THE COLLEGES OF OXFORD UNIVERSITY

HISTORY AND ECONOMICS

WEDNESDAY 7th DECEMBER 2011

Time allowed: 45 minutes
For candidates applying for the joint school of Modern History and Economics

Answer all questions
Calculators must not be used

1. A red car and a blue car set off from the same point to travel the same journey. The red car has a start of three minutes before the blue car sets off.

   If the red car travels at 40 kph and the blue car travels at 60 kph, how many kilometres will have been travelled when the cars are level? (30 marks)

2. In economic theory, moral hazard is a situation in which a party insulated from risk behaves differently from how he/she would behave if he/she were fully exposed to the risk. For example, if your bike is not insured you will take great care to avoid it being stolen. If it becomes insured for its full value then if it is stolen you do not really lose out. Therefore, you have less incentive to protect against theft. In this case, an insurance firm faces a dilemma. When your bike is uninsured, it has (say) a 10% chance of being stolen. Therefore, if the bike is valued at £1,000, the cost of insurance would be based around £100. However, once insured, if your precautions against theft decline, the bike now has a 30% chance of being stolen. Therefore, if the insurance firm charges £100 based on the 10% risk, it will lose out.

   a. How does an insurance firm protect itself against losses associated with the potential moral hazard of insurees as in the example of bicycle theft above? (10 marks)

   b. If governments, central banks or other institutions stand by to provide assistance to banks and other financial institutions if they get into difficulties, what effect might this have on bank behaviour? (10 marks)

   c. Why might governments, central banks or other institutions nonetheless bailout struggling financial institutions? (10 marks).

   d. How can governments, central banks and other institutions protect themselves against the potential moral hazard of financial institutions? (10 marks)

   e. Provide two historical examples of circumstances under which moral hazard could have arisen. At least one example should be non-financial. (20 marks)

   f. What evidence might exist to measure the extent of moral hazard in the cases you have outlined in e. above? (10 marks)