

This homework is due on Thursday December 11 at the end of class

When you are asked to make a graph please carefully label all variables, axis, and the slope of each line you draw.

The homework consists of 6 questions.

Note that there are 160 points available not 100. Consider the extra 60 points as extra credits to help your grade.

**Question 1: (40 points)**

Read the paper by Fernández-Villaverde, Jesús, Luis Garicano, and Tano Santos, "Political Credit Cycles: The Case of the Eurozone." *Journal of Economic Perspectives*, 27(3): 145-66. (the paper is available on the class website and on Angel).

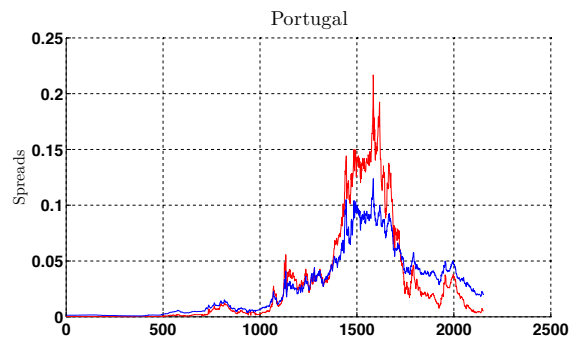
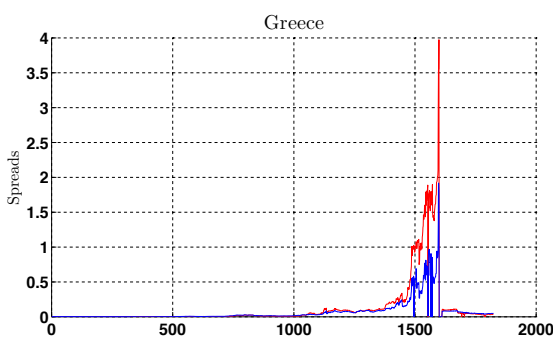
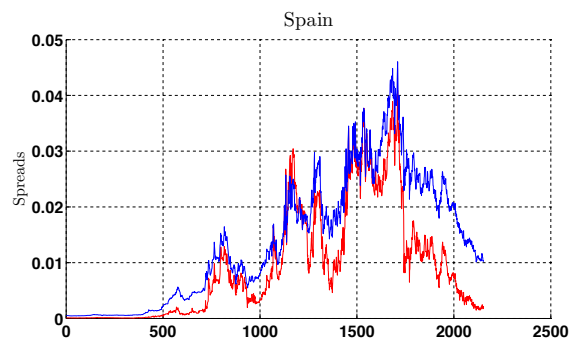
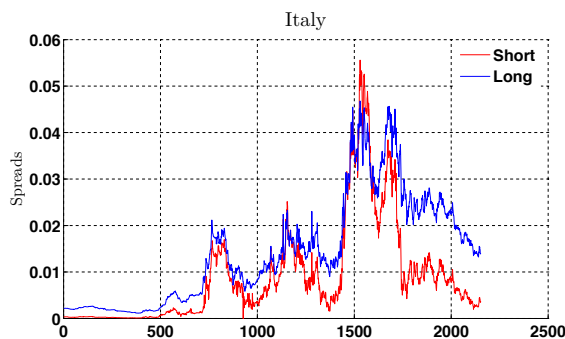
Please write a summary of the paper (around 500 words). Make sure to summarize what is the main thesis of the paper and which data they cite to support it. Be as precise and concise as possible.

**Question 2: (40 points)**

Please do Exercise 4 at the end of Chapter 1 in the lecture notes.

**Question 3: (20 points)**

Define what a sovereign default is. What is an interest rate spread? Define what a credit default swap (CDS) is.



The picture plots the CDS at 1 year (labelled "Short", red line) and 5 year (labelled "Long", blue line) for rate for 4 Southern European countries. The data are daily. The big spike coincide with 2011-2012.

What is the term structure of the CDS? Is it typically upward sloping or downward sloping? What about during crisis? Do you see these typical features in the picture above?

**Question 4: (20 points)**

Please explain the two-way feedback link between high spreads for the sovereign and weak bank balance sheet (what is commonly referred to as "*doom-loop*")

**Question 5: (20 points)**

Please do Exercise 1 at the end of Chapter 11.

**Question 6: (20 points)**

Please do Exercise 2 at the end of Chapter 11 in the lecture notes.