Behavioral Economics and Finance

FINC-GB.2111.20, Spring 2016 (first half).

Venue: 44 W 4th St, room KMEC 2-80

Wed 3-5.45pm, February 3 to March 9

Instructor: Xavier Gabaix, xgabaix@stern.nyu.edu, KMEC 9-77

Administrative assistant: Olivia Domba odomba@stern.nyu.edu, KMEC (near 9-72)

Requirements: There will be 2-3 problems sets, and a short term paper. I may ask some of your to be “scribes” for some lectures.

There is no textbook.

We shall study the main behavioral facts and models. We will discuss the empirical evidence, but we’ll emphasize the models – especially the novel, promising approaches, rather than a review of past successes.

Topics will include: bounded rationality, inattention, imperfect understanding of probabilities, non-rational expectations, narrow framing, boundedly rational dynamic programming, dynamic reference point; and more specialized finance models: limits of arbitrage, aggregate stock market behavior, cross-sectional stock market behavior, loss aversion in stock trading, behavioral corporate finance.

The course can be followed by students with little knowledge in finance

We’ll try to follow the following plan. Please let me know if there’s (potentially additional) material that particularly interests you.

The latest version of the syllabus is at:

1. Introduction [0.5]
2. Bounded rationality [1]
   a. Facts
   b. Inattention, slow adjustment
c. Sparsity approach
d. Entropy-based modeling of inattention: Sims, Woodford

3. Dual-self models: Laibson, Gul-Pesendorfer, Fudenberg-Levine, etc. [0.5]

4. Loss aversion and dynamic reference point. [1]
   a. Kahneman-Tversky’s basic prospect theory
   b. Koszegi Rabin: endogenous reference point
   c. Difficulties of dealing with small probability events:
      a. Barberis, Fehr-Duda
      b. Overvaluation of small stocks etc.

5. Formation of expectations [0.5]
   a. Some facts.
   b. Macro-models for expectations
   c. Beshears, Laibson et al.
   d. BR updating of probabilities, what comes to mind
   e. Rabin, Rabin and Vayanos: law of small numbers.

6. Household finance [0.25]

7. Agents in the markets, behavioral IO [0.25]

8. Implications in Finance [2]
   a. Limits of arbitrage, price pressure: Shleifer Vishny, Gromb Vayanos
   b. The aggregate stock market
   c. The cross-section of stocks
   d. Propensity to sell winners rather than losers: Barberis, Odean, Hirshleifer:
      reluctance to sell losers, and the modeling of that.
   e. Corporate finance implications

Recommended texts (optional).


**Introduction**


**Bounded rationality**


**Limited attention and salience**


Koszegi, B. and A. Szeidl A Model of Focusing in Economic Choice QJE 2013

**Mental accounts and decision vs experienced utility**

Farhi, E. and Xavier Gabaix “Optimal Taxation with Behavioral Agents”
https://www.dropbox.com/s/1r02vbs3nq0q9s4/BR-Taxes.pdf

**Inattention, slow adjustment**


Entropy-based rational inattention


Woodford, M. “Inattentive Valuation and Reference-Dependent Choice,” February 2012.


Please also look for updates from Andrew Caplin’s web page.

Some other approaches

Jehiel, Philippe. Analogy-Based Expectation Equilibrium JET 2005


Dual Self Models


Attitudes towards Risk and reference-dependence


**Reference point and its dynamics**


Andries, M. and V. Haddad Information Aversion 2014

**The formation of expectations**


Barberis, Nicholas, Robin Greenwood, Lawrence Jin, and Andrei Shleifer "X-CAPM: An Extrapolative Capital Asset Pricing Model", JFE 2015


Woodford, M. “Macroeconomic analysis without the rational expectations hypothesis,” Annual review of economics, 2013.


**Household finance**


Annamaria Lusardi’s facts: http://www.dartmouth.edu/~alusardi/pub.html

**Behavioral agents in the market**


Spiegler, Rani. Bounded Rationality and Industrial Organization

Finance models

Limits of arbitrage
Inefficient markets, Ch. 2, 4.


Full-Scale macro / finance models


The cross-section of stocks


**Propensity to sell winners**


**Behavioral corporate finance**


**Potential Other topics**


Post-earnings announcement drift

Inattention: Dellavigna Pollet, Cohen et al.