

## Answer Outline

ECONOMICS 353 (SECTION 2)  
EXERCISE 3: 6 POINTS TOTAL

L. Tesfatsion/Spring 04  
DUE: Tuesday, February 3, 2:10pm

**\*\*IMPORTANT REMINDER: LATE ASSIGNMENTS CANNOT BE ACCEPTED – NO EXCEPTIONS\*\***

### EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 3** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the first five questions Q1 through Q5, below, which are in multiple choice format.
- (3) The sixth question Q6 is a Web Browse Exercise. Please put your **name and student ID number** at the top of your answer sheet for Q6 along with **353-2 Exercise 3-Q6** and **separately** hand in your answer sheet for Q6 in addition to your answer bubble sheet for questions Q1 through Q5.
- (4) Each question Q1 through Q6 is worth 1 point.

**Q1.** A type of financial institution that plays a major role in the underwriting and sale of securities in PRIMARY financial markets is

- A. a savings and loan association
- \*\*B.** an investment bank
- C. an over-the-counter market
- D. a pension fund
- E. none of the above

**Q2.** Which of the following can be described as a SECONDARY market transaction:

- A. The U.S. Treasury holds an auction for a new issue of Treasury bills.
- B. A venture capital firm supplies start-up funds to an inventor with a new patent.
- C. You provide a loan to your friend.
- \*\*D.** You buy a share of IBM on the New York Stock Exchange.
- E. Halliburton Inc. buys commercial paper newly issued by Iraq Petroleum Inc.

**Q3.** Ways in which common stock and corporate bonds are DISTINGUISHED from each other include:

- A. holders of common stock must receive an annual dividend equal to a fixed proportion of company profits.
- B. bond holders have priority over holders of common stock when it comes to voting on corporate policies at annual company meetings.
- \*\*C.** if bankruptcy occurs, bond holder claims on corporate assets have priority over common stock holder claims.
- D. all of the above
- E. only A and B

**Q4.** Which of the following can be described as instances of INDIRECT finance.

- \*\*A.** You secure a mortgage from First National Bank.
- B. You receive a loan from your Dad.
- C. You buy shares of Microsoft on the NASDAQ.
- D. You buy U.S. Treasury bonds in the U.S. government bond market.
- E. Only A and B

**Q5.** The concept of adverse selection in markets for loans

- A. refers to the incentive of borrowers to shift to more risky loan projects after their loan contracts are signed.
- B. refers to the high risk faced by loan applicants due to their lack of information about the lender's financial condition.
- C. refers to the tendency of lenders to gamble on high-return loans with high probability of default.
- \*\*D.** refers to the tendency for high-risk borrowers to be attracted into a lender's pool of loan applicants (and low-risk borrowers to exit the pool) if the lender tries to set a single interest rate to cover average (expected) default costs.
- E. None of the above.

**See the next page for question Q6**

## Q6. Web Exercise – A look at a major controversy concerning basic corporate finance.

Citing work by Colin Mayer, Mishkin (Chapter 2, Box 1, page 31) asserts the following: “Studies of the major developed countries, including the United States, Canada, Great Britain, Japan, Italy, Germany, and France, show that when businesses go looking for (external) funds to finance their activities, they usually obtain them indirectly through financial intermediaries and not directly from securities markets.”

More precisely, Mayer’s work concludes that internal financing (retained earnings) is by far the most dominant mode of corporate financing in major developed countries (anywhere from 70 to 90 percent), followed by external bank financing (from 11 to 27 percent). External financing through new issue of equities or bonds is negligible relative to bank financing in all major developed countries except the U.S. (where equity financing is negligible but bond financing is on par with bank financing). In brief, then, Mayer concludes that financing patterns do not differ very much across the major developed countries.

However, in a widely distributed and discussed paper (“Financing Patterns: Measurement Concepts and Empirical Results,” revised November 2003), authors Andreas Hackethal and Reinhard Schmidt strongly challenge the correctness of Mayer’s conclusions. They argue that Mayer’s work relies on a questionable use of corporate financing data. These authors argue that, once this data problem is corrected, the “traditional” view that patterns of external financing differ strongly and systematically across the major developed countries reasserts itself. For example, they argue that bank loans remain the dominant source of external finance for both Germany and Japan, whereas U.S. corporations have emancipated themselves from bank financing and now rely largely on capital markets and loans from non-bank financial intermediaries (pension funds, mutual funds,...) for their external financing needs.

Based on a Web browse or other literature search, try to find out in more precise terms the nature of the “data problem” that is fueling this ongoing controversy between Hackethal and Schmidt on the one hand and Mayer (and his major co-authors Jenny Corbett and Tim Jenkinson) on the other. Then do the following:

- Provide a **BRIEF SUMMARY (300 words or less)** outlining what it is about Mayer’s treatment of corporate financing data that Hackethal and Schmidt so strongly object to, and how they propose to correct this problem.
- Support your assertions with complete citations to any sources on which you are relying. For print sources, this means author, title, publisher, and date of publication. For Websites, a correct URL should be given.
- Pass in your brief summary and citation list on a separate answer sheet with **YOUR NAME** and **ECON 353-2, EXERCISE 3-Q6** given at the top of the sheet.

## Brief Summary of Perceived “Data Problem” (300 words or less)

Andreas Hackethal and Reinhard Schmidt (2003) strongly challenge the correctness of the conclusions by Colin Mayer (1990) – summarized above in the statement of Q6 – on the grounds that Mayer inappropriately relies on aggregate NET flows of funds between economic sectors. They argue that Mayer assumes that corporate internal funds (which do not have to be repaid) flow FULLY into physical investment whereas only the NET flow from the financial sector to the non-financial corporate sector flows into physical investment (with repayments, expenses, financial asset accumulations, and stock and bond buy-backs all netted out).

Hackethal and Schmidt argue that these data assumptions lead Mayer to overestimate the role of internal funds and to underestimate the role of external funds in the financing of corporate physical investments. They instead use GROSS flows of funds, and conclude that the financial systems of major developed countries do indeed differ from one another in substantial ways. For example, they argue that banks are the primary source of external funding in some major developed countries such as Germany and Japan, whereas securities markets are the dominant source of external funding in the U.S.

Colin Mayer and his co-authors have recently written a rebuttal to these arguments (Corbett et al., 2004). For example, they conclude that “net flows are conceptually and practically the right approach and gross flows are distorted by irrelevant considerations.” And so the debate continues.

## References

- Jenny Corbett, Jeremy Edwards, Tim Jenkinson, Mayer, Sussman (2004), “A Response to ‘Financing Patterns: Measurement Concepts and Empirical Results’ by Andreas Hackethal and Reinhard Schmidt,” Working Paper, University of Oxford, January 15. (Available On-Line)
- Andreas Hackethal and Reinhard Schmidt (2003), “Financing Patterns: Measurement Concepts and Empirical Results,” Working Paper No. 33, Johann Wolfgang Goethe University, Frankfurt, Germany, revised November. (Available On-Line)
- Colin Mayer (1990), “Financial Systems, Corporate Finance, and Economic Deveopment,” in *Asymmetric Information, Corporate Finance, and Investment*, ed. R. Glenn Hubbard (Chicago: University of Chicago Press), pp. 307-332.