RPRD 802
Fall 2016

Exercise Sheet 2:

1. F&R Ch.4 Section 4.2.
   (a) Prove Result 4.2a
   (b) Prove Result 4.2b.
   (c) How robust are these results to more realistic assumptions? See F&R pages132 -134.

2. The theoretical literature on optimal contracting for borrower/lender relations (F&R Ch.4) pays little attention to the empirical literature on bankruptcy , workouts etc. (See Hotchkiss et al (2008) for a survey). Roberts and Sufi (2009) makes an attempt to summarize the empirical research relevant for optimal contracting. What is missing from their survey? Note: This is an open-ended question about the state of research in the area.

3. Recall the Diamond-Dybvig discussion in F&R Ch. 7.
   (a) One solution is to have deposit insurance. Show how this works to eliminate the bank run equilibrium.
   (b) In the UK in 2007, Northern Rock faced a bank-run. Was this a conventional bank-run by depositors? What was the driver of this run? (See Shin (2009) or Shin (2010) Chapter 8). What can you learn from this episode?
   (c) Lender of Last Resort (LOLR) facilities are often justified as a means to remove destructive bank runs. How successful is this mechanism empirically? What are the hidden costs? Hint: See F&R Section 7.7 and Caprio and Honohan (2015).

4. The DSGE models, used in Central Banks as policy models, failed during the Crisis.
   (a) They did not have financial sectors or banking. Why?
   (b) Subsequently, some attempts have been made to introduce a financial sector, but what are the limitations? (See Stephen Snudden’s overheads for a discussion.)