FINANCIAL MARKETS AND DECISIONS II

ECONOMICS BEE 3034 2010

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GENERAL REFERENCES

- J. Tirole, *The Theory of Corporate Finance*, MIT Press, 2005.
- G. M. Constantinides (Editor), et al. *Handbook of the Economics of Finance*, North Holland Amsterdam.
  - Very expensive at £150, but worth buying if you are wealthy.
- P. Milgrom and J. Roberts, *Economics, Organization and Management*, Prentice Hall 1992.
  - Currently out of print but worth buying if you can find a second-hand copy.

Method of Assessment Two hour written examination 100%.

COURSE ORGANISATION The course consists of 20 hours of lectures.

COURSE OUTLINE AND READING LIST (provisional)

1. **The Modigliani-Miller Theorems** The financial structure of the firm, choice between debt and equity financing, dividend policy, effect of taxes.
   - ◇*Modigliani, F. and M. Miller, (1958), "The cost of capital and the theory of investment", *American Economic Review,* 48, 261-297.
   - Miller, M., (1988), "The Modigliani-Miller Propositions After Thirty Years." *Journal of Economic Perspectives,* 2, 99-120.
   - Tirole Ch. 2.
   - *Milgrom and Roberts, Ch.14.
   - ◇Myers, S.C. (2001), "Capital Structure", *Journal of Economic Perspectives,* 15, 81-102.
   - Allen, F. and R. Michaely, (2003), 'Payout Policy', in G. M. Constantinides (Editor), et al. *Handbook of the Economics of Finance*, North Holland Amsterdam.
2. **The Market for Lemons** Analysis of a simple model of a market with asymmetric information.
   - ◇*Akerlof, G.A. (1970) 'The market for "lemons": qualitative uncertainty and the market mechanism', *Quarterly Journal of Economics*, 84: 488-500.
   - Milgrom and Roberts pp.149-154.
   - *Kreps, *A Course in Microeconomic Theory,* pp 625-629.
3. **Moral Hazard and Incentives** Moral hazard and incentive contracts, the informativeness principle, the incentive intensity principle and the monitoring intensity principle.

- *McMillan, J. *Games Strategies and Managers*, Oxford University Press, Chs. 8,9.
- *Milgrom and Roberts Ch.7.

4. **Incentive effects of Debt and Equity** Effect of financing on incentives to supply effort and avoid bankruptcy. Past debt reduces the incentive for future investment.

   - *Milgrom and Roberts, Ch.15.
   - Tirole Ch. 3.
   - Myers, S., (1977),'Financing of corporations', in G. M. Constantinides (Editor), et al. *Handbook of the Economics of Finance*, North Holland Amsterdam.
   - ♢Myers, S., (1977), "Determinants of Corporate Borrowing" *Journal of Financial Economics,* 5, 147-175.
   - Stein, J.C. (2001) 'Agency, Information and Corporate Investment', in G. M. Constantinides (Editor), et al. *Handbook of the Economics of Finance*, North Holland Amsterdam.

5. **Adverse Selection and the Debt-Equity Ratio** Financial signalling, models, the implications for investment, adverse selection and investment.

   - Tirole Ch. 6.
   - *Milgrom and Roberts, Ch.15.
   - ♢*Ross, S. (1977), "The Determination of Financial Structure: The Incentive Signalling Approach," *Bell Journal of Economics*, 8, 23-40.
   - *Myers, S.C. and N.S. Majluf, (1984), "Corporate Financing and Investment Decisions when Firms have Information that Investors do not have", *Journal of Financial Economics,* 13, 187-221.
   - Myers, S.C. (2001), "Capital Structure", *Journal of Economic Perspectives,* 15, 81-102.
   - ♢Leland, H. and D. Pyle (1977), "Informational Asymmetries, Financial Structure and Financial Intermediation", *Journal of Finance*, 32, 371-387.

6. **Takeovers and Auctions** Common value auctions, the winner's curse, application to takeovers, the effect of toeholds.

