Topics in applied economics and finance

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Informal institutions, financial decisions and financial development

Course purpose and description

This course reviews a recent trend of literature on the determinants of investors financial decisions and the role of informal institutions – such as trust and social capital – in shaping the adoption of financial instruments, the working of financial markets and financial development. There is no reference textbook. The focus is on applications rather than on theory.

Course purpose and description

This course reviews basic retail investors financial choices and the recent trend of literature on the determinants of investors financial decisions and the role of informal institutions – such as trust and social capital – in shaping the adoption of financial instruments, the working of financial markets and financial development. The sequence is a 20-hour course based on lecture notes and the direct reading of a number of articles from the literature.
There is no reference textbook.
Students will be required to read thoroughly one of the papers in the reading list and present and discuss it in class.

Grading policy

Grades will be based on the presentation of the paper and participation in class discussion and on the performance on a final exam. The presentation and discussion counts for 20% of the grade, the exam for the remaining 80%.

Topics and readings

The list of topics and readings is tentative and is still subject to change but gives you a fair idea of what the contents of the course will be.

The course is divided into two parts. The first deals with households financial decisions, portfolio allocation, financial markets participation. The second with social interactions, trust, culture and finance.

A. Household finance

1. What is Household finance about

An introduction to household finances. Provides definition of what household finances is about, main empirical features of household financial wealth and financial choices, definitions of financial markets and how households rely on financial markets to achieve their objectives.
Material: slides and (*) reading

Readings

1. (*) John Campbell (2006), "Household Finance", Presidential Address to the American Finance Association, *Journal of Finance*, Volume 61 Issue 4 Page 1553 - August 2006.
2. (*) Luigi Guiso, Michael Haliassos and Tullio Jappelli (2001): Introduction to "Household Portfolios", L. Guiso, T. Jappelli and M. Haliassos (eds.), MIT Press, Boston.
3. Luigi Guiso and Tullio Jappelli (2001): "Households Portfolio in Italy" in "*Household Portfolios*", L. Guiso, T. Jappelli and M. Haliassos (eds.), MIT Press
4. Stephanie Curcuru, John Heaton, Deborah Lucas and Damien Moor (2004), "Heterogeneity and Portfolio Choice: Theory and Evidence", Handbook of Financial Econometrics, *Handbook of Financial Econometrics*, L. Hansen, ed., forthcoming.

2. Portfolio Choice

Discusses households portfolio choice in the simplest scenario of one safe and one risky assets when choice is made in a frictionell word.
Material: slides and Gollier chapter.

Readings

1. (*) Christian Gollier (2001) “What Does Classical Theory Have to Say about Household Portfolios?”, in L. Guiso, T. Jappelli and M. Haliassos (eds.), “*Household Portfolios*”, MIT Press, Boston.

3. Preferences for risk and risk aversion

Defines risk aversion of the utility function when endowment is certain and how risk attitudes are affected by background risk. Discusses thoroughly how preferences for risk can be elicited at the level of the single investors and the pros and cons of various elicitations strategies.
Material: slides and starred readings.

Readings

1. (*) Thomas Dohmen, Armin Falk, David Huffman, Uwe Sunde, Jurgen Schupp and Gert G. Wagner (2005) “*Individual Risk Attitudes: New Evidence from a Large, Representative Experimentally validates Survey*”, mimeo **R**
2. (*) Luigi Guiso and Monica Paiella (2005), “Risk aversion, wealth and background risk”, mimeo **R**
3. Charles Holt and Susan Laury “ Risk aversion and incentive effects”, American Economic review **R**
4. Matilde Bombardini & Luca Terbbi (2005), “Risk Aversion and Expected Utility Theory: A Field Experiment with Large and Small Stakes.”, Harvard University mimeo **R**

4. The stockholding puzzle

Explains the stockholding puzzles and proposes one solution to the puzzles: the presence of fixed participation costs. Argues that participation costs can explain certain key features of the data but not all.

