This review sheet is intended to cover everything that could be on the exam; however, it is possible that I will have accidentally left something off. You are still responsible for everything in the chapters covered except anything that I explicitly say you are not responsible for. Therefore, if I left something off of this sheet, it can still be on the exam. There will be no multiple-choice questions. Most of the questions will be like the ones in the homework assignments, and possibly a few definition questions, but I am more likely to ask questions that make you use the definitions rather than recite them. I will probably ask one of the questions from the book at the end of the chapters.

The review session will be at a time to be determined in class, probably 11/12.

Chapter 10: What is meant by the term **long-run aggregate supply curve**? What determines its shape and its location? How does it relate to the PPF, a.k.a. the PPC? What is **aggregate demand**? Why does it take its shape? <u>Note the logic used for the demand curve's slope does not apply to the slope of the aggregate demand curve.</u> What moves the AD curve? *Anything that changes the demand for goods and/or services (C+I+G+X), other than price induced changes in the demand, will move AD. Remember that for all curves, if a variable on one axis changes causing the other variable to change, then you did not move the curve, you retraced it.* What causes inflation? What are **demand pull and cost push inflation**? The book goes into more detail in Chapter 11.

Chapter 11: What are the four assumptions of the **classical school**? What did **Say say**? How does it relate to the **SRAS curve**? Note that we went into more detail than the book on that explanation. How does it relate to labor supply and labor demand? Why should S = I? What assumptions did **Keynes** make? How did that relate to the SRAS curve? Why do we draw the "**Modern**" SRAS? *Unless I specify otherwise, when I refer to the SRAS, use the "Modern SRAS."* What moves the SRAS? *Notice that the only thing that moves SRAS without moving LRAS is the price of inputs because they do not affect how much could be produced if we are <u>at full employment</u>. Note the book has useful tables on Pages 217 (Chapter 10) and 240, which is slightly misleading in the next to last line. Marginal **business and/or sales** tax rates move the SRAS because it is a cost of production, while marginal **income** tax rates affect aggregate demand because they reduce income, not raising the cost of production. The prices of inputs only temporarily affect the costs of production without any long-term effects. Since expected future price increases will increase wages, which are an input price, it will move only the AD and SRAS curves but not the LRAS curve.* What is meant by **supply shock** and **demand shock**? What are **inflationary and recessionary gaps**? How will they solve themselves if the government takes no actions? What are the demand pull and cost push inflations? How does a change in the value of the dollar on the foreign exchange market affect the SRAS/LRAS/AD diagram? *Note that the book should combine the panels in Figure 11-12. Unless specified otherwise, use the "modern" SRAS curve when asked for the SRAS curve. If you are not told that unemployment is high or low (recessionary gap or inflationary gap respectively), start your graph with LRAS crossing SRAS where it crosses AD.*

Chapter 13: What is fiscal policy? What should the government do with taxes and spending if there is an **inflationary gap** or **a recessionary gap**? Show those actions on the **LRAS/SRAS/AD diagram**. What are the drawbacks of doing fiscal policy, for example, **crowding out investment, direct expenditure offset,** and **lags**? Why are these problems? What is the **Laffer Curve** and why does it matter? What is Ricardian Equivalence and why should it hold? Note that **Ricardian Equivalence**, the size of crowding out and lags are often debated among economists. What are automatic stabilizers?

Chapter 14: What determines the size of the **government deficit/surplus**? Why should we know the unemployment rate when considering the desirability or lack of desirability of the deficit? How does a deficit differ from the **debt**? Be able to calculate the **full-employment deficit**. What is the difference between **gross public debt** and **net public debt**? What are the problems caused by them? To what extent are these arguments valid: **high interest payments hurt, future generations must pay the debt, crowding out,** and **we owe foreigners the money**? How is the government deficit related to the **trade deficit**, i.e., the **twin deficits**? Why is it important to know why the deficit is big? How are the short-run and long-run effects of the deficit different? Why is it difficult to reduce the deficit? For example, why are most expenditures tough to cut and why isn't raising taxes a good option? Why does **Paul O'Neill** say that the government owes a lot more than the amount they borrowed?

This is the non-graded Assignment #8A that will be reviewed with Assignment #8.

According to The Treasury, http://www.treasurydirect.gov/NP/debt/current, on 2015/11/5, the total federal public debt was $18,532,854,382,821.74. According to the Census Bureau's population clock at 9:30 PM on 2015/11/5 http://www.census.gov/popclock/, the population was about 322,102,511 people. That is $ $57,537.13 per person. According to NASA, http://map.gsfc.nasa.gov/universe/uni_age.html, the solar system started 4,500,000,000 years ago. Therefore, if you earned 0.78 cents every minute (without earning interest) from the start of the solar system, you would not have enough to pay the debt.

1) (25 points) Explain the differences between the *net public debt, gross public debt,* and the debt which Paul O'Neill talked about. Which do you think is the more relevant one when we are discussing the problems caused by the debt? Explain your logic.

2) (15 points each) For each of the following explanations of problems caused by the debt, explain the argument. Do you think the argument is valid or not? Explain your logic.
A) When we pay off the debt, we will have to raise taxes which will hurt our economy.
B) High interest payments hurt the economy.

3) (25 points) Suppose the government spending was $1000, transfer payments are $950 – .01*GDP, and tax revenue is .19*GDP. If GDP is $10,000 then how much is the government deficit or surplus. If Y_{FE} is $9,000 then how much is the full-employment deficit? Show all work. Is the government doing good fiscal policy? Explain your logic.

4) (20 points) Explain how the government deficit can cause a trade deficit.