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CHICAGO BOOTH
The Initiative on Global Markets
Our Purpose

The massive global movements of capital, products, and talent in the modern economy have fundamentally changed the nature of business in the 21st century. They have also generated confusion among policymakers and the public.

The University of Chicago Booth School of Business continues its role as a thought leader on how these markets work, their effects, and the way they interact with policies and institutions. The Initiative on Global Markets organizes these efforts. It supports original research by Chicago Booth faculty, prepares our students to make good decisions in a rapidly changing business environment, and fosters an exchange of ideas with policymakers and leading international companies about the biggest issues facing the global economy. The Initiative on Global Markets spans three broad areas: (1) international business, (2) financial markets, and (3) the role of policies and institutions.

Thank You

The Initiative on Global Markets is grateful for the generous support provided by our corporate partner, AQR Capital Management; and by Myron Scholes, MBA ’64, PhD ’70; Eugene Fama, MBA ’63, PhD ’64; Ramsey Frank, ’86; and John Meriwether, ’73.
The Initiative on Global Markets (IGM) supports research on international business, financial markets, and the role of public policies and institutions. We also host distinguished visitors and engage with the public to promote informed debate about how these markets and institutions work, and their effects on issues of importance to the public.

Some of these efforts relate to the financial crisis that struck in 2008. The IGM’s US Monetary Policy Forum—which brings together academic researchers, market economists, and policymakers for an annual gathering in New York—featured a panel discussion this year on unconventional monetary policy and a conference report on macroprudential principles for stress testing. To help policymakers look for ways to lower systemic financial risks, the IGM also arranged a small high-level meeting in Miami in September 2010, in which academics, central bank officials, and senior managers of global financial institutions discussed systemic aspects of financial regulation.

This ongoing attention to the credit crisis, however, is only one part of the IGM’s efforts. During the past year, for example, we sponsored public talks and debates in the Myron Scholes Global Markets Forum—our distinguished speakers series—on the economies of Latin America, budget options for the US, the general lessons that economics can offer to developing countries, and the insights that the Chicago approach can provide into sports, along with crisis-related talks on the governance of the euro area and the role of central clearing in reducing risks from derivatives.
In mid-2011, Chicago Booth faculty members began writing a weekly column for Bloomberg in which they offer views and analysis related to current problems in business and policy. This column on the Bloomberg View website enables our faculty members to share with the public the wide range of practical insights that they have gained by examining important questions at the frontier of research. Public outreach activities such as the Bloomberg columns are part of the IGM’s core mission: fostering better understanding of business and markets worldwide, including the way they interact with public policies and institutions, and their role in shaping the movements of capital, goods, and people that drive so much of modern economic life.

Along with this public mission, the IGM also supports a wide range of research projects and conferences that shed light on important issues affecting global markets and institutions, including research in accounting, economics, and finance. More than 40 members of Chicago Booth’s faculty contribute significantly to the IGM, allowing us to devote substantial intellectual energy to its mission.

This report summarizes all of these efforts, along with our other activities during the past year. It includes descriptions of our conferences, Myron Scholes Forum events, visiting scholars, and recent research projects. In addition, we encourage you to visit our home page at www.chicagobooth.edu/igm/.
Conferences
Scholes Forum
Visiting Fellows
Research
The Initiative on Global Markets organizes and supports conferences for scholars doing high-quality research in their fields. Some of these meetings also draw on the insights of leading practitioners. In 2010–11, the IGM sponsored seven conferences.
The IGM held its fifth annual US Monetary Policy Forum (USMPF) in New York in February 2011. The USMPF brings academic researchers, market economists, and policymakers together. A standing group of academic and private sector economists share rotating responsibility for reporting on a critical medium-term issue confronting the Federal Open Market Committee (FOMC).

