**TCHE 303 – MONEY AND BANKING**

**TUTORIAL 7**

1. How can the bursting of an asset-price bubble in the stock market help trigger a financial crisis? **Bùng nổ giá asset -> stock prices fall -> net worth falls -> value of collaterals fall -> risk rises -> tighten lending policy -> financial crisis**
2. What impact do declining price levels have on lending by financial institutions? **Price level falls -> net worth falls -> value of collaterals fall -> risk rises -> tighten lending policy -> financial crisis**
3. How can a decline in real estate prices cause deleveraging and a decline in lending? **Giá bđs giảm -> value of coll falls -> risk rise -> loan losses -> a decline in net worth abd a deterioration in the balance sheet -> deleveraging**
4. How does a deterioration in balance sheets of financial institutions and the simultaneous failures of these institutions cause a decline in economic activity? **They will have fewer resources to lend, and lending will decline. The contraction in lending then leads to a decline in investment spending, which slows economic activity.**
5. How does a general increase in uncertainty as a result of a failure of a major financial institution lead to an increase in adverse selection and moral hazard problems? **The high levels of uncertainty make it difficult for the lenders to distinguish bad credit risk from good credit risk due to the difficulty of obtaining information about a borrower. This ultimately causes strain in lending and borrowing. The inability of financial institutions to find out about the creditworthiness of a borrower causes adverse selection. At the same time, when a borrower fails to disclose information about their creditworthiness, making them acquire a loan without the lender having credible details on them causes a moral hazard.**
6. What is a credit spread? **The difference between interest rates on c-cbonds and Treasury bonds of the same maturity.** Why do credit spreads rise significantly during a financial crisis? **Credit spreads rise during financial crisis because at that time it was hard to judge the riskiness of corporate borrowers and weaken the ability of the markets to channel funds to borrowers with productive investment opportunities**
7. What causes bank panics to occur?
8. Why do bank panics worsen asymmetric information problems in credit markets?
9. How does the concept of asymmetric information help to define a financial crisis?
10. How can financial innovation lead to financial crises?
11. What role does weak financial regulation and supervision play in causing financial crises? **Financial institutions will take on excessive risk -> when it happens, this cause a large deterioration in their balance sheets -> cut back lending, economic activities decline**
12. The Great Depression of 1930 and the financial crises of 2007–2009 have some similarities and some differences. Compare and contrast the two economic crises.

* **Similarities: *Both were preceded by asset prices boom. Credit spreads widened, the availability of credit shrank and economic activities sharply declined. They both had profound impacts on the global economy and led to significant changes in economic policy and regulation.***
* **Differences:** ***The sources of asset-price boom***
* **The GD:** Stock market crash due to the rising interest rate, then asset-price declined, bank failures;
* **The FC:** The bursting of the United States housing bubble, subprime mortgage crisis, and the subsequent contagion effects on the global financial system.

1. What do you think prevented the financial crisis of 2007–2009 from becoming a depression?
2. What technological innovations led to the development of the subprime mortgage market? **The use of data mining to give households numerical credit scores that can be used to predict defaults and the use of computer technology to bundle together many small mortgage loans and cheaply package them into securities. Together both enable the origination of subprime mortgages, which then can be sold off as securities.**
3. Why is the originate-to-distribute business model subject to the principal–agent problem?
4. “Financial engineering always leads to a more efficient financial system.” Is this statement true, false, or uncertain?
5. How did a decline in housing prices help trigger the subprime financial crisis that began in 2007?
6. What role did the shadow banking system play in the 2007–2009 financial crisis?
7. When can a decline in the value of a country’s currency exacerbate adverse selection and moral hazard problems? Why?
8. How has the European sovereign debt crisis led to higher borrowing costs for governments
9. . What are the two basic causes of financial crises in emerging market economies?
10. Why might financial liberalization and globalization lead to financial crises in emerging market economies? **Financial liberalization without proper regulatory and supervisory measures can lead to excessive risk-taking, poor lending standards, and the accumulation of unsustainable debt. These vulnerabilities can magnify the impact of external shocks and increase the likelihood of financial crises.**
11. Why might severe fiscal imbalances lead to financial crises in emerging market economies? **Gov spending > gov revenue, budget deficit**
12. What other factors can initiate financial crises in emerging market economies?
13. What events can ignite a currency crisis? **Speculative Attacks: Speculators betting against a currency can initiate a currency crisis. They may sell large amounts of the currency, creating a downward pressure on its value. As more people start selling the currency, it can lead to a self-fulfilling prophecy and a rapid depreciation.**
14. Why do currency crises make financial crises in emerging market economies even more severe? **Currency crisis makes e down leading to NX down, high inflation, foreign debt increase in value, raise interest rate -> do not have enough money to pay back, the economy, giá trị đồng tiền nội địa giảm, banking crisis**
15. How did the financial crises in South Korea and Argentina affect aggregate demand, short-run aggregate supply, and output and inflation in these countries? **FC in SK leaded to AD decrease as high price level, tax and interest rate increase due to high inflation, AS fell because các dự án hạ tầng sản xuất ngưng trệ do khủng hoảng, không đủ tiền. FC in Arg leaded to a banking, debt, currency crisis => fall in GDP, high unemployment, low AD&AS, hyper inflation**
16. Why might emerging market economies want to implement financial liberalization and globalization gradually rather than all at once? **Enforcing financial liberalization and globalization needs plenty of adjustments in the emerging demands. Financial liberalization induces instabilities in the economic markets of the emerging markets. Emerging markets require to create organizations, regulatory bodies, market spectators, etc.**
17. What role does weak financial regulation and supervision play in causing financial crises? **Financial institutions take on excessive risk when the market discipline is weakened -> when these loans become bad debt, there will be a deterioration in the bank balance sheet, => cut back lending, economy do not work efficiently -> financial crisis**
18. Why do debt deflations occur in advanced countries but not in emerging-market countries?
19. How can opening up to capital flows from abroad lead to a financial crisis? **Capital inflows rise -> NCO down -> e rises -> exports less competitive -> trade deficit -> economic unbalance -> capital flight -> e down -> DC depreciation -> unable to pay foreign debt -> crisis hoặc If the capital inflows are too rapid or excessive, they can lead to asset bubbles and overvaluation of domestic assets, such as real estate or stocks. When these bubbles burst or when investor sentiment changes, it can trigger a financial crisis.**
20. Why does the twin crisis phenomenon of currency and banking crises occur in emerging-market countries? **Currency crisis – currency devaluation – reduce profit capability of debtors – cannot pay back the debt on time – the loan turns into bad debt – deterioration of the bank balance sheet – bank insolvency – bank run – bank contagion – banking crisis**
21. How can a currency crisis lead to higher interest rates? **Currency crisis could result in decline in exchange rate, thus, inflation rate increases. To fight the crisis, the Central Bank must reduce the money supply, leading to increased domestics currency demand, thus, higher interest rate.**
22. What key factors trigger speculative attacks leading to currency crises in emerging market countries? **The deterioration in bank balance sheets and severe fiscal imbalances are the key factors. To counter a speculative attack, a country might try to raise interest rates. Raising interest rates, however, would worsen the problem of banks that are already in trouble. Speculators recognize this and seize the opportunity. When there are severe fiscal imbalances, there is concern that government debt will not be paid back. Funds are pulled out of the country and domestic currency is sold leading to a decline in the value of the domestic currency. Speculators will once again seize the opportunity.**