

## 14.462(B): ADVANCED MACROECONOMICS II

**Note:** The grade for this half of 14.462 has two components: a) (30 points) A 7-10 pages summary of the news on the ongoing liquidity crisis (please include a chronology), due on Friday, April 11th; b) (60 points) A final exam, which will take place on Wednesday, May 14th.

### 1 Aggregate Liquidity

#### 1.1 Introduction

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3. Greenlaw D, J. Hatziu, A. Kashyap, and H. Song-Shin, “Leveraged Losses: Lessons from the Mortgage Meltdown,” University of Chicago Mimeo, February 2008.
4. Kiyotaki, N. and J. Moore, “Credit Cycles,” *Journal of Political Economy* 105:211-248, 1997
5. Krishnamurthy, A. “Collateral Constraints and the Amplification Mechanism,” *Journal of Economic Theory*, 111:277-292, 2003
6. Tirole, J., *The Theory of Corporate Finance*, Princeton University Press, 2006 – Chs 14 and 15

#### 1.2 Public Liquidity Provision / Liquidity Supply

1. Woodford, M., “Public Debt as Private Liquidity,” *AER Papers and Proceedings* 80:382-388, 1990.
2. Holmstrom, B. and J.Tirole, “Private and Public Supply of Liquidity,” *Journal of Political Economy* 106:1-40, 1998
3. Diamond, D. and R.Rajan “Liquidity Risk, Liquidity Creation and Financial Fragility,” *Journal of Political Economy*, 109:287-327, April 2001

4. Allen F. and D. Gale, *Financial Innovation and Risk Sharing*, Ch 9., MIT Press, 1994
5. Eisfeldt, A., “Endogenous Liquidity in Asset Markets.” *Journal of Finance*, 59:1-30, February 2004
6. Bhattacharya, S., “Aspects of Monetary and Banking Theory and Moral Hazard,” *Journal of Finance*, 37: 371-84, May 1982
7. Geanakoplos, J. and W. Zane, “Collateral, Default and Market Crashes,” Yale University Mimeo, 2000
8. Eisfeldt, A. and A. Rampini, “Financing Shortfalls and the Value of Aggregate Liquidity” AFA 2008 New Orleans Meetings Paper, January 2007.
9. Jacklin, C.J., “Demand Deposits, Trading Restrictions and Risk Sharing,” in *Contractual Arrangements for Intertemporal Trade* ed by E.Prescott and N.Wallace. University of Minnesota Press, 1987.
10. Guerrieri, V. and G. Lorenzoni, “Liquidity and Trading Dynamics,” MIT Mimeo, June 2007

### 1.3 Bailouts and Lender of Last Resort

1. Diamond, D. and P.Dybvig, “Bank Runs, Deposit Insurance, and Liquidity,” *Journal Political Economy* 91:401-419, 1983.
2. Diamond, D. and R.Rajan, “Bank Bailouts and Aggregate Liquidity,” University of Chicago Mimeo 2002
3. Gorton, G and L. Huang, “Liquidity, Efficiency, and Bank Bailouts,” *American Economic Review*, 94:3, 455-483, June 2004
4. Caballero, R.J. and A. Krishnamurthy, “Collective Risk Management in a Flight to Quality Episode,” *Journal of Finance*, (forthcoming)
5. Ashcraft, Adam and Darrell Duffie, “Systemic Dynamics in the Federal Funds Market,” Stanford University Mimeo, 2006.
6. Tirole, J. *The Theory of Corporate Finance*, Princeton University Press, 2006 – Ch 12
7. Peck J. and K. Shell, ”Equilibrium Bank Runs,” *Journal of Political Economy*, 111:103-123, February 2003.
8. Dell’Ariccia G., Detragiache E and R. Rajan. ”The Real Effect of Banking Crises,” CEPR Discussion Papers 5088, 2005.
9. Hellwig, M. “Liquidity Provision, Banking, and the Allocation of Interest Rate Risk,” *European Economic Review*, 38:1369-89, 1994.

