Study Questions No. 2 (January 26, 2011)
Economics 130
Winter 2012

These key terms and questions are designed to help you in your understanding of the material covered in class and in the textbook.

**Key terms:**

“Classical” theory of asset prices
Gordon growth model of stock prices
Bubbles
Rate of return versus yield to maturity
Ex post versus ex ante real interest rates
Margin requirements
High yield spread
Inverted yield curve
Tax treatment of municipal bonds—impact on yields
Loanable funds model of interest rate determination
Liquidity preference model of interest rates—connection to LM curve, and IS/LM model;
Call versus put option
Hedge fund
IPO
OTC
Modigliani-Miller theorem
Segmented markets theory of interest rates
Rational expectations
Efficient markets theory
Gordon growth model of asset valuation
Asymmetric Information
Lemon’s Problem
Adverse Selection
Moral Hazard in Equity Markets
Moral Hazard in Debt Contracts
Restrictive Covenants on Debt Contracts
Free-rider problem
Conflicts-of-Interest
Financial liberalization
CDOs
CDS
Sub-prime mortgages
Securitization
MBS
Leverage
Prudential supervision
Collateral
Covenant
Principal-agent problem

Questions:

1. What effect would reducing income tax rates have on the interest rates of municipal bonds? Would interest rates of Treasury securities be affected, and if so, how?

2. After careful analysis, you have determined that a firm’s dividend should grow at 7% on average in the foreseeable future. The firm’s last dividend was $3. Compute the current price of this stock, assuming the required return is 18%.

3. “Forecasters’ predictions of inflation are notoriously inaccurate, so their expectations of inflation cannot be rational.” If this statement true, false, or uncertain? Explain your answer.

4. “If stock prices did not follow a random walk, there would be unexploited profit opportunities in the market.” Is this statement true, false, or uncertain? Explain your answer.

5. If the public expects a corporation to lose $5 per share this quarter and it actually loses $4, which is still the largest loss in the history of the company, what does the efficient market hypothesis say will happen to the price of the stock when the $4 loss is announced?

6. If you read in the Wall Street Journal that the “smart money” on Wall Street expect stock prices to fall, should you follow that lead and sell all your stocks?

7. Can a person with rational expectations expect the price of a share of Google to rise by 10% in the next month?

8. How might behavioral finance explain bubbles and crashes in stock markets?

9. Why is the Classical Model of Asset Valuation difficult to test? Why might it be consistent with virtually every rise of fall in stock prices?

10. The yield curve in 1981 was inverted and in 2011 it is upward sloping. What does this imply about the future short term interest rates? How are these two different yield curves related to monetary policy?

11. How did the following factors contribute to the U.S. subprime financial crisis? CDOs, conflicts of interest of the credit rating agencies, the “originate-to-distribute” model of mortgage lending, moral hazard in investment banks, sub-prime, reduced supervision of financial industry. (Hint: see article on credit rating agencies).

12. How did financial deregulation lead to the financial boom and bust in Iceland?

13. How did speculation in real estate markets lead to a boom and bust in Ireland?
14. What is the Sarbannes-Oxley Act of 2002? What scandal was this legislation responding to? What does it attempt to accomplish?

15. What are restrictive covenants in debt contracts? What basic problem in finance do restrictive covenants attempt to address?

16. Questions 7, 8 and 9 on page 218-19 of textbook.

17. Questions 1, 2, 3, 4, 6, 10 on pages 154-155 of textbook.

18. Questions 1, 6, and 9 on pages 119-120 of textbook.