Class Assignment 2

API 5125

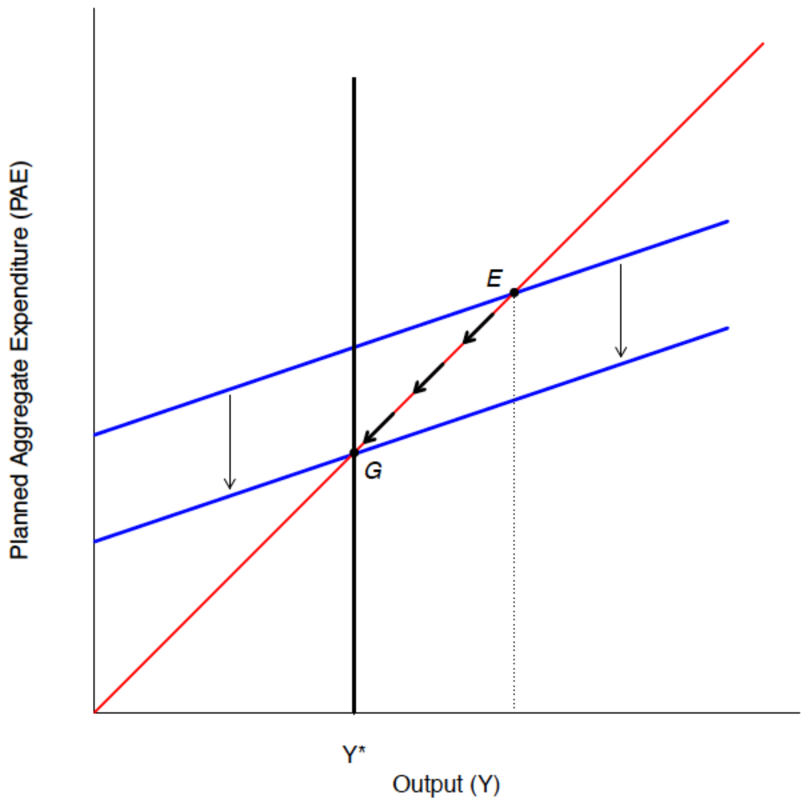
October 20th, 2016

Instructions

- Please note that an electronic version of this assignment is available at http://milescorak.com. This version has active hyperlinks to some of the websites that are referred to, and coloured versions of some of the figures.
- The assignment is due in hardcopy to be handed directly to the professor at the beginning of class on November 3rd. Late assignments will not be accepted, and the student will receive a grade of zero for the assignment.
- Feel free to work individually or in small groups when preparing to answer the questions. But each individual must complete and hand in their own work.
- The assignment has 4 questions. In order to be able answer all of these questions you will have to read ahead and use the materials in the course reading list for the November 3rd and November 10th classes.

Question 1

Consider the following figure.



(a) Carefully copy it into your answer booklet, and label all the lines and other relevant points with clear explanatory labels.
(b) Use your knowledge of macro-economic theory to intuitively explain what the figure is meant to represent, and explain why the outcome is significant.
(c) What government policies can be used to address this issue, and under what circumstances are they appropriate.

Question 2

Consider the hypothetical macro-economy described by the following equations.

$$C = 640 + 0.8(Y - T) - 400r \tag{1}$$

$$I^P = 250 - 600r \tag{2}$$

$$G = 300 \tag{3}$$

$$NX = 20 \tag{4}$$

$$T = 250 \tag{5}$$

(a) Briefly explain what each of these equations means, including a statement of whether a variable is exogenous or endogenous.
(b) Write a numerical equation linking planned aggregate expenditure to output, showing your calculations.
(c) Assume that the real interest rate is set by the Bank of Canada to equal 0.05 (in other words, 5 percent) for the economy described by these equations. Find the short-run equilibrium output, showing your calculations. What other piece of information would you need to know to assess whether this interest rate is "appropriate" or not?

Question 3

The following two articles, published in the May 23rd, 2015 issue of *The Globe and Mail,* deal with the role of macroeconomic policy in the United Kingdom, and the debate over it in the outcome of the recent election in that country.

1. Niall Ferguson (2015), "Deficits vs. austerity: New facts, same old Keynesianism," *The Globe and Mail*, May 23rd. Available at: https://milescorak.files.wordpress.com/2015/05/de vs-austerity-new-facts-same-old-keynesianism-the-globe-and-mail.pdf, accessed May 25th.

2. Robert Skidelsky (2015). "Deficits vs. austerity: Pain for little gain," *The Globe and Mail*, May 23rd, Available at: https://milescorak.files.wordpress.com/2015/05/deficits-vs-austerity-pain-for-little-gain-the-globe-and-mail.pdf, accessed May 25th.

(a) Read both articles and offer a brief biography of each of the authors. In addition, identify all the major political figures and economists to whom the authors make reference in their articles, and make clear the roles they play in the government and politics of the United Kingdom.
(b) Use your knowledge of macroeconomic theory to explain from which theoretical perspective each author is writing, clearing stating the underlying assumptions that distinguish their views of the macro-economy.

(c) Explain, in your view, the important features of these models that might appeal to politicians and policy advocates who have different predetermined visions of the functioning of markets and the role of the state in economic life.

Question 4

(a) In 1991 The Bank of Canada and the Minister of Finance introduced an agreement on inflation targeting as the basis for Canadian monetary policy. This agreement has been renewed every five years, and is slated for renewal in 2016. Explain the nature of the original 1991 agreement, basing your answer on the materials from the Bank of Canada website at http://www.bankofcanada.ca/core-functions/monetary-policy/renewing-canadas-inflation-control-agreement/, in particular extracts from the March 1991 *Bank of Canada Review* available as part of the listed "information about previous agreements" [http://www.bankofcanada.ca/wp-content/uploads/2011/12/bocreview-mar1991.pdf], and the course reading list. Be certain to clearly explain what the Bank means by "price stability" for its operational purposes, the limits of the CPI in measuring it, and the nature of the index that the Bank proposed to target. Also explain the Bank's assessment of the costs and benefits of inflation, and why pursuing a "zero" inflation rate target was seen as helpful in its fight against inflation.
(b) Obtain and use information from the Statistics Canada web site on a sufficiently long times series of the inflation rate—as measured both by changes in the CPI and the appropriate index the Bank targets—to explain the evolution of the inflation rate, and assess the extent to which the Bank has reached its goal. Your analysis should include the most recently available data, and assess the period before 1991 to the most recent experience. Did the Bank attain the original targets set out in 1991? What has happened since? What other macroeconomic variables would you find helpful to look at in order to assess the costs and benefits of this policy?
(c)The Bank of Canada publishes an overview of its monetary policy every three months (that is every quarter) called the *Monetary Policy Report*. Obtain a copy of the latest of these overviews from the Bank of Canada web site [http://www.bankofcanada.ca/publications/mpr/]. For the period covered in the report, did the Bank of Canada raise interest rates, cut them, or leave them unchanged? What were the major developments in the economy that were of concern to the Bank, and how have these developments influenced the Bank's current monetary policy stance?