Seminar Problem in ECON 4335 Economics of Banking, Fall 2015

Problem set 9 (November 05, 2015)

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.

Problem 2

Use the Holmstrom Tirole model to analyse, briefly, the impact on the various equilibrium rates of interest if we have:

- An expansion in credit from banks,
- A lower probability for success if choosing the good project, P_H,
- Banks that become more effective in their role as monitors, making the monitoring cost, c, smaller.