

The Present and Future of Financial Economics

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Financial markets became extremely complex in the past 30 years. Forwards, futures, swaps, and options are used by companies and banks as often as cash. More sophisticated contracts, such as credit default swaps, are now commonplace among traders and investors. The unregulated use of contracts of this nature was recognized by many researchers as one of the main causes of the financial crisis in 2008 [1]. This view, however, is not a consensus [2]. Empirical and theoretical divergences are not uncommon in financial economics. In the aftermath of the Great Recession, economists were challenged to rebuild the financial market both in practice as well as in theory. Governments, central banks and securities & exchange commissions around the world put in practice new laws and regulations. The debate about the future of financial economics and the consequences of this new environment, however, persists in the academia.

Maybe the most recent portrait of how economic views are not completely consolidated in financial economics is the 2013 Nobel Prize awarded to Eugene F. Fama, Lars Peter Hansen and Robert J. Shiller “for their empirical analysis of asset prices”. What the Royal Swedish Academy of Sciences did not mention is that their analyses about how agents and institutions behave in the financial markets were quite different. In the early 1970’s Eugene Fama developed what is now known as the efficient-market hypothesis. His framework worked well with general equilibrium models [3], in which agents are completely aware of all possible states of the nature, prices and endowments, originating the asset pricing models. These models were later changed to accommodate situations in which states of the nature are uncertain, incomplete markets, sunspot and other forms of market failures or structures. The primitives of the models (preferences, rationality, information, etc.), however, were still intact [4]. Along with general equilibrium models (or partially using it), many economic models were developed to predict the behavior of financial markets, like capital asset price, multifactor, term structure, and the discount factor frameworks, for example [5]. Most of them were based on the efficient-market hypothesis, meaning that when the model did not predict well, it was hard to tell if it was because the model was not good or because the market was not efficient.

What made this Nobel Prize interesting is that Robert J. Shiller [6] research challenged the efficient-market hypothesis. In his seminal paper, “Do stock prices move too much to be justified by subsequent changes in dividends?”, he argued that discount factors and other parameters did not justify the movements observed in the stock market. In his view, the flaw was on the hypothesis that agents act rationally. His research gained room in the academia as financial markets frequently presented bubbles and crashes in the past 30 years. Along with his research, many economists proposed models that partially explain

some anomalies in stock markets using different sets of irrationality hypotheses: overconfidence, bounded rationality, specialization, heterogeneous agents, etc.

Although this award may intrigue some people, economists think it actually reflects how the field of financial economics has developed in such a short period of time. Financial economics now ranges from asset prices to corporate finance, from general equilibrium models to behavioral models, and from time series models to dynamic stochastic models. The future of financial economics certainly reserves room for both traditional and behavioral models. Farmer and Geanakoplos [7] argue that “there are situations where equilibrium models provide useful predictions and there are situations where they can never provide useful predictions”.

The future of financial economics is expected to reshape the existing (rational) agent based model to include micro founded behavioral aspects. General equilibrium model containing heterogeneous agents with bounded rationality instead of fully rational and identical agents is one possibility, for example. One of the challenges in this process is to convince researchers that equilibrium models have limitations and at the same time provide alternative approaches. Understanding how agents behave and how they interact with each other is an essential part of the future agenda in financial economics.

How these new and certainly more complex models will be developed depends on how many types of irrational behaviors theorists will be able to identify in financial markets and describe in a formal model and, obviously, on how these models will fit real data in empirical models. The only thing certain in financial economics is the fact that it has a wide agenda and is one of the most exciting fields in economics.

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