1. For each of the following, choose the potential explanations that are consistent with the given observed facts (more than one explanation might be correct). Explain, noting any relevant assumptions that you make and using a carefully labeled graph if helpful.

a) Observation: the real interest rate has risen and the share of spending on investment has fallen. Potential explanations: i) government spending has increased; ii) foreign income has increased; iii) tax revenues have increased.

b) Observation: the real interest rate has fallen and the share of spending on consumption has risen. Potential explanations: i) taxes have increased; ii) government spending has decreased; iii) foreign income has decreased; iv) marginal profit rates have increased.

c) Observation: the real interest rate has risen, and the share of spending on consumption and net exports has fallen. Potential explanations: i) a decrease in tax revenues; ii) an increase in marginal profit rates; iii) an increase in government spending; iv) an increase in foreign income.

2. Read Chapter 32 in Miller, Benjamin and North. What view of government deficits do these authors espouse? Justify your answer.

3. One common argument against the Ricardian view of deficits is that foreign citizens, rather than US households, purchase much of the government’s debt. Does this fact affect the Ricardian view that deficits per se (holding government spending constant) have no effect on real interest rates and consumption? Explain.

4. If the US goes to war with Iraq, the amount of federal government spending will undoubtedly rise. Assuming that other government spending stays more or less the same, what effect will more military purchases likely have on real interest rates and private household spending? Does your answer depend on how the government finances these additional expenditures (that is, either by increasing taxes or by increasing its budget deficit)? Why or why not?

5. Suppose that firms expect marginal profit rates to increase, so the investment demand curve shifts to the right. Explain how this shift will change in the exchange rate (i.e. the number of dollars it takes to buy one euro).