ECON 4335 – fall 2014

Problem set 6 – seminar #6 (October 14, 2014)

Problem 1 - Bubbles in asset prices

1. Bubbles in asset prices are said to exist when the prices deviate from their fundamental values. What is meant by "fundamental value" in this context? Give examples.

2. Bubbles may sometimes be compatible with rational expectations. Under what conditions can this happen?

3. It is often argued that rational bubbles reduce real investment. How is this explained?

4. Some authors argue that bubbles may actually have an expansionary effect on the economy. Describe in words mechanisms that can lead to this. Why are expansionary bubbles of particular interest when banking crises are discussed? Is there historical evidence that supports this?

5. Some authors claim that bubbles occur often, but that they are caused by expectations that extrapolate trends even when this is not fully rational according to the definition that has been common in modern macroeconomics. Would this kind of bubbles be distinguishable from fully rational bubbles if we look only at credit growth and investment? Are there other macro variables that would be informative?

6. Many studies claim that deregulation is an important risk factor for banking crises. What do the competing theories about bubbles and expectations have to say about this?

Problem 2

Use the Holmström-Tirole model (on the reading list) to analyze, briefly, the impact on the various equilibrium rates of interest if we have:

- An expanison in credit from banks
- A lower probability for success if working (not shirking), p_H, and a lower return if success R
- Banks become more effective in their role as monitors, making the monitoring cost, c, smaller and also by lowering the opportunity cost of working under monitoring, b.

If banks should have reduced lending capacity, some firms will in equilibrium be squeezed out from not getting their (fixed-size) projects financed. You are asked to come up with a (short) proposal as to what the government can do to counteract this reduced investment activity so as to prevent a recession.