

SIMON FRASER UNIVERSITY
Department of Economics

Econ 305
Intermediate Macroeconomic Theory

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PROBLEM SET 3
(Due March 26)

1. How would the market-clearing approach to business cycles (sometimes called the ‘Real Business Cycle’ model) explain the recent recession? According to this approach, was a government ‘stimulus plan’ needed? Explain.
2. Explain how the market-clearing approach to business cycles could account for the ‘dotcom’ boom of the 1990s based on anticipated improvements in information technology. Now suppose that people overestimated the benefits of information technology, and the anticipated higher productivity never materialized. According to our model, what would happen in the future once people realize that productivity will *not* be higher? To what extent are these predictions consistent with what happened during the early years of this decade.
3. Use the Keynesian 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.
4. 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 Keynesian IS-LM model, what mix of monetary and fiscal policy will achieve this goal?
5. During the 1980s, the Canadian federal government ran budget deficits while the Bank of Canada pursued a tight monetary policy. According to the Keynesian IS-LM model, what is the predicted consequence of this policy mix?