   - *McMillan, *Games Strategies and Managers*, OUP. 1992., Ch.11.
   - *♡Klemperer, P., (1998), "Auctions with Almost Common Values: The 'Wallet Game' and its Applications" *European Economic Review,* 42, 757-69.
   - *♢Roll, R. (1986), "The Hubris Hypothesis of Corporate Takeovers" *Journal of Business*, 59, 197-216.
   - ♢♡Bulow, J., M. Haung and P. Klemperer, (1999), "Toeholds and Takeovers", *Journal of Political Economy,* 107, 427-4.

The books on the reading list should be available in the short loan section of the library. A selection of readings has been provided for each topic to avoid pressure on library resources.
TEXTBOOK PURCHASE As can be seen there is no single textbook which covers all the material. The most useful book to buy would be Tirole.

* Denotes essential reading

♢ article available on-line from `www.jstor.ac.uk.`

♡ article available on-line from `http://www.paulklemperer.org/index.htm` (This site also contains some additional material on auctions.)

The course web site which contains copies of handouts, links to some articles and books, etc. can be found at `http://www.people.ex.ac.uk/dk210/fmd--II-09.html`

(Note this contains more information than the SOBE web-site.)

for Be familiar with the market Financial financing environment in which Instruments hedging takes place Part II Know how projects affect Know how to value the Know how to value a Determine the proper mix of the risk of the firm: financial instruments hedging instrument asset classes Valuing â€¢ Individual projects considered for financing Financial â€¢ Acquisitions Derive a proper mix of individual assets Assets.Â decisions Structure Know how financing affects real investment decisions Know how financing affects operating decisions Part Financial market stability IV. Stable exchange rates V. Stable interest rates Which of the following is true about the relative weight placed on these goals? I, II, and III are given greater weight than IV and V. Sustainable growth refers to growth in.. potential output from growth in inputs.Â As inflation expectations inform firms' pricing and wage decisions, stabilizing inflation expectations around 2 percent prevents actual inflation from deviating too far from this level for long, thus helping the achieve the goal of price stability. The European monetary union and the European Central Bank (ECB) were formed with the idea that _ was the primary problem faced by European economies. InFinancial Decisions and Markets, John Campbell, one of the field's most respected authorities, provides a broad graduate-level overview of asset pricing. He introduces students to leading theories of portfolio choice, their implications for asset prices, and empirical patterns of risk and return in financial markets.Â Part II Intertemporal Portfolio Choice and Asset Pricing 5 Present Value Relations 5.1 Market Efficiency . . . 5.1.1 Tests of Autocorrelation in Stock Returns . . .Â It may be helpful to relate Financial Decisions and Markets to my earlier work, and to competitors. My first book (Campbell, Lo, and MacKinlay, CLM 1997) covers much of the same material (specifically Chapters 3â€“8 of this book), but by now has become dated. Presentation on theme: "BEE3049 Financial Markets and Decisions II Lecture 2."â€” Presentation transcript: 1 BEE3049 Financial Markets and Decisions II Lecture 2. 2 Asymmetric Information What happens to market outcomes when there is asymmetry of information between sellers and buyers (or investors and borrowers)? If an entrepreneur wants financing of a project, (s)he knows the intrinsic worth of the project. George Akerlof first posed this problem in 1970, in what became a Nobel prize-winning paper. 3 The market for lemons He used the analogy of the used car market. â€“In the US, a bad quality us Financial markets is a broad term that refers to a marketplace where buyers and sellers participate in the trade, i.e., buying and selling of assets.Â Importance. Financial markets are common to each country, and they play a major role in the economic growth of the country. Some countries have small markets, while some have big financial markets, like NASDAQ. Such markets act as an intermediary between savers and investors, or they help savers to become investors. On the other hand, they also help businesses to raise money to expand their business. It wonâ€™t be wrong to say that investors and businesses access the financial markets to raise money and also to make more money. Moreover, they also help in lowering unemployment as these markets c