ECO 301: Money and Banking
Week 12 Homework: Financial Crises and Regulation

Directions: Provide written answers for the following questions and prompts. You may print these sheets and put your answers in the space provided or you may use your own paper to write your answers.

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 decrease in the future will want to hold more variable-rate assets and fewer variable-rate liabilities."
   (b) "A bank that expects interest rates to increase 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. Describe the difference between an insolvent bank and an illiquid bank. Describe how an illiquid bank can become insolvent. Would a government lending to an illiquid bank likely see the funds repaid and with interest? Would a government lending to an insolvent bank likely see the funds repaid and with interest? Explain.

5. Describe what is systemic risk. Describe one reason a government may want to rescue an insolvent financial institution. Describe one reason why it may want to let the financial institution fail.

6. Describe and illustrate the impact of a financial crisis equilibrium interest rates and lending in the bonds market, and the short-run macroeconomic impact on investment, real GDP, and price level.