Introductory Macroeconomics

In-Tutorial #5
Week Starting 12th April 2021

Questions.

1. The type of money controlled by a central bank is quite *narrow*,[1] basically cash plus bank reserves. Call this narrow measure of the money supply M_0. The amount of money M in the $MV = PY$ equation is however *broad*, and refers to a wide range of close substitutes for narrow money that are routinely used in the broader economy. Implicitly the quantity theory assumes these are proportional $M = kM_0$ where $k > 1$ is some constant. Then control of M_0 is then tantamount to control of M.

   How would a fall in this k affect a central bank's ability to control inflation?

2. During the second half of the 1970s, the Reserve Bank of Australia, and other central banks around the world followed a process of *monetary targeting*. What is monetary targeting and what was the rationale behind it? What factors caused central banks to abandon the process of monetary targeting?

3. In 2008, at the height of the global financial crisis, the Australian government introduced the Financial Claims Scheme to provide insurance to depositors up to the value of $250k. They also guaranteed larger deposits and wholesale funding by banks up until the year 2015.[2]

   This deposit insurance effectively meant that if a bank or financial intermediary went bankrupt, the government would compensate the depositor.

   (a) What effect do you think guaranteeing deposits would have upon the ability and cost of banks and other financial institutions to raise funds?

   (b) If it became difficult for banks to raise funds, what impact do you think this would have on the broader economy? Explain your reasoning.

[1] Sometimes referred to as 'inside money' or 'base money' or 'high-powered' money.

[2] Wholesale funding refers to the sale of bonds and other financial instruments to raise funds. Although deposits fund the majority of bank lending in Australia, a significant amount of funding for financial intermediaries comes from other sources.