

Economics 234A. Macroeconomic finance

Syllabus

Spring 2011, Tuesday 4-6, 608-7 Evans Hall

<http://econ.berkeley.edu/~szeidl/ec234A/ec234Aindex.htm>

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Office hours: Monday 2-4pm

This course is an introduction to finance. The first part of the course develops static portfolio choice, the capital asset pricing model (CAPM), and consumption based asset pricing. In the second part, we use these tools to analyze puzzles in financial economics and study household finance. In the final part, we explore financial institutions, behavioral finance and market microstructure. Finance is a data-driven field, and the emphasis of the course is both theoretical and empirical.

Requirements for the course include four assignments, paper reviews and a final exam. Some of the assignments will contain computational exercises. In most weeks, I will assign a paper for you to read. You will need to write a short, critical assessment in less than 1 page and e-mail it to me the day before class. Your course grade will be determined as follows:

Assignments	40%
Paper reviews	10%
Final	50%

Economics 234A is intended for PhD students in economics, and knowledge of first year microeconomics, macroeconomics and econometrics is assumed.

The textbook for the course is

John H. Cochrane, *Asset Pricing*, Princeton University Press

The following books are also useful:

John Y. Campbell and Luis M. Viceira, *Strategic Asset Allocation: Portfolio Choice for Long Horizon Investors*, Oxford University Press, 2002

John Y. Campbell, Andrew Lo and Craig MacKinley, *The Econometrics of Financial Markets*, Princeton University Press, 1997

Andrei Shleifer: *Inefficient Markets*, Oxford University Press, 2000.

For most classes, lecture notes will be made available.

Reading List

* denotes required reading. The reading list and the schedule of topics is likely to be updated as the course evolves. The latest version will be posted on the course website.

1. Choice under uncertainty, expected utility, risk aversion.

*Mas-Colell, Whinston and Green, *Microeconomic Theory*, Oxford University Press, 1995, Chapter 6.

*Rabin, Matthew, "Risk Aversion and Expected Utility Theory: A Calibration Theorem," *Econometrica* 68, 1281-1292, 2000.

Kimball, Miles, "Precautionary Saving in the Small and in the Large," *Econometrica* 58, 53-73, 1990.

Chetty, R., and Szeidl, A. "Consumption Commitments and Risk Preferences," *Quarterly Journal of Economics*, 2007.

2. Static portfolio choice.

Campbell-Viceira, Chapter 2.

*Cochrane, Chapters 1, 2, 3.

Epstein, Lawrence and Stanley Zin, "Substitution, Risk Aversion, and the Temporal Behavior of Consumption and Asset Returns: A Theoretical Framework," *Econometrica*, 57, 937-968, 1989.

Malmendier, Ulrike, and Stefan Nagel, "Depression Babies: Do Macroeconomic Experiences Affect Risk-Taking?" *Quarterly Journal of Economics*

3. No arbitrage and the stochastic discount factor. Volatility bounds.

*Cochrane, Chapters 4, 5, 6, 7, 8.

Hansen, Lars Peter and Ravi Jagannathan, "Implications of Security Market Data for Models of Dynamic Economies," *Journal of Political Economy*, 99, 225-262, 1991.

4. Factor pricing models and the CAPM.

*Cochrane, Chapters 9, 10, 11, 12 and 20.2

Fama, Eugene and Kenneth R. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance* 47, 427-465, 1992.

Fama, Eugene and Kenneth R. French, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics* 33, 3-56, 1993.

*Fama, Eugene and Kenneth R. French, "Multifactor Explanations for Asset Pricing Anomalies," *Journal of Finance* 51, 55-84, 1996.

Gibbons, Michael, Stephen Ross and Jay Shenken, "A Test of the Efficiency of a Given Portfolio," *Econometrica* 57, 1121-1152, 1989.

*Calvet, Laurent, John Campbell and Paolo Sodini, "Down or Out: Assessing the Welfare Costs of Household Investment Mistakes," *Journal of Political Economy* 115:707-747, 2007.

5. Present value relationships, stock return predictability.

*Cochrane, 20.1

Campbell, Lo and MacKinley, Chapters 2 and 7.

Ang, Andrew and Geert Bekaert, "Stock Return Predictability: Is It There?," unpublished, Columbia University.

