

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) For EITHER the argument in Part A OR the argument in Part B, state what the term means and explain how it could cause countercyclical fiscal policy to be less effective.

- A) Crowding out
- B) Direct expenditure offset

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

- A) The MD curve has two asymptotes. Draw one of them and explain why it is there.
- B) What is meant by a “financial intermediary”? Why do we use them?

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

A) Suppose the government spending is \$1000, government transfers are $\$500 - .1 * GDP$, tax revenue is $.4 * GDP$. If GDP is \$2800, then what is the government’s budget deficit or surplus? Show all work and state how you know whether it is a deficit or a surplus. If the full employment level of GDP is \$3300, then what is the government’s full-employment budget deficit or surplus? Show all work and state how you know whether it is a deficit or a surplus.

B) What is the difference between the budget deficit and the full-employment budget deficit? Explain why the latter is important for determining if the government deficit or surplus is a good value?

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

A) Draw the LRAS/SRAS/AD diagram with the economy in a recessionary gap. Show the gap on the graph and state how you found it. If the economy is left alone, how will it resolve the problem? Explain your logic and show the effects on the graph. Explain why the curve(s) moved as drawn.

B) Draw the LRAS/SRAS/AD diagram. Illustrate the effects of the dollar losing value on the foreign exchange market (US\$ depreciates). Explain why the curve(s) moved as drawn.

5) (16 points) Answer EITHER Part A OR Part B.

A) Draw the LRAS/SRAS/AD diagram with the economy in a recessionary gap. Show the gap on the graph and state how you found it. If the government was to do monetary policy, what policy would it do to fix the problem? Explain your logic and show the effects on the graph. Explain why the curve(s) moved as drawn.

B) Draw the LRAS/SRAS/AD diagram with the economy in an inflationary gap. Show the gap on the graph and state how you found it. If the government was to do fiscal policy, what policy would it do to fix the problem? Explain your logic and show the effects on the graph. Explain why the curve(s) moved as drawn.

6) (28 points) Answer EITHER Part A OR Part B.

A) Draw the MS/MD diagram and the LRAS/SRAS/AD diagram. Illustrate the effects of the Federal Reserve’s increasing the required reserve ratio? Explain why the curves moved as drawn. What happens to real GDP, price level, nominal interest rates, and the money supply?

B) Draw the MS/MD diagram and the LRAS/SRAS/AD diagram. Illustrate the effects of the government increasing the income tax? Explain why the curves moved as drawn. What happens to real GDP, price level, nominal interest rates, and the money supply?