



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: Tuesday 27 October 2015

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 5 questions. There are 70 points in total and a maximum of 30 points have been awarded for the term paper. 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 November 17 at the latest.

Good luck!

Question 1 (20)

- A) Draw a simplified version of a bank's balance sheet containing: Equity, Reserves, Short- and Long Term Debt, The bank's main buildings, Deposits, and Investments.
- B) Assume that reserve requirements are binding so that banks only keep as much reserves as they have to. Further assume that these requirements initially are at 10 percent and that they are dropped to 5 percent. How much is credit expanded?
- C) Former head of the US Fed Alan Greenspan once said "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". What is your take on this argument?
- D) Theoretically explain the reason that makes banks both useful and fragile. Do not just provide equations but also the intuition behind what you show, please.
- E) What tools are commonly used to reduce the fragility of the banking sector described in C)? What are their strengths and weaknesses?
- F) Consider a situation where a large bank's assets are worth less than its liabilities. If you were the policy maker in charge of dealing with the problem, what would you do? Motivate your answer!

Question 2 (15)

- A) Discuss the relationship between central bank policy and the buildup and the “popping” of asset price bubbles.
- B) Imagine that you were a policy maker in an economy where private credit has grown for, say, 10 percent per year the last seven years. Most of this credit has gone into housing so the housing prices have almost doubled over this period. What policy options would you contemplate and why?
- C) Say that you don't do anything and all over sudden you have a massive wave of bank failures on your hand. You first realize that the money supply has shrunk dramatically, but also that output has decreased even more than your standard monetary macro models would predict. Why could this be the case?

Question 3 (15)

- A) Consider that you are a bank manager lending to various projects, some of which are riskier than others. How would you price your loans?
- B) Now assume that you cannot tell if one project is riskier than another. Sketch a model showing the implications of this scenario. Don't forget to provide the intuition behind the results of model that you sketch.
- C) Given the above, discuss briefly why legal enforcement and "social capital" can be useful to financial development.

Question 4 (10)

- A) What were, in your opinion, the major design problems of the Eurozone leading up to the euro crisis the last couple of years?
- B) Have any of these design problems been dealt with?

Question 5 (10)

- A) What is in your opinion the strongest argument in favor of “the efficient market hypothesis”?
- B) What is in your opinion the strongest argument in against “the efficient market hypothesis”?