Study Guide for Second Midterm

1. Bank runs.
   a) Explain how bank runs can arise in the model explained by Diamond.
   b) How can bank runs lead to recessions?
   c) Explain how the following interventions can be used to end or avoid bank runs: central bank lending to banks, convertibility suspension and deposit insurance.

2. Financial crises
   a) Explain the role of leverage in the shadow banking system.
   b) Why did a reversal in the rise of housing prices in the US lead to a deleveraging crisis? What was the role of mortgage securitization in the crisis?
   c) What is a fire sale and how does it compound a decline in asset values?

3. Consequences of a financial crisis
   a) Explain how a credit crisis can lead to a recession.
   b) Why might long-term interest rates rise even though the short-term policy interest rate declines in a crisis?
   c) Why might banks accumulate reserve rather than make loans when the central bank increases the money supply in a crisis? (Why might an expansionary monetary policy still stem a deeper crisis?)

4. The response to the crisis
   a) What was the purpose of extraordinary measures by the Fed in the crisis? (Use an example or two.)
   b) What is the importance of whether a financial intermediary is illiquid or insolvent for central bank or treasury support?
   c) Many commentators on financial crises emphasize moral hazard in bailouts. In this crisis, some have also criticized the Fed for inconsistency in its handling of runs on investment banks. Do you think concerns over moral hazard played a role in these decisions?
   d) Discuss the case for central bank intervention or explain its purpose.

5. More on recessions
   a) Why might we observe a sharp drop in investment but not consumption in this recession?
   b) In a recession, firm earnings fall. How might this be compounded by a reduction in credit to firms caused by a reduction in internal financial resources of firms? (This is about the financial accelerator, or agency model, of credit.)
   c) The dominant argument for why the recession following the crash of 1929 developed into a depression concerns monetary policy. Explain this argument.