*Campbell, John Y and Robert J. Shiller, "The Dividend-Price Ratio and Expectations of Future Dividends and Discount Factors," *Review of Financial Studies* 1, 195-228, 1988.

Campbell, John Y. "A Variance Decomposition for Stock Returns," *Economic Journal* 101, 157-179, 1991.

*Campbell, John Y. and Robert Shiller, "Valuation Ratios and the Long-Run Stock Market Outlook: An Update," NBER Working paper No. 8221, 2001.

Campbell, John Y., and Moto Yogo, "Efficient Tests of Stock Return Predictability," *Journal of Financial Economics*

Fama, Eugene and Kenneth R. French, "Business Conditions and Expected Returns on Stocks and Bonds," *Journal of Financial Economics* 25: 23-49, 1989.

Voulteenaho, Tuomo, "What Drives Firm-Level Stock Returns?," *Journal of Finance* 57, 233-264, 2002.

6. Asset pricing puzzles

Bansal, Ravi and Amir Yaron, "Risks For The Long Run: A Potential Resolution of Asset Pricing Puzzles," *Journal of Finance*, 2004.

Barro, Robert, "Rare Disasters and Asset Markets in the Twentieth Century," *Quarterly Journal of Economics*, 2006.

*Campbell, John Y., "Consumption Based Asset Pricing," Chapter 13 in George Constantinides, Milton Harris and Rene Stulz eds., *Handbook of the Economics of Finance* Vol. IB, North-Holland, Amsterdam, 803-887, 2003.

Brav, Alon, George M. Constantinides and Christopher C. Geczy, "Asset Pricing with Heterogenous Consumers and Limited Participation: Empirical Evidence," *Journal of Political Economy*, 110, 793-824, 2002

*Campbell, John Y. and John H. Cochrane, "By Force of Habit: a Consumption-Based Explanation of Aggregate Stock Market Behavior," *Journal; of Political Economy* 107, 205-251, 1999.

Constantinides, George, "Habit Formation: A Resolution of the Equity Premium Puzzle," *Journal of Political Economy* 98, 519-543, 1990.

Constantinides, George M., John B. Donaldson and Rajnish Mehra, "Junior Can't Borrow: a New Perspective on the Equity Premium Puzzle," *Quarterly Journal of Economics* 117, 269-296, 2002.

*Constantinides, George M. and Durrell Duffie, "Asset Pricing with Heterogenous Consumers," *Journal of Political Economy* 104, 219-240, 1996.

Grossman, Sanford J. and Robert J. Shiller, 1982, "Consumption Correlatedness and Risk Measurement in Economies with Non-Traded Assets and Heterogeneous Information", *Journal of Financial Economics* 10, 195-210, 1982.

Hansen, Lars Peter and Kenneth J. Singleton, "Stochastic Consumption, Risk Aversion, and the Temporal Behavior of Asset Returns," *Journal of Political Economy* 91, 249-268, 1983.

Lettau, Martin and Sydney Ludvigson, "Consumption, Aggregate Wealth and Expected Stock Returns," *Journal of Finance* 56, 815-849, 2001.

Mehra, Rajnish and Edward Prescott, "The Equity Premium: A Puzzle," *Journal of Monetary Economics*, 15, 145-161, 1986.

Vissing-Jorgensen, Anette, "Limited Asset Market Participation and the Elasticity of Intertemporal Substitution," *Journal of Political Economy* 110, 825-853, 2002.

7. Cross-sectional asset pricing.

Asness, Clifford S., Tobias J. Moskowitz, and Lasse H. Pedersen, "Value and Momentum Everywhere," Working paper, Chicago GSB and NYU Stern.

*Campbell, John Y. and Tuomo Vuolteenaho, "Bad Beta, Good Beta," *American Economic Review*.94, 1249-1275, 2004.

Cohen, Randolph, Christopher Polk, and Tuomo Vuolteenaho, "Money Illusion in the Stock Market: The Modigliani-Cohn Hypothesis", *Quarterly Journal of Economics*, 2005.

Gomes, Joao F., Leonid Kogan and Motohiro Yogo, "Durability of Output and Expected Stock Returns," *Journal of Political Economy*

Lettau, Martin and Sydney Ludvigson, "Resurrecting the (C)CAPM: A Cross-Sectional Test when Risk Premia are Time-Varying," *Journal of Political Economy* 109, 1238-1286, 2001.

