MOT1421
Economic Foundations
Week Six

MACROECONOMICS: THE KEYNESIAN MODEL SELF-TEST

The self-assessment consists of 10 Questions. Each Question has a weight of 1. Your maximum score therefore is 10. A score of 6 means that you have successfully passed the test.

Question 1
Use the circular flow of income to explain the Keynesian multiplier process.

Question 2
Explain the Keynesian notion of 'animal spirits' and why these animal spirits matter for business investment.

Question 3
What is the 'paradox of thrift'? Use an example to illustrate your answer.

Question 4
What is counter-cyclical fiscal policy? What is the role for the government budget (deficit) in counter-cyclical fiscal policy?

Question 5
What is the 'liquidity trap'? What is the role of money in this liquidity trap?

Question 6

Keynes argued that (1) investment is financed by credit; and (2) savings are determined by investment. Explain these two statements and why Keynes's approach rejects the neoclassical loanable funds market.

Question 7

Consider the following Keynesian macro-economic model:

(1)	$y = d = c + g + i + e - m$	macro-economic equilibrium
(2)	$c = c_0 + mpc \times (1 - \tau) \times y$	*c* = real consumption
(3)	$g = \bar{g}$	*g* = real government current expenditure
(4)	$i = i_0 - \rho \times r$	*i* = real investment
(5)	$e = \bar{e}$	*e* = real exports
(6)	$m = m_0 + \mu \times y$	*m* = real imports

where *y* = real GDP; *d* = aggregate demand; *mpc* = the marginal propensity to consume ($0 < mpc < 1$); $c_0 =$ autonomous real consumption; $\bar{g} =$ exogenous real government current expenditure; $i_0 =$ autonomous real investment; *r* = the real interest rate; $\bar{e} =$ exogenous real exports; $m_0 =$autonomous real imports; $\tau =$ real income taxes paid by households; $\rho =$ the sensitivity of real investment to the real interest rate; and $\mu =$ the marginal propensity to import.

Derive the reduced form equation for equilibrium real GDP. Derive the multiplier for *g*.

Question 8

What are automatic fiscal stabilisers? Give one example and explain how this stabiliser works.

Question 9

Why does higher public spending not lead to the crowding out of business investment and household consumption in the Keynesian model?

Question 10

Consider the following Keynesian macro model:

$$c = 500 + 0.7 \times (y - t)$$
$$g = 150$$
$$i = 250$$
$$e = 400$$
$$m = 200 + 0.2 \times y$$
$$t = 140$$
$$y = c + g + i + e - m$$

Calculate equilibrium real GDP y . By how much does y increase if public current expenditure is raised by 10 units? By how much does y decrease if taxes are increased by 10 units? What can we say about the balanced-budget multiplier in this model?

End of self-test Week 6