The topic of the USMPF’s main report this year was “Stressed Out: Macroprudential Principles for Stress Testing.” David Greenlaw (Morgan Stanley), Anil Kashyap (Chicago Booth), Hyun Song Shin (Princeton University), and Kermit Schoenholtz (NYU Stern) wrote the report, which explores the design of stress tests and the lessons that can be drawn from the previous tests in the United States and Europe. The report begins with a contrast between the historical motivations for stress tests, which relate to the solvency of individual institutions, and the goals of “macroprudential” tests that seek to determine whether the banking system as a whole has the balance sheet capacity to support the economy. The authors propose five principles that should guide macroprudential tests and compare the 2009 US and 2010 European tests to these standards. Neither test seems to have completely alleviated the stresses in the respective banking systems, but the European ones were much less effective. The report concludes with some guidance about what the 2011 European tests will need to do in order to succeed.
President Jeffrey Lacker, Federal Reserve Bank of Richmond and Peter Diamond, institute professor and professor of economics at MIT, presented their views on the report. The discussion was moderated by Stephen Cecchetti, economic adviser and head of the monetary and economic department at the Bank for International Settlements.

Donald Kohn, senior fellow, economic studies, at the Brookings Institution, gave the lunch address, which was on “Challenges for Central Banks.”

The conference ended with a panel discussion on unconventional monetary policy. It featured Charles Bean, deputy governor of the Bank of England, Vítor Constâncio, vice president of the European Central Bank, and Janet Yellen, vice chairman of the Board of Governors of the Federal Reserve. The discussion was moderated by Steve Liesman, CNBC senior economics reporter.

The 17th Annual Empirical Investigations of International Trade conference was held at Chicago Booth from October 15-17, 2010. Fifteen papers were presented by authors from three continents, and keynote addresses were given by Stephen Redding (Princeton University) and Robert Lucas (University of Chicago). More than 60 economists attended the conference.

The papers presented and discussed included research on trade adjustment and productivity in big crises, by Brent Neiman of Chicago Booth; papers on the relation between trade liberalization and labor outcomes, such as the wage skill premium and labor market dynamics; and the relationship between the business cycle and trade in intermediate inputs.

The conference also featured a paper by David Weinstein, of Columbia University, asking “Is New Economic Geography Right? Evidence from Price Data.”

A full program as well as drafts of presented papers can be found at www.freit.org/EIIT/2010/.
The Initiative on Global Markets helped sponsor a conference in London called Regulating Financial Intermediaries: Challenges and Constraints. It was held at the London Business School, on January 21–22, 2011.

The objective of the two-day conference was to bring together leading academics, practitioners, journalists, and policymakers, to discuss recent research on the regulation of financial intermediaries with broader implications for practice and policy. The first day of the conference featured speeches and panel discussion from leading policymakers and practitioners in Europe and the US. The second day of the conference followed an academic format and consisted of presentations of academic papers that are at the frontier of research on the governance and regulation of financial intermediaries.

A highlight of the second day was the lunch speech by Sir John Vickers, chair of the Independent Commission on Banking. He argued that financial institutions deemed “too big to fail” must establish a new system which allows them to “fail safely.” The conference received wide publicity in major media outlets such as the Financial Times, the BBC, and The Telegraph and the speech was covered live by all major television outlets in London.
Twenty-five years ago, Sanford Grossman and Oliver Hart published a seminal paper – “The Costs and the Benefits of Ownership: A Theory of Vertical and Lateral Integration.” In the years that have followed, we have witnessed an explosion of literature on incomplete contracts, in areas as diverse as international trade and finance. To mark the 25th anniversary, therefore, the IGM helped to organize a conference in Brussels in June 2011, to discuss the achievements of this literature and its future directions. The conference featured dinner speeches by both Grossman and Hart. It also featured a panel discussion on incomplete contracts and the boundaries of the firm, by Bengt Holmstrom of MIT, Thomas Hubbard of Northwestern Kellogg, Steve Tadelis of the Haas School of Business, UC Berkeley, and Jean Tirole of the Toulouse School of Economics (the panel was chaired by Luigi Zingales of Chicago Booth). Other panel discussions examined the role that incomplete contracts play in shaping wide-ranging aspects of economic activity. These included panels on incomplete contracts and:

- Corporate finance
- Industrial organization
- International trade
- Public ownership and cooperatives
- Political economy

The conference concluded with a discussion of new directions for research on incomplete contracts.

