

Place your name on the back of this sheet of paper and nowhere else. Staple your answers face up on the front of this sheet of paper. Failure to follow these directions will cost you 10 points. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to type it will cost you 10 points. If you use double-sided printing or print on the back of scrap paper, I will give you one additional point.

1) (25 points) Draw the Keynesian Cross, a.k.a. 45° diagram. Illustrate the effects of an increase in government spending. Why did the curve(s) moved as drawn? Given your diagram, what do you estimate the size of the government spending multiplier to be? Explain how you reached the conclusion.

2) (20 points) Draw the LRAS/AD diagram. Illustrate the effects of an increase in government spending. Explain why the curve(s) moved as drawn. What happens to the price level and GDP?

3) (20 points) Draw the LRAS/AD diagram. Illustrate the effects of an increase in population. Explain why the curve(s) moved as drawn. What happens to the price level and GDP?

4) (5 points) What is wrong with the following statement? “When the price level increases, people cannot afford to buy as much. That is why AD slopes down.”

5) (15 points each) Answer each part in separate paragraphs. When we estimated the size of the government spending multiplier, we implicitly made several assumptions. For each of the variables below, state what we assumed about that variable. Then explain what would happen to the size of the multiplier if we relaxed that assumption. Also explain why the multiplier would change as described.

A) Taxes

B) Imports