

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 100 points (to be scaled up to 160 points) and is scheduled to take 50 minutes. Therefore, expect to spend 1 minute for every 2 points. For example, a 12-point question should take 6 minutes. I cannot give extra time because some students have a class after your class.

1) (10 points each) Answer TWO of the following parts.

- A) What is meant by *direct expenditure offset*? Why might it mean that fiscal policy does not work?
- B) What is meant by *lags*? Why might it mean that fiscal policy does not work?
- C) What is meant by *Ricardian Equivalence*? Why might it mean that fiscal policy does not work?

2) (12 points) Answer EITHER Part A OR Part B.

- A) Which of the Fed's tools is the least commonly used one for affecting the money supply? Explain how it changes the money supply.
- B) There are three components of demand for money which result in the money demand curve. Which one is most closely associated with M2 rather than M1? Explain your logic.

3) (16 points) Answer EITHER Part A OR Part B.

- A) Suppose the government's tax revenue is  $-20 + .3Y$  and they are spending 290. If the GDP is 1000 and the full-employment GDP is 1100, then what are the government's deficit and their full-employment deficit? Show all work. Is the government's fiscal policy a good policy? Explain your logic. Most of the points are for determining if the policy is a good policy.
- B) In class, I have blamed the slower growth of the economy from the early 1980s until the mid 1990s AND the large trade deficit during the same period, on the debt and deficit caused by the Reagan administration. How can the debt and deficit cause those two problems?

4) (16 points) Answer EITHER Part A OR Part B.

- A) What is meant by *moral hazard*? Give an example of how banks reduce the problem. Explain how their action reduces the problem.
- B) What is meant by *adverse selection*? Use it to explain a problem caused by the FDIC. (I fully support the existence of the FDIC, but like all good things, its existence does cause problems.)

5) (18 points) Answer EITHER Part A OR Part B.

- A) Suppose you were elected President this year. (I know you are too young, but play along.) What TWO actions would you take to cut the deficit? Explain why you would take those two actions and how they would reduce the deficit.
- B) Give TWO reasons why it is hard to cut the government's deficit by raising taxes.

6) (18 points) Answer EITHER Part A OR Part B.

- A) Illustrate a recessionary gap on the LRAS/SRAS/AD diagram. How can you tell it is a recessionary gap? Assuming the government wants to take action, what should the government do in this situation? Illustrate the effects of that action on the diagram. Explain why the curve(s) moved as drawn. (Assume that fiscal policy will work unlike what is asked in Question #1.)
- B) Draw the MS/MD diagram. Illustrate a decrease in taxes on the diagram. Explain why the curve(s) moved as drawn. How does this relate to the problems caused by the government deficit? Explain your logic.