The goal of the China Economics Summer Institute (CESI) is to enhance economic research on China by helping promising young researchers interact with experienced scholars who know the country well, and to gain insights into important institutional characteristics of China’s economy. The CESI held its third annual conference in Beijing in July 2010, and is quickly becoming recognized as a high-quality gathering for researchers studying China.
In September 2010, the IGM organized a small high-level meeting on the financial crisis. The format, which allowed for in-depth discussion and a free exchange of ideas, emulated a similar gathering that the IGM had arranged in 2009, on “Saving the Financial System.” Participants in the 2010 meeting included Brian Barry, Anil Kashyap, and Luigi Zingales from Chicago Booth, academics from other schools, central bank officials, and senior managers of global financial institutions.

Topics discussed at this meeting included sovereign debt risks and restructuring in Europe, bail in mechanisms, derivatives regulation, central bank monitoring of systemic risks, and the monetary and financial consequences of risky sovereign debt.

In October 2010, the IGM renewed its sponsorship of the Political Economy in the Chicago Area (PECA) conference for the fourth year. The conference was hosted at Northwestern University and cosponsored by the Ford Motor Company Center for Global Citizenship at the Kellogg School of Management and the University of Chicago Harris School of Public Policy’s Program on Political Institutions. The conference is an annual event with the goal of encouraging collaboration across political economy research groups.

The one-day conference brought together academic researchers spanning business schools, law schools, policy schools, and political science and economics departments in the Chicago area. Some of the presenters included: Professor Christian Leuz (Chicago Booth), Professor Luzi Hail (Wharton), Professor Georgy Egorov (Northwestern Kellogg), and Professor Matthew Gentzkow (Chicago Booth).
In the Myron Scholes Global Markets Forum, business leaders, policymakers, and distinguished scholars speak publicly on issues of current interest.

These events take various forms, including discussion panels, political debates, and lectures by individuals. Featured speakers range from members of our faculty to global economic leaders. The talks, usually held at Chicago Booth’s Gleacher Center downtown, are open to the public. They are generously sponsored by Myron Scholes, MBA ’64, PhD ’70.
How the economic lives of citizens living in the world’s poorest countries can be improved is one of the big questions facing humanity today. Robin Burgess talked about how economics can be used to study and influence the development process, how this has changed over time, and whether economics is providing meaningful responses to the growth and development challenges being thrown up across the globe.

One important change in development economics over the past couple of decades, said Burgess, is that there is now more data being collected in many more ways. So rather than just debating theories in an ideological way, economists can now test them and build evidence in ways that “are percolating through to policy.” This process has been aided by economists going into the field to study developing economies directly and to collect data.

Burgess also described the work of the International Growth Centre (IGC)—he is a founder and academic director—in providing evidence-based advice to policymakers in developing countries. The IGC was set up in 2008 with funding from the UK government. But since its researchers give independent advice in response to requests from developing economies, said Burgess, policymakers in those countries can get the answers they need while being accountable to their people.
Sebastian Edwards discussed his book *Left Behind*, explaining why the nations of Latin America have failed to share in the fruits of globalization and highlighting the dangers of the recent turn to economic populism in the region. He detailed the ways Latin American governments have stifled economic development over the years with excessive regulation, currency manipulation, and corruption. He discussed the neoliberal reforms of the early 1990s, which called for the elimination of deficits, lowering of trade barriers, and privatization of inefficient public enterprises. Flawed implementation, however, meant the promised gains of globalization were never felt by the mass of citizens, and growing frustration with stalled progress has led to a resurgence of populism throughout the region, exemplified by the economic policies of Venezuela’s Hugo Chávez. But such measures, Edwards warns, are a recipe for disaster; instead, he argues, the way forward for Latin America lies in further market reforms, more honestly pursued and fairly implemented.

