

Written Exam at the Department of Economics summer 2018

Economics of Banking

Final Exam

10 August 2018

(3-hour closed book exam)

Answers only in English.

This exam question consists of 2 pages in total

NB: If you fall ill during an examination at Peter Bangsvej, you must contact an invigilator in order to be registered as having fallen ill. In this connection, you must complete a form. Then you submit a blank exam paper and leave the examination. When you arrive home, you must contact your GP and submit a medical report to the Faculty of Social Sciences no later than seven (7) days from the date of the exam.

Be careful not to cheat at exams!

- 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

1. After some years of economic recession, there is widespread criticism of the credit policy of the banks which is considered as too restrictive, to which the banks would reply that the projects which are proposed for credit arrangements are too risky. In particular, in the field of robotics technology the potential innovators are complaining: the outcome of the projects is of course subject to uncertainty and has in the past been very high as well as rather low, but the excessively high rates of interest demanded leaves many good projects unrealized. Is this criticism well-founded, and if so, explain why?

It turns out that a new type of enterprises is under establishment. They are based on space technology, and typically they yield a rather large payoff subject only to the risks connected with the launch and subsequent unfolding of the devices. The banks have been very active in offering credits to this field of business and argue that this shows that they assess the overall risks in the best possible way for society. Are they right here?

2. A small bank has attracted funds from persons who have received large lump-sum pension payments. While looking for the favourite villa in Provence these persons deposit their funds with the bank, which invests them in long-term public-private infrastructure projects. The depositors may need their funds at short notice, but it may also take some time before they claim it back, and since the investments of the bank have a rather high low-risk outcome, an attractive interest rate is offered.

Describe the efficient contract between bank and depositor in this situation. Explain that there is an inherent instability in this contract.

It has been proposed that the instability, which is accentuated by the fact that the individual deposits are too large to be covered by deposit insurance, could be avoided if the relationship was reorganized as shadow banking. Will this be a possibility in the situation considered?

3. In a country with several rather small banks it is argued that recent financial instability can be explained by the competitive behavior of the banks which are taking too large risks in order to obtain a larger share of the market, and it is suggested that the situation may be improved if the banks are consolidated into a few larger unities. Give an assessment of this argument based on theory.

In the debate on this matter, it is mentioned that if there are only a few banks, then each of these banks may get involved in too risky engagements since they expect to obtain assistance from the central bank if they incur a liquidity crisis. What should be made of this argument?