

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

A) What do you consider to be the biggest problem with the current huge federal government debt?

Explain how the debt causes that problem and why you feel it is a bad problem.

B) Explain the *twin deficits*. How does one cause the other?

2) (12 points) For EITHER the problem in Part A OR the problem in Part B, explain how the problem could make expansionary fiscal policy less effective.

A) Direct expenditure offset.

B) Lags.

3) (12 points) For EITHER *medium of exchange* OR *store of value*, determine if M1 or the items in M2 which are not in M1 do a better job with that quality of money. Explain your logic.

4) (12 points) Answer EITHER Part A OR Part B.

A) The current unemployment rate is 7.3%. The government deficit for the fiscal year which ended Sept. 30th is estimated to be \$680 billion. (That's nearly \$2200 per person.) What can you tell me about the size of the full-employment deficit? Explain your logic.

B) We have borrowed a lot from China. I think this is bad, but there is a good aspect of the large amount of borrowing from them. What problem with the deficit and debt is reduced by borrowing from China?

5) (22 points) Answer EITHER Part A OR Part B.

A) What is adverse selection? Give an example from banking. What do banks do to reduce the problem? Explain how that action reduces the problem.

B) What is moral hazard? Give an example from insurance. What do insurance companies do to reduce the problem? Explain how that action reduces the problem.

6) (30 points) Answer EITHER Part A OR Part B.

A) Draw the LRAS/SRAS/AD diagram and the MS/MD diagram for an economy in an **inflationary gap**. Explain how you know you drew an inflationary gap. What type of **fiscal policy** should be done to fix the problem? Illustrate the effects of that policy on both diagrams. Explain why the lines moved as drawn. What happens to interest rates, real GDP, inflation, and the unemployment rate? Briefly state how you know how each variable changed.

B) Draw the LRAS/SRAS/AD diagram and the MS/MD diagram for an economy in a **recessionary gap**. Explain how you know you drew an inflationary gap. What type of **monetary policy** should be done to fix the problem? Illustrate the effects of that policy on both diagrams. Explain why the lines moved as drawn. What happens to interest rates, real GDP, inflation, and the unemployment rate? Briefly state how you know how each variable changed.