Week 14 Homework: Overview

ECO 301: Money and Banking

Financial Crisis and Response

Suppose a financial crisis leads to a drop in business confidence for future profitability, and a loss of confidence among lenders in the ability of borrowers to repay loans.

1. What is the impact on business investment? Describe and illustrate the short-run equilibrium effects on real GDP, price level, employment, and wage.

2. Describe and illustrate the equilibrium effects on the bond market, including the price of bonds, interest rates, and the quantity of bonds bought and sold.

3. Suppose the Federal Reserve responds to the crisis by changing the interest rate on reserve balances. In what direction should it change the interest rate? Describe and illustrate the impact of this policy on the market for reserves, including the effect on the quantity of reserves and the federal funds rate.

Open Market Operations

4. Suppose the Federal Reserve responds with an open market operation. Should it buy or sell bonds? Describe and illustrate the impact of this policy on both the market for reserves and the bond market, including the effects on the quantity of reserves, the federal funds rate, the price of bonds, and interest rates on bonds.

5. Describe and illustrate the impact on the Federal Reserve's policies in the previous two questions on the short-run equilibrium effects on real GDP, price level, employment, and wage.

6. Suppose the federal funds rate and interest rates on short-term federal government bonds are close to zero, so the Federal Reserve responds with a quantitative easing policy that involves open market purchases of long-term government bonds. Describe and illustrate the impact of this policy on the yield curve.