Name of Student

Name of Professor

Name of Class

Day Month Year

Module 8 Essay

**Stock Price Booms and Expected Capital Gains By Klaus Adam, Albert Marcet, and Johannes Beutel\***

The boom in the U.S. stock prices in the post-war era can be associated with the fluctuations in expectations of investors regarding capital gains. These expectations demonstrate a high level of optimism at the market in terms of market peaks and too much negativity to market managers. Through the framework of Internal Rationality of Marcet and Adam, subjective price beliefs to an otherwise normal asset pricing structure alongside utility investors are incorporated. The dynamics of subjective beliefs can disassociate the stock prices from their basic value on a temporary basis and surge the asset prices that lead to an overall out of order price. The model repeats the instability of stock prices and the optimum correlation between expected return and price-dividend (Adam et al., pp. 2354). The positive correlation between price expected return and price-dividend are observed quite often in market surveys. The large portion of U.S. stock price fluctuations are not because of the basic standard indicators, rather originate from self-imposed belief systems instigated by these basics.

The empirical evidence casts enough doubt on the prevalent view that stock price fluctuations are efficient. In this regard, the rational expectations hypothesis leads to a significant counterfactual forecast about the pattern of investors return or capital gain prospects. In addition, the counterfactual forecast is a model-free inference of the rational expectation hypothesis.

Furthermore, the empirical behavior of assets pricing indicates that rational return prospects relate negatively to price-dividend. Therefore, rational expectation hypothesis forecasts that investor has not been optimistic regarding next future stock returns at the beginning of the year 2000, at the time when the tech stock and the Price-Dividend ratio of the S&P 500 attained their peak. However, the current survey evidence suggests it is not the case. The quantitative survey measures of capital gain for the American economy, undoubtedly and collectively positively relate with the Price-Dividend ration; and as return prospects reach maximum for the time being instead of a minimum in the initial of 2000 which was exactly the height of the tech stock boom, a reality that was earlier displayed in Vissing-Jorgensen (2003). Moreover, the proper econometrics tests of null hypothesis; the evidence of the survey is in line with Rational Expectation, and yields that the hypothesis of capital gain prospects is heavily overturned by the data. The tests are right for little sample bias; contribute to autocorrelations in the error patterns, are resistant to the availability of the data at agents’ end, and to the availability of measurements error within the survey data. A significant aspect of the tests is that it gives hints as to why the Rational hypothesis fails; the failure occurs as the Rational Expectations, and the survey expectations covary variably with the Price-Dividend ratio, a survey which is advantageous for administrating the search for empirically more reasonable expectation model.

Conclusively, a model with rational investigation agent is presented which leads to the market shortcomings in a way that the stock price diverges from its basic value. This divergence becomes the type of assets price boom and bust cycle that are strengthened by the beliefs upgrading prospects of investors whose overall attitude is positive in relation to the behavior of stock price. Positive belief also enables investors’ capital gain expectation to work positively with the price-dividend ration, in line with the evidence demonstrated by investor surveys. These aspects may not be repeated in asset price models that create rational price expectation.

Moreover, the advanced statistical tests indicate that the behavior of survey return prospects is not compatible with the rational expectation hypothesis. Thus, it suggests that asset pricing prospects are under the influence of investor’s positive and negative approaches, such as the asset price variation are inefficient significantly. The inefficiency takes place as the balance of stock prices are set by the total of dividends which gets a discount through stochastic discount element indicated by investors' subjective consumption program, which is affected by investors price beliefs.

Two questions arise: Should the policy influence the plan to stabilize asset prices? What can be a comprehensive policy for the overall stock market and investors irrespective of their subjective beliefs?

**International Recessions By Fabrizio Perri and Vincenzo Quadrini**

Most of the industrialized countries were hit by the recession. The recession of 2008 is based on two theories. Firstly, the recession was the outcome of the global liquidity shortfall persuaded by negative self-fulfilling hope. The global recession had many commonalities at the macroeconomic level, and those were taken into account pre and post 2008 crises in America and the rest of the G-7 countries (Perri, Fabrizio, and Vincenzo Quadrini pp. 935). Secondly, it demonstrates how financial integration makes an impact on the possibility and magnitude of crises. In fact, crises do not frequently occur when countries are financially integrated. However, in a crises situation, its impact is huge and more interconnected as far as different countries of the world are concerned.

Also, the theory of financial boom and bust is significant from two perspectives. First, with exogenous credit surprises, the model creates cross-nation co-movement not only in terms of real variables but also in a financial respect. In order to demonstrate this, first, a type of model in which country related credit situation varies endogenously needs to be reviewed. In addition, if financial markets are interconnected and endogenous narrowing of credit in one of the countries affects employment and output in the other one as well. In contrast, when the country goes through the shock faces a credit crunch, the other country goes through a credit boom. In this respect, the model would not lead to financial synchronization until endogenous credit shocks are connected across countries. Therefore, by standardizing credit conditions, the model yields synchronized events in financial as well as real variables.

