Written Exam for the B.Sc. or M.Sc. in Economics summer 2013

Economics of Banking

Master's Course

9 August 2013

(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 (including this page)

1. After a period with many bank failures, there is some concern about the way in which banks are regulated. In particular, it is argued that the traditional institution which deal with banks in distress, the lender of last resort, is too lenient since it may be costly to deny assistance, thereby forcing the bank to liquidate, so that it does not discipline the banks choosing too risky a strategy.

Give a short presentation of the underlying theory, and give some suggestions to what can be done to make decisions of the lender of last resort more in line with what is best for society.
Can there be situations where authorities would be needed in order to prevent that the banks from take excessive risks?

2. It has been argued in the debate that there are too many banks in this country, since the competition of banks for funding leads to high costs of funds, so that loan rates remain high, which in its turn will lead to a more risky loan portfolio in each bank.

Give a theoretical overall assessment of this argument. Is it always true that more banks will lead to higher risk?

3. A country needs to develop the extraction of a certain mineral from the subsoil. The industry is characterized by small investors who buy the right to use the land. The technology is simple and the market is stable, but each investor faces some uncertainty as to whether the particular piece of land contains the mineral in a quantity which makes extraction meaningful.

It has been decided that credits should be administered by a bank set up for the purpose. The bank is a non-profit organization, and it should offer credits af a fixed rate of interest, common for all, subject to the condition that investors must finance 10% of the project with own means.

It is argued that this arrangement will give rise to adverse selection so that the best projects will not be developed. Give an account of the theory of credit rationing under adverse selection, and of whether it applies to the present case.