

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 1 point. 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) (20 points) Draw the Keynesian Cross, a.k.a. 45° diagram. Illustrate the effects of an increase in the interest rates. Explain why the curve(s) moved as drawn. What happens to real GDP?
- 2) (20 points) Draw the Keynesian Cross, a.k.a. 45° diagram. Illustrate the effects of an increase in the marginal propensity to save. Explain why the curve(s) moved as drawn. What happens to real GDP?
- 3) (25 points) Draw the Keynesian Cross, a.k.a. 45° diagram. Illustrate the effects of an increase in government spending. Explain why the curve(s) moved as drawn. What happens to real GDP? Given your graph, what is the size of the government spending multiplier? Explain how you reached that conclusion. Why isn't the answer 10 like we predicted?
- 4) (15 points) When we estimated the size of the government spending multiplier, we implicitly made several assumptions about variables. What did we assume about taxes? If we relax that assumption, then how would that affect the size of the multiplier? Explain your logic.
- 5) (20 points) What is meant by "crowding out"? Explain how it occurs. How could it make counter-cyclical fiscal policy less effective? Why is this both a short-run problem and a long-run problem?