SIMON FRASER UNIVERSITY
Department of Economics

Econ 305 — Prof. Kasa
Intermediate Macroeconomic Theory — Spring 2013

PROBLEM SET 3
(Due March 27)

1. (20 points). One of the reasons there has been so much focus on fiscal policy is the argument that monetary policy is currently stuck in a 'Liquidity Trap'. What exactly is a Liquidity Trap? Why is it a trap? When and why do they occur? Why does monetary policy lose its ability to influence output in a liquidity trap? Use the Keynesian IS-LM model to illustrate a liquidity trap. (Hint: See the Krugman article entitled "IS-LMentary" posted on the class webpage).

   According to the market-clearing/neoclassical model, are 'liquidity traps' a problem? Why or why not?

2. (20 points). Explain how the neoclassical/market-clearing model explains a positive correlation between inflation and output. (Hint: See either the notes or textbook under the heading 'Lucas Supply Curve'). According to this view, can monetary policy be used to stabilize output? Why or why not?

3. (20 points). According to the open-economy IS-LM model, would an economy's output and employment be more stable under flexible exchanges or fixed exchange rates? Illustrate your answer with a graph.