

ECONOMICS OF BANKING

Re-Exam 19.08.2026

Outline of answers

1. The banks hold liquid reserves to meet the demand for liquidity of their depositors and to cover unexpected delays in repayments of debts. Using the interbank market and drawing on the central bank the liquidity reserves may be kept at a low level but banks become vulnerability to unexpected events which pertain to the whole sector. A tax on interbank and central bank loans increases the cost of supplementing own reserves. As a consequence the optimal liquidity reserve will be larger, and the argument that taxes make it more attractive for the banks to increase their reserves is correct.

The effects of the tax on competition among banks are less clear. If the tax is seen as a permanent increase in the cost of accepting deposits, then an oligopolistic bank choosing quantities may reduce the amount of deposits accepted, causing a decrease in the deposit rate. The necessary increase of reserves may be relatively smaller for the large banks, thus giving them an advantage against the smaller banks. The loan rate will either remain unaffected or increase slightly, and consequently there will be few if any effects on the riskiness of the banks' loan portfolios. The increase in liquidity reserves for the banking sector as a whole will however increase its robustness against unexpected liquidity shocks.

2. Merging the banks means that their number becomes smaller, and assuming that the banking sector is oligopolistic, we may use the results from the Boyd-deNicoló model, which fits with the described situation, where banks offer credits rather than investing directly. According to the model, a smaller number of banks will result in lower deposit rates and higher loan rates, and the increase in loan rates may cause the entrepreneurs to select more risky projects with a higher payoff.

If banks must keep a certain amount of other banks' equity, then credits offered by the banks to the non-bank sector will be reduced, but overall riskiness of the banking sector may not change since the risks are generated by the same types of engagements as before. It may give rise to some improvement of the monitoring of the individual banks' credit engagements due to shared information, but this information sharing may also have negative effects on the competition of the banks.

3. The sector described is one which corresponds to that of the deMeza-Webb model:

The entrepreneurs have individual projects with largely the same payoff in case of success, which here is acceptance by the ministry, but with varying probabilities of success. It is therefore to be expected that there may be an oversupply of credits. The argument that there is an insufficient supply of credits can therefore not be upheld.

The specialized institution set up to provide credits should work in a way to prevent the above oversupply from occurring. The simplest way would be increasing the interest rate to be paid for credits, but this may conflict with the non-for-profit nature of the institution. Another way of achieving the purpose is to reduce the percentage of the investment which can be financed by credits, demanding higher participation of the entrepreneurs.