

ECO 301: Money and Banking
Instructor: Dr. James Murray
Homework: Economics of Banking
Due: Wednesday, April 11, 2012

Learning Objectives:

- LO1: Understand and appreciate the importance of financial markets for the overall functioning of the economy.
 - LO2: Understand the role money plays in the interaction with markets for other assets.
1. Briefly explain whether you agree with the following statements. In your answer, explain the effects on banks' profits or net worth.
 - (a) "A bank that expects interest rates to increase in the future will want to hold more variable-rate assets and fewer variable-rate liabilities."
 - (b) "A bank that expects interest rates to fall will want the duration of its assets to be greater than the duration of its liabilities."
 2. Do banks typically have a positive or negative variable-rate gap (usually defined simply as *gap*)? Explain your answer by listing common bank assets and liabilities, and whether each are typically variable-rate or fixed-rate.
 3. Do banks typically have a positive or negative duration gap? Explain your answer by listing common bank assets and liabilities, and whether each typically has long or short durations.
 4. Many central banks around the world have the explicit goal of maintaining a low and stable rate of inflation, before any other goals. Kydland and Prescott argue that maintaining a low stable rate of inflation leads not only to inflation stability, but financial market stability, and production and employment stability. Explain their argument.
 5. Suggest three reasons central banks should target a low, but positive rate of inflation, instead of 0% inflation (price stability).