

Written Exam for the M.Sc. in Economics summer 2014

Economics of Banking

Master's Course

3. June 2014

(3-hour closed book exam)

Please note that the language used in your exam paper must correspond to the language of the title for which you registered during exam registration. I.e. if you registered for the English title of the course, you must write your exam paper in English. Likewise, if you registered for the Danish title of the course or if you registered for the English title, which was followed by "eksamen på dansk" in brackets, you must write your exam paper in Danish.

This exam question consists of 2 pages in total

1. In order to provide a regulated way of liquidating banks with a large number of troubled assets, a country has set up a government institution taking over all assets and liabilities of these banks and carrying out day-to-day business while seeking to sell suitable parts of the activities to other private banks.

It has been proposed that such an institution should take action as soon as the solvency rate of the bank falls below a certain limit. Give an assessment of such a mechanical rule for reconstructing troubled banks, taking into consideration the possibility of contagion. Can the activity of the government institution aggravate the banking crisis?

2. In a small country with an economy based mainly on agriculture but with some industrial production as well, there are two banks serving the community. In order to have as much competition in the banking sector as possible, both banks have been urged to offer credits to both agriculture and industry.

It has been decided to introduce a system of full deposit insurance, and it is agreed that each bank should pay for the insurance according to full cost of reimbursing depositors. Explain based on relevant theory how the insurance premia should be determined.

It is argued that if any the two main sectors in the economy experiences a downturn, both banks will be in serious trouble, so that the financial sector may be hit very hard. What can be done avoid this situation, and can the deposit insurance premia provide the relevant incentives?

3. A new export oriented industry is characterized by many small entrepreneurs having only limited capital of their own, so they need credits from the banks. The business is very promising in the sense that the profits earned may be large, depending however on the skills of the entrepreneur, but each firm in the industry is subject to a general risk of losing its investment in the overseas market.

The sector is complaining that credit is too tight. Sketch a model of the situation which can be used to assess whether these complaints are justified, and give suggestions for regulation if the particular credit market is not functioning in an optimal way.