Lewellen, Jonathan and Stefan Nagel, "The Conditional CAPM does not Explain Asset-Pricing Anomalies," *Journal of Financial Economics*, forthcoming.

Parker, Jonathan and Christian Julliard, "Consumption Risk and Cross-Sectional Returns," *Journal of Political Economy* 113, 185-222, 2005.

8. Household finance

*Aguiar, Mark and Erik Hurst, "Consumption vs. Expenditure," *Journal of Political Economy* 113(5), 919-948, 2005.

Ameriks, John, Andrew Caplin and John Leahy, "Wealth Accumulation and the Propensity to Plan," *Quarterly Journal of Economics* 118, 1007-1047, 2003

Brunnermeier, Markus and Stefan Nagel, "Do Wealth Fluctuations Generate Time-Varying Risk Aversion? Micro Evidence on Individuals' Asset Allocation," *American Economic Review*, June 2008.

*Campbell, John "Household Finance," *Journal of Finance*, June 2006.

Campbell, John and Joao Cocco, "How Do House Prices Affect Consumption? Evidence from Micro Data" *Journal of Monetary Economics* 54, 591-621, 2007.

Chetty, Raj and Adam Szeidl, "The Effect of Housing on Portfolios" Working paper.

Heaton, John, and Deborah J. Lucas, "Portfolio Choice and Asset Prices: The Importance of Entrepreneurial Risk," *Journal of Finance*, 55, 1163-1198, 2000.

Hong, Harrison, Jeffrey D. Kubik and Jeremy Stein "Social Interaction and Stock-Market Participation," *Journal of Finance*, Vol. LIX, No. 1, Feb. 2004.

Hurst, Erik, "Grasshoppers, Ants, and Pre-Retirement Wealth: A Test of Permanent Income Consumers," NBER Working Paper #10098.

*Johnson, David S., Jonathan A. Parker and Nicholas S. Souleles, "Household Expenditure and the Income Tax Rebates of 2001," *American Economic Review* 96, 1589-1610, 2006.

9. Housing and mortgage markets

Campbell, John, Stefano Giglio and Parag Pathak, "Forced Sales and House Prices," *American Economic Review*, forthcoming.

Piazzesi, Monika and Martin Schneider, "Momentum traders in the housing market: survey evidence and a search model," *American Economic Review PP*, 2009.

*Mian, Atif and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis," *Quarterly Journal of Economics*, 2009.

Mian, Atif and Amir Sufi, "House Prices, Home Equity-Based Borrowing, and the U.S. Household Leverage Crisis," Working paper.

Keys, Benjamin, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, "Did Securitization Lead to Lax Screening? Evidence From Subprime Loans," *Quarterly Journal of Economics*, 2010.

10. Bonds [won't be covered this year]

*Cochrane, Chapters 19, 20.

Campbell, Lo and MacKinley, Chapters 10, 11.

Bekaert, Geert, Robert J. Hodrick, and David A. Marshall, "On Biases in Tests of the Expectations Hypothesis of the Term Structure of Interest Rates," *Journal of Financial Economics* 44, 309-348, 1997.

Cochrane, John H., and Monika Piazzesi, “Bond Risk Premia,” *American Economic Review* 95, 138-160, 2005.

Cox, John C., Jonathan E. Ingersoll and Stephen A. Ross, “An Intertemporal General Equilibrium Model of Asset Prices,” *Econometrica* 53: 363-384, 1985.

11. Portfolio choice for long horizon investors [won't be covered]

*Campbell-Viceira, Chapters 3,4,6,7

Bodie, Zvi, Robert Merton and William Samuelson, “Labor Supply Flexibility and Portfolio Choice in a Life Cycle Model,” *Journal of Economic Dynamics and Control*, 16, 427-449, 1991.

Canner, Niko, N. Gregory Mankiw and David N. Weil, “An Asset Allocation Puzzle,” *American Economic Review* 87, 181-191, 1997.

12. Risk-sharing in finance

Alvarez, Fernando and Urban Jermann, “Efficiency, Equilibrium and Asset Pricing with Risk of Default,” *Econometrica* 68, 775-797, 2000.

Allen, Franklin and Douglas Gale, “Limited Market Participation and Volatility of Asset Prices,” *American Economic Review* 84, 933-955, 1994.

