SIMON FRASER UNIVERSITY
Department of Economics

Econ 305 — Prof. Kasa
Intermediate Macroeconomic Theory — Spring 2012

PROBLEM SET 3
(Due March 21)

1. (15 points). Conservative commentators in the US often attribute the slow recovery to market concerns about what Obama might do in the future. In particular, it is often argued that people are worried that he might raise taxes and spending in the future, and that this is holding back the recovery today.

   (a) Use the market-clearing Real Business Cycle model developed in chapters 9-11, to analyze the effects of expectations of higher future government spending and (lump-sum) taxes. Under what conditions can this explain a slow recovery?

   (b) Now suppose that taxes are not lump-sum, but instead have the effect of reducing incentives and productivity. Explain how this would change your analysis. Would the 'Obama effect' become more or less convincing?

2. (15 points). There has been much debate among economists about Classical versus Keynesian business cycle models. It would be nice to be able to distinguish between them. Some people have argued that we can do this by looking at how employment responds to productivity shocks. Explain why this is. Compare and contrast what each model predicts about how employment responds to productivity shocks. If possible, use graphs to illustrate your answers.

3. (15 points). There has been much debate among economists about Classical versus Keynesian business cycle models. It would be nice to be able to distinguish between them. Some people have argued that we can do this by looking at the correlation between output and the price level. Explain why this is. Compare and contrast what each model predicts about the correlation between output and the price level. If possible, use graphs to illustrate your answers.

4. (15 points). Use the Keynesian IS-LM model to provide one possible explanation of the recent financial crisis. Use a graph to illustrate your answer. Describe how monetary and fiscal policies could be used to respond to the crisis, and discuss the pros and cons of each.