

ECO 3223 – Money and Banking – Spring 2006

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Solution to Assignment I

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Chapter 11

2. Describe the problem of asymmetric information that an employer faces in hiring a new employee. What solutions can you think of? Does the problem persist after the person has been hired? If so, how? What can be done about it? Is the problem more or less severe for employees on a fixed salary? Why or why not?

*Answer: Prior to hiring a new employee, an employer may have difficulty identifying candidates who would do the best job. After someone has been hired, the employer may not know whether that person is working hard. Probationary periods when the new employee can be terminated are a simple solution, as are salaries based on performance. A fixed salary makes it difficult to create the proper incentives for employees to do their best.*

5. Define the term *economies of scale* and explain how a financial intermediary can take advantage of such economies.

*Answer: Economies of scale is when average costs fall as production increases. By using standardized forms for gathering information about potential borrowers and for issuing loans, financial intermediaries can take advantage of economies of scale.*

7. The financial sector is heavily regulated. Explain how government regulations help to solve information problems, increasing the effectiveness of financial markets and institutions.

*Answer: The government requires firms to disclose information.*

13. Would you be happy or unhappy if a company whose stock you owned was bought by a leveraged buyout specialist who financed the purchase with junk bonds? Why?

*Answer: If the buyer paid a high price and purchased my stock, I would be happy. If, instead, left me holding stock, then that stock will be much more risky, and I would be unhappy. I would also be unhappy because I would not have information about the new owner.*

## Chapter 13

4. Banks have been losing their advantage over other financial intermediaries in attracting customers' funds. Why?

*Answer: Other financial firms now exist to provide individuals with services typically performed by banks. Money market mutual funds offer customers access to financial instruments that pay a higher rate of interest than bank deposits, yet are still very liquid and can easily be converted into a means of payment. Banks no longer have an advantage in screening loan applicants because of the ease with which individuals can transmit information, so a customer who needs a loan can go online to get price quotes instead of going to the local bank. Discount brokerage firms provide individuals with low-cost access to the financial markets.*

5. What has been the impact of the Internet on the structure of the banking industry?

*Answer: The Internet has rendered the physical location of a particular bank irrelevant, allowing large banks to expand across the country, and reducing the number of small local banks.*

12. Why might a person who changes jobs frequently have a lower retirement income than someone who stays with the same employer for a long time?

*Answer: Companies with defined-benefit pension plans base the size of the retirement income of a former employee on the number of years the employee worked at the company and on the employee's final salary. Someone who does not stay with any particular company for very long would have a lower retirement income.*

17. An industry with a large number of small firms is usually thought to be highly competitive. Is that supposition true of the banking industry? What are the costs and benefits to consumers of the current structure of the U.S. banking industry?

*Answer: When the banking industry consisted of a large number of small firms, the industry was less competitive than it is today. This is because each small bank had a monopoly within its geographic area. As large banks branch across the country and the number of small local banks falls, consumers benefit by having access to a larger network of ATMs and by being able to engage in a wider range of financial activities through their banks. Costs to consumers have fallen as a result of increased competition. However, the level of personal service that consumers receive has declined.*

## Chapter 14

3. Will knowing about the too-big-to-fail policy affect your choice of where to open a bank account? Why or why not?

*Answer: For a small depositor, knowing about the too-big-to-fail policy is unlikely affect where the depositor chooses to open an account. Because his account is covered by deposit insurance, the depositor will get all his money back even if the bank does fail. Nevertheless, having ones bank fail could create an inconvenience. So if given a choice between a bank that you know will not be allowed to fail, and one that could, you might choose the larger bank.*

8. Why do regulators insist that banks hold a minimum level of capital?

*Answer: Capital cushions banks against a decline in the value of their assets, and also reduces the problem of moral hazard by ensuring that owners have an interest in the bank remaining solvent.*

9. Many of the people the government employs to supervise and monitor banks eventually leave the government in order to work for the banks. Is this revolving door a problem? Why or why not?

*Answer: This could be a problem because the former supervisors could give banks advice on how to work around existing regulations to take on more risk. However, bank employees who formerly worked for the government probably help banks to maximize their returns while keeping risk at an acceptable level.*

14. If you ran a large international bank headquartered in the United States, would you be for or against uniform regulations for all international banks, regardless of where they are based? What difference would it make if each country regulated its own banks, even those that have operations abroad?

*Answer: I would be for uniform regulations. Regulations for U.S. banks are relatively strict compared to banks in other countries; if banks were subject only to the regulations of their country and not to a set of standardized regulations, then banks from countries with lax regulations would have an advantage over banks from countries with strict regulations.*