Econ 497 Professor Ickes

Economics of the Financial Crisis Spring 2012

Review Questions III

1. Explain how a worldwide shortage of safe assets drove securitization? Why was there a worldwide shortage of safe assets? Why did this cause growth in the demand for securitized products? Explain.

2. If stock prices are high relative to dividends this could forecast higher dividend growth in the future. Is this consistent with efficient markets? Explain. Several decades of empirical work suggest, however, that high price-earnings ratios only forecast low returns. How is this possible? Explain. What does this have to say about situations when house prices are high relative to rents? Explain.

3. What is a normal accident? What are the critical features that describe a normal accident? How does a normal accident differe from conventional accidents? Is it useful to think of the financial crisis as a normal accident? Explain. Are there any limitations to the normal accident interpretation?

4. If managerial incentives are convex what are the implications for investment choice? Explain. How does the convexity of managerial incentives play a role in the financial crisis?

5. Explain the economics of fire sales. What are the salient features of fire sales that are relevant for studying the financial crisis? Why aren't fire sales self-correcting? Explain.

6. Losses from subprime mortgages were on the order of magnitude of a small daily loss in equity prices. How could these losses drive a financial crisis?

7. Is securitization consistent with the Modigliani-Miller theorem? Explain. What does this tell us about the nature of the financial transactions concerned.

8. Explain the role of leverage in the financial crisis.

9. Why are systematic risks more important for mortgage backed securities than for conventional corporate bonds? Explain.

10. What is repo? Explain how this works. Why are senior tranches of asset-backed securities likely to be used as collateral for repo transactions?
    (a) When the ABX indices began publishing how did this impact the repo market?
    (b) What vulnerabilities did investment banks face that financed their operations with repo? Explain.

11. What is a haircut? Why did haircuts rise during 2007 and 2008? What impact did the rise in haircuts have?.

12. What are synthetic CDOs? How do they relate to conventional CDOs? What does the emergence of synthetic CDOs signify about the financial markets? Explain.

13. "If people on Wall Street had just believed in efficient markets most of the problems that led to the financial crisis would have been avoided." Do you agree or disagree? Explain.

14. "The big problem with financial markets is the difficulty of shorting." Do you agree or disagree? Explain.

15. What are the critical factors that underlay the European Debt crisis?

    (a) What defects, if any, in the design of the common currency have led to the crisis that Europe faces now?

    (b) Why is it more difficult for a group of countries to respond than for a single country? Explain.

16. To what extent was the European Debt Crisis imported from the US? To what extent did European problems contribute to the US Financial Crisis. Explain.

17. Discuss the applicability of This Time is Different Syndrome to the financial crisis of 2008. Discuss the applicability of TTID to the European Debt Crisis.