## 1.4 Financial Contagion

1. Kiyotaki, N. and J. Moore, "Credit Cycles," *Journal of Political Economy* 105:211-248, 1997
2. Kiyotaki, N. and J. Moore, "Balance-Sheet Contagion," *AER Papers and Proceedings*, 92: 46-50, 2002.
3. Allen, F. and D.Gale, "Financial Contagion," *Journal of Political Economy*, 108:1-33, 2000.
4. Brunnermeir, M. and L.Pedersen, "Market Liquidity and Funding Liquidity," *Review of Financial Studies*, (forthcoming)
5. Kyle, A. and W. Xiong, "Contagion as a Wealth Effect," *Journal of Finance* 56, 1401-1440, 2001.
6. Adrian, T. and H.S. Shin, "Liquidity and Financial Contagion," *Financial Stability Review* 11, Banque de France, February 2008, 1-7.
7. Plantin, G., H. Sapra and H.S. Shin, "Marking-to-Market: Panacea or Pandora's Box?" LBS mimeo, August 2007

## 1.5 Fire Sales and Limits of Arbitrage

1. Shleifer, A. and R. Vishny, "Limits of Arbitrage," *Journal of Finance*, 52:35-55, 1997.
2. Weill, P.O., "Leaning Against the Wind," *Review of Economic Studies*, (forthcoming)
3. Kondor, P., "Risk in Dynamic Arbitrage: Price Effects of Convergence Trading," *Journal of Finance*, (forthcoming)
4. Adrian, T. and H.S.Shin, "Liquidity and Leverage," Mimeo 2007
5. Grossman, S. and B. Zhou, "Equilibrium Analysis of Portfolio Insurance," *Journal of Finance*, 51:1379-1403, 1996.
6. Geanakoplos, J. and W. Zame, "Collateral, Default and Market Crashes," Yale University Mimeo, 2000.
7. He, Z. and A. Krishnamurthy, "Intermediated Asset Prices," Kellogg School of Management Mimeo, 2007
8. Vayanos, D. "Flight to Quality, Flight to Liquidity, and the Pricing of Risk," LSE Mimeo, 2005

9. Gabaix, X., A. Krishnamurthy and O. Vigneron, "Limits of Arbitrage: Theory and Evidence from the MBS Market," *Journal of Finance*, 62:557-596, 2007.
10. Froot, K.A. and P.G. O'Connell, "The Pricing of US Catastrophe Reinsurance," in *The Financing of Catastrophe Risk*, ed. by K. Froot. University of Chicago Press, 1999.
11. Allen, F. and D. Gale, "Limited Market Participation and Stock Market Volatility," *American Economic Review* 84:933-55, 1994
12. Shim, I. and G. von Peter, "Distress Selling and Asset Market Feedback," BIS WP #229, June 2007
13. Mitchell, M., L.H. Pedersen, and T. Pulvino, "Slow Moving Capital," *American Economic Review Papers and Proceedings*, forthcoming

## 1.6 Large Players

1. Brunnermeir, M. and L. Pedersen, "Predatory Trading," *Journal of Finance*, 60:1825-1863, 2005.
2. Acharya, V.V., D. Gromb, T. Yorulmazer, "Imperfect Competition in the Inter-Bank Market for Liquidity as a Rationale for Central Banking," LBS Mimeo, October 2007
3. Kyle, A., "Continuous Auctions and Insider Trading," *Econometrica*, 53, 1315-1335, 1985.

