Week 8 Review Session Questions

Thursday, February 27th, 4 and 5pm, North Hall 1110

1. Today, the economy is at the full-employment level of GDP and the government has a balanced federal budget. Tomorrow, the economy enters a recession, how will the federal budget change?

2. Discuss the relationship between the federal deficit and the national debt.

3. Calculate the change in real GDP that would result in each of the following cases, assuming there are no automatic stabilizers.

   a. Government spending and taxes both rise by $30 billion and mpc=0.75.
   b. Government spending and taxes both fall by $30 billion and mpc=0.75.

4. After you graduate with a degree in Economics, you fulfill your lifelong dream of balancing the budget for your hometown of Bacon, Delaware (this amazing city actually exists). Your first job is to assess whether the government has been fiscally responsible over the last five years. You are given the following information

	Five years ago	Today
Debt	1,200	3,000
Nominal GDP	5,000	8,000
Price Level	120	140

   a. What is the debt-to-GDP ratio five years ago and today? Has the government been fiscally responsible?
   b. The government has to pay 5% interest on the debt. What is the size of the interest payment today vs. five years ago? What must the tax rate be in order to cover the interest payments in each year?
   c. Calculate the real GDP and argue whether or not the government of Bacon has effectively increased their debt.

5. What will happen to the money supply (increase, decrease or stay the same) in the following situations:

   a. Consumers become concerned that their deposits at a bank are not safe.
   b. The Federal Reserve changes the required reserve ratio and banks do not need to hold as many deposits in reserve.
   c. Because of the Great Recession, banks are not able to find as many credit-worthy borrowers as in the past.

6. Discuss the main differences between the M1 and M2 money supply.

7. Briefly explain whether each of the following is counted in M1:

   a. Coins in your pocket.
   b. Funds in your checking account.
   c. Funds in your savings account.
   d. d. A set of traveler's checks you have in preparation for a vacation abroad.