

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 305  
Intermediate Macroeconomic Theory

Prof. Kasa  
Fall 2008

PROBLEM SET 3  
(Due November 10)

1. Use the IS-LM model to predict the effects of each of the following shocks on output, the interest rate, consumption, and investment. In each case, explain what the Central Bank should do if it wants to keep income at its initial level.
  - (a) Following the invention of a new computer chip, many firms decide to upgrade their computer systems.
  - (b) Improvements in ATMs lead people to reduce their demand for money.
  - (c) A best-seller entitled *Retire Rich* convinces people to increase their savings rate.
2. Suppose the government wants to encourage investment but keep aggregate output constant, since it fears that if output increases beyond capacity it will eventually produce inflation. In the IS-LM model, what mix of monetary and fiscal policy will achieve this goal?
3. During the 1980s, the Canadian federal government ran budget deficits while the Bank of Canada pursued a tight monetary policy. What is the predicted consequence of this policy mix?
4. The Central Bank is considering two alternative operating procedures: (1) Keep the money supply constant, and let the interest rate adjust to clear the money market, and (2) Keep the interest rate constant by adjusting the money supply (which implies the LM curves becomes horizontal). In the IS-LM model, which policy will better stabilize output under the following conditions:
  - (a) All shocks to the economy arise from exogenous changes in the demand for goods and services.
  - (b) All shocks to the economy arise from exogenous changes in the demand for money.
5. Using the Mundell-Fleming model (i.e., a small open economy with perfect capital mobility), explain why fiscal policy does not affect output when the exchange rate is flexible. Explain why monetary policy does not affect output if the exchange rate is fixed. Use graphs to illustrate your answer.