

FINAL EXAM (December 7)

Answer the following questions True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (8 points each).

1. The Bank of Canada controls the money supply.
2. Reducing inflation causes the unemployment rate to rise.
3. According to the Mundell-Fleming model, output is more stable under flexible exchange rates than under fixed exchange rates.
4. Real Business Cycle models predict that output growth is uncorrelated with money growth.
5. Inflation targeting will de-stabilize output when there are supply shocks.

The following questions are short answer. Briefly explain your answer. Clarity will be rewarded.

6. (20 points). The U.S. economy is currently in a recession. At the same time, inflation has been falling.
 - (a) Use the AD-AS model to describe what must be happening in the U.S. economy. What sort of shock must have occurred? Do you think this is more supportive of the Keynesian or Classical approach to business cycles? Why?
 - (b) Use the IS-LM model to describe two reasons why this may have occurred.
 - (c) Briefly discuss two policy responses to the recession. How do they differ? Suppose no policy response is taken. What would happen over time? Would the economy stay in recession? Why or why not?
7. (20 points). China has a fixed exchange rate against the U.S. dollar. Suppose the U.S. economy experiences a severe recession. Would China be better off with a fixed exchange rate, or should it allow its exchange rate to float? Does your answer depend on *why* the U.S. economy experiences a recession? Use the Mundell-Fleming model to illustrate your answer.
8. (20 points). Canada has a flexible exchange rate against the U.S. dollar. Suppose the U.S. and Canadian economies are both in a recession. The U.S. authorities can respond to their recession by either cutting interest rates, or by increasing government spending. As a Canadian, which would you prefer? Why? (Hint: Use the Mundell-Fleming model).