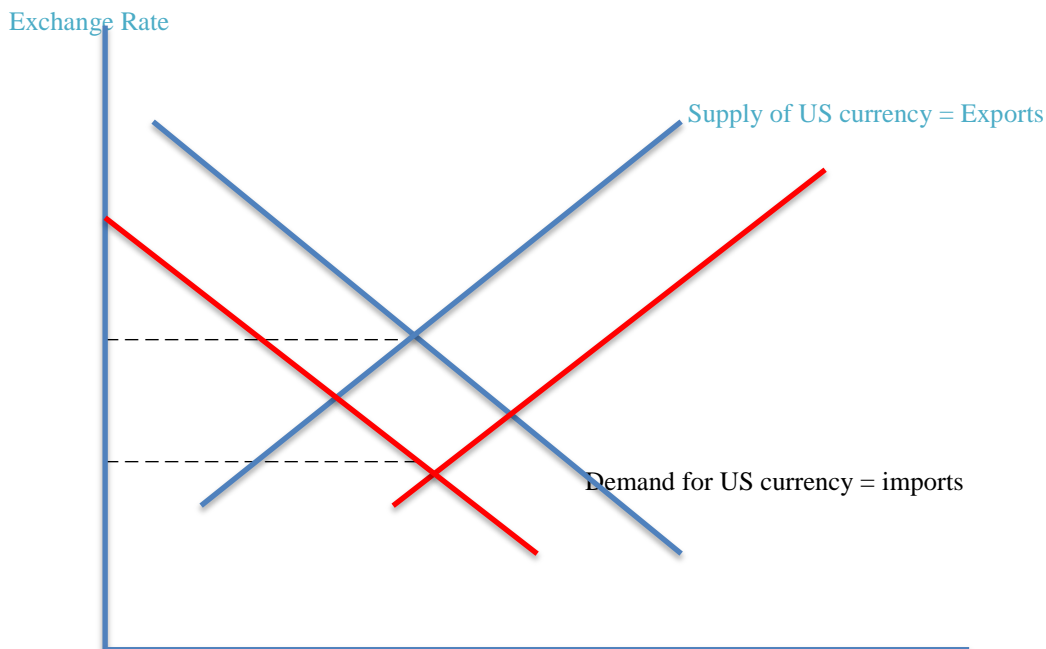


Part III: Long Answer Questions (10 Marks Each, Total = 30 marks)

1. "There is a direct relationship between declines in wealth, and declines in consumption and business investment, which along with government spending represent the economic engine. Between June 2007 and November 2008, Canadians lost an estimated average of more than a quarter of their collective net worth"

- (i) Suppose Canada wants to fight these declines using monetary policy. Explain in detail how the central bank will do this focusing especially on how net exports plays a role and how the exchange rate is affected. Illustrate graphically and provide an intuitive explanation.

Answer: The Central Bank should set a lower interest rate (using the overnight interest rate technique) to increase Investments, Next exports and Consumption. Exchange rate will however decrease because investors prefer to buy assets in Canada then in any other Country (e.i USA). The Canadian Currency appreciates (The demand for this currency is higher).