The outcome endorses the view that a self- fulfilling shortage in global liquidity instead of isolate country-related shock is imperative to understand the financial crises of 2008. Secondly, the exogeneity of the credit boom and bust enables people to evaluate the possibility and severity of crises change when financial markets are more interconnected. The self-fulfilling crises demand a high level of coordination in expectation; the probability of coordination comes down when markets are interconnected. An interconnected market is a bigger market which demands the coordination of more agents. However, as the chances of crisis is less, the motivation to leverage increases. Therefore, crises are less likely in case of interconnected markets, but its implications at the macro level are bigger. About financial integration, two symmetric countries are considered having the same preferences and technology.

My hypothesis says that workers cannot purchase a share of foreign and domestic companies. However, in case of financial connectivity, investors can make purchases of shares of both foreign and domestic companies; companies borrow in an international bond market at a mutual interest rates; also, workers can exchange state contingent claim with overseas workers. Since the companies depend on country specific shock, the investor gets from expanding cross-country proprietorship of shares. In this regard, it is simple to demonstrate that it is ideal for investors to hold the same quantity of local and foreign shares. Therefore, domestic and foreign investors have uniform consumption, which suggests a mutual stochastic rebate factor. Investors' consumptions are the sum of the total dividends that international and local companies pay.

Finally, the crisis of 2008 can be attributed to a high level of global synchronization both in financial and real variables. A theoretical model can create a movement with the help of exogenous boom. Booms improve the borrowing capability of borrowers and yield optimum production and more employment opportunities. On the other hand, crises limit the borrowing capacity and cause a significant contraction in real activities. Crises are international when financial markets are interconnected. The financial globalization not only changes the level of macroeconomic and financial level but also impacts the probability of a crisis. When counties are interconnected, crises do not occur frequently.

Two questions arise: In the context of international crises, should capital markets be integrated? What measures can be adopted to avoid another financial crisis like 2008?

**Foreign Direct Investment in Latin America and the Caribbean**

The year 2017, witnessed a few emerging trends in the global scenario. In this regard, the decisions of possible limitations on trade and pressure to shift production to first world countries were finalized. Meanwhile, China took some measures to stop the outflows of Foreign Direct Investment (FDI) to line up these flows with the help of a strategic plan (Garcia-Fuentes et al.). In addition, contributing to these elements is the diversification of digital trends, whose international diversification demands little investment in physical assets. Companies highly focus on in the United States and China that minimizes the need for cross-border merging and acquisition. The group of these elements reaches to an extent to explain the decline in global Foreign Direct Investment, even after considerable economic growth, enough international liquidity, large corporate returns and positivity in financial markets. In this international respect, Foreign Direct Investment goes to Latin America and the Caribbean squeezed for the third consecutive year in the year 2017, to 161.911 US billion dollars, 3.6 less as compared to the 2016 figure and 1/5th less in comparison with the year 2014.

In the medium term, this constant decline since the year 2014 may be characterized to the decline in export commodity rats, which considerably reduced investment opportunities in industries, and to the economic recessions during 2015 and 2016, which was intense in Brazil. The two indicators were altered to some extent in the year 2017. However, when the area went back to growth (1.3% of GDP) and metal and oil rates increased. The upward trend in prices increased the return on investments after quite a few years of decline, which also motivated reinvestment of profit, although not sufficient to compensate the decline in Foreign Direct Investment in Oil and Gas sector.

Currently, in states for which information is available, Foreign Direct Investment inflows to the primary are one-third of the figures in the years 2011 and 2012. Alternatively, in the service industry inflows declined by 11%, while in manufacturing they remained steady. Also, in the year, 2016 Foreign Direct Investments were low in most of the countries in Latin America, in the year 2017 Foreign Direct Investment increased in most of the countries, and the slump was deep in Brazil as inflows decreased 9.7%, Chile (decreased 48.1%, and to some extent in Mexico.

Hypothesis: It is assumed that FDI had an impact on Latin American economies concerning employment opportunities and production capacities.

The region’s economy has been making a recovering after many years of recession, and it made some progress in the last year. Although metal and oil prices gained some ground lately, the recession of 2015 and 2016 still have some effects. FDI inflows will possibly be the same as 2017 figures, with 2% margin on either side. Efforts should be made in bringing investments that add to sustainable development and structural shift in the region. Therefore in the light of these figures, FDI is not an indicator of improving production capacity and employment opportunities.

Two questions arise: How can the governments in Latin American countries attract foreign investment? In the next five years will there be more political stability in Latin America.

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Works Cited

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