

Write your name on the cover of the test booklet and nowhere else. Enclose this sheet with the booklet. Failure to follow these directions will cost you 1 point. The test has 150 points (to be scaled up to 210 points) and is scheduled to take 75 minutes. Therefore, expect to spend 1 minute for every 2 points. For example, a 14-point question should take 7 minutes. I can give extra time, but I will not give a lot of extra time.

1) (10 points each) For TWO of the following, determine what happens to M1 and M2. Explain your logic.
A) You remove \$500 cash from your savings account.
B) You deposit a \$30 paycheck into your checking account.
C) You buy a \$400 textbook with a credit card.

2) (10 points) Answer EITHER Part A OR Part B.

A) There are four properties that money should have. Which one does not exist when there is high inflation? Explain your logic.

B) Suppose a new type of account is invented. It allows you to withdraw money from an ATM up to twice a month. The interest is a little bit better than a savings account. Would you classify that as M1 or M2? Explain your logic.

3) (12 points) Answer EITHER Part A OR Part B.

A) Explain why an increase in government spending of \$1000 will increase GDP by more than \$1000.

B) Would the autonomous expenditure multiplier be smaller or larger if there was an income tax in our model? Explain your logic.

4) (14 points) Answer EITHER Part A OR Part B.

A) The government of the USA has a very large deficit and a medium sized debt. One economist predicted last year that if the policies continued, the long-term growth of the USA may approach 0%. How do you think he reached this conclusion? (I personally think he was overly pessimistic.)

B) Most economists feel that George W. Bush's fiscal policy is good in the short-run for the economy, but is bad for the economy in the long-term. What is their logic?

5) (14 points) Answer EITHER Part A OR Part B.

A) Our government has a very large budget deficit and our country has a very large trade deficit. Are they related? Explain your logic.

B) Why is it difficult to reduce the government deficit?

6) (14 points) Define EITHER *adverse selection* OR *moral hazard*. Give an example of the problems it causes for banks.

7) (14 points) There are several reasons why some economists feel that fiscal policy should not be used to affect the economy in the short-run. Explain EITHER the Ricardian Equivalence argument OR the lags argument.

8) (14 points) Answer EITHER Part A OR Part B.

A) Referring to the qualities of money like liquidity and interest earned, explain why the definitions of M1 and M2 are not as good as they were when they were revised in 1980.

B) Suppose that the following equations describe the economy: Government spending = 250, government transfer payments are $300 - 0.1 \cdot \text{GDP}$, and tax revenue = $0.4 \cdot \text{GDP}$. If GDP is 1000 and the full employment level of GDP is 1200, then what are the budget deficit/surplus, and the full employment deficit/surplus? Show all work.

9) (38 points) Illustrate EITHER the event in Part A OR the event in Part B on BOTH the LRAS/SRAS/AD diagram, AND the 45° diagram, a.k.a. the Keynesian cross diagram. Illustrate the SAME event in BOTH diagrams. Determine the effects upon the GDP, interest rates, and the price level. Explain why the curve(s) moved as drawn.

A) The government increases its spending.

B) The Federal Reserve increases the money supply.