

Due: Wednesday, March 6

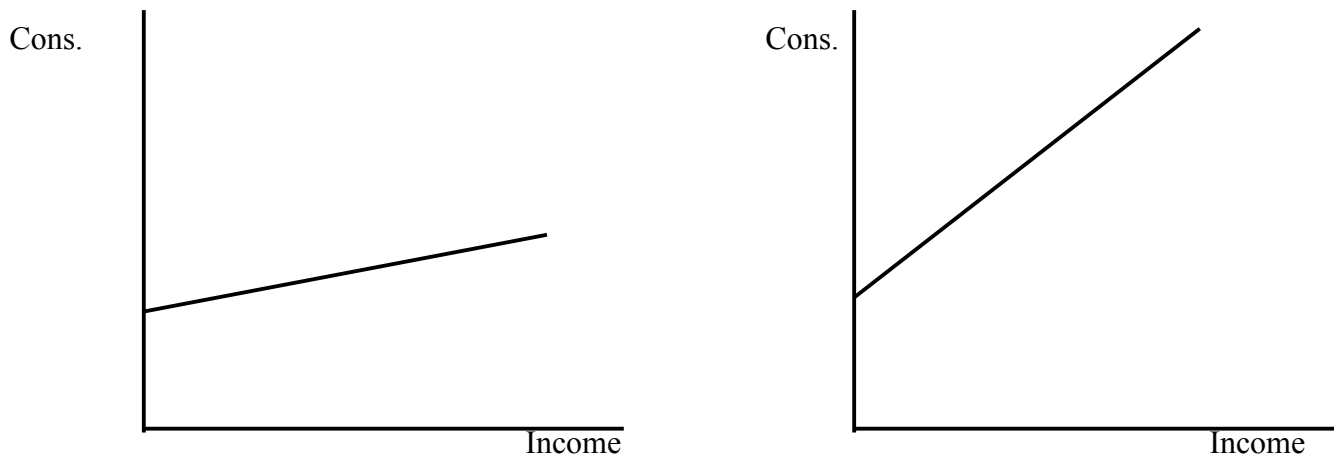
1. For each statement below, indicate whether it comes from a supply side perspective, demand side perspective, or both. Briefly explain each of your answers.

- a) Monetary policy stabilizes the economy by adjusting interest rates and therefore changing the cost of borrowing.
- b) Technological change is the engine of long-run economic growth.
- c) Low tax rates encourage a greater number of average citizens to work, and to work harder.
- d) Tax cuts are most effective when they are given to groups in the society who will immediately use their windfall to go shopping or take a trip.
- e) Higher saving can hurt the economy in the short run, but it is a key to long-run prosperity.

2. Briefly define human capital and identify one way to increase human capital. Describe in two or three sentences why a rise in human capital expands the supply side of an economy.

3. Some estimates indicate that the marginal propensity to consume (MPC) for the nation as a whole is roughly 0.90. Explain in words what this means. What is your personal MPC?

4. Compare the two consumption functions below. How do the marginal propensities to consume differ? Explain your answer briefly.



5. A comparison of the time right before World War 2 and the years immediately following World War 2 indicates that consumers had *both* more income *and* more wealth in the postwar years. Use a "consumption function" graph to demonstrate the effects of *both* of these changes on consumption.

6. There is much concern these days about the budget deficit of the U.S. federal government. One view is that taxes will need to be increased at some point in the future. Suppose news arrives that tax increases will take place two years from now.

a) Show how this news will affect consumption *this year* with a graph of the consumption function. Explain the changes in the graph.

b) From a demand-side perspective, explain how this news could weaken the U.S. economy. Why is this perspective consistent with “Keynesian” macroeconomic theory?

c) Briefly explain how this news could weaken the economy from a supply-side perspective.

7. Define firm "cash flow." Why is investment likely to depend on "cash flow"? Why does the link between investment and cash flow help to explain cyclical fluctuations in investment?