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FINANCE AND ECONOMICS†

The Interrelations of Finance and Economics: Theoretical Perspectives

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It is traditional in a discussion piece to organize the material in one of two ways. The writer can either take a historical perspective and attempt to explain how it is we got where we are today and where we are likely to go from here, or the writer can describe the current state of the art, dwelling on particular points of interest or promise in the prevailing research. Having quite recently done both, I thought I would take a somewhat different approach. I would like to try to briefly describe the main characteristics of a neoclassical theory of finance that captures the essential themes of modern finance and relate these characteristics to the general themes of economics.

Finance uses the modeling framework constructed in economics but, within this scaffolding, finance has taken a different methodological perspective. It is wrong to characterize finance, or financial economics to be formal, as simply another of the specialty areas of economics—not unlike, for example, labor economics or development economics or public finance. While finance is specialized in its focus on the financial markets, the differences between economics and finance only begin there. The principal distinction is one of methodology rather than of focus. If labor markets behaved like financial markets, the theories of finance would be used to study them. Indeed, the line where financial theoretic analysis leaves off and more conventional patterns of economic reasoning begin is an active research issue.

I. Data and Theory

In finance, the data are voluminous and of high quality. We have daily and even intradaily price data on the most important financial markets. Furthermore, the data are generated by processes that make it true transactions data or, at the least, close to that. The quality and the volume of the data subtly alter the reward structure for researchers in finance from that of other areas of economics. There is a premium on modeling close to the data. Which is not to say that there is no interest in the indicative models that are stylistic depictions of economic phenomena, rather than there is a great reward in explaining regularities in the existing data. That, in turn, leads to models whose variables are themselves observables rather than abstractions of classes of observables. There are very few models of securities markets with a variable called "all stocks."

Furthermore, there is a strong and subtle pressure to build models that utilize the data within the financial database. This aids and abets the focus on relative pricing. As financial economists we are concerned with the relation between the prices of different financial assets, rather than with their relation with other economic variables such as wage

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