

Adv. PSE I: Tutorial Questions for Chapter 7

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9 Lemon Banking (Ch. 7)

Use the “model on one page” to answer questions b) through d).

- 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.)

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