Roger Lowenstein talked about his experiences in researching and writing *The End of Wall Street* (about the 2008 collapse), and offered his perspective on the causes and enduring legacy of the crash, including the recent financial reforms, as well as some thoughts on some of his earlier works, including *When Genius Failed*.

Although the financial crisis that struck in 2008 had complex origins, said Lowenstein, one contributing factor was a changing ethos among participants in financial markets, leading to speculation in risky new asset classes based on reasoning that does not seem sensible.
A panel of three Chicago Booth faculty members discussed choices the United States faces in trying to fix its long-term federal budget problems. The economists explored the tradeoffs involved in adjusting taxes versus changing spending, and provided some principles to use in judging alternative proposals.

One basic trend that they highlighted is that taxes have been fairly stable as a share of GDP while expenditures have increased. Although increasing taxes would be one way to lower the deficit and stabilize the debt-to-GDP ratio, higher taxation would involve deadweight losses, and the economists discussed the potential size of these losses and some implications.

Davis added a brief discussion of the rules imposed on the Congressional Budget Office (CBO) when it makes budget projections. These lead to official CBO figures that often fail to reflect the actual policy options and tradeoffs involved, said Davis, which makes it harder to have a useful public debate about US budget choices.

The three economists also discussed the risks of reaching a tipping point at which the debt-to-GDP ratio would begin to rise much more rapidly. They described some of the assumptions and conditions involved in gauging when the US might risk finding itself in that situation, and debated whether this could happen in the next few decades.
At Chicago Booth, we look at both theory and data to gain insight that either confirms or challenges existing thinking. In a business school, we do this mostly in the context of economics, along with finance, marketing, accounting, and basic business practices. But this approach can lead to novel discoveries in other contexts too.

By taking the Chicago approach with everyday debates about sports, Tobias Moskowitz delivered insights into both the world of sports and the world of business. Rigorous analysis yields insights into the real reasons why home field advantage exists in all sports, for example.

His insights stem from research into a recently published book, *Scorecasting*, in which he teamed up with veteran *Sports Illustrated* writer L. Jon Wertheim to overturn some of the most cherished truisms of sports and reveal the hidden forces that shape how basketball, baseball, football, and hockey games are played, won, and lost.

Ken Griffin discussed the risks to financial system stability that are created by trading arrangements used for most derivative securities. He explained why a reform to these arrangements—using central clearinghouses for over-the-counter derivatives—could be beneficial to most parties buying the derivatives and to overall financial stability.

In centrally cleared markets, clients face dealers, and dealers face a central clearinghouse, which acts as a repository for all the risk transference. The clearinghouse has a very explicit procedure for mutualizing losses in the event that a clearing member defaults. This approach, said Griffin, offers a way to reduce “too-interconnected-to-fail” risks for the financial system and taxpayers, while promoting more open, competitive, and efficient derivatives markets.
Axel Weber discussed the current problems in the euro area, which he described as more of a debt crisis than a currency crisis. Fiscal policy in some member countries has failed to meet the requirements of a currency union, he said. “The financial crisis has focused people’s attention and... it has revealed unsustainable developments in some member countries. They were there before but weren’t seen during the crisis.”

Some short-term measures have been taken in an attempt to stabilize the situation, said Weber. What is now required, he said, is to “focus on the painful long-term adjustment process, as there’s a long to-do list.” One measure he advocated was structural reforms to make euro area economies more flexible and to increase their long-term potential growth.

