

This review sheet is intended to cover everything that could be on the exam. However, it is possible that I may have overlooked something. 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 on Tuesday, 4/8 at 7:00 PM. It will be in the normal room, Steinman 105.**

Chapter 7: Know how Friedman's permanent income hypothesis and Modigliani's life-cycle income explain the consumption function. How do assets, durable goods, interest rates, expectations, and consumer credit affect consumption?

Chapter 8: What is investment? What are its costs and benefits? Know how to set up a present value calculation to determine whether the investment is worth doing. Note that if you leave this year's costs out of the calculation, then you have to determine if  $V_p$  is greater than this year's costs. If you include this year's costs in the calculation, you have to determine if  $V_p$  is positive. Why is investment a function of interest rates? What determines the interest elasticity of demand for investment? Why does investment depend upon net national product? You can omit the  $np$  subscript on the  $Y$  and  $I$  would replace  $I_0'$  with  $I_0 - ci$  in equation 8-6 so that it explicitly covers all variables. How does the induced investment affect the (autonomous expenditure) multiplier? If investment is a function of the change in GDP, then how will that affect the IS/LM diagram and the multiplier? That effect is called the accelerator process. Ignore pages 298 through the end of the chapter except for figure 8-6. Why does this curve take its shape?

Chapter 9: How do income taxes and lump-sum taxes affect the Keynesian cross, a.k.a.  $45^\circ$  diagram? Ignore figure 9-2 and similar figures because we ignored the similar ones for the previous test. How does the government spending multiplier compare to the lump-sum tax multiplier? Why? Why do we treat transfers like negative taxes? How does fiscal policy affect the IS/LM diagram? How do we calculate the budget deficit/surplus and the full-employment budget deficit/surplus? Why do we care about the latter? What are structural and cyclical deficits? What are the built-in stabilizers in the economy? What would happen to the effectiveness of fiscal policy if the government had to balance its budget? What is crowding out and what are the effects of it? What are the effects of monetizing the debt? Be able to show both crowding out and monetization on the IS/LM diagram.

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Non-graded assignment #6A

To be reviewed with assignment #6

1) (15 points) In 1986, the economy was doing well. I believe the unemployment rate was under 5%. The US government ran a budget deficit. Using the terms "full-employment deficit," "structural deficit," and "cyclical deficit," explain why this was poor policy.

2) (40 points) Illustrate an increase in the marginal tax rates on the IS/LM diagram and the Keynesian cross, a.k.a.  $45^\circ$  diagram. Explain why the curves moved as drawn.

3) (20 points) Prior to World War II, the business cycles were more extreme than the ones since the war. What has caused the change in the cycles?

4) (25 points) Illustrate on the IS/LM diagram an increase in government spending. Explain why the curve(s) moved as drawn. Show the crowding out on the graph. Explain how you knew this.