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Introduction to financial economics [☆]

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Abstract

This introduces the symposium on financial economics.

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1. Introduction

Financial economics is a broad field covering corporate finance, asset pricing, and financial intermediation. The foundations of modern corporate finance date back to the celebrated papers of Modigliani and Miller [63,64] and the development of agency theory starting with Jensen and Meckling [47]. Asset pricing was revolutionized by the development of mean-variance analysis by Markowitz [59] and the Capital Asset Pricing Model by Lintner [57] and Sharpe [71]. The theory of efficient markets by Samuelson [70], the option pricing model of Black and Scholes [17] and Merton [61], and the role of asymmetric information in Grossman and Stiglitz [40] followed. Financial intermediation theory lagged behind with the modern literature dating back to Bryant [20], Diamond and Dybvig [28] and Diamond [27].

The financial crisis that started in the summer of 2007 has emphasized the crucial role of finance in economics. This has led to a resurgence of interest in the field. This symposium contains

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a number of important recent theoretical contributions. Some were presented at the July 2011 European Summer Symposium in Economic Theory, held in Gerzensee, Switzerland at the Study Center of the Foundation of the Swiss National Bank. This meeting was to mark the twentieth anniversary of the series. Many of the papers in this JET Symposium were prompted by the crisis. This is true of the papers on banking crises that are discussed in Section 2 and those in Section 3 that cover the interaction of various institutional structures with the crisis. Section 4 discusses a number of novel approaches to asset pricing that extend the frontiers of the field significantly.

2. Banking crises

Financial crises have occurred frequently both historically and in recent years as documented by Bordo, Eichengreen, Klingebiel and Martinez-Peria [18] and Reinhart and Rogoff [68]. However, the fact that prior to 2007 the last major banking crisis in the U.S. was during the Great Depression in the 1930's meant that the study of crises was a niche subject primarily studied by those interested in economic history or international economics.

There were traditionally two theories to explain the origins of banking crises. One line of argument maintains that they are undesirable events caused by random deposit withdrawals unrelated to changes in the real economy. In the influential work of Bryant [20] and Diamond and Dybvig [28] bank runs are sunspot phenomena as in Cass and Shell [21]. In these models, agents have uncertain needs for consumption in an environment in which long-term investments are costly to liquidate. If depositors believe that other depositors will withdraw then all agents find it rational to redeem their claims and a panic occurs. Another equilibrium exists where everybody believes no panic will occur and agents withdraw their funds according to their consumption needs. In this case, their demand can be met without costly liquidation of assets.

The second set of theories of banking crises is that they are a natural outgrowth of the business cycle. An economic downturn will reduce the value of bank assets, raising the possibility that banks are unable to meet their commitments. If depositors receive information about an impending downturn in the cycle, they will anticipate financial difficulties in the banking sector and try to withdraw their funds, as in Jacklin and Bhattacharya [45]. This attempt will precipitate the crisis. According to this interpretation, crises are not random events but a response of depositors to the arrival of sufficiently negative information on the unfolding economic circumstances. This view is consistent with the evidence in Gorton [35] that in the U.S. in the late nineteenth and early twentieth centuries, a leading economic indicator based on the liabilities of failed businesses could accurately predict the occurrence of banking crises.

One strand of the business cycle explanation of crises emphasizes the role asymmetry of information plays in triggering banking crisis. In this view, a panic is a form of monitoring. Chari and Jagannathan [24] focus on a signal extraction problem where some depositors withdraw money for consumption purposes while others withdraw money because they know that the bank is about to fail. In this environment, depositors who cannot distinguish whether there are long lines to withdraw at banks because of consumption needs or because informed depositors are getting out early may also withdraw. Chari and Jagannathan show crises occur not only when the outlook is poor but also when liquidity needs are high despite no one receiving information on future returns.

Building on the empirical work of Gorton [35], Allen and Gale [7] develop a model that is consistent with the business cycle view of the origins of banking crises. They assume that depositors can observe a leading economic indicator that provides public information about future bank asset returns. If there are high returns then depositors are quite willing to keep their funds in

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