Weber also said that budget consolidation is required, to improve fiscal sustainability. A third important item on the list, said Weber, was the need to perform stress tests for banks, recapitalizing them where necessary.
Conferences
Scholes Forum
Visiting Fellows
Research
The Initiative on Global Markets sponsors extended visits by prominent faculty from other institutions to contribute to the research environment at Chicago Booth. The IGM hosted 10 visiting fellows in the 2010–11 academic year.
Professor Robin Burgess’ research interests include development economics, public economics, political economy, labor economics, and environmental economics. He has published on a variety of topics: natural disasters, mass media, rural banks, land reform, labor regulation, industrial policy, taxation, poverty, and growth. He is a professor of economics at the London School of Economics, and founder and academic director of the International Growth Centre, which promotes sustainable growth in developing countries by providing demand-led policy advice based on frontier research.

While visiting the IGM, Professor Burgess gave a talk in the Myron Scholes Global Markets Forum on the current state of development economics and the implications for policymakers in developing countries. He also interacted with many members of the Booth faculty, discussing mutual research interests as well as informing faculty members about the ways in which the International Growth Centre is interacting with researchers at the forefront of economics.

Robert Bushman’s research focuses on corporate governance, debt contracting, prudential regulation of banks, managerial incentives, and asset price formation. Bushman is a leading expert on the governance role played by financial accounting information in disciplining the behavior of corporate executives. His recent research examines the role of financial reporting in disciplining the risk taking behavior of bank managers and in impacting the contribution of individual banks to system-wide risk, as well as the role of bank reputation in certifying borrowers’ accounting numbers.

Bushman is the Forensic Accounting Distinguished Professor and Chair of the accounting area at Kenan-Flagler Business School, University of North Carolina at Chapel Hill. During his visit, Professor Bushman worked extensively with several members of the Booth faculty on a variety of research projects. He also attended and participated in a number of research workshops, and met extensively with faculty and PhD students at Chicago Booth.
Barry Eichengreen is an economic historian whose research examines international financial issues, economic policy challenges and the dynamics of crises. He is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley. His book *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* is one of the seminal works on the Great Depression. He has won numerous awards and prizes including Guggenheim and Fulbright Fellowships, a doctor honoris causa from the American University in Paris, and the 2010 Schumpeter Prize from the International Joseph A. Schumpeter Society. He was president of the Economic History Association in the 2010–11 academic year.

During his visit, Professor Eichengreen attended the macro and international workshop and also presented his new research on “The Federal Reserve, the Bank of England, and the Rise of the Dollar as an International Currency, 1914–1939” in that same workshop. In addition, he met with many faculty in the economics and finance groups at Booth as well as faculty from the Department of Economics.

Oliver Hart is the world expert on incomplete contracts. During his stay at Chicago, he gave three lectures that summarized the state of the field. The first lecture reviewed his work from the 1980s and 1990s, while the second and third lectures presented his new work on contracts as reference. This work explores the idea that contracts shape the expectations of the contracting parties, so any variation tends to generate grievance and under-performance. Professor Hart presented experimental evidence supporting this approach. He also discussed the wide implications of this theory for understanding the employment relationship and the nature of the firm in general.
Oleg Itskhoki’s research focuses on international trade and macroeconomics. His work spans various topics, ranging from the effects of trade on labor market inequality and unemployment, to dynamic pricing models and exchange rates and to the choice of the currency of exporting. He has published extensively in top economics journals, including the *American Economic Review*, the *Quarterly Journal of Economics*, *The Review of Economic Studies*, and *Econometrica*. Oleg was visiting Chicago Booth from Princeton where he serves as an assistant professor of economics and international affairs. He received his PhD in economics from Harvard University in 2009. During his visit, he presented his recent work entitled “Labor Market Rigidities, Trade and Unemployment” in the macro/international workshop. He also presented his work on “Durable Goods Pricing” at the informal macro seminar that the junior macro/international faculty from Booth and the Department of Economics run. He attended various seminars and workshops, including the macro/international workshop at Booth and the money and banking workshop in the Department of Economics, and he met regularly with junior and senior faculty at Chicago Booth and the Department of Economics.

