thrift Supervision (OTS)?
- 26) What concerns are expressed regarding the provisions in the bill on derivatives?
- 27) What concerns are expressed about the Office of Financial Research (OFR)?
- 28) What is the Congressional Budget Act of 1974? How was it to be violated?
- 29) How did Congress get around the constraints of the Congressional Budget Act?
- 30) Should the prudential (safety and soundness) regulators have been given veto authority over a CFPB proposed rulemaking?
- 31) Should the CFPB have been funded directly, rather than through the Fed?
- 32) What were the three goals Senator Warner indicated that the legislation should have? How does the legislation achieve those goals?
- 33) Does the bill delegate too much to the regulators?
- 34) What does Senator Kaufman state about writing laws? Is Dodd-Frank "sweeping overhaul," or as Senator McCain asserts, does the "legislation ... (do) little, if anything—to tackle the tough problems facing the financial sector, nor ... institute real, meaningful and comprehensive reform?
- 35) What does Senator McCain indicate is the biggest problem with the legislation? What false remedies does he identify?
- 36) Why does Senator Feingold indicate that Glass-Steagall should have been re-imposed?
- 37) Are the differences between R's and D's over the bill's enactment substantively or ideology based?
- 38) Why were Senators opposing the legislation citing the concerns of farmers?
- 39) Does too big to fail still exists? What advantages does that give to too big to fail institutions?
- 40) Can there ever be an orderly write-down of today's "too big to fail" institutions?
- 41) Who selects the heads of the regulatory agencies?
- 42) To what extent, if any, does the President's political appointments to regulatory offices influence the regulatory and regulatory enforcement process?
- 43) To what extent are the regulatory agencies subject to political ideology?
- 44) What is the purpose of Senator's, such as Kerry, Lincoln and Boxer, making statements regarding their understanding of particular provisions of the bill?
- 45) Are the changes to the Federal Reserve's emergency authority the "Achilles' Heel" of Dodd-Frank?
- 46) What are stress tests? What entities receive stress tests? What are the criteria for stress tests?
- 47) What is a fiduciary duty? How does Dodd-Frank address potential fiduciary duties of broker-dealers and investment advisors?

- 48) What deposit insurance reform, if any, does Dodd-Frank make? What were the arguments against the passage of Dodd-Frank?
- 49) Do you believe that Dodd-Frank should have been enacted? If you were a Senator or Congressman, setting aside party politics, would you have voted for it?
- 50) Are there any provisions that are of particular concern to you?
- 51) If you were Cam Fine would you have gone along with Frank?
- 52) Was as Kaiser asserts, Dodd-Frank an example of Congress working? Why or why not?
- 53) What responsibility if any does Congress have in overseeing the regulatory and regulatory enforcement process?
- 54) To what extent, if any, was/is the recovery being held back by regulatory uncertainty?
- 55) Senator Johnson's remarks address federal preemption. What is federal preemption and how is it important to federally chartered institutions?
- 58) Senator Johnson also addresses the standard of care of brokers, dealers and investment advisers. What does he mean by "standard of care?" How, if at all does it differ from a fiduciary duty? How is standard of care implemented in Dodd-Frank?
- 59) What does Senator Reed indicate that Dodd-Frank does to increase the reliability and validity of credit ratings?
- 60) What are remittance fees? How did they contribute to the crisis?
- 61) Did the Congress miss an opportunity to deal with Fannie and Freddie as Senator Kaufman asserts? Will we ever have the political will do deal with Fannie and Freddie?
- 62) How does Senator Finegold characterize the ""too big to fail" problem? Do institutions that are too big to fail have a competitive advantage against other smaller institutions?
- 63) Should auto-dealers have been excluded from CFPB oversight?
- 64) What were the arguments in favor of the passage of Dodd-Frank?
- 65) What were the arguments against the passage of Dodd-Frank?
- 66) Do you believe that Dodd-Frank should have been enacted? If you were a Senator or Congressman, setting aside party politics, would you have voted for it?

NO CLASS MARCH 30 - SPRING WEEKEND

Classes 22 & 23 (Tuesday, April 4 & Thursday, April 6) - **Dodd-Frank**

Class Presentations Due at the Beginning of Class 22 on Tuesday, April 4

Class Presentations to be posted on Canvas by the Beginning of Class 23 on Thursday, April 6

Readings:

Greenspan, A.

Dodd-Frank Fails to Meet test of our times

Financial Times, (2011)

http://www.ft.com/intl/cms/s/0/14662fd8-5a28-11e0-86d3-00144feab49a.html#axzz3i8TJup9z

Note: You will have to create a sign-in that will give you access to three articles per month.

