Regrade policy: If you would like your test regraded, please submit a written statement to explain why. Your entire test will be regraded, so there is a possibility that points could be lost rather than gained.

Multiple Choice:
Version A: 1) d 2) a 3) d 4) c 5) c 6) d 7) c 8) b
Version B: 1) c 2) d 3) c 4) b 5) d 6) a 7) d 8) c

Problem 1: Keynesian Cross

a) \[ \Delta Y = -\text{MPC}/(1-\text{MPC}) \Delta T \]
version a: The MPC is 0.8, and \( \Delta Y \) is $100 bil.
Plugging in: \( $100 \text{bil} = -0.8/(1-0.8) \Delta T \), so \( $100 \text{bil} = -0.8/(0.2) \Delta T \), \( $100 \text{bil} = -4 \Delta T \)
So \(-$25\text{bil} = \Delta T \) Taxes should be cut $25 bil.

version b: The MPC is 0.75, and \( \Delta Y \) is $30 bil.
Plugging in: \( $30 \text{bil} = -0.75/(1-0.75) \Delta T \), so \( $30 \text{bil} = -0.75/(0.25) \Delta T \), \( $30 \text{bil} = -3 \Delta T \)
So \(-$10\text{bil} = \Delta T \) Taxes should be cut $10 bil.

b) A rise in government purchases would be better. The multiplier for government purchases is larger
in absolute value than for taxes, because government purchases has a direct effect on planned
expenditure, whereas taxes work only indirectly through consumption. This means the necessary rise
in government spending is smaller than the necessary tax cut, which implies a smaller drop in
government saving. (Note that to get a perfect score, you must explain the economic reason for WHY
the government spending multiplier is larger; it is not enough just to state that it is larger.)

Problem 2: IS-LM AS-AD Model

Problem 3: IS LM model

Version a: check only middle box; Version b: check only bottom box
The bare-bones argument is as follows. Only the rise in real money demand would both raise
interest rates and lower investment. (It shifts the LM curve left). A rise in taxes is wrong on both
counts: by shifting the IS curve left, it lowers the interest rate and raises investment. An
exogenous fall in investment would indeed lower investment, but it is wrong because it would
lower the interest rate (as it shifts the IS curve left).

(12/3/09)