“The theory of rational expectations assumes that investors’ expectations change more or less instantaneously in response to each shock and that investors immediately see through to the impacts of each shock on the long-run equilibrium prices for real estate and stocks and commodities. In contrast the insight from financial history is that expectations change slowly at some times and rapidly at others as various groups realize – sometimes at different moments and at other times more or less simultaneously – that the current forecasts of prices in the distant future differ from earlier projections of these same prices. The change in the mindsets of investors from confidence to pessimism compounds the instability in the credit markets as some lenders eventually realize that the borrowers’ indebtedness is too large relative to their incomes. The lenders slow their willingness to buy more of the IOUs from the borrowers. The borrowers adjust to their new perceptions about the future by reducing their spending so they will have the cash to pay the interest and to reduce debt. Some firms may sell divisions and operating units to get the cash to repay loans. The lenders recognize that they have too many risky loans and they seek repayment of outstanding loans from the riskier borrowers and they become reluctant to renew these loans as they mature and they raise the credit standards for new loans. The period of financial distress may last weeks, months or even several years, or it may be concentrated in a few days. The economic downturn that followed the collapse of the US stock market in 1929 continued for four years – until a new, more interventionist government came to power in March 1933.”

Kindleberger, Charles P.. Manias, Panics, and Crashes (pp. 104-106). Palgrave Macmillan UK. Kindle Edition.

Minsky’s three-part taxonomy of finance Minsky distinguished among hedge finance, speculative finance, and Ponzi finance – on the basis of the relation between the operating income of individual firms and their debt service payments. A firm is in the hedge finance group if its anticipated operating income is more than sufficient to pay both the interest and the scheduled reduction in its indebtedness. A firm is in the speculative finance group if its anticipated operating income is sufficient to pay the interest on its indebtedness; however, the firm must use cash from new loans to pay part or all of the amounts due on maturing loans. A firm is in the Ponzi group if its anticipated operating income is smaller than the amount needed to pay all of the interest on its indebtedness on the scheduled due dates, so the firm must either increase its indebtedness or sell some assets to get the cash for these interest payments.

Kindleberger, Charles P.. Manias, Panics, and Crashes (pp. 41-42). Palgrave Macmillan UK. Kindle Edition.

Time Varying Risk Aversion

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Luigi Guiso
Einaudi Institute for Economics and Finance (EIEF); Einaudi Institute for Economics and Finance

Paola Sapienza
Northwestern University - Kellogg School of Management - Department of Finance; National Bureau of Economic Research (NBER); Centre for Economic Policy Research (CEPR)

Luigi Zingales

University of Chicago - Booth School of Business; National Bureau of Economic Research (NBER); Centre for Economic Policy Research (CEPR)

Date Written: August 2013

Abstract

We use a repeated survey of an Italian bank's clients to test whether investors' risk aversion increases following the 2008 financial crisis. We find that both a qualitative and a quantitative measure of risk aversion increases substantially after the crisis. After considering standard explanations, we investigate whether this increase might be an emotional response (fear) triggered by a scary experience. To show the plausibility of this conjecture, we conduct a lab experiment. We find that subjects who watched a horror movie have a certainty equivalent that is 27% lower than the ones who did not, supporting the fear-based explanation. Finally, we test the fear-based model with actual trading behavior and find consistent evidence.

The Bagehot doctrine and insolvent banks The Bagehot doctrine discussed in Chapter 11 was that a central bank should lend freely – but at a penalty interest rate – to forestall the likelihood that a liquidity crisis would cascade into a solvency crisis because a commercial bank would sell securities and assets to get the cash to meet the demands of their depositors that wanted their money. The prices of these securities would decline, and some of the banks that previously had been well-capitalized then might have too little capital as the prices of the securities in their portfolios fell.

Kindleberger, Charles P.. Manias, Panics, and Crashes (p. 322). Palgrave Macmillan UK. Kindle Edition.