Athanasoulis, Stephano and Robert Shiller, “The Significance of the Market Portfolio,” *Review of Financial Studies* 13, 301-329, 2000.

*Cochrane, John, “A Simple Test of Consumption Insurance,” *Journal of Political Economy* 99, 957-976, 1991.

13. Asymmetric information and market microstructure.

*Abreu, Dilip and Markus Brunnermeier, “Bubbles and Crashes,” *Econometrica* 71, 173-204, 2003.s

Allen, Franklin, Stephen Morris, and Hyun Song Shin, 2005, “Beauty Contests, Bubbles, and Iterated Expectations in Financial Markets”, *Review of Financial Studies*.

*Cohen, Lauren, Andrea Frazzini and Christopher Malloy, “The Small World of Investing: Board Connections and Mutual Fund Returns,” *Journal of Political Economy*, forthcoming.

Dasgupta, Amil, and Andrea Prat, “Information aggregation in financial markets with career concerns,” *Journal of Economic Theory*, forthcoming.

Glosten, Lawrence and Paul Milgrom, “Bid, Ask and Transaction Prices in a Specialist Market with Heterogenously Informed Traders,” *Journal of Financial Economics* 14, 71-100, 1985.

*Grossman, Sanford and Joseph Stiglitz, “On the Impossibility of Informationally Efficient Markets,” *American Economic Review* 70, 393-408, 1980.

*Kyle, Albert S., “Continuous Auctions and Insider Trading,” *Econometrica* 53, 1315-1335, 1985.

14. Behavioral finance

Barberis, Nicholas, Ming Huang and Tano Santos, “Prospect Theory and Asset Prices,” *Quarterly Journal of Economics* 116, 1-53, 2001.

*DeLong J. Bradford, Andrei Shleifer, Lawrence Summers and Robert Waldmann, “Noise Trader Risk in Financial Markets,” *Journal of Political Economy* 98, 703-738, 1990.

*Gennaioli, N. A. Shleifer and R. Vishny, “Neglected Risks, Financial Innovation, and Financial Fragility” *Journal of Financial Economics*, forthcoming, 2011.

Harrison, J. Michael and David M. Kreps, “Speculative Investor Behavior in a Stock Market with Heterogenous Expectations,” *Quarterly Journal of Economics* 92, 323-336, 1978.

*Hong, Harrison and Jeremy Stein, “A Unified Theory of Underreaction, Momentum Trading and Overreaction in Asset Markets,” *Journal of Finance*, Vol. LIV, No. 6, Dec. 1999.

Hong, Harrison and Jeremy C. Stein, “Differences of Opinion, Rational Arbitrage and Market Crashes”, *Review of Financial Studies* 16, 487-525, 2003.

Lamont, Owen A. and Richard H. Thaler, “Anomalies: The Law of One Price in Financial Markets”, *Journal of Economic Perspectives* 17, 191-202, 2003.

Ofek, Eli and Matthew Richardson, “DotCom Mania: The Rise and Fall of Internet Stock Prices”, *Journal of Finance* 58, 1113-1137, 2003.

Scheinkman, Jose and Wei Xiong, “Overconfidence and Speculative Bubbles”, *Journal of Political Economy* 111, 1183-1219, 2003.

15. Financial institutions

Brunnermeier, Markus and Stefan Nagel, “Hedge Funds and the Technology Bubble,” *Journal of Finance* 59, 2013-2040, 2004.

*Brunnermeier, Markus and Lasse Pedersen, “Market Liquidity and Funding Liquidity,” *Review of Financial Studies*, 2009, 22(6), 2201-2238

*Diamond D., Dybvig P. H. “Bank runs, deposit insurance, and liquidity” *Journal of Political Economy* (1983) 401–419.

Diamond D. and R. Rajan. “Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking” *Journal of Political Economy* 2001, 287-327.

Diamond D. and R. Rajan, “The Credit Crisis: Conjectures about Causes and Remedies” *American Economic Review* PP, 2010.

*Shleifer, Andrei and Robert Vishny, “The Limits of Arbitrage,” *Journal of Finance* 52, 35-55, 1997.

Shleifer, Andrei and Robert Vishny, “Unstable Banking,” *Journal of Financial Economics*, 2010.

Shleifer, Andrei and Robert Vishny, “Fire Sales in Finance and Macroeconomics”, *Journal of Economic Perspectives*, forthcoming, 2011.