



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: **Sunday 23rd October 2016**

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

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

Use one cover sheet per question. 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. Short answers (12 credits in total, 1.5 per correct answer)

- i) A bank's balance sheet
 - a) shows that total assets equal total liabilities plus equity capital.
 - b) lists sources and uses of bank funds.
 - c) indicates whether or not the bank is profitable.
 - d) does all of the above.
 - e) does only A and B of the above.

- ii) Rules used to predict movements in stock prices based on past patterns are, according to the efficient markets hypothesis
 - a) a waste of time
 - b) profitably employed by all financial analysts.
 - c) the most efficient rules to employ
 - d) consistent with the random walk hypothesis

- iii) The secondary market is useful because it
 - a) Provides liquidity for investors
 - b) Provides a price for the assets traded
 - c) Allows firms to raise capital
 - d) All of the above
 - e) A) and B) above
 - f) None of the above

- iv) When we refer to the shadow banking system, what are we talking about?
 - a) hedge funds, investment banks, and other nonbank financial firms that supply liquidity
 - b) the "underground" banking system used for illegal activities
 - c) the subsidiaries of depository institutions
 - d) none of the above

- v) The efficient markets hypothesis is weakened by evidence that
 - a) stock prices tend to follow a random walk.
 - b) stock prices are more volatile than fluctuations in their fundamental values can explain.
 - c) technical analysis does not outperform the overall market.
 - d) an investment adviser's past success or failure at picking stocks does not predict his or her future performance.

- vi) Which of the following statements is false?
- a) A bank's assets are its uses of funds.
 - b) A bank issues liabilities to acquire funds
 - c) A bank's assets provide the bank with income.
 - d) Bank capital is an asset on the bank balance sheet.
- vii) For a given return on assets, the lower is bank capital,
- a) the lower is the return for the owners of the bank.
 - b) the higher is the return for the owners of the bank.
 - c) the lower is the credit risk for the owners of the bank
 - d) both A and C of the above
- viii) Which of the following statements is false?
- a) A bank's assets are its uses of funds.
 - b) A bank issues liabilities to acquire funds
 - c) A bank's assets provide the bank with income.
 - d) Bank capital is an asset on the bank balance sheet.

Question 2. (20 credits)

- a. Explain the Diamond-Dybvig model. In your explanation, clearly outline the assumptions of the model. Furthermore, state a mathematical condition for when the simple Diamond-Dybvig model discussed in class predicts a bank run, and when it does not predict a bank run.

- b. Give at least three policy suggestions designed to minimize the risk of a bank run. Explain their advantages and disadvantages.

- c. Name a subset of the financial sector that includes non-depository financial institutions that are prone to bank runs. Can you explain why these institutions are prone to bank runs using the Diamond-Dybvig model?

Question 3. (20 credits)

- a. Explain why more bank equity may increase the stability of the financial system.

- b. Are there any implications of higher capital requirements for economic growth, if we abstract from their potential impact on financial stability?

- c. An argument against higher capital requirements is that bank equity is expensive. Discuss in what sense this argument is correct and in what sense it is not.

- d. Do you think that banks would hold the socially optimal amount of bank equity if we could get rid of the distortions directly imposed by the government?

Question 4. (18 credits)

A common policy suggestion for improved efficiency is increased transparency.

- a. In the light of the model/s presented in this course, discuss how more transparency can improve the efficiency of financial markets.

- b. Can you link any empirical patterns in from the “growth and finance” literature that are consistent with the view that transparency is beneficial?

- c. Can you think of instances where the opposite is true, that is where less transparency can improve how well financial markets function?