Week 6: Introduction: Why Banks?

The present short overview of this week’s lecture is the first of a series of similar weekly messages, to be circulated at the first lecture in the relevant week. They can also be downloaded from the homepage at

www.econ.ku.dk/keiding/underv/bank

where they will appear before the weekend preceding the relevant week.

As outlined in the teaching plan (also on the homepage), we work ourselves through (most of) Chapter 1 this week. It so happens that the very first topics to be dealt with are quite basic, and it we do not finish the chapter (even skipping section 5) this week, but we catch up next week (where we have lectures both Monday and Thursday).

Our discussion of banks and banking starts with a short intuitive overview of the main fields of banking activities. After that we start with the first main question: Why are there banks? According to the standard way of understanding the functioning of an economy (general equilibrium theory) there is no need for banks! The story comes in the introduction to Chapter 1, and you need not bother too much about details, they are simpler than they look at the first sight. The message is that banks have nothing to do in the standard general equilibrium framework which is not already taken care of by other institutions. Consequently, the banks must be there as a result of some kind of market failure.

We present four possible explanations, all of which contain asymmetric information in some disguise. Notice that each explanation contains of thee parts, namely

(i) an outline of the special type of business considered,
(ii) an explanation of why the ordinary money market cannot cope with the situation, at least not in a satisfactory way,
(iii) a demonstration that a suitably designed financial intermediary can improve on the situation.

Here are the four explanations:

(1) The first one treated is that of liquidity insurance. Banks are needed since consumers are affected by shocks in the form of unforeseen expenditure, and their deposits in the banks give them a form of insurance against utility losses caused by such shocks. But of course this puts the banks into some risk (of a bank run). We shall have more to say about bank runs at a later stage of the course.

(2) Delegated Monitoring. Here, the information problem is seen from another angle, namely that of lenders monitoring borrowers. Again there is a scale advantage
in monitoring, and therefore the bank can do it cheaper on behalf of its depositors than the latter could do it themselves. Also delegated monitoring is a recurrent topic, although it does not show up again exactly in this form.

(3) Moral hazard: In a world where the use of credits, once granted, cannot be readily observed, we may have a situation where high interest rates force investors into risky projects with low average payoff, and as a result the money market cannot fund such investment contracts. A bank which can observe investor behavior at a cost can force investors to choose projects with better average performance so that investment can be performed after all.

(4) Information signaling: Here attention is focussed on the borrower side: Since the lender does not know the borrower detail, there is a need for signaling creditworthiness, for example by the share of the investment project which the borrower finances herself. This is costly, and it may be cost saving to join a coalition of borrowers which makes a common information signaling – and this coalition eventually becomes a bank. The model is somewhat technical, and we use a result about expected utility under the normal distribution, which is rather intuitive but not quite straightforward to prove. In the case you should worry about this proof, it is also there, but you may skip it at wish.

We skip section 5, which addresses the question of whether financial intermediation can create cycles (so that the banks might be the cause of a real economic downturn), an interesting question to which we return in another context later.

In the textbook, there are some problems at the end of the chapter (all textbooks have such). You may have a look at them; some, but not all, of them are of the type that you may see at the exam. We return to what may occur at the exam when we have proceeded somewhat further in the curriculum. There is a link on the homepage to short indications of answers.

We read:

    Chapter 1 except Section 5.