

Chapter 37

A company's share price on 1st March is €2.50. The company releases a statement saying that one of the products it manufactures has been removed from sale following the release of an article in a medical journal which associates the product with an increased risk of cancer in young children.

1. Explain what you would expect to happen to the share price of the company as a result of this new information.

Answer: The information is bad news on the one hand but the company seems to have been proactive in removing the product swiftly. The effect is that the share price is likely to be depressed but how far it goes down depends on the seriousness of the allegations, the number of people involved, what other information comes to light and how the company respond to the situation in the coming weeks. The market will seek to take into account all this information in pricing the share price of the company and the extent to which it believes the information will impact on the future profitability of the business.

2. Is it morally corrupt to use the efficiency of markets to trade contracts in disasters and terrorist events?

Answer: The answer will depend on the perceived benefits that might arise from such a market in relation to the costs. Is it morally corrupt to use a market to gather additional intelligence (which is after all what it would be) which might prevent serious events from occurring which may claim many lives? Would such a market mean that there would be an increased likelihood of such events occurring or would it encourage more people to share information and intelligence thus help to reduce them? Is there a risk that markets could be manipulated and resources diverted to preventing something which is not going to happen whilst being able to hide plans to cause problems elsewhere?

3. Look at the table below and answer the questions.

Quarterly Economic Growth in G7 Countries, 2006–2009.

Country	Q4: 2006	Q1: 2007	Q2: 2007	Q3: 2007	Q4: 2007	Q1: 2008	Q2: 2008	Q3: 2008	Q4: 2008	Q1: 2009	Q2: 2009
Canada	0.5	0.9	1.0	0.5	0.3	-0.2	0.1	0.1	-0.9	-1.6	-0.9
France	0.7	0.7	0.4	0.7	0.3	0.5	-0.5	-0.2	-1.4	-1.3	0.3
Germany	1.0	0.3	0.3	0.8	0.1	1.6	-0.6	-0.3	-2.4	-3.5	0.3
Italy	0.9	0.3	0.1	0.2	-0.4	0.5	-0.6	-0.8	-2.1	-2.7	-0.5
Japan	0.8	1.4	-0.2	-0.1	0.8	1.0	-1.1	-1.0	-3.5	-3.1	0.9
UK	0.8	0.7	0.6	0.5	0.5	0.8	-0.1	-0.7	-1.8	-2.4	-0.7
US	0.7	0.3	0.8	0.9	0.5	-0.2	0.4	-0.7	-1.4	-1.6	-0.3

Source: OECD (<http://stats.oecd.org/index.aspx>) accessed September 14, 2009

a) Which country was the first to enter recession and when?

Answer:

Japan – in quarter 3 2007. The technical definition of recession is two successive quarters of

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negative economic growth. Japan might be said to have had a double dip recession!

b) From the data, which country suffered the most severe recession and why?

Answer: From the data we can see that the UK suffered five successive quarters of negative growth which might be argued to be severe. The fall in output in Germany was significant especially in Q4 2008 and Q1 2009. Given that Japan suffered decline in 2007 and then again from Q2 2008 and that the size of the decline in Q4 2008 and Q1 2009 was considerable it might be argued that Japan suffered most.

4. Is it inevitable that a period of rising house prices will suffer a correction?

Answer: Whether house price increases suffer some sort of correction would depend on the state of the market and the demand and supply of houses as well as what was driving the market upwards. It would also depend on how we interpret the word 'correction'. For homeowners the key is the difference between the price they buy a property at and the price they get when they sell it. Any talk of house price values when active trades are not being considered is largely irrelevant for those not involved. If an individual buys a house for €300 000 in year x and then sells it for €450 000 in year $x + y$ does this represent a correction if a year before the sale the value of the property was rated at €500 000? There might be periods when house prices are falling but to get a better picture we might want to look at the trend in house prices over a period of time and history tends to show that the trend is essentially positive. This might suggest that it is far from inevitable that house prices will suffer a correction.

5. Why did the market for credit default swaps seem to be associated with lower risk?

Answer:

CDS are relatively new instruments which were developed during a period of relatively strong economic activity. The data on which default risks were based tended to be skewed, therefore, as it did not include periods where asset holders faced significant financial pressures.

6. Briefly describe the main stages to show how an increase in defaults on sub-prime mortgages led to the financial crisis.

Answer: Owners of mortgages deemed sub-prime begin to default on payments (possibly because of job loss, death or illness in the family etc.). Bonds were sold on the basis of the stream of income coming from mortgage payers are used to pay investors. When this income stream slows, some investors do not get their payments. Bond holders may have insured the risk of default via a CDS and so the protection seller has to pay out the protection buyer. CDS were not only traded between those directly involved in the bond but to other interested parties and so the amount the protection seller has to find to pay holders of the CDS increases. To fund these liabilities, protection sellers look to borrow money from the interbank market. However, protection sellers, holders of bonds and sub-prime loans may also be banks who are themselves facing increased exposure. As these institutions look to protect their assets or build up their capital they cut back lending on the interbank market unless the interest rate is higher. For borrowers the higher cost of borrowing may mean it is not worth taking out the loan even if they could find a willing lender and so credit dries up. Banks with excess exposure least able to finance the extent of their obligations become insolvent and those that go under default on their obligations and so the process spirals.