Material: slides and starred readings.

Readings

1. Michael Haliassos and Carol Bertaut (1995), “Why so few hold stocks?” The Economic Journal, 05, pp. 1110-1129.
2. (*) Annete Vissing Jorgerson (2002), “Towards an explanation of household portfolio choice heterogeneity: nonfinancial income and participation cost structure”, Northwestern University, **R**
3. (*) Annete Vissing Jorgerson and Orazio Attanasio (2003), “Stock-Market Participation, Intertemporal Substitution and Risk Aversion”, American Economic Review, pp. 383-391 **R**

4. Monica Paiella (2005) " Limited Financial Market Participation: A Transaction Cost-Based Explanaton", http://www.ifs.org.uk/wps/wp0106.pdf
5. (*) Luigi Guiso and Tullio Jappelli (2005), "Awareness and Stock Market Participation", Review of Finance, **R**

5. Topics

Discusses three topics in household finance. A) the portfolio of the rich; B) the effect of information on financial decisions and the choice of how much information collect; C) behavioral finance, providing an introduction to basic concepts in psychology and finance, such as loss aversion, ambiguity aversion and overconfidence and a discussion of their effects of financial decisions.

Material: slides and starred readings.

Readings

1. (*) Cristopher Carrol (2001), "Portfolios of the Rich", in L. Guiso, T. jappeli and M. Haliassos (eds.) Household Portfolios, MIT Press, Boston **R**
2. Nikolai Roussanov (2006), "Status, Diversifcation, and Entrepreneurial Risk*", University of Chicago, mimeo*
3. (*) Joel Peress (2004), "Wealth, Information Acquisition and Portfolio Choice", The Review of Financial Studies, 17, pp. 879-914. **R**
4. (*) Luigi Guiso and Tullio Jappelli (2005), "Information Acquisition, Overconfidence and Portfolio Performance", mimeo **R**
5. (*) Nicholas barberis and Richar Thaler (1999), "A survey of Behavioral Finance",
6. (*) Richard Thaler (1999), "The end of behavioral finance", Perspectives, Association for Investment management and Research **R**
7. Matthew Rabin and Richard Thaler (2001), "Anomalies. Risk Aversion", Journal of Economic Perspectives, Winter, pp.219-232. **R**

B. Social capital, trust and business behavior
(Informal institutions, financial decisions and financial development)

a. Trust, social capital and social interactions: what they are and why they matter

Discusses the meaning of informal institutions, their relation to each other and their link to financial decisions and financial markets.

Readings: slides and starred articles

1) Robert Putnam (1993) "Making Democracy Work", Civic Traditions in Modern Italy. Princeton: Princeton University Press.
2) Francis Fukuyama (1995) "Trust: The Social Virtues and the Creation of Prosperity", Free Press, 1995.
3)* Partha, Dasgupta (2201), "Social Capital and Economic Performance: Analytics"
4) * Adam, F., Roncevic, B. (2005), Social Capital: Recent Debates and Research Trends, Social Science Information, 42(2), 155-183.
5) * Diego Gambetta (2000) 'Can We Trust Trust?', in Gambetta, Diego (ed.) *Trust: Making and Breaking Cooperative Relations*, electronic edition, Department of Sociology, University of Oxford, chapter 13, pp. 213-237, http://www.sociology.ox.ac.uk/papers/gambetta213-237.pdf

b. Measuring trust and social capital

Shows how trust and social capital can be measured following various strategies.

