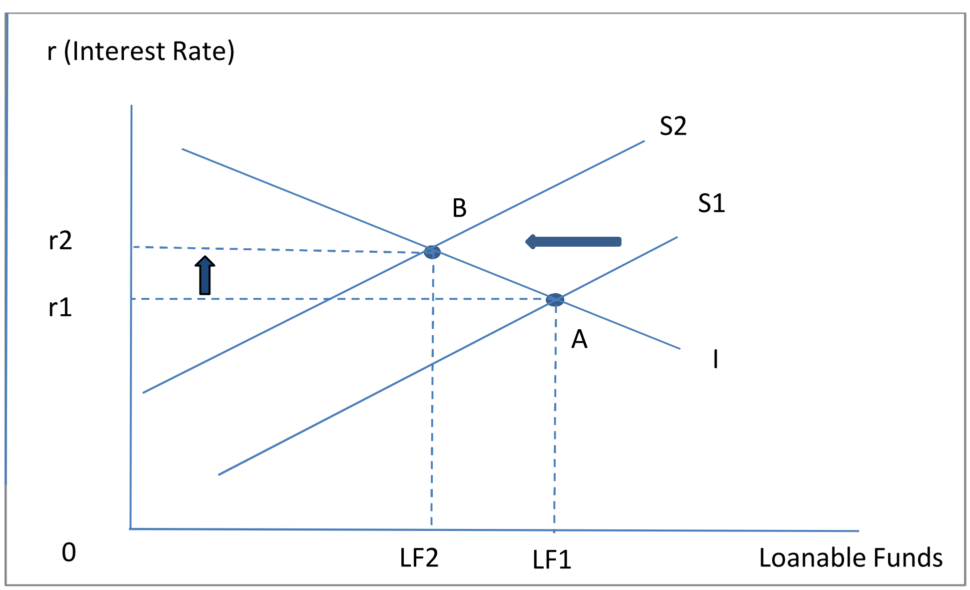
PRACTICE FINAL EXAM
University of Ottawa, ECO1102B (Winter 2008)
Answer Key

[1 point each]

1. C	17. C	33. B	49. D	65. A
2. A	18. A	34. D	50. C	66. B
3. B	19. C	35. D	51. B	67. B
4. A	20. D	36. B	52. B	68. A
5. A	21. B	37. B	53. B	69. B
6. B	22. C	38. D	54. A	70. A
7. A	23. C	39. B	55. A	71. A
8. C	24. D	40. C	56. A	72. B
9. A	25. A	41. D	57. A	73. A
10. A	26. D	42. B	58. B	74. A
11. A	27. C	43. A	59. A	75. B
12. C	28. C	44. B	60. A	76. B
13. C	29. D	45. A	61. B	77. A
14. A	30. D	46. C	62. B	78. A
15. C	31. A	47. D	63. A	79. A
16. C	32. A	48. D	64. A	80. B
				81. A

82. (4 points) Explain why sustained government deficits are likely to lead to lower living standards in the long run You may want to use a diagram.

Sustained government deficits reduce national savings. In the market for loanable funds, this means that the supply curve shifts left. This shift causes a rise in the interest rate and a fall in capital investment, which will lead to lower productivity and lower living standards in the long run.



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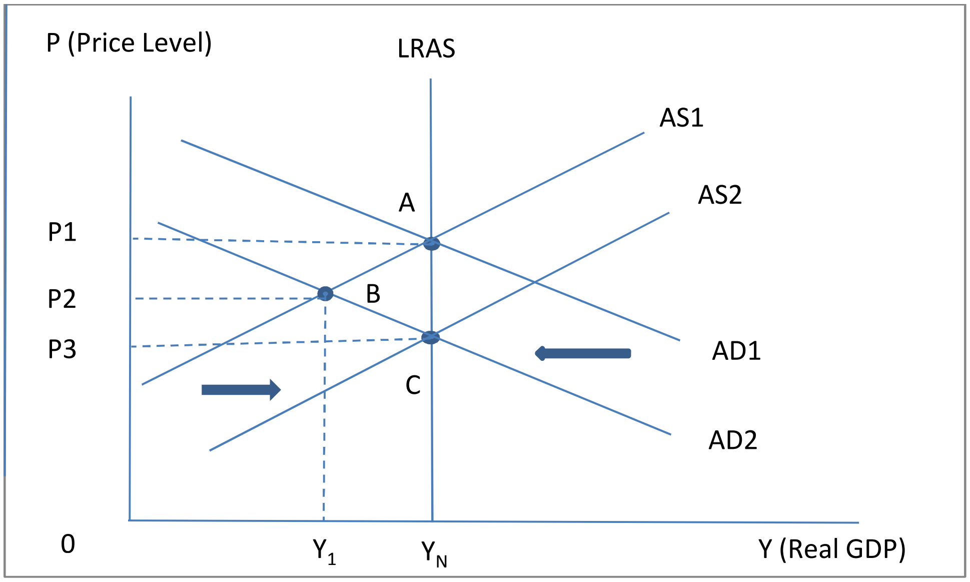
83. (10 points) Suppose that the economy is in a long-run equilibrium.

a. Use a diagram to illustrate the state of the economy. Be sure to show aggregate demand, short-run aggregate supply and long-run aggregate supply.

