## Βιβλιοκρισίες - Book Reviews

# Asset Prices, Booms and Recessions

*by*
*Willy Semmler*

Review authors:
*Sotiris Karkalakos* and Evangelos Benos***

The field of financial economics is one of the hottest fields of finance these days, so a good book on the subject finds its audience, even with rapidly growing number of the books devoted to the field. Asset Prices, Booms and Recessions contributes to the intersection of two areas of study: finance and economics. The book studies the interaction of the financial market, economic activity and the macroeconomy from a dynamic perspective. This comprehensive, up-to-date textbook provides a weal – organized and substantial exposition of many finance topics. The text adds a systematic discussion of the empirical evidence and of the current practice to this in-depth theoretical treatment. The author pays considerable attention to nurture the reader s curiosity through a number of practical examples from the real – world examples.

The financial market to be studied here encompasses the money and bond market, credit market, stock market and foreign exchange market. Economic activity is described by the activity of firms, banks, households, governments and countries. The book shows how economic activity affects asset prices and the financial market and how asset prices and financial market volatility feed back to economic activity. The focus in this book is on the theories, dynamic models and the empirical evidence. Empirical applications relate to episodes of financial instability and financial crises of the United States of America, Latin America, Asian as well as Euro-area countries. The book is sophisticated, yet accessible; full of details, yet

* University of Illinois at Urbana - Champaign, Department of Agricultural and Cunsumer Economics.
** University of Illinois at Urbana - Champaign, Department of Finance.

intriguing. A careful effort has been made to develop the statistical techniques within the context of particular financial application. The choice of research in the field. This, together with an extensive bibliography, make it particular useful for researchers and industry professionals as well.

What are the specifics of the major financial markets and do they differ in importance for economic activity? Has financial risk increased and will financial liberalization lead to booms and crashes? Do monetary and fiscal policies impact the financial markets and how do financial markets impact government policies? These are just a few of the questions raised in the book for which an answer is provided or the state of the art is presented. The most impressive contribution of the book is in the step-by-step linkages that the author construct to illustrate the inter – relation among different types of markets such as money and bond.

The book is organized in five parts containing a total of 13 chapters. It opens with a description of money, bonds and economic activity (Part I), then treats the credit market and economic activity (Part II), before turning to stock market and economic activity (Part III), asset pricing (Part IV), foreign exchange and financial instability (Part V). Finally, the last chapter (13) provides some policy conclusions. As the title of the book suggests, the author shows repeatedly his willingness to view market finance from a macroeconomic perspective, and vise versa, throughout the book. Another significant objective is to ensure early on the book that the reader is aware of actual financial decisions made by firms, given economic conditions. This allows the author to combine a theoretical analysis of financial decisions with a discussion of how these decisions are actually made.

Part I deals with money, bonds and economic activity. The basis of money and bond markets and the role of monetary policy are covered by chapter 1. Empirical trends and stylized facts are related to theoretical models from a macroeconomic perspective. Chapter 2 discusses interest rates which play an important role for asset and derivative pricising. Basic stochastic processes are employed to model the interest rate process. Moreover, econometric regression shows that the spread between two longer maturity bond rates provides useful predictions for future short term rate movements and thus for the term structure of interest rates.

The originality of Part II of the book mainly lies in the coverage of theories and empirical evidence on the credit market. Chapters 3 and 4 focus on the theory of perfect and imperfect capital markets and the role of the banking system for the relationship of credit and economic activity by posting that firms and households finance their activity largely through credit market instruments such as loans or commercial papers. In the later, asymmetric information, moral hazard and adverse selection as well as asset prices become relevant issues for studying borrowing and lending. Furthermore, linear and nonlinear models are used to test of credit risk and economic activity. Finally, debt sustainability is an important issue in credit rating of private and sovereign debt and the suggested methodology can be applied to provide estimates of the long-run debt sustainability and credit risk.

