Stockholm University

Department of Economics

Course name: **Financial Development and Crises**

Course code: **EC7213**

Examiner: **Jonas Vlachos**

Number of credits: **7,5 credits**

Date of exam: **Saturday 3rd December 2016**

Examination time: **3 hours [09:00- 12:00]**

Write your identification number on each paper sheet (the number stated in the upper right hand corner on your exam cover).

Explain notions/concepts and symbols. If you think that a question is vaguely formulated, specify the conditions used for solving it. Only legible exams will be marked. **No aids are allowed.**

The exam consists of 4 questions. You have a maximum of 30 credits from the term paper and on the exam, there is a total of 70 points that can be awarded. For the grade E 45 points are required, for D 50 points, C 60 points, B 75 points and A 90 points.

Your results will be made available on your "My Studies" account **(**www.mitt.su.se) on 15 working days after the examination at the latest.

Good luck!

Question 1. (20 points)

i) Firm raise very little capital through stock markets but much attention is still given to stock market developments. Why can it be useful for management to have shares traded at the stock market even though no, or very little, money is raised that way?
ii) What further service does the secondary market provide and why is this useful?
iii) Assume that there are two assets, A and B, in the market. What happens to the price of asset A if asset B becomes more liquid while nothing happens to asset A?
iv) Explain briefly what the main insight from the weak version of the efficient market hypothesis is.
v) Explain briefly the concept of “Private benefits of control”.

Question 2 (10 points).

The resolution of the Swedish banking crisis in the early 1990's has almost become a "textbook model" of how to resolve such crises. Which were the three main elements in the policies implemented in Sweden during the crisis?

Question 3.(20 points)

a) Explain briefly the difference between a liquidity problems and solvency problems facing a bank.

b) Explain how liquidity problems can turn into a solvency problem.

c) Explain how fears of solvency problems can turn into a liquidity problem.

d) What are the most basic measures used to prevent banks from running into liquidity problems and to help them if they do?

e) What is the main risk that these facilities create?

f) In a column in the Financial Times, Alan Greenspan, former head of the Federal Reserve Bank, discusses capital requirements. He states that “The buffer may encompass expensive building materials whose earthquake flexibility is needed for only a minute or two every century, or an extensive stock of vaccines for a feared epidemic that may never occur. Any excess bank equity capital also would constitute a buffer that is not otherwise available to finance productivity-enhancing capital investment.” Briefly explain why you agree/do not not agree with Mr. Greenspan here.

Question 4. (20 points)

i) A lender can potentially compensate for the riskiness of an investment by raising the interest rate charged. Explain why this may not be possible in the presence of asymmetric information between borrower and lender.
ii) Not so long ago, many investment banks were partnerships with unlimited personal liability. Nowadays, they are usually listed on the stock market which means that the owners have limited liability. Explain why such a shift in industry structure can induce so called *risk shifting* into riskier assets.
iii) Explain why banks that are insolvent do not have an incentive to reveal this to the public.
iv) Why can a delay in finding out that a bank is insolvent increase the cost of the ultimate bankruptcy. Which actors will bear these costs?