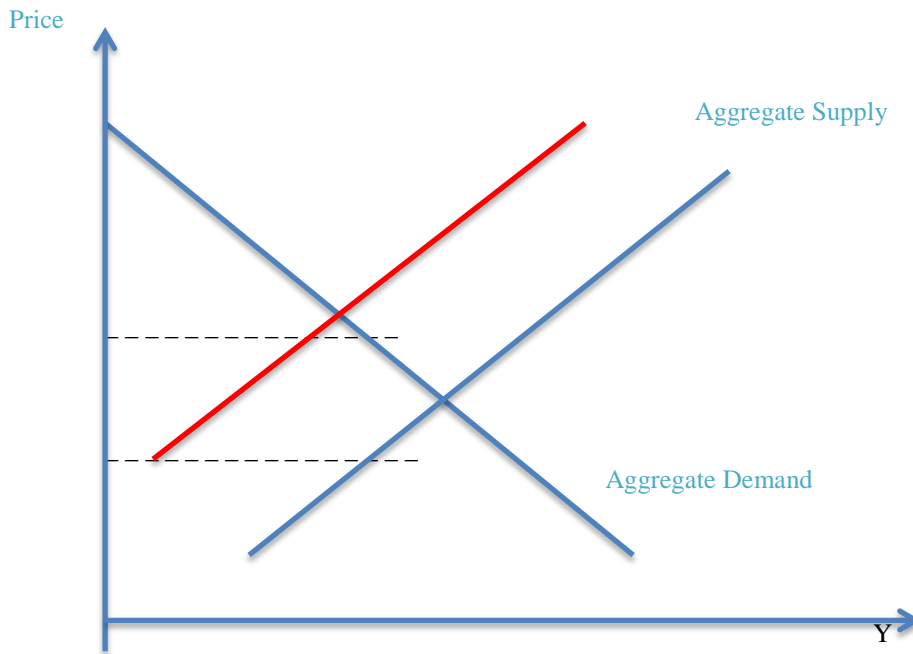


- (ii) Now assume that Canada has a fixed exchange rate with the US. Explain how the central bank can stop the change in the exchange rate caused by the anti-recession policy discussed in (i). Explain in detail why monetary policy is not effective under a fixed exchange rate system. Illustrate graphically and provide an intuitive explanation.

(i)

The Bank of Canada will buy and sell US and Canadian currencies to react to any changes in the exchange rate. In this case the BoC will sell Canadian currency and buy US currency because there is an excess demand for Canadian currency. This will decrease the value of the Canadian dollar and therefore increase the exchange rate.

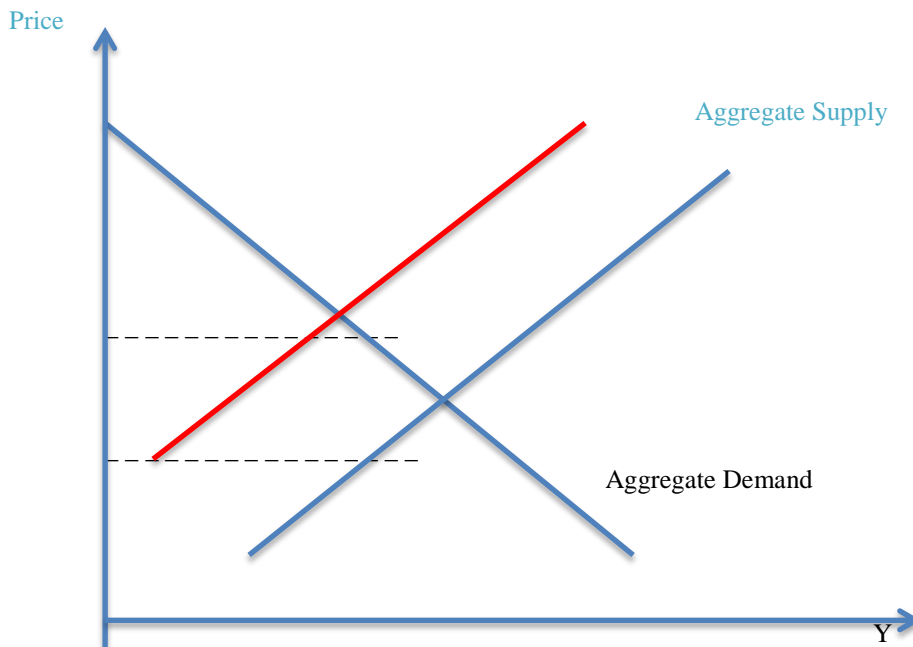
Under fixed exchange rate system, monetary policies won't be effective because by decreasing the interest rate, the BoC increases the Net exports. However the exchange rate is fixed, therefore increasing the Net exports will be counterproductive.



1. "Oil prices spike due to fighting in Iraq and instability in Venezuela"

- (i) Oil is an important factor input in the production processes of many industries. Assuming the economy was initially at its potential level of Y , how does an increase in the price of a factor input affect national income and the price level in the short run? Illustrate graphically and provide an intuitive explanation.

In the Short run, the AS will decrease because the costs of producing are higher.



- (ii) How could the federal government use fiscal policies to bring the economy back to full employment?

The federal government will attend to increase AD by increasing its government expenditure (G).