A further more important part of the financial market is the stock market, which is presented in Part III. Chapters 5, 6 and 7 refer to the equity market, as an important part of the security market and explore approaches that focus on the intersection of asset pricing and economic activity. The book haw pursued two directions. Firstly, the impact of the stock market on economic activity. In other words, the author presents the role of wealth, as evaluated in the stock market, on borrowing, lending and spending behavior of financial institutions, corporations and households. Secondly, another important line of research is to show how real economic activity affects asset prices and returns. Two models that deal with the interaction of macro-economic factors and the stock market are presented to account for the above direction of research. However, the basic structure of the models does not include policy on stock prices and output. Furthermore, technology is not taken into account and thus its impact is unknown.

In the previous models there was no evaluation of new technologies that could impact productivity, output and asset prices. However, the book extends its discussion to models that incorporate the technology factor. In general, as Hobijn and Jovanovic (1999) have shown firms that fail to innovate successfully may be the object of mergers and acquisitions. Overall, the author wants to stress that long swings and sort run volatility of stock prices in an economy with rapid technological change cannot be interpreted solely as excess volatility, but real determinates are important as well as when new technology arises.

Part IV elaborates on asset pricing theories such as the Capital Asset Pricing Model (CAPM), The percent Value (PV) Approach and the consumption and production based interteporal asset pricing theory. Chapter 8 discusses theoretical foundations and empirical evidence for the most prominent asset pricing theory using a static portfolio theory. Advanced test of the CAPM are undertaken that show that broad stock market indices are no adequate proxies for the market portfolio. Chapter 9 employs a dynamic asset-pricing framework. It is studied a typical production based asset pricing theory based on stochastic growth model. Basic for the consumption-based asset pricing model is the utility function of the investor. Moreover, the book presents a discussion of production-based asset pricing models that do not use utility theory. The latter is an important contribution of the author. In Chapter 10, Real Business Cycle (RBC) Model is presented as a macroeconomic model. It tries to explain macroeconomic fluctuations as equilibrium reactions of the representative agent economy of complete markets. The estimation technique used follows the Maximum Likelihood (ML) method in Semmler and Gong (1996). The advantage of the suggested methodology is that the closed – form solutions for the financial variables can be directly used in the estimation algorithm. This reduces the complexity of the estimation substantially. Finally, it should be mentioned that the author uses a production based dynamic pricing theory with the representative agent framework theory. Recently, researchers (Cochrane, 2001) have departed from this approach by employing the framework of heterogeneous agents.

Foreign exchange market, financial instability and economic activity are presented in Part V. The interaction and the relation of those markets are examined through a macroeconometric perspective (Chapter 11). Indeed, balance sheets of economic agents have been at the center studies on the financial interaction, the financial sector and economic activity. As the author declares in this chapter, he sketches a model of the financial sector that is ready for use for studying the impact of financial stock on the real side of the economy. This approach suffices as a framework that will help to explain how external shocks to an economy may generate a financial crisis and large output loss. The latter is considered in Chapter 12 where a review of the stylized facts and a survey of some recent theories are presented. The author tries to illustrate the basic mechanism and the connection among financial conditions and large exchange rate shocks that lead to credit contraction, real crisis and large output loss.

Finally, Chapter 13 offers some policy conclusions. Monetary authorities should help to provide stability for financial market and reduce the likelihood of financial instability not only in the credit market and banking sector, but also instability arising from extreme changes in asset prices. The book has dealt with financial markets and economic activity from a macroeconomic perspective. In order to study the dynamics of the financial – real interaction, the author has used macro approaches, presumed optimizing and non-optimizing behavior, employed zero horizon and infinite horizon models and has used linear and nonlinear models. The above techniques are summarized in Wohrmann and Semmler (2002).

Overall the book is a well-written text in the field of financial economics. It is alert, explicit and articulate about assumptions, complete attitudes, levels of abstraction, scope of applicability, interpretation, and relevance of the statistical methodologies developed. The value as a textbook would increase if, in a future edition, the author could add more examples and provide more intuitive proofs for some of the advanced topics. Nonetheless, even as it is, the book is a splendid offering not only for researchers and practitioners in the field of financial engineering, but also for researchers and practitioners in the field of economics. To recapitulate, the book s main purpose is to provide an analysis about financial markets through a macro-economic perspective. It is very successful in doing that, and does it in a clear writing style and very smooth exposition of the material. Moreover, and most important, we believe that the book will facilitate the learning process for numerous researchers of financial economics, in their attempts to study the subject.

### *References*

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