

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 14-point question should take 7 minutes. I cannot give extra time because some students have a class after your class.

1) (10 points) When we estimated the size of the government spending multiplier, we implicitly assumed many things were held constant. For EITHER imports OR interest rates, explain how relaxing that assumption would affect the size of the multiplier.

2) (14 points) Answer EITHER Part A OR Part B.

A) Suppose you were to move \$500 from a savings account to a checking account. What would happen to M1 and M2? Explain your logic. If you then wrote a check to buy \$500 worth of books, what would happen to M1 and M2? Explain your logic.

B) Is M1 or M2 better as a store of value? Which is better medium of exchange? Explain your logic for both parts.

3) (14 points) Answer EITHER Part A OR Part B.

A) Alan Greenspan, the former Chair of the Federal Reserve System, said recently that he thinks that when the economy returns to normal, the interest rates will go very high because of the government's deficit and debt. Explain why that might happen and why that would be so bad.

B) Explain why the government's deficit will be so hard to reduce? Give at least two ways to reduce it and explain why they are not easy to achieve. If you want to read the bipartisan proposal for reducing the deficit which came out on November 10<sup>th</sup>, go here:

[http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair\\_Draft.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf)

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

A) What is *adverse selection*? How do banks reduce this problem? Explain how that reduces the problem.

B) What is financial intermediation? Why do we use it rather than direct finance? Mention at least two reasons.

5) (14 points) For EITHER *Ricardian Equivalence* OR *direct expenditure offset*, explain why that might cause fiscal policy to be ineffective. Do you believe it to be a valid argument? Explain your logic.

6) (16 points) Answer EITHER Part A OR Part B.

A) Illustrate the effects of the drop of GDP on the money supply/money demand diagram. Explain why the curve(s) moved as drawn. What happens to the quantity of money and the interest rates?

B) Illustrate the effects of the Fed's buying bonds on the open market on the money supply/money demand diagram. Explain why the curve(s) moved as drawn. What happens to the quantity of money and the interest rates?

7) (18 points) Answer EITHER Part A OR Part B.

A) Draw a LRAS/SRAS/AD diagram for an economy in an inflationary gap. State how you know the graph shows a recessionary gap. If the government was to change its spending to solve the problem, what should it do? Illustrate the effects of that change in government spending. Explain why the curve(s) moved as drawn. What happens to GDP and prices?

B) Suppose that current government spending is \$500, transfer payments like Social Security and welfare are \$400, interest payments on the debt are \$200, and the tax revenue is \$1000. What is the government's deficit or surplus? Suppose that at full employment, transfers would drop to \$300 and tax revenue would go up to \$1100. How much is the government's full-employment deficit or surplus? Show all work for both parts and briefly state what you did.