

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 150 points (to be scaled up to 210 points) and is scheduled to take 75 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) Would M1 or M2 be a better medium of exchange? Explain your logic.
- B) Would M1 or M2 be a better store of value? Explain your logic.

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

- A) What is crowding out, and why is it my biggest concern for our economy?
- B) Explain how the government deficit could cause a trade deficit.

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

- A) Some economists say we should not do counter-cyclical fiscal policy because of Ricardian Equivalence. What is it? Explain why that would mean Obama's and Bush's stimulus packages should not have occurred.
- B) What are the lags in fiscal policy? Why might they cause counter-cyclical fiscal policy to worsen the business cycles?

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

- A) What is *moral hazard*? Explain how the banking system reduces it.
- B) What is *adverse selection*? Explain how FDIC insurance can make that situation worse.

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

- A) Suppose the government is spending \$500, paying out \$300 in transfer payments, paying \$200 in interest and collecting \$900 in taxes. How much is the government's deficit or surplus? Show all work and briefly explain your logic. Suppose that the GDP needs to increase 10% to get us to full employment. If that happens, transfer payments will go down by \$30 and tax revenue goes up by \$90. What would be the government's full employment budget deficit or surplus? Show all work and briefly explain your logic.
- B) What are the automatic stabilizers? Explain how they stabilize the economy. How do they play a role in determining whether a government deficit is too large or not large enough?

6) (20 points) Answer EITHER Part A OR Part B.

- A) How are the long-run and short-run effects of a government's deficit different? How does the deficit cause those different results?
- B) Explain why balancing the government's budget is so difficult to do. Make sure you address both of the general methods of balancing the budget.

7) (20 points) Illustrate the effects of EITHER the event in Part A OR the event in Part B on the 45° diagram, a.k.a. the Keynesian Cross diagram. Explain why the curve(s) moved as drawn. What happens to the equilibrium level of GDP?

- A) An increase in the marginal propensity to consume.
- B) An increase in the interest rate.

8) (24 points) Answer EITHER Part A OR Part B.

- A) Illustrate the effects of an increase in the price level on the supply and demand for money. Explain why the curve(s) moved as drawn. What happens to the interest rate and the real GDP?
- B) Use the supply and demand for money to explain why the government can choose to control the money supply or the interest rates, but they cannot control both at the same time.

9) (24 points) Answer EITHER Part A OR Part B.

- A) Two years ago, the unemployment rate was 4.4%. Draw that situation on the LRAS/SRAS/AD diagram. Explain how you know you are showing that unemployment rate. What fiscal policy should the government do? Explain why they should have done that and explain how it moves those curve(s). Illustrate those movements on the graph.
- B) Illustrate an increase in government spending on the 45° diagram, a.k.a. the Keynesian Cross diagram. Explain why the curve(s) moved as drawn. Given your diagram, what value would you estimate the size of the government spending multiplier would be? Explain your logic.