ECO575/FIN575: Topics in Financial Economics

Time and Location:
Part I: Sept. – Oct. 15: TTh 3:00 pm - 4:30 pm, Room 317, Bendheim Hall
Part II: Oct. 18 – Dec.: MW 4:30 pm - 6:00 pm, Room 317, Bendheim Hall

Aim of the Course:
The course is designed as a topics course for second and third year PhD students, who want to specialize in Financial Economics. Thorough knowledge of game theory and general equilibrium theory as taught in the first year Microeconomics course is assumed. Master and undergraduate students can also attend in the course. Aim of the course is to bring students to the research frontier and help them to conduct independent research in finance. This course is split in two parts. The first part will be taught by Prof Hong, the second part by Prof. Brunnermeier. We plan to make this course very interactive and incorporate student presentations. Additional course material will be made available on our websites.

Structure of the Course:

Part I: (Prof. Hong)
A) MARKET EFFICIENCY:
   1. Introduction to Market Efficiency
   2. Arguments and Evidence

B) LIMITS TO ARBITRAGE

C) OVER- AND UNDERREACTION
   1. Evidence
   2. Theories and Further Evidence

D) INVESTOR BEHAVIOR

Part II: (Prof. Brunnermeier)
A) ASSET PRICING UNDER ASYMMETRIC INFORMATION
   1. Market Microstructure Models
      • Rational Expectations Equilibrium versus Bayesian Nash Equilibrium Concept
      • Insider Trading Models and Sequential Trade Models
      • Share Auctions
2. Allocative and Informational Efficiency
3. Higher Order Uncertainty, No-Trade Theorems

B) LIMITS TO ARBITRAGE AND BUBBLES
1. Noise trader risk (myopic versus long horizons)
2. Synchronization Risk

C) BELIEF BIASES
1. List of Psychological Biases
2. The Optimal Expectations Framework

D) LIQUIDITY ASSET PRICING – INSTITUTIONAL FINANCE
1. LTCM case and Predatory Trading
2. Funding Liquidity versus Market Liquidity
3. Consumer Liquidity demand - Bank runs
4. Credit Cycles
5. Liquidity Asset Pricing

E) INTRODUCTION TO INFORMATION THEORY

* Given the time constraints, we cannot guarantee that all topics will be covered.

Detailed Reading List:

PART I:

A) MARKET EFFICIENCY

1. Introduction


2. Arguments and Evidence


B) LIMITS TO ARBITRAGE - INTRODUCTION


Hong, Harrison, Jeffrey D. Kubik and Amit Solomon, 2000, Security analysts’ career concerns and herding of earnings forecasts, Rand Journal of Economics 31, 121-144.


C) OVER- AND UNDERREACTION

1. Evidence


2. Theories and Further Evidence


D) INVESTOR BEHAVIOR


PART II

A) ASSET PRICING UNDER ASYMMETRIC INFORMATION


CHAPTER 1-3. (see detailed references in this book)
B) LIMITS TO ARBITRAGE AND BUBBLES


Roll, Richard, 1984, Orange juice and weather, American Economic Review 74, 861-880.


C) BELIEF BIASES

1. List of Psychological Biases


2. The Optimal Expectations Framework


Gollier, Optimal Illusions and Decisions under Risk, Working paper, University of Toulouse...

D) LIQUIDITY ASSET PRICING – INSTITUTIONAL FINANCE

1. LTCM and Predatory Trading


2. Funding Liquidity versus Market Liquidity


Brunnermeier, Markus K. and Lasse Pedersen, Funding Liquidity and Market Liquidity, mimeo.

3. Consumer Liquidity demand – Bank runs

Diamond, Douglas and Phil Dybvig, Bank runs, deposit insurance, and liquidity, Journal of Political Economy 1993

Freixas and Rochet, *Microeconomics of Banking*, MIT Press, 1999

4. Credit Cycles – Balance Sheet Effects


5. Liquidity Asset Pricing


E) BRIEF INTRODUCTION TO INFORMATION THEORY

Cover, Thomas M. and Joa A. Thomas, Information Theory, Wiley. 1991

Sims, Chris “Rational Inattention”, Working paper, Princeton University