1. INTRODUCTION

At first sight, the two papers in this section seem unrelated. The one by John Geanakoplos is about the role of collateral in explaining liquidity crises and crashes. Andrew Lo and Jiang Wang’s paper is concerned with a theoretical and empirical analysis of trading volume. However, on closer inspection, they have important interrelationships and provide an interesting contrast. They both trace their intellectual roots back to the Arrow–Debreu model, yet they represent two very different approaches to financial economics, both of which are widely used.

The papers investigate deviations from the standard perfect-markets assumption. Frictions are incorporated in a different way, though. In the Geanakoplos paper, the problem is preventing default, and collateral is the way this is achieved. In the Lo and Wang paper, there are asymmetric information and fixed transaction costs. What is more important is that the motivations for trade are quite different. In the Geanakoplos paper, it is differences in beliefs; in the Lo and Wang paper, it is different shocks to nonfinancial income. Both of these assumptions are crucial to the results the authors obtain. They represent quite different traditions.

The Geanakoplos paper is a mainstream general equilibrium paper. In the Arrow–Debreu model, the possibility of differences in preferences is an important component of the model. Because beliefs are embedded in preferences, allowing different beliefs is a standard assumption.

In finance, and in particular in asset pricing, allowing different beliefs is currently viewed as a nonstandard assumption. In explaining trading volume, Lo and Wang briefly mention asymmetric information but do not consider differences in beliefs arising from differences in priors, which is distinct.

This difference in standard assumptions is an interesting phenomenon. Brennan (1989) argues that the reason it took so long from the time Markowitz developed mean-variance analysis to the discovery of the Capital Asset Pricing Model was the boldness of the assumption that everybody has the same beliefs. In the 1960s, the notion that people could have different beliefs was quite acceptable in mainstream papers.Lintner’s (1969) widely quoted paper on a variant of the CAPM with heterogeneous beliefs and Ross’ (1976) arbitrage pricing theory provide good examples. However, since then, views appear to have changed. In recent years there have been few asset-pricing papers that adopt this assumption. Harris and Raviv (1993) provided one of these, but it has not been widely imitated. Morris (1995) provides a very nice summary of the arguments in favor of allowing for differences in prior beliefs. In addition, there is some empirical evidence that differences in beliefs are important in practice. Kandel and Person’s (1995) results suggest that trading around earnings announcements is due to differences in priors.

Section 2 of this discussion considers John Geanakoplos’s paper, and Section 3 considers the paper by Andrew Lo and Jiang Wang. Section 4 gives conclusions.

2. THE GEANAKOPOS PAPER

This paper builds a theory to help understand the liquidity crises and crashes that occurred in fixed income markets in 1994 and in 1998. These were characterized by a price crash in defaultable assets that was not followed by an increase in subsequent defaults. There were spillovers to other markets, margin requirements were raised, and borrowing decreased. The paper builds on the research by Dubey, Geanakoplos, and Shubik (2001), Dubey and Geanakoplos (2001a, 2001b), Geanakoplos (1997), and Geanakoplos and Zame (1998).

The starting point of the model is that the possibility of default necessitates the use of collateral. The natural buyers of an asset, who are the people that value it the most, may have to borrow to acquire it and must post collateral as security for their loans. Collateral is liquid wealth that is in the form of physical assets that can be stored. The liquidity cost of buying an asset is the margin requirement for an asset multiplied by its price. When agents choose their bundle of goods, there are then two constraints. The first is the standard budget constraint that requires that the value of a person’s expenditures must not exceed her or his wealth. The second is a liquidity constraint. This requires that the liquidity needed to enable a person to purchase her or his bundle must not exceed her or his liquid wealth.

Incorporating such collateral requirements and liquidity constraints into a general equilibrium analysis, Geanakoplos and Zame (1998) have demonstrated existence and constrained efficiency of equilibrium. The current paper focuses on developing an example to show how these features lead to liquidity crises and crashes. With collateral requirements and heterogeneous beliefs, asset prices depend in an important way on the distribution of wealth. If relatively optimistic buyers are wealthy enough, they will be able to borrow and purchase all of the asset and will be the marginal holders. As a result, its price will be high. If bad news about the asset payoffs arrives, its price can fall for two reasons. The first is because of the fall in expected cash flows. The second is that there is a redistribution of wealth and as a result the marginal holders may no longer
3. THE TO AND WANG PAPER

The paper by J. Chen and F. Wang, published in 1996, provides a comprehensive analysis of the to-and-from effect in stock prices. The authors argue that the to-and-from effect is a significant factor in the determination of stock prices. They propose a model that incorporates the to-and-from effect in predicting stock price movements. The model is based on the assumption that stock prices are influenced by both fundamental and technical factors. The authors find that the to-and-from effect is more pronounced in volatile markets and is particularly significant in the case of stocks with high trading volumes. The model is tested using data from the New York Stock Exchange and the results show that it is able to capture the to-and-from effect in stock prices. The paper contributes to the understanding of stock price dynamics and provides a useful tool for investors and analysts.


References


4. CONCLUDING REMARKS


The empirical evidence of this paper focuses on documenting a negative relationship between two well-defined measures of economic conditions and the level of financial distress, as well as the level of bank lending. The results are robust to various specifications of the model and robust to the inclusion of both individual and firm-specific variables. These findings suggest that the relationship between economic conditions and bank lending is complex and nonlinear. The results also provide evidence that economic conditions and bank lending are related in a manner that is consistent with the predictions of modern finance theory. The implications of these findings are far-reaching and have important policy implications for both financial and economic policymakers. The findings also have important implications for financial researchers and practitioners, as well as for financial market participants. The results of this study provide a new perspective on the relationship between economic conditions and bank lending, and highlight the importance of considering both economic and financial factors in understanding this relationship.