

Econ 116b
Problem Set 2

I. Answer True/False/Uncertain. Explain your answers. No credit without explanation.

1. Because firms can meet unexpected changes in sales by having their inventories change, actual investment is always equal to planned investment for a firm.
2. If a balanced budget amendment were passed, this would increase the size of the government spending multiplier.

II.

1. Explain carefully the difference between an endogenous variable, an exogenous variable, and a parameter or coefficient.
2. Consider the model $C = b(Y - T)$, $T = tY - TR$, $Y = C + I + G$, where C is consumption, I is planned investment (exogenous), G is government spending (exogenous), Y is output, T is net taxes, t is the tax rate (exogenous), and TR is the value of transfer payments (exogenous). b is the marginal propensity to consume. Assume that $b = .75$ and $t = 1/3$. How much does Y increase when G increases by 10? How much does Y increase when TR increases by 10? Explain carefully why these two multipliers are not the same—what is the intuition? Is the subject matter of this question relevant for the debate about the form that the stimulus bill should take? Why?
3. In the above question, how much will the government deficit increase if G is increased by 10? How much will it increase if TR is increased by 10?
4. What was the growth rate of real GDP (at an annual rate) in the fourth quarter of 2008? What was the value of inventory investment (level in real terms, not the growth rate)? Is this value good or bad news regarding the future growth of the economy?