

Adv. PSE I: Tutorial Questions for Chapter 7

Severin Weingarten*

February 1, 2015

10 Lemon Banking (Ch. 7)

Use the “model on one page”

- a) Briefly explain the term “financial leverage”.
- b) Unregulated markets
 - i) Identify the term that represents bank profits in the case of unlimited liability and explain its components in plain English.
 - ii) Identify the term that represents bank profits in the case of limited liability and explain its components in plain English.
 - iii) What is the main difference between the two cases in terms of the distribution of potential bank profits?
 - iv) Identify the term that represents the “bankruptcy externality”.
 - v) Explain the economic intuition of this term.
- c) Regulation in a closed economy
 - i) Explain in plain English why banks will always set $C = \varepsilon$.
 - ii) Identify the target function of the social planner.
- d) Regulation in an open economy
 - i) The result for $\frac{\partial W}{\partial \varepsilon}$ depends on α and β . Identify the five different combinations of these two variables that yield economically distinct results.
 - ii) For each combination, assess whether governments have an incentive to impose a capital requirement ε that is high enough to induce the social optimum. (Slides 53-60 from the lecture.)

*Chair of Public Finance, severin.weingarten@uni-jena.de, <http://sweingarten.de/>