Dear Bubblers, The following Preview of The New Edition of the KAM Paradigm should be illuminating for all of us. Best, Bill Rapp

The Enduring Relevance of "Manias, Panics, and Crashes"

The seventh edition of *Manias, Panics, and Crashes* has recently been published by Palgrave Macmillan. Charles Kindleberger of MIT wrote the first edition, which appeared in 1978, and followed it with three more editions. Robert Aliber of the Booth School of Business at the University of Chicago took over the editing and rewriting of the fifth edition, which came out in 2005. (Aliber is also the author of another well-known book on international finance, *The New International Money Game*.) The continuing popularity of *Manias, Panics and Crashes* shows that financial crises continue to be a matter of widespread concern.

Kindleberger built upon the work of Hyman Minsky, a faculty member at Washington University in St. Louis. Minsky was a proponent of what he called the "financial instability hypothesis," which posited that financial markets are inherently unstable. Periods of financial booms are followed by busts, and governmental intervention can delay but not eliminate crises. Minsky's work received a great deal of attention during the global financial crisis (see here and here; for a summary of Minksy's work, see *Why Minsky Matters* by L. Randall Wray of the University of Missouri-Kansas City and the Levy Economics Institute).

Kindleberger provided a more detailed description of the stages of a financial crisis. The period preceding a crisis begins with a "displacement," a shock to the system. When a displacement improves the profitability of at least one sector of an economy, firms and individuals will seek to take advantage of this opportunity. The resulting demand for financial assets leads to an increase in their prices. Positive feedback in asset markets lead to more investments and financial speculation, and a period of "euphoria," or mania develops.

At some point, however, insiders begin to take profits and withdraw from the markets. Once market participants realize that prices have peaked, flight from the markets becomes widespread. As prices plummet, a period of "revulsion" or panic ensues. Those who had financed their positions in the market by borrowing on the promise of profits on the purchased assets become insolvent. The panic ends when prices fall so far that some traders are tempted to come back into the market, or trading is limited by the authorities, or a lender of last resort intervenes to halt the decline.

In addition to elaborating on the stages of a financial crisis, Kindleberger also placed them in an international context. He wrote about the propagation of crises through the arbitrage of divergences in the prices of assets across markets or their substitutes. Capital flows and the spread of euphoria also contribute to the simultaneous rises in asset prices in different countries. (Piero Pasotti and Alessandro Vercelli of the University of Siena provide an analysis of Kindleberger's contributions.)

Aliber has continued to update the book, and the new edition has a chapter on the European sovereign debt crisis. (The prior edition covered the events of 2008-09.) But he has also made his own contributions to the Minsky-Kindleberger (and now –Aliber) framework. Aliber characterizes the decades since the early 1980s as "…the most tumultuous in monetary history in terms of the number, scope and severity of banking crises." To date, there have been four waves of such crises, which are almost always accompanied by currency crises. The first wave was the debt crisis of developing nations during the 1980s, and it was followed by a second wave of crises in Japan and the Nordic countries in the early 1990s. The third wave was the Asian financial crisis of 1997-98, and the fourth is the global financial crisis.

Aliber emphasizes the role of cross-border investment flows in precipitating the crises. Their volatility has risen under flexible exchange rates, which allow central banks more freedom in formulating monetary policies that influence capital allocation. He also draws attention to the increases in household wealth due to rising asset prices and currency appreciation that contribute to consumption expenditures and amplify the boom periods. The reversal in wealth once investors revise their expectations and capital begins to flow out makes the resulting downturn more acute.

These views are consistent in many ways with those of Claudio Borio of the Bank for International Settlements (see also here). He has written that the international monetary and financial system amplifies the "excess financial elasticity," i.e., the buildup of financial imbalances that characterizes domestic financial markets. He identifies two channels of transmission. First, capital inflows contribute to the rise in domestic credit during a financial boom. The impact of global conditions on domestic financial markets exacerbates this development (see here). Second, monetary regimes may facilitate the expansion of monetary conditions from one country to others. Central bankers concerned about currency appreciation and a loss of competitiveness keep interest rates lower than they would otherwise, which furthers a domestic boom. In addition, the actions of central banks with international currencies such as the dollar has international ramifications, as the current widespread concern about the impending rise in the Federal Funds rate shows.

Aliber ends the current edition of *Manias, Panics and Crashes* with an appendix on China's financial situation. He compares the surge in China's housing markets with the Japanese boom of the 1980s and subsequent bust that initiated decades of slow economic growth. An oversupply of new housing in China has resulted in a decline in prices that threatens the solvency of property developers and the banks and shadow banks that financed them. Aliber is dubious of the claim that the Chinese government will support the banks, pointing out that such support will only worsen China's indebtedness. The need for an eighth edition of *Manias, Panics and Crashes* may soon be apparent.