Economics 435
Spring 2014
University of Wisconsin-Madison

Menzie D. Chinn
Social Sciences 7418

Problem Set 3

Due ***in lecture*** on Wednesday, April 30. Be sure to put your name on your problem set. Put "boxes" around your answers to the algebraic questions.

1. Consider a CC-LM model as laid out in the Bernanke-Blinder article.
1.1 Show what happens, graphically, if the Fed undertakes open market operations, by selling Treasury bonds.
1.2 Explain the economics behind why the curve(s) shift(s).

2. Consider a two period model of collateral constrained firms:
2.1 Show how a boom in stock price valuations could affect output and employment decisions.
2.2 Compare the behavior of the economy collateral constraints are important, and stock market valuations and cash flow rise with output, as compared to when investment behaves as:

$$I = b_0 - b_2 i$$

Use equations to help explain your answer. Be as quantitative as possible.

Chapter 18, Question 13
Suppose the demand for reserves is stable. Use a graph of the market for Bank Reserves to show how the Open Market Trading Desk would implement a decision by the FOMC to raise the target federal funds rate. You should assume that the discount and deposit rates are adjusted so that the spreads between them and the target federal funds rate are maintained.

Chapter 18, Question 15
Consider a situation where reserve requirements were binding and the Federal Reserve decided to reduce the requirements. Use the graph of the Market for Bank Reserves to illustrate how the Open Market Trading Desk would react to this change assuming the demand for excess reserves remains unchanged.

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