Hensarling, J.
After Five Years Dodd-Frank Is a Failure *The Washington Post*, July 15, 2015

http://www.wsj.com/articles/after-five-years-dodd-frank-is-a-failure-1437342607

Hoskins, S.M. and Labonte, M. An Analysis of the Regulatory Burden on Small Banks Congressional Research Service (April, 2015) https://www.fas.org/sgp/crs/misc/R43999.pdf

Konczal, M.

Does Dodd-Frank Work? We asked 16 Experts to Find Out *The Washington Post* Wonkblog, (2013)

http://www.washingtonpost.com/blogs/wonkblog/wp/2013/07/20/does-dodd-frank-work-we-asked-16-experts-to-find-out/

Konczal, M.

Ignore the Naysayers: Dodd-Frank Reforms Are Finally Paying Off *New Republic*, (2014)

http://www.newrepublic.com/article/118814/dodd-frank-reforms-are-finally-paying

'A Major Transformation': The Pros and Cons of Dodd-Frank Wharton, University of Pennsylvania

http://knowledge.wharton.upenn.edu/article/a-major-transformation-the-pros-and-cons-of-the-dodd-frank-act-2/

Some Pros and Cons of the Financial Reform Bill (And Titanic Metaphors Squashed (June 30, 2010)

http://squashed.tumblr.com/post/755376832/some-pros-and-cons-of-the-financial-reform-bill

The Dodd-Frank Act: a cheat sheet Morrison & Forester, (2010)

http://media.mofo.com/files/uploads/images/summarydoddfrankact.pdf

Dodd Frank is over 2,000 pages in length and, five years later, is still not fully implemented. Three-hundred- and-ninety (390) rules must be promulgated by the various financial regulatory agencies. Two-hundred-and-forty-seven (247) rules have finalized, sixty (60) rules have been proposed. Another eighty-three (83) rules remain to be promulgated. Over thirty-percent have failed to meet Congressional deadlines for promulgation. Regulations issued to date total well over 14,000 pages.

Studying Dodd-Frank in depth would encompass a course of several semesters. Davis Polk produces a monthly progress report on its implementation at: http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/

Dodd-Frank remains very controversial. In that regard, the short articles are designed to provide various perspectives on the law.

Discussion Questions:

- 1) What are the major provisions of Dodd-Frank?
- 2) What does the fact that nearly half of the rule-making remains say about the regulatory process and the regulatory agencies?
- 3) What impact is the delay on the rule-making having on the financial services industry? On the economy as a whole? Who are the members of the Financial Services Oversight Council (FOSC)? What are its functions? Was/is it needed?
- 4) What is the Consumer Financial Protection Bureau (CFPB)? Was/is it needed?
- 5) What is the orderly liquidation authority?
- 6) What are the corporate governance provisions within Dodd-Frank?
- 7) What are the credit rating provisions within Dodd-Frank?
- 8) What are the changes to the Federal Reserve's emergency authority? Are those changes the "Achilles' Heel" of Dodd-Frank?
- 9) What changes does Dodd-Frank make with respect to SWAPs?
- 10) What are stress tests? What entities receive stress tests? What are the criteria for stress tests?
- 11) What are the criteria for being designated as a systematically important financial institution? What are the consequences, if any, of that designation?
- 12) What deposit insurance reform, if any, does Dodd-Frank make? What impact, if any, does that reform have on systemic risk?
- 13) Does Dodd-Frank address each of the contributing factors to the Great Recession identified by majority and minority in the Financial Crisis Inquiry Report? If so, how?
- 14) Does Dodd-Frank address each of the contributing factors to the Great Recession that we have identified? If so, how?
- 15) Should Dodd-Frank have gone further in overhauling the financial regulatory system?
- 16) How, if at all, does Dodd-Frank impact the competitiveness of U.S. financial institutions in the global marketplace?
- 17) Was Dodd-Frank necessary?
- 18) Should Dodd-Frank be repealed?
- 19) Does Dodd-Frank, as suggested by Alan Greenspan, fail to meet the test of our times?
- 20) Does Dodd-Frank as asserted by Former Fed Chairman Greenspan, place the burden on the regulators? If so, what does that portend about the future?

Class 24 (Tuesday, April 11) - Substantive Exam (Closed Book, Closed Notes)

Class 25 (Thursday, April 13) - **Presentations Groups 1 - 3**

Class 26 (Tuesday, April 18) - Presentations Groups 4 - 6

Class 27 (Thursday, April 20) - **Presentations Groups 7 - 9**

NOTE: YOU MUST BE PRESENT FOR YOUR GROUP PRESENTATION.
PRESENTATIONS MAY RUN BEHIND AS WE MAY NOT BE ABLE TO HAVE THREE PRESENTATIONS IN ONE DAY. PLEASE REMAIN FLEXIBLE.