The economy is at point A in the diagram below. [2 points]



b. Now, suppose that firms become pessimistic about future business conditions and significantly cut their capital investments. Use your diagram to show what happens to output and the price level in the short run. What happens to the unemployment rate?

Because the wave of pessimism affects investment plans, the AD curve shifts left. In the short run, the economy moves along the initial short-run AS supply curve to point B. The price level falls and output falls. The latter indicates the economy is in a recession. The unemployment rate increases since firms respond to lower profits and output by reducing employment. [2 points]

c. Assuming no change in policy, what would happen to output, employment and the price level in the long run? Explain. (For now, assume that there is no change in the long-run aggregate supply curve.)

At point B, the price level is lower than people had come to expect. Price expectations will adjust to this new reality by falling in the long run. Negotiations between firms and workers will reduce wages, some firms that delayed reducing prices will do so, and some firms will realize that their relative price did not fall. For each of these reasons, output will increase for any given level of prices, and the AS curve will shift right. This will move the economy to point C. At this new long-run equilibrium, output is back to its natural rate and the price level is lower by an amount sufficient to offset the initial shift in the AD curve. [2 points]

d. Is there anything the government and/or the Bank of Canada could do in the short run to soften the impact on the economy? Explain.

The government could increase expenditures and/or the Bank of Canada could increase the money supply. Either would increase AD. If those policies can offset the initial shift in AD, the economy would return to point A, output and employment would return to their natural rates, and the price level would return to its initial level. [2 points]

e. How might the drop in capital investment affect the long-run aggregate supply curve?

The drop in capital investment could lead to a fall in productivity and living standards that would be reflected in a shift in the LRAS curve to the left. [2 points]

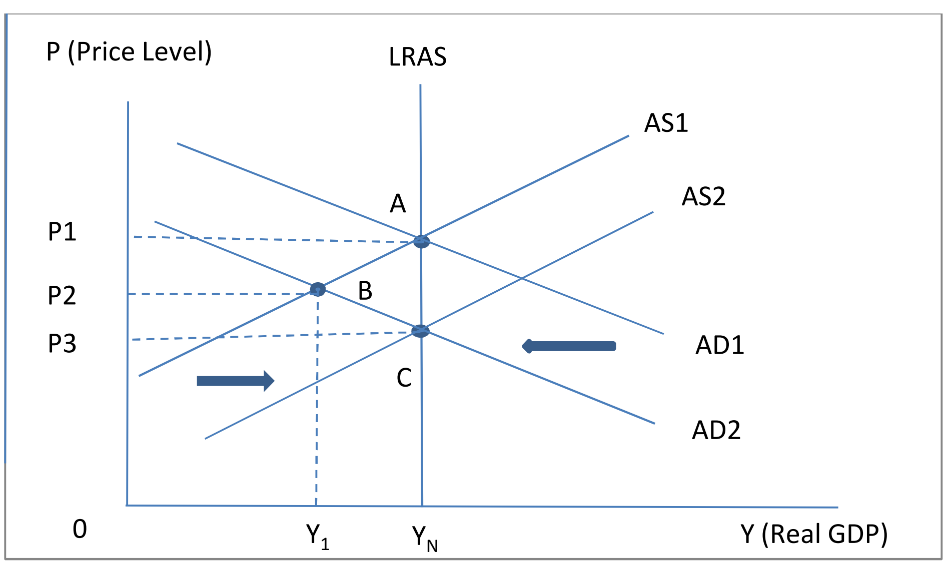
84. (5 points) In the 1970s, people had become accustomed to high inflation. In 1979, the Bank of Canada decided to fight inflation and decreased the money supply growth rates. Many people thought that the Bank of Canada's action would cause a recession.

a. Is this thinking consistent with the aggregate demand and aggregate supply model? Explain.

Yes, it is consistent. The AD/AS model predicts that a drop in the money supply will lead to a drop in AD (i.e., the AD curve shifts left). This will cause price to fall, but it will also cause real GDP to fall, which results in a recession. The economy moves from point A to point B in the diagram below. [3 points]

b. According to the sticky wage theory, what should have happened to output if people had believed the Bank of Canada's commitment to reduce the inflation rate and had perfectly anticipated the drop in prices. Explain.

If people had perfectly anticipated the drop in prices, then nominal wages would have dropped. In other words, the short-run AS curve would have shifted right, which means that the recession could have been averted. The economy would have moved from point A directly to point C in the diagram below. [2 points]



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85. (5 points) On April 22, the Bank of Canada will announce whether it increases, decreases or does not change the bank rate. What do you expect the announcement to be? Explain. (I am not looking for exact numbers, just the direction of a change if a change is announced; you may want to use a diagram to explain your answer.)

I would not ask this question in this way. If I were to ask a question like this, I might provide the following facts and then ask what you to determine how they would be reflected in the AD/AS diagram, and what the Bank of Canada's response might be.

Some facts:

- The US economy is slowing down, which means that NX is falling.
- Canadian stock markets are down, which means that both C and I are falling.
- Inflation seems to have subsided.

The first two facts strongly suggest that AD is shifting left.

An increase in the money supply will increase inflation. But since inflation has subsided, maintaining the inflation target should not be a problem.

Thus, to counteract the fall in AD, the Bank of Canada will probably want to increase the money supply by reducing the bank rate.