Readings: slides and starred papers

1) (*) Glaeser, Edward L.,D. Laibson,J A.Scheinkman, and C. Soutter (2000): "Measuring Trust," *Quarterly Journal of Economics*, 115(3), 811–846.
2) * Alberto Alesina and Eliana La Ferrara (2002) "Who Trusts Others?," Journal of Public Economics, 85(2), 207-234, 2002.
3) (*) King-Casas, B, Tomlin, D, Anen, C, Camerer, CF, Quartz, SR, Montague, PR (2005) Getting to Know You: Reputation and Trust in a Two-Person Economic Exchange. ***Science*** 308:78-83. PDF
4) Glaeser, Edward L.,D. Laibson,J, B. Sacerdote (2000): "The economic approach to social capital," *NBER WP* 7728, 115(3), 811–846.
5) Thomas Dohmen, Armin Falk, David Huffman, and Uwe Sunde (2006), " The Intergenerational Transmission of Risk and Trust Attitudes", IZA, mimeo
6) Guiso Luigi, Paola Sapienza and Luigi Zingales (2003) "People's Opium. The effect of religion on economic attitudes", Journal of Monetary Economics.

The Effect of Trust on Finance and Trade

Readings
1) * Luigi Guiso, Paola Sapienza and Luigi Zingales (2005) "Trusting the Stock Market", NBER WP
2) Guiso Luigi and Tullio Jappelli (2005) "*Awarness and Stock Market Participation*" Review of Finance
3) * Luigi Guiso, Paola Sapienza and Luigi Zingales (2004) "Cultural Biases in Economic Exchange", NBER WP 11005
4) Sophie Shive (2004) "An Epidemic Model of Investor behavior"
5) * Laura Bottazzi, Marco Da Rin, "The Importance of Trust for Investment: Evidence from Venture Capital", WP

Determinants of financial development. The Role of the Law and Social capital

a. The role of the law

Readings:
* La Porta, Rafael; Lopez de Silanes, Florencio; Shleifer, Andrei and Vishny, Robert. "Legal Determinants of External Finance." *Journal of Finance,* July 1997a, *52*(3), pp. 1131–50.1)
* La Porta, Rafael; Lopez de Silanes, Florencio; Shleifer, Andrei and Vishny, Robert. "Law and Finance." *Journal of Political Economy,* July 1998, *106*, pp. 1113–55)

b. The role of social capital

* Luigi Guiso, Paola Sapienza and Luigi Zingales (2004) "*The Role of Social capital in Financial Development*" , *American Economic Review*
3) Luigi Guiso, Paola Sapienza and Luigi Zingales (2004) "Does Local Financial Development Matter?" *Quarterly Journal of Economics*, 2004, 119(3), pp. 929-69;
4) * Harrison Hong, Jeffrey D. Kubik and Jeremy Stein (2004),"Social Interaction and Stock-market Participation", Journal of Finance
5) Knack, Stephen and Keefer, Philip. "Does Social Capital Have an Economic Payoff? A Cross-Country Investigation." *Quarterly Journal of Economics,* November 1997, *112*(4), p. 1251.
5) Knack, Stephen and Zack, Paul. "Trust and Growth." *Economic Journal*, April 2001, *111*(470), pp. 295–321.
7) "Trust in Large Organizations." *American Economic Review,* May 1997b, (*Papers and Proceedings*), *87*(2), pp. 333–38.
8) Luigi Guiso and Tullio Jappelli (2005), "Awareness and Stock Market Participation*", Review of Finance*

Culture and Financial and Economic Outcomes

<u>Readings:</u>
1) * Luigi Guiso, Paola Sapienza and Luigi Zingales (2006) “Does Culture Affect Economic Outcomes?, The Journal of Economic Perspectives
2) Lauren Cohen “*Loyalty based portfolio choice*” , 2005 Yale University
3) Harrison Hong and Marcin Kacperczyk "The Price of Sin: The Effects of Social Norms on Markets", 2005 Princenton University
4) Adair Morse and Sophie Shive (2004) “Patriotism in your portfolio”,
5) * Una Okonkwo and Anna Paulson (2004) “Institutional Quality and Financial Market Development: Evidence from International Immigrant in the US”, Chicago FED WP 2004-19
6) * Rene’ Stulz and Rohan Williamson (2003) “Culture, Openness and Finance”, Journal of Financial Economics, 313-249