Class 28 (Tuesday, April 25) - A Global Perspective

Readings:

Bernanke, B.

The Global Savings Glut and the U.S. Current Account Deficit

Remarks at the Sandridge Lecture, Virginal Association of Economists, Richmond, Virginia (March 2015)

http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm

Serven, L and Nguyen, H., Global Imbalances Before and After The Global Crisis The World Bank, (June 2010)

Download at UNCC Library

Bernanke addresses the reasons the United States, with the world's largest economy, is a borrower rather than a lender and the long-term implications for the nation. Serven and Nguyen survey the academic and policy debate on the role of global imbalances, their role in the inception of the global crisis and their prospects in the aftermath.

- 1) How is the world financial system more global today than in the past? What are the advantages and disadvantages of that?
- 2) What kind of governments benefit from increased globalization? What kinds are harmed?
- 3) What is meant by the term "global imbalances?"
- 4) How might it be asserted that global imbalances led to the Great Recession?
- 5) To what extent did global imbalances contribute to the housing bubble in the U.S.?
- 6) Why, if at all, should economists care about global imbalances?
- 7) How are global imbalances normally corrected? How, it at all, was the Great Recession different?
- 8) Do you foresee an increase or decrease in global imbalances in the future? Why or why not?
- 9) What countries are funding the U.S. deficit?
- 10) What does a large current account deficit indicate about savings?
- 11) Why did the Great Recession have a greater impact on emerging countries?
- 12) What are the two economic and policy views of global imbalances as described by Seven and Nguven?
- 13) Should Americans care about the U.S. reliance on Chinese capital? Why/why not? Is this more, or less, important during a time of crisis?
- 14) In 2009 the British government advised the Caymanian government that "It would be unwise ... to expect that the Cayman Islands' prosperity can presume on an offshore tax haven status." Does the financial crisis mean the end of tax competition?
- 15) Do you foresee an increase or decrease in global imbalances in the future? Why or why not?

Class 29 (Thursday, April 27) - Financial Regulation

Readings:

Brunnermeir, M., Crockett, A., Goodhart, C., Persaud, A.D, and Shin, H.

The Fundamental Principles of Financial Regulation

International Center for Monetary and Banking Studies and The Centre For Economic Policy Research, (2009)

http://scholar.princeton.edu/sites/default/files/geneval1_0.pdf

Note: Read section 8 (Conclusions), pages 63 - 66.

Sherman, M.

A Short History of Financial Deregulation in the United States

Center for Policy and Research, (June, 2009)

http://www.cepr.net/documents/publications/dereg-timeline-2009-07.pdf

Turner, Lord A.

Chairman, United Kingdom Financial Services Authority

The Financial Crisis and the Future of Financial Regulation

The Economist's Inaugural City Lecture, (February 4, 2009)

http://corpgov.law.harvard.edu/2009/02/04/the-financial-crisis-and-the-future-of-financial-regulation/

The Squam Lake Report Fixing the Financial System

Princeton University Press, (2010)

http://www.stat.unc.edu/faculty/cji/890-11/SquamLake.pdf

Note: Read Chapter 1 (Introduction), pages 5 - 17) and Chapter 11 (Conclusion), pages 79 - 87.

Sherman provides a summary of the major regulatory changes over the past three decades. Lord Turner, the chair of the UK's financial regulatory agency, in a controversial speech in 2009, argued that financial crisis revealed that Britain's financial industry is too large and needs to be downsized. Brunnermeir, Crockett, Goodhart, Persaud, and Shin provide key recommendations on macroprudential measures, as well as other minor issues such as the role of stress tests. The Squam Lake Report, crafted by a group of 15 leading economists, provides specific policy recommendation on specific issues that might have mitigated the financial crisis.

- 1) What regulatory changes instituted over the last 3-decades contributed to or exacerbated the crisis?
- 2) Is the financial industry too large? If so, should it be downsized as suggested by Lord Turner?
- 3) Be prepared to discuss each of the general conclusions and recommendations of Brunnermeir, Croickett, Goodhart, Persaud, and Shin. Do you agree? Are the recommendations politically feasible? Why or why not?

- 4) Do you agree with the principles set forth in the Squam Lake Report?
- 5) Would the financial crisis have occurred if the recommendations in the Squam Lake Report had been in place?
- 6) How does one distinguish between the health of an individual financial institution and the stability of the entire financial system?
- 7) What regulatory changes instituted over the last 3-decades contributed to or exacerbated the crisis?
- 8) What changes in financial system oversight does Lord Turner recommend?

Class 30 (Tuesday, May 2) – Catch-Up, Conclusion and Wrap-Up

Final Exam: (Tentative) Thursday, May 11, 2017 8:00AM - 10:30 AM