Ron Kaniel’s research focuses on theoretical and empirical asset pricing with an emphasis on implications of how incentives of intermediaries in financial markets (such as fund managers) impact portfolio choice decisions and asset prices, and implications of endogenous relative wealth considerations. He has also conducted extensive research on the relation between trading volume and investors’ order flow and subsequent stock returns. Kaniel is a leading financial economist in the area of delegated portfolio management. During his visit, Professor Kaniel presented his recent work entitled “The Delegated Lucas Tree” in the finance workshop. He also attended and participated in a number of research workshops in the business school, and met extensively with both junior and senior faculty at Chicago Booth.
Felix Oberholzer-Gee is the Andreas Andresen Professor of Business Administration in the strategy unit at Harvard Business School. His research and consulting are centered on competitive strategy, international competition, and also nonmarket strategy, a branch of strategic management that studies how companies best work with government and nongovernmental groups. In recent work, he studied how entertainment companies can successfully manage the digital transition.

During his visit at Booth, Professor Oberholzer-Gee worked on two projects, one related to the effects of SEC enforcement activities on foreign companies cross-listed in the United States (this is joint work with Christian Leuz, Joseph Sondheimer Professor of International Economics, Finance, and Accounting at Booth), and a second project commissioned by the US Federal Communications Commission (FCC). In this latter project, the FCC is interested in the effects of its policies on viewpoint diversity in local television news. Professor Oberholzer-Gee attended several workshops and also used his time at Booth to meet with several faculty, in particular those interested in media economics. Finally, he presented a paper on charitable donations in the micro lunch workshop that was attended by a broad group of faculty and PhD students.

Peter Rossi is the James Collins Professor of Marketing, Statistics, and Economics at the UCLA Anderson School of Management. He has done pathbreaking research on quantitative marketing and Bayesian statistical analysis. His work in the area of target marketing presaged many of the developments in targeting today as practiced in electronic couponing and by web-based retailers. His work in data-based pricing and methods for estimation of high-dimensional demand systems influenced the development of analytic pricing tools in use today. He was a member of the Booth faculty for 25 years and was the founding director of the Kilts Center for Marketing.

His previous work with Günter Hitsch and Jean Pierre Dubé was funded by the IGM and during the visit he continued this collaboration. He also met with other Booth faculty in marketing, economics, and finance. He attended the marketing workshop and gave a pair of special lectures that were open to the entire Booth community. The first was
Bayesian instrumental variable estimation and the second was on the Bayesian analysis of aggregate random coefficient demand models.

Laurence van Lent’s most recent work emphasizes the relation between politicians and firms. He has studied how stock ownership by US Congress members affected the government’s decisions during the financial crisis and he is currently investigating the relation between political connections of firms and their credit rating. Van Lent is professor of empirical accounting research at the Center for Economic Research at Tilburg University and editor-elect of the European Accounting Review, the journal of the European Accounting Association.

While at Booth, Professor van Lent presented his paper “Personal Wealth Interests of Politicians and Government Intervention in the Economy: the Bailout of the US Financial Sector.” He also discussed his work with faculty and PhD students as well as participated in the research workshops of the accounting group.

Axel Weber recently completed a seven-year term as the president of Deutsche Bundesbank. While at the Bundesbank, he also was a member of the steering committee of the European Systemic Risk Board and a member of the steering committee of the Financial Stability Board. In addition, he has served as the German Governor of the International Monetary Fund, as a member of the board of directors of the Bank for International Settlements, and as a member of the G7 and the G20 Ministers and Governors. Prior to joining the Bundesbank, he was a professor of international economics at the University of Cologne and a member of the German Council of Economic Experts.

