

Written Exam at the Department of Economics summer 2019

Economics of Banking

Final Exam

23 August 2019

(3-hour closed book exam)

Answers only in English.

This exam question consists of 2 pages in total

Falling ill during the exam

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- contact an invigilator who will show you how to register and submit a blank exam paper.
- leave the examination.
- contact your GP and submit a medical report to the Faculty of Social Sciences no later than five (5) days from the date of the exam.

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You cheat at an exam, if during the exam, you:

- Make use of exam aids that are not allowed
- Communicate with or otherwise receive help from other people
- Copy other people's texts without making use of quotation marks and source referencing, so that it may appear to be your own text
- Use the ideas or thoughts of others without making use of source referencing, so it may appear to be your own idea or your thoughts
- Or if you otherwise violate the rules that apply to the exam

Problem 1

A small country, where fishery and industries based on fishery are the main sources of income, has only a few banks, and all are specialized in serving the domestic public with regard to both savings accounts and credits. It is decided to introduce a mandatory deposit insurance, administered by an independent non-profit organization. Its first task is to decide on the financing of this insurance. Give a survey of the basic principles and their consequences.

After several years of prosperity, the economy of the country experiences a downturn, and some of the banks become insolvent and cease their activity. It then turns out that the deposit insurance organization has insufficient funds so that the government has to step in. Explain what went wrong.

Problem 2

An industry in a country complains that its access to credit is too limited and that credit is too expensive. Many former entrepreneurs have given up and moved abroad, where several of them have been successful. On the other hand, local banks point to a high frequency of bankruptcies which has caused large losses to the banks. The underlying problem seems to be the way in which the entrepreneurs conduct the business once the credits have been granted.

Give a brief sketch of a theoretical framework, which can encompass both of the above observations. What can be done to improve the situation?

It is now proposed that the loan contracts should be formulated not as a standard contract but rather as a participation contract, where the borrower pays back an agreed fraction of the gross income derived from the investment. Give an assessment of this proposal and its consequences.

Problem 3

In a particular region, there has traditionally been a large pharmaceutical industry, and recently many small entrepreneurs have become interested in developing new medical treatments for several types of cancer. The typical developer in this field needs some initial capital, and there is only a small chance of actually finding the right drug. The probability of success can be estimated rather precisely from previous similar cases.

It is argued that the banking sector, which has until now supplied credits to the developers, is inefficient in the sense that it prevents profitable activities, which would be beneficial for the community, to be initiated. Give a theory-based assessment of this argument.

After a long debate on this issue, it is decided to create a specialized non-profit credit institution for drug development, so that credits can be offered in a way, which is tailor-made for the sector. How should the loan contracts be set up?