

HOMEWORK 8. Due Monday April 12.

1. (This is a question from a final exam I gave at Binghamton.) Consider the Consumption-CAPM (C-CAPM). Assume that there are two states of the economy next year, “good” and “bad”, the good state happens with probability 0.5 (and the bad state with probability 0.5). In the good state aggregate consumption grows 4% and in the bad state it grows 0%. Now consider assets D and E. For these we know the pay-outs. For D the payout is 20 in the bad state and 10 in the good state, while for E the payout is 5 in the bad state and 5 in the good state. Use the C-CAPM as it was derived in the handout. The safe rate of return is 1%.

What would be the price of asset D and asset E?

2. Romer 7.3. [This is also based on a famous paper.]