

Week 12 Homework: Banking and Financial Crises

ECO 301: Money and Banking

Week 12 Homework: Financial Crises

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.

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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.