GX423

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NATIONAL UNIVERSITY OF IRELAND, GALWAY

SUMMER EXAMINATIONS 2002

MONEY AND BANKING (EC 369)

Financial Mathematics and Economics, Arts, Commerce, and visiting students

Professor H. Dixon
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Time allowed: TWO hours
Please answer SIX questions from Part A and TWO questions from Part B.
Each question in Part A is worth 8 points and each question in Part B is worth 26 points.

PART A

1. Explain the theoretical definition of money supply in measuring the stock of money. How would you measure money using the approach of weighted aggregates ?

2. Explain the announcement effect of discount loan policy. When is this effect subject to misinterpretation ? How can misinterpretation be avoided ?

3. Explain the problem of adverse selection in the securities market and why the private production and sale of information is an unsatisfactory solution to this problem.

4. For the Baumol-Tobin model of the transactions demand for money, explain (i) the implications of the model for the income and interest rate elasticities of money demand and (ii) the integer-constraint criticism.

5. Explain the traditional view of regulation and the theory of regulatory capture. Which of the two theories would better explain the S&L crisis in the US in the 1980s?

6. Explain the concept of bank liability management and provide three examples.

7. Explain the problems of adverse selection and moral hazard faced by the banking regulators. Are these problems exacerbated by the existence of deposit insurance ? Explain.

8. Explain whether and how the development of the Federal Funds market would affect the size of monetary base and money supply.

PART B

1\. (a) Compare and contrast the following three theories of money demand: (i) the Keynesian liquidity preference theory, (ii) Tobin's speculative money demand theory and (iii) Friedman's modern version of the Quantity theory of money. In your answer include the following areas (18 pts):

(i) The determinants of money demand
(ii) the number of assets considered
(iii) the consideration of the return on money
(iv) the variability of money demand
(v) the predictability of velocity

(b) Explain the assumptions of the Baumol-Tobin model of the transactions demand for money and derive the money demand function of the model. (8 pts)

2\. (i) Explain the necessary criteria for choosing operating and intermediate targets in the implementation of monetary policy (8 pts)

(ii) Explain the cause of the breakdown of monetary targets in the 1980s. (5 pts)

(iii) Explain why in the presence of money demand shocks, a Central Bank cannot simultaneously target the money supply and the interest rate. (7 pts)

(iv) Explain the relative advantage of a nominal income target over a monetary target in dealing with an aggregate demand shock. (6 pts)

3\. (i) Compare the relative size of the M1 and M2 multipliers. Which factors account for their difference ? (5 pts)

(ii) Explain the determinants of the size of the (ER/D) ratio. (8 pts)

(iii) Suppose the Fed decides to pay interest on bank excess reserves. Would this have any effect on the size of the monetary base and the money supply ? Explain. (7 pts)

(iv) (7 pts) Imagine an economy in which banks hold borrowed reserves according to the relation $BR/R=5(i-i_d)$, where i is the market interest rate, i_d is the discount rate (both measured in fractional units), BR is the total amount of borrowed reserves and R is total reserves. Suppose that required reserves RR are £88 bn., nonborrowed reserves NB are £81 bn., the discount rate is 10%, and the market interest rate i is 12%. What is the amount of excess reserves ER ? (6 pts)

4. (i) One of the factors that led to the persistence of the U.S. banking crisis of the 1980s was regulatory forbearance. Explain its meaning and its causes. (6 pts)

   (ii) What other factors led to the US banking crisis of the 1980s ? (9 pts)

   (iii) Were the proposals introduced by the FDICIA of 1991 to reform the U.S. banking system adequate ? Explain. (7 pts)

   (iv) Define contestability and provide <u>one</u> argument for the lack of contestability in retail banking markets in post-1992 Europe. (4 pts)