

## EC908 Topics in Financial Economics

The module, though giving some basics about asset pricing, focuses on financial contracting. The students are encouraged to take module EC907 for a more comprehensive picture of asset pricing.

After finishing the module, the students suppose to know the fundamental principles about security issuing and gain some edges in looking for relevant jobs such as investment banking and consultancy.

### **General Readings**

#### Textbooks:

1. (main) *Corporate Finance*, by R. Brealey, S. Myers and F. Allen, 2006, McGraw Hill, 8<sup>th</sup> edition. Hereafter BMA.
2. *Financial Markets and Corporate Strategy*, by M. Grinblatt and S. Titman, 2<sup>nd</sup> edition, 2002, Irwin McGraw Hill. Hereafter GT.
3. *Corporate Finance*, by J. Beck and P. DeMarzo, 2007, Pearson Education, Inc. Hereafter BD.

#### Papers:

1. Oliver Hart (2001), "Financial Contracting", *Journal of Economic Literature*, 39, NO 4, 1079-1100;  
<http://www.economics.harvard.edu/faculty/hart/files/Financial%2BContracting%2BJEL.pdf>.
2. Harris, Milton and Raviv, Arthur. "The Theory of Capital Structure." *Journal of Finance*, 1991, 46(1), pp. 297-355.
3. Steven Kaplan and Per Stromberg, (2003), "Financial Contracting Theory Meets The Real World: An Empirical Analysis Of Venture Capital Contracts," *Review of Economic Studies*, 70(2), 281-315.
4. Rajan, R and L. Zingales (1995), "What do we know about capital structure? Some evidence from international data," *Journal of Finance*, 50, 1421-60.

### **Course materials**

Lecture notes and classes exercises are made available in the Course Material Repository.

### **Course outline**

#### **Spring Term**

##### **Topic 1: Basic Asset Pricing and MM:**

- *Balance Sheet.*

- *Financial contracting and asset pricing*
- *MM.*

**Reading:**

- Modigliani, Franco and Miller, Merton H. (1958) "The Cost of Capital, Corporate Finance, and the Theory of Investment." *American Economic Review*, 48(3), pp. 261-297.
- Miller, M.H. (1988), "The Modigliani-Miller propositions after thirty years," *Journal of Economic Perspectives*, pp. 99-120.

**Topic 2: Trade-Off Theory:**

- *Capital Structure*
- *Tax Trade-off Theory*

**Reading:**

- Harris, Milton and Raviv, Arthur. "The Theory of Capital Structure." *Journal of Finance*, 1991, 46(1), pp. 297-355
- Myers, Stewart C. "Capital Structure." *Journal of Economic Perspectives*, 2001, 15(2), pp. 81-102.

**Topic 3: Moral Hazard and Risk Shifting:**

- *Moral hazard*
- *Outside equity,*
- *Debt: risk shifting and debt overhang*
- *The advantages of debt in providing incentive*

**Reading:**

- Jensen, Michael C. and William H. Meckling. "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics*, 1976, 3(4), pp. 305-60.
- Myers, S. (1977), "Determinants of corporate borrowing," *Journal of Financial Economics* 5, 147-75.

**Topic 4: Adverse Selection and Pecking Order Theory 20:**

- *Adverse Selection*
- *Signalling with debt*
- *Pecking order Theory*

**Reading:**

- George Akerlof (1970), The Market for "Lemons: Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, Vol. 84, No. 3. 488-500
- Ross, S.A. (1977), "The determination of financial structure: the incentive signalling approach," *Bell Journal of Economics and Management Science* 8(1), pp. 23-40.
- Myers, Stewart C. and Majluf, Nicholas S. "Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have." *Journal of Financial Economics*, 1984, 13(2), pp. 187-221.
- Myers, Stewart C. 1984. "The Capital Structure Puzzle." *Journal of Finance*. July, 39:3, pp. 575-92.

**Topic 5: Incomplete Contract Approaches:**

- *Incomplete Contract Approach and control*
- *Debt and equity*

**Reading:**

- Aghion, P. and P. Bolton (1992), “An incomplete contracts approach to financial contracting,” *Review of Economic Studies* 59(3), pp. 473-494.
- Hart, Oliver (1995), *Firms, Contracts, and Financial Structures*, Clarendon Press, Oxford, UK.

**Topic 6: Merger and Acquisition 24:**

- *Free Riding*
- *Collective Action Problem and M&As*

**Reading:**

- Grossman, S., and Hart, O. (1980): “Takeover bids, the free rider problem, and the theory of the corporation”, *Bell Journal of Economics*, V. 11, 42-64.