Upon leaving the Bundesbank, he joined Booth as a visiting professor and began the visit as an IGM fellow. Professor Weber participated in the finance brown bag lunch and in the macro and international workshop and met with a number of Booth faculty from economics, finance, and accounting. He also delivered a Myron Scholes Lecture on the “Future of Economic Governance in the Euro Area.” The crowd for that lecture was overflowing and the talk was broadcast live by Reuters.
Conferences
Scholes Forum
Visiting Fellows
Research
FUND MANAGERS, CAREER CONCERNS, AND ASSET PRICE VOLATILITY

We (Guerrier and coauthor Peter Kondor) propose a model where investors hire fund managers to invest either in risky bonds or in riskless assets. Some managers have superior information on the default probability. Looking at the past performance, investors update beliefs on their managers and make firing decisions. This leads to career concerns that affect investment decisions, generating a positive or negative “reputational premium.” For example, when the default probability is high, uninformed managers prefer to invest in riskless assets to reduce the probability of being fired. As the economic and financial conditions change, the reputational premium amplifies the reaction of prices and capital flows.
A MACROPRUDENTIAL APPROACH TO FINANCIAL REGULATION

Many observers have argued the regulatory framework in place prior to the global financial crisis was deficient because it was largely "microprudential" in nature (Crockett, 2000; Borio, Furfine, and Lowe, 2001; Borio, 2003; Kashyap and Stein, 2004; Kashyap, Rajan, and Stein, 2008; Brunnermeier et al., 2009; Bank of England, 2009; French et al., 2010). A microprudential approach is one in which regulation is partial-equilibrium in its conception, and aimed at preventing the costly failure of individual financial institutions. By contrast, a "macroprudential" approach recognizes the importance of general-equilibrium effects, and seeks to safeguard the financial system as a whole.

In the aftermath of the crisis, there seems to be agreement among both academics and policymakers that financial regulation needs to move in a macroprudential direction. According to Federal Reserve Chairman Ben Bernanke (2008): Going forward, a critical question for regulators and supervisors is what their appropriate "field of vision" should be. Under our current system of safety-and-soundness regulation, supervisors often focus on the financial conditions of individual institutions in isolation. An alternative approach, which has been called systemwide or macroprudential oversight, would broaden the mandate of regulators and supervisors to encompass consideration of potential systemic risks and weaknesses as well.
BEST PRICES

We (Kashyap and coauthor Judith Chevalier) explore the role of strategic price discrimination by retailers for price determination and inflation dynamics. We model two types of customers: “loyals” who buy only one brand and do not strategically time purchases, and “shoppers” who seek out low-priced products both across brands and across time. Shoppers always pay the lowest price available, the “best price.” Retailers in this setting optimally choose long periods of constant regular prices punctuated by frequent temporary sales. Supermarket scanner data confirm the model’s predictions: the average price paid is closely approximated by a weighted average of the fixed-weight average list price and the “best price.” In contrast to standard menu cost models, our model implies that sales are an essential part of the price plan and the number and frequency of sales may be an important mechanism for adjustment to shocks. We conclude that our “best price” construct provides a tractable input for constructing price series.

THE MACROPRUDENTIAL TOOLKIT

Most treatments of financial regulation worry about threats to the banking system and the economy from defaults or credit crunches. This paper argues that the recent crisis points to fire sales through capital markets as another source of financial and economic instability. Accounting for fire sales implies several changes to the standard approach. First, if there are three channels of instability, then three regulatory tools are needed to deliver stability. Second, if only a single capital tool and a single liquidity tool are available, then there is a risk that using them pushes activity into the shadow banking system. Third, liquidity requirements on the asset side of bank balance sheets are conceptually different from liquidity requirements on the liability side.

