§ 2: Problems

1) What is finance? Bodie/Merton (2000), p. 2

2) What are the distinctive features of financial decisions? Bodie/Merton (2000), p. 2

3) What is the ultimate objective of the financial system? How does it contribute to this goal? Bodie/Merton (2000), pp 2, 24

4) Financial decisions of households:

    a) To start with, explain why households hold a special position in finance. Bodie/Merton (2000), p. 2

    b) What are the four types of financial decisions of households? Bodie/Merton (2000), pp 5 - 7

5) Financial decisions of firms

    a) From what perspective does finance view the behaviour of firms? Bodie/Merton (2000), p. 5

    b) What is the primary function of firms? Bodie/Merton (2000), p. 6

    c) Explain the two types of capital that firms deal with. Bodie/Merton (2000), p. 6

    d) What is the first decision any firm has to take? Why is this decision related to finance? Bodie/Merton (2000), p. 6

    e) Name and elaborate on the three areas of financial decision making that follow. Bodie/Merton (2000), pp 6n

6) Effiency:

   a) When is an allocation of resources called “efficient”?

   b) When is a distribution of consumption goods called “efficient”?

   c) What is meant by “efficiency” of the exchange process? Bodie/ Merton (2000), p. 27

7) Consider a person A who wants to sell a book and buy a shirt of equal value.

   a) Suppose there is no generally accepted means of payment. Please explain how A can affect the trade …

      - … by way of the “double co-incidence of wants”

      - … by establishing a “chain of exchanges”.

   b) What is the problem in a)?

   c) How does a generally accepted means of payment facilitate the trade?

8) What properties should a generally accepted means of payment have in order to reduce the transaction costs of the exchange process? Please illustrate your explanations by the following example: you sell your car in Hamburg and use the proceeds for purchases of clothing, bread and beer in Siegen and in Frankfurt.

9) How must the payment system be organized such that transactions are also facilitated across borders, i. e. between residents of different areas of legislation? What is the minimal requirement, what would be optimal?

10) How should the financial system support efficient risk management? Baldwin/Wyplosz (2009), pp 550n [2006, pp 429 n]; Bodie/Merton (2000), p. 27. Illustrate your answer by the example of a share.

11) The following tables are taken from European Central Bank (2011), pp 46 – 52:

http://www.ecb.int/pub/pdf/other/monetarypolicy2011en.pdf?ad9f4122036a49ed19ac83de469040d9

They show data for important financial assets for the euro area, the USA and Japan. Can you find evidence to support the hypothesis that the USA have a more market-based financial system in comparison to the euro area which has a more bank-based system?

Table 2.8 Amounts outstanding for debt securities denominated in national currency issued by residents in the euro area, the United States and Japan at the end of 2009

(as a percentage of GDP)

	Total	Issued by financial corporations	Issued by non-financial corporations	Issued by general government
Euro area	154.6	81.8	7.8	64.9
United States	175.8	89.8	19.5	66.5
Japan	224.8	21.1	15.3	188.2

Table 2.9 Stock market capitalisation in the euro area, the United States and Japan

(end of year; as a percentage of GDP)

	1990	1995	1998	2000	2002	2006	2007	2008	2009
Euro area	21	27	63	86	50	80	84	38	55
United States	54	93	144	153	104	146	142	81	106
Japan	97	67	63	68	53	106	99	64	65

Table 2.13 Bank deposits and loans in the euro area, the United States and Japan at the end of 2009

(as a percentage of GDP)

	Bank deposit liabilities[1]	Bank loans	Bank loans to non-financial corporations
Euro area	131.9	141.5	52.4
United States[2]	63.7	55.6	22.0
Japan	215.2	145.3	47.4

Sources: Euro area accounts (ECB); Flow of Funds (US Federal Reserve System); Financial Accounts (Bank of Japan).
1) Consolidated (i.e. excluding estimated intra bank deposits).
2) US banks comprise commercial banks, savings institutions and credit unions.

The following questions 12) – 14) are based on Baldwin/Wyplosz (2009), pp 552n [2006, p. 431]

12) Scale economies

a) What are scale economies?

b) Why are there scale economies in the financial sector?

c) Please name strategies of the financial system to benefit from scale economies.

13) What is meant by “network externalities” in the financial system?

14) What is meant by “asymmetric information” in the financial system? What are its potential consequences?