

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 305  
Intermediate Macroeconomic Theory

Prof. Kasa  
Fall 2015

PROBLEM SET 3  
(Due November 19)

1. (25 points). There has been a lot of recent debate about the effects of ‘fiscal austerity’. Suppose the government decides to permanently reduce spending, perhaps based on the belief that the budget deficit is ‘too high’. Use the real intertemporal model developed in chapter 11 of the textbook to analyze the effects of this policy on output, employment, investment, consumption, wages, and interest rates. Some people argue that fiscal austerity will harm the economy. What does the model predict? (Hint: Be sure to distinguish between output and welfare).
2. (25 points). One of the things that makes economics difficult is that expectations about the future can have effects today. Use the real intertemporal model from Chapter 11 to analyze the effects today of an anticipated increase in *future* productivity. What happens to current output, employment, consumption, and investment. Suppose the expectations turn out to be incorrect, and productivity turns out to be lower than expected. What happens next period? (Hint: It might help to use graphs to illustrate your reasoning).