

Finance 319 Lecture 8

Course Website

<http://www.citi.umich.edu/u/galka/319>

- ◆ Galina Albert Schwartz
- ◆ Department of Finance
- ◆ University of Michigan
- ◆ Business School



Video: what have we learned?

1. Market efficiency. Does it hold?
2. Diversification: What is that and when it works?
3. Risk and return: How do they relate?
4. How does 3. connected to 1.?

How The Really Smart Money Invests: A Brief History of Investing

Investment History

Video: producer's goals

1. Have you noticed any contradictions?
2. How can you explain them?
3. What role does Ken (the market addict) play?
[i.e. why do we see him in the plot?]
4. Producer's goal and his means: what, how & whether the goal was reached successfully?

How The Really Smart Money Invests: A Brief History of Investing

Today's plan: Empirical evidence: to trust or not?

- ◆ short run & long run: how long?
- ◆ Real Income [& neutrality of money]
- ◆ **Real vs Nominal: how precise?**
- ◆ PPP empirical evidence and real life
 - risk management
 - location choice for profit maximization
- ◆ Next time: starting the IRP chapter:
 - forward premium & forward discount
 - covered interest rate arbitrage [covered against what?]

Short run & long run

- ◆ How long does it take to get to a long run equilibrium?
- ◆ Depends on what we are looking
 - price of gasoline
 - stock market prices
 - government bonds prices
 - exchange rate [i.e. dollar price in terms of..]

Real Income

- ◆ Levich, p. 106
- ◆ Question: Is real income a well defined concept?
- ◆ Neutrality of money
 - a definition
 - is neutrality easy to prove or disprove?
 - does it hold?

Empirical problems

- ◆ What are we trying to measure {and why}?
 - Production costs: home and abroad
 - Exchange rate risks
 - » we face them no matter what
 - » have to hedge!

Next Lecture: Interest Rate Parity

- ◆ Interest Rate Parity = IRP
- ◆ To read: **Levich**, Ch. 4 & 5
- ◆ Rogoff, Kenneth, (1996), "The Purchasing Power Parity Puzzle," *Journal of Economic Literature*, Vol. 34, No. 2. , pp. 647-668. (S)