Should the financial system be heavily regulated after the crisis?
(Syllabus Section III.D)

Assigned Discussion Group Moderators: Lan Liu (lanliu@iastate.edu), Sana Sehar (sanas@iastate.edu), and Qun Zhou (qzhou@iastate.edu)

Date of Discussion: Thursday, November 6, 2008, 11-12:20 (first 80 minutes of class)

Required and Recommended Readings For In-Class Discussion:

   - ** Moderator’s Opening Statement (Henry Tricks, Finance Editor, The Economist)
   - ** Proposition’s Opening Statement (Myron S. Scholes, Frank E. Buck Professor of Finance, Emeritus, Stanford University, Nobel Laureate 1997)
   - ** The Opposition’s Opening Statement (Joseph E. Stiglitz, University Professor, Columbia University, Nobel Laureate 2001)

2. Debate Background Materials
   - ** Jason Zweig, “What History Tells Us About the Market,” Wall Street Journal Online, October 11, 2008 ATTACHED
   - ** Nina Easton, “Main Street Turns Against Wall Street,” CNN Online, September 28, 2008, ATTACHED CNNMoney.com
   - * “Timeline: Global Credit Crunch,” BBC News, 10/20/08, ATTACHED newsvote.bbc.co.uk/mpapps/pagetools/print/news.bbc.co.uk/2/hi/business/7521250.stm

PLEASE NOTE: All students should prepare to participate in this discussion by studying at least the required [**] readings above and by considering possible answers to the discussion questions posed below.
Related required and recommended readings to be taken up in regular in-class discussion for syllabus section III.D:


**Specific Responsibilities of Discussion Group Moderators:**

The moderators should prepare a clear concise hand-out for distribution to the class on the discussion date November 6th. The hand-out should provide suggested answers to discussion questions detailed below (to the extent that the moderators believe that definite answers can be provided) as well as pointing out any aspects of these questions that the moderators conclude are controversial, hence difficult to answer in a definite way. If possible, the hand-out should also be distributed in advance using the class email list macro502@iastate.edu at least one day prior to November 6th.

The moderators should come to class on November 6th prepared to lead a class discussion on their hand-out (hence on the discussion questions below). The moderators should encourage the participation of all students in the discussion by (if necessary) calling on students to express their ideas.

**Some Suggestions:** Rather than going over all of the moderators’ responses to all of the discussion questions all at once, prior to any class discussion, I recommend that the moderators instead take up each discussion question one by one. As each discussion question is considered, the class participants should be encouraged (or called upon!) to comment on the moderators’ proposed answer as outlined in their handout. Preparation of a few transparencies/ppt slides could help to focus the discussion.

**Evaluation of Discussion Group Moderators:**

I will evaluate the performance of the moderators (as a group) on the basis of their hand-out and in-class discussion moderation. It is expected that each of the moderators will actively participate in both aspects. The judgements of all class participants will be taken into account in this evaluation through an anonymous ballot. The points earned by the moderators (up to a maximum of ten) will be included in the determination of each member’s overall course score.
BASIC ISSUE:
As discussed by debate moderator Henry Tricks [1], the past few weeks have seen Western governments “resolve to part-nationalise numerous banks in the biggest state incursion into free-market capitalism since the second world war.” A key question is what should happen after the crisis has subsided.

In particular, should governments of countries seriously affected by the global financial crisis take a “light-touch” response to the crisis, as advocated by Nobel Laureate Myron Scholes (co-inventor of the famous Black-Scholes model in finance)?

Or should these governments, instead, impose new regulations within new strengthened regulatory structures, as advocated by Nobel Laureate Joseph Stiglitz (renowned for his demonstration that asymmetric information can lead to persistently inefficient markets).

Discussion Question 1: Finance 101 Give brief but careful definitions for the following key concepts that appear in the debate reading materials [1] and [2]: financial market; security (financial instrument); securities broker; securities dealer; equity; return on equity; common stock share; preferred stock share; bank; loan; leverage; risk (as defined in finance); mortgage; subprime mortgage; derivative (form of financial instrument); option; mortgage-backed security; collateralized debt obligation (CDO); credit default swap (CDS); hedge fund; capital requirements; liquidity; bank run (or bank panic); bankruptcy; insolvency; asymmetric information; and moral hazard.

Note: The moderators should include these brief definitions in their hand-out for students to read in advance of the in-class discussion. There should be no need to go over these definitions in the actual in-class discussion.

Discussion Question 2: In your opinion, what is the proper role of a financial sector within a well-working macroeconomy? In particular, what should be the relationship between the financial sector (creation, purchase, and sale of financial assets) and the “real” sector (production, purchase, and sale of physical assets and services)? Include considerations both of short-run efficiency (i.e., the efficient use of existing productive resources) and longer-run efficiency (i.e., proper incentives for investment in new types of productive resources).

Discussion Question 3: Briefly summarize the arguments of Myron Scholes against the need to regulate the financial system more heavily after the global financial crisis has subsided. Include, in particular, Scholes’ views regarding the relationship between (re)regulation and financial innovation.

Discussion Question 4: Briefly summarize the arguments of Joe Stiglitz in favor of regulating the financial system more heavily after the global financial crisis has subsided. Include, in particular, Stiglitz’s views regarding relationship between (re)regulation and financial innovation.
**Discussion Question 5:** Whose arguments do you find more convincing, Scholes (DQ3) or Stiglitz (DQ4), and why?

**Discussion Question 6:** What do you believe governments should do (if anything) with regard to (re)regulating the financial sectors of their countries after the global financial crisis has subsided?