Professor Christiano
C-11, Winter 1999

Notes on Answers, Second Midterm, for TA's

1. Question 1. An asset price bubble occurs when a rise in stock prices is not justified by any current or prospective rise in the income generated by the underlying productive resources financed by the stock. In an asset pricing bubble, people are willing to pay inflated prices for stock simply because they expect that someone else will buy it from them later at an even greater price. Central bankers worry when they think they've identified an asset pricing bubble. They think that when the bubble bursts, and people recognize how far from fundamental values the price has gotten, then a new market psychology will set in and stock prices will fall. Then, a lot of people who borrowed on the assumption that they could pay back the loan out of the appreciation of the stock, find that they cannot. When they default on their loans, then this can give rise to a default by the people who lent to them. If lots of people in the economy are connected to each other by credit chains (person A borrowed from person B, who in turn got the money by borrowing from person C, etc) then there could be waves of default which could damage sectors all over the economy.

2. Question 2. ε is the price of the foreign good to the price of the domestic good, in dollar terms. When this is high, it is no surprise that X is high, since foreigners will indeed want to buy stuff from the US. Similarly, domestic agents will want to buy less stuff from foreigners. Also, when a person's income goes up, you'd expect them to increase consumption of all goods, not just domestic goods. This explains the X and Q functions.,