Wilfrid W. Csaplar Jr. Intermediate Macroeconomics Review Sheet for Exam 3

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 probably be Thursday, 4/1, at 7:00, in the normal room. Those students going on the trip with Professor Hendrickson will start at 8:30 in the normal room, assuming it is free.

Juniors should be discussing with a member of the department the topic of their senior project.

There will be a question which will require you to explain one of two equations.

Chapter 7: Know how Duesenberry's relative income theory, Friedman's permanent income hypothesis, and Modigliani's life-cycle income explain the consumption function. How do assets, durable goods, interest rates, expectations, distribution of income, 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? How do the elasticity of supply of capital and the durability of capital affect 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° 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.

This is the non-graded assignment #6A that will be gone over with assignment #6.

1) (20 points) Will capital with a long durability have a greater or smaller elasticity of investment to interest rate than capital with a shorter durability? Explain your logic.

2) (20 points) Figure 9-10 illustrates the high-employment (full employment) budget deficit. After the Reagan tax cuts and government spending increases, full employment budget deficit became negative. *The Economist*, in *A Flood of Red Ink* from Nov. 6, 2003, *Can't Last* from Jan. 8, 2004, and *An Election Year Farce* from Feb. 5, 2004, complains that the present Bush administration is even worse than Reagan when it comes to sensible fiscal policy. The end of the first article says, "[T]he path back to a sustainable fiscal policy will be extremely painful, even without any dramatic fiscal crisis. Long after Dubya is back on his ranch, Americans will be trying to recover from the mess he created." Why does *The Economist* feel this is such a big problem?

3) (20 points) How does changing the lump-sum tax to an income tax affect the shape of the IS/LM diagram? Explain your logic.

4) (20 points) How does the government spending multiplier compare to the lump-sum tax multiplier? Explain your logic.

5) (20 points) What are the automatic stabilizers? Why are they called that?