“Then there is a shock – perhaps a change in government policy, an unexplained failure of a firm previously thought to have been successful – that leads to a pause in the increase in the prices of securities. Soon some of the investors who had financed most of their purchases with borrowed money become distress sellers because the interest payments on the money borrowed to finance their purchases are larger than the rental income on the real estate and the dividends on the stocks. The prices of these securities decline below their purchase prices and now the buyers are ‘under water’ – the amounts owed on the money borrowed to finance the purchases of these securities are larger than their current market prices. Their distress sales lead to sharp declines in the prices of the securities and a crash and a panic are likely to follow. The economic situation in a country after several years of mania-like behavior resembles that of a young bicycle rider who needs to maintain the forward momentum – if the bike stops moving forward, the rider becomes unstable and crashes. The analogy is that if the prices of securities stop increasing, they will then decline rather than remain more or less unchanged at the new and higher plateau. During the mania, the prices of real estate and securities increase, and they begin to decline immediately after they stop increasing – there is no plateau, no ‘middle ground’. The decline in the prices of some securities leads to the concern that prices will decline further and that the banking system will experience ‘distress’. The rush to sell these securities becomes self-fulfilling and so precipitous that it resembles a panic. The prices of commodities – houses, buildings, land, stocks, bonds – crash to levels that are 30 to 40 percent of their prices at the peak. Bankruptcies surge, economic activity slows, and unemployment increases sharply.”

Kindleberger, Charles P.. Manias, Panics, and Crashes (p. 20). Palgrave Macmillan UK. Kindle Edition.

Ponzi finance, chain letters, pyramid schemes, manias, and bubbles Ponzi finance, chain letters, bubbles, pyramid schemes, and manias are somewhat overlapping terms for non-sustainable patterns of financial behavior, in that the prices of securities today are not consistent with the anticipated prices at distant future dates. Ponzi schemes generally involve promises to pay an interest rate of 30 or 40 or 50 percent a month; the entrepreneurs that develop these schemes always claim they have discovered a new secret formula so they can earn these high rates of return. They make the promised interest payments for the first few months with the money received from their new customers attracted by the promised high rates of return. But by the fourth or fifth month, the money received from these new customers is less than the monies promised the first sets of customers and the entrepreneurs go to Brazil or jail or both. Bernie Madoff ran one of the largest Ponzi schemes ever, and his posted returns were in the range of ten to twelve percent – but steady. And he remained in business for more than fifteen years – probably long enough to merit the top position on the hit parade of longest-running Ponzi scheme. A chain letter is a particular form of pyramid arrangement; the procedure is that individuals receive a letter asking them to send $1 (or $10 or $100) to the name at the top of the pyramid and to send the same letter to five friends or acquaintances within five days; the promise is that within thirty days they will receive $64 for each $1 'investment'. Pyramid arrangements often involve sharing of commission incomes from the sale of securities or cosmetics or food supplements by those who actually make the sales to those who have recruited them to become sales personnel. A bubble involves the purchase of an asset, usually real estate or a security, in anticipation that the asset or security can be sold to someone else at an even higher price; the term 'the greater fool' has been used to suggest the last buyer was always counting on finding someone else to whom the stock or the condo apartment or the baseball cards could be sold. The term 'bubble' suggests that when the prices stop increasing, they are likely – indeed almost certain – to decline.

Kindleberger, Charles P.. Manias, Panics, and Crashes (pp. 21-22). Palgrave Macmillan UK. Kindle Edition.

Leveraged bubbles$ Òscar Jordà , Moritz Schularick , Alan M. Taylor   Available online 15 September 2015
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abstract What risks do asset price bubbles pose for the economy? This paper studies bubbles in housing and equity markets in 17 countries over the past 140 years. History shows that not all bubbles are alike. Some have enormous costs for the economy, while others blow over. We demonstrate that what makes some bubbles more dangerous than others is credit. When fueled by credit booms, asset price bubbles increase financial crisis risks; upon collapse they tend to be followed by deeper recessions and slower recoveries. Credit-financed housing price bubbles have emerged as a particularly dangerous phenomenon. & 2015 Published by Elsevier B.V