The paper starts with a review of the recent theoretical work on fire sales that form the building blocks for a next generation of models of the financial system. A summary of some evidence suggesting that fire sales were present in the crisis is offered. Next, a general equilibrium framework is introduced to describe a financial system in which default, credit crunches, and fire sales are all possible. The paper concludes with a discussion of the regulatory options and some speculation on how this framework could be extended.
In a world with interest on reserves, the central bank has two distinct tools that it can use to raise the short-term policy rate: it can either increase the interest it pays on reserve balances, or it can reduce the quantity of reserves in the system. We (Kashyap and coauthor Jeremy C. Stein) argue that by using both of these tools together, and by broadening the scope of reserve requirements, the central bank can simultaneously pursue two objectives: 1) it can manage the inflation-output tradeoff using a Taylor-type rule; and 2) it can regulate the externalities created by socially excessive short-term debt issuance on the part of financial intermediaries.
SOVEREIGN WEALTH FUND PORTFOLIOS

Using a novel, hand-collected dataset of sovereign wealth fund (SWF) investments in public equities, private firms, and real estate, we (Morse and coauthor Alexander Dyck) establish what SWF portfolios look like. SWF allocations are balanced across risky asset classes, very home-region biased, and very biased toward certain industries, in particular, toward finance (owning 4.8% of world equity) and transportation, energy, and telecommunication. SWFs invest actively (with control rights) in both public and private sectors, but mainly in these industries in their home regions. We use these allocations to understand better the objectives that drive SWF investment decisions.

We find evidence for financial portfolio investor benchmarking and for hedging of income covariance risk. We introduce and test an industrial planning hypothesis as an alternative objective and find this has considerable explanatory power. We find that both measures to capture financial portfolio and industrial planning objectives together explain 14.4% of SWF portfolio variation. Of this, industrial planning accounts for 45%. There is significant variation in the power of industrial planning objectives across SWFs revealing important heterogeneity in this investor class. Industrial planning helps to explain active ownership, predicting higher ownership stakes.
TRADE ADJUSTMENT AND PRODUCTIVITY IN LARGE CITIES

We (Neiman and coauthor Gita Gopinath) empirically characterize the mechanics of trade adjustment during the Argentine crisis using detailed firm-level customs data covering the universe of import transactions during 1996–2008. Our main findings are as follows: First, the extensive margin defined as the entry and exit of firms or of products (at the country level) plays a small role during the crisis. Second, the sub-extensive margin defined as the churning of inputs within firms plays a sizeable role in aggregate adjustment. This implies that the true increase in input costs exceeds that imputed from conventional price indices. Third, the relative importance of these margins and of overall trade adjustment varies with firm size.

Motivated by these facts, we build a model of trade in intermediate inputs with heterogeneous firms, fixed import costs, and roundabout production to evaluate the channels through which a collapse in imports affects total factor productivity (TFP) in manufacturing. Measured aggregate productivity in the sector depends on within-firm adjustments to the varieties imported as well as the joint distribution of each firm’s technology and the share of imports in its total spending on inputs. We simulate an imported input cost shock and show that these mechanisms can deliver quantitatively significant declines in manufacturing TFP.
The McFadden Act of 1927 was one of the most hotly contested pieces of legislation in US banking history, and its influence was still felt over half a century later. The act was intended to force states to accord the same branching rights to national banks as they accorded to state banks. By uniting the interests of large state and national banks, it also had the potential to expand the number of states that allowed branching. Congressional votes for the act therefore could reflect the strength of various interests in the district for expanded banking competition. We (Rajan and coauthor Rodney Ramcharan) find congressmen in districts in which landholdings were concentrated (suggesting a landed elite), and where the cost of bank credit was high and its availability limited (suggesting limited banking competition and high potential rents), were significantly more likely to oppose the act. The evidence suggests that while the law and the overall regulatory structure can shape the financial system far into the future, they themselves are likely to be shaped by well-organized elites, even in countries with benign political institutions.
The Initiative on Global Markets Corporate Partners Program is designed to build a deeper relationship between the private sector and faculty from the University of Chicago Booth School of Business. Our corporate partner, AQR Capital, supports the research efforts of the world’s best faculty in accounting, economics, and finance on topics of great importance to financial and economic decision-making around the globe, and they foster access between company executives and faculty.

AQR Capital Management is an investment management firm that specializes in using a “disciplined multi-asset, global research process” to achieve long-term success in both investment and risk management. They apply research-driven models as well as good common sense to a broad spectrum of products.