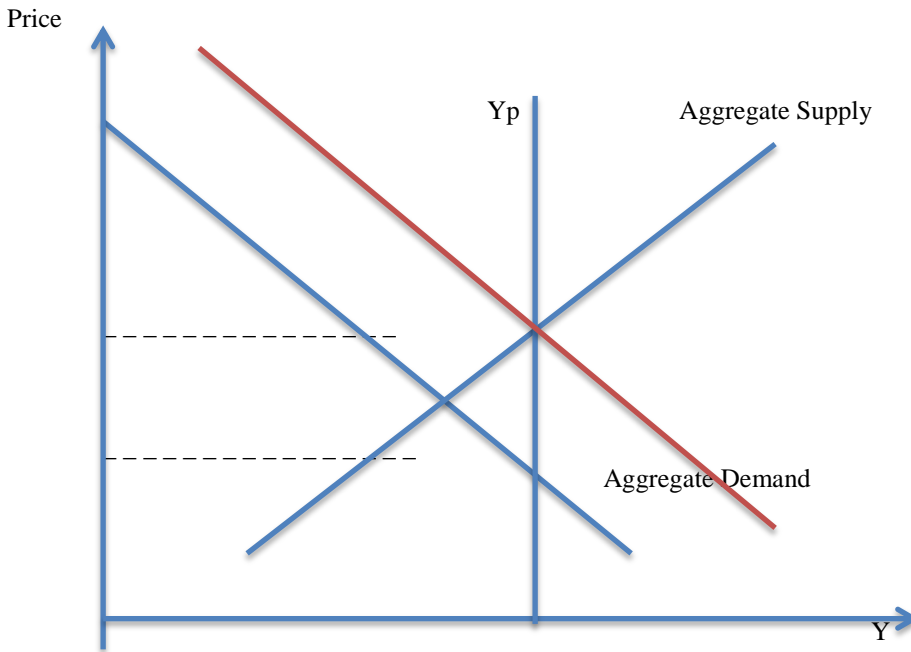
(iii) How would these policies affect the government's budget balance and debt to GDP ratio?

The Budget Balance: $BB = tY - G$ will decrease because G increases. The budget balance could even be negative depending on what are the tax rate and GDP. If the public debt do increase ($\text{Public Debt} = -BB$) the debt to GDP ratio would then also increase.

2. "Following a recession, the Canadian government decided it was time to take action and spur the market."

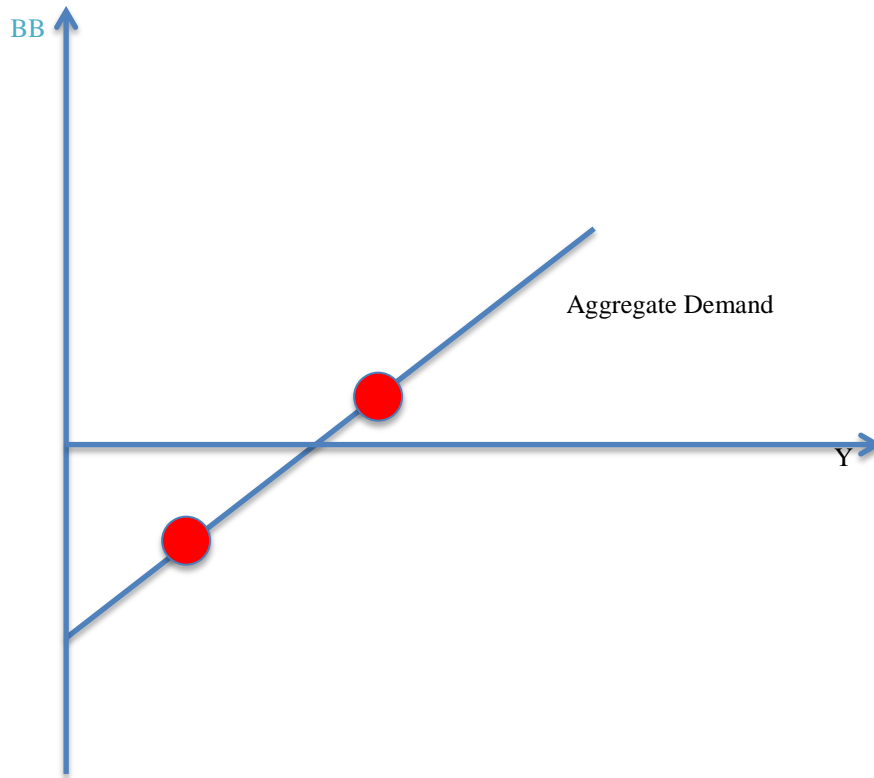
(i) Explain, using a graph, how the BoC will adapt its policy to spur the market, all the while focusing your answer on which policy will be implemented.

To spur the market the BoC can decrease the interest rate (Increase the Money supply). This will increase Consumption, Investment and Net Exports.



(ii) Based on your answer in (i), how will this affect the government's budget balance intuitively? Illustrate graphically.

The only way this can affect the budget balance is by automatic stabilization (change in Y). This will be a move of Y along the BB curve.



THANK YOU! DO YOUR BEST ON THE FINAL EXAM!

PLEASE REMEMBER TO FILL OUT THE EVALUATION AT THE END OF THE SESSION!