

Written Exam at the Department of Economics summer 2021

## **Economics of Banking**

Final Exam

31. May 2021

(3-hour closed book exam)

**This exam question consists of 2 pages in total**

### **Falling ill during the exam**

If you fall ill during an examination at Peter Bangsvej, you must:

- 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.

### **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.** A country experiences a need for local production of specific medical equipment. The final products have guaranteed prices, but there are severe quality requirements, so that a fraction, which depends on details of the production process, must be discarded. Banks offer credit contracts for entrepreneurs who want to set up a production.

The investment program must be assessed after some time of working. Give an assessment based on relevant theory of whether the contracts will have worked in a satisfactory way.

It has been proposed that since investment in this field is important for society, the loan rates of the banks should be subsidized by government. Comment on this in view of the previous considerations.

**2.** In a country it has been decided that the previous system of state scholarships for higher education should be replaced by credits supplied by private banks under government supervision. After some time, the new system is criticized as too expensive for the students, but the banks argue that the rates only cover the costs, which are high due to dropouts and failed repayments of loans.

It is proposed that the banks should introduce special contracts for students in educations with high dropout rates involving the use of collateral. Give a theoretical explanation of why this might improve the situation.

The idea of contracts with collateral is rejected as disfavoured students from low-income families, but the need for a loan contract which guarantees the banks a reasonable remuneration and improves the situation of the students remains. Give a suggestion for such a contract.

**3.** After several bank failures, it is decided to establish a fixed procedure for deciding whether a troubled bank should be assisted with loans or whether it should be liquidated. The information needed for this decision consists of actual capital requirements as signalled by the bank and the value of the bank's assets assessed after a 2-days audit of the bank. The decision may be taken either by the central bank as lender of last resort or by the deposit insurance organization.

Give a theory-based suggestion for the solution of this problem: Who should take the decision?

It is argued that banks experiencing runs should be assisted in the first place by the other banks by a reconstruction and possibly take-over, and that central bank or deposit insurer should only act in the case that the banking sector cannot solve the problem itself. How does this argument fit into the theoretical model used above?