## 1.7 Credit Booms and Underinsurance

1. Gourinchas, P.O., O. Landerretche, and R. Valdes, "Lending Booms: Latin America and The World," *Economia*, 1:47-89, 2001.
2. Caballero, R.J. and A.Krishnamurthy, "Smoothing Sudden Stops," *Journal of Economic Theory* 119:104-127, 2004.
3. Lorenzoni, G., "Inefficient Credit Booms," *Review of Economic Studies*, (forthcoming)
4. Caballero, R. and G. Lorenzoni, "Persistent Appreciations and Overshooting: A Normative Analysis," MIT Mimeo, April 2007
5. Geanakoplos, J. and H. Polemarchakis, "Existence, Regularity, and Constrained Suboptimality of Competitive Allocations when the Asset Market Is Incomplete." in W. Heller, R. Starr, and D. Starrett (eds.), *Essays in Honor of Kenneth Arrow*, Vol. 3. Cambridge University Press, 1986, pp. 65-95.

6. Farhi E., M. Golosov and O. Tsyvinski, A Theory of Liquidity and Regulation of Financial Intermediation, MIT Mimeo, 2007
7. Allen and Gale "Financial Markets, Intermediaries and Intertemporal Smoothing" *Journal of Political Economy*, 105:523-546, 1997.

## 2 Bubbles

### 2.1 Introduction

1. Kindleberger, C., *Manias, Panics, and Crashes - A History of Financial Crises*, Basic Books, 2nd ed., 1989
2. Shiller, R., *Irrational Exuberance*. Princeton University Press, 2nd ed. 2005.
3. Camerer, C., "Bubbles and Fads in Asset Prices: A Review of Theory and Evidence," *Journal of Economic Surveys* 3:3-41, 1989.
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5. Caballero, R.J., "On the Macroeconomics of Asset Shortages," in The Fourth European Central Banking Conference 2006.

### 2.2 Rational Bubbles

1. Caballero, R.J., E. Farhi and J. Ventura, "Bubbles and Rents" MIT Mimeo, March 2008
2. Abel, A.B., N.G. Mankiw, L.H. Summers and R.J. Zechhauser, "Assessing Dynamic Efficiency: Theory and Evidence," *Review of Economic Studies* 56:1-19, 1989.
3. Obstfeld M. and K. Rogoff, "Ruling our Divergent Speculative Bubbles," *Journal of Monetary Economics*, 17:349-362, 1986.
4. Ventura, J., "Bubbles and Capital Flows," CREI Mimeo, January 2004.
5. Tirole, J., "Asset Bubbles and Overlapping Generations," *Econometrica*, 53:1499-1528, 1985, .
6. Santos, M. and M.Woodford, "Rational Asset Pricing Bubbles," *Econometrica*, 65:19-57, 1997.
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13. Arce, O. and Lopez-Salido, "Housing Bubbles," Bank of Spain Mimeo, February 2008
14. Saint-Paul, G., "Fiscal Policy in an Endogenous Growth Model," *Quarterly Journal of Economics*, 107:1243-59, November 1992
15. Farhi, E, and J.Tirole, "Bubbly and Bubbleless Liquidity," Mimeo, February 2008.

### 2.3 Behavioral Models

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2. Abreu D. and M. Brunnermeier, "Bubbles and Crashes," *Econometrica*, 71:173-204, 2003.
3. Scheinkman, J. and W. Xiong, "Overconfidence and Speculative Bubbles," *Journal of Political Economy*, 111:1183-1219, June 2002.
4. Plantin G. and H.S. Shin, "Carry Trade and Speculative Dynamics," Princeton Mimeo November 2007.
5. Anders J., O. Ledoit, and D. Sornette, "Crashes at Critical Points," *Finance Paper*, 2-99, 1998.

## 2.4 Agency

1. Allen, F. and D. Gale, "Bubbles and Crises," *Economic Journal*, 110:236-255, 2000.
2. Allen, F. and G.Gorton, "Churning Bubbles," *Review of Economic Studies*, 60:813-836, 1993.
3. Hong, H., J. Scheinkman and W. Xiong, "Advisors and Asset Prices: A Model of the Origins of Bubbles," *Journal of Financial Economics*, forthcoming.