

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 170 points) and is scheduled to take 50 minutes. Therefore, expect to spend 1 minute for every 2 points. For example, a 10-point question should take 5 minutes. I cannot give extra time because some students have a class after your class.

1) (10 points) Answer EITHER Part A OR Part B.

- A) Why does our theory say that M1 should be a better predictor of the economy than M2 or M3?  
 B) Why do we care if the velocity of money is constant?

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

- A) Explain why an increase in the price level will have a different effect on the demand for money than an increase in the inflation rate.  
 B) In Assignment #7, I asked “For each of the following events, determine what people would do with their money. How would that affect M1, M2, and M3?” I meant to ask, “. . . How would that affect money demand?” Explain how those two questions are different using the example of a reduction in the risk of stocks.

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

- A) Is inflation a leading, lagging, or coincident variable? Does it move pro-cyclically, counter-cyclically, or a-cyclically? Explain your logic.  
 B) If the leading indicators are indicating that the economy is improving, but the lagging indicators indicate the economy is going down, then what do you think is occurring? Why do you feel that?

4) (16 points) Explain EITHER  $\frac{\Delta Y}{Y} = \frac{\Delta A}{A} + a_x \frac{\Delta K}{K} + a_N \frac{\Delta N}{N}$  (ignoring  $a_K$  and  $a_N$  and treating fractions as one variable) OR  $c = f(k) - (n+d)k$ , making sure you explain both effects  $k$  has.

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

- A) What can the government do to increase the savings rate? Explain how that would have the desired effect.  
 B) Suppose a new account was invented. You could take money out once a month. It could be taken out via a check, and ATM transaction, or a transfer. It does pay interest. Would you consider that part of M1, M2, or M3? Explain your logic.

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

- A) Draw the diagram for the Solow Growth Model. Use it to explain why Solow’s model concludes that the economies of the world should approach each other. What is wrong with this argument?  
 B) Draw the diagram for the Solow Growth Model. Use it to find the long-run equilibrium level of the capital-labor ratio,  $k^*$ . Why is it unlikely that  $k^* = k_G$  for the USA?

7) (18 points) Illustrate EITHER the event in Part A OR the event in Part B on the SRAS/LRAS/AD diagram. Explain why the curve(s) move as drawn. What happens to GDP and prices?

- A) Nominal wages increase.  
 B) The income tax rate increases.