

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

Remember, Tuesday we will be back in Steinman 200 for the one class because of comps.

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

A) Which has greater liquidity, M1 or M2? Explain your logic.

B) Why aren't credit cards part of either M1 or M2?

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

A) What are the "twin deficits" and why are they called that?

B) Why did the former Secretary of the Treasury, Paul O'Neill, say at Bethany College that the US government's debt is actually much larger than the official number given by the Treasury?

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

A) What is crowding out? Why is it normally a big problem for a country whose government is running a large deficit and has a big debt (like ours)?

B) What is meant by "direct expenditure offset"? Explain how it could cause fiscal policy to not work well.

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

A) Explain the autonomous expenditure multiplier, a.k.a. government spending multiplier, a.k.a. the multiplier. In other words, how can an increase in government spending of \$1000 cause GDP to go up by more than \$1000? Give a reason why our estimates of the size of the multiplier, $1/(1-MPC)$, is too large.

B) Draw the 45° diagram (a.k.a. Keynesian Cross). Illustrate the effects of an increase in the MPS. Explain why the curve(s) move as drawn.

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

A) Draw the MS/MD diagram. Illustrate the effects of an increase in the price level. Explain why the curve(s) moved as drawn. What happened to interest rates and the quantity of money?

B) Use the quantity theory of money ($MV=PY$) to explain why classical economists dislike using monetary policy.

6) (18 points) Answer EITHER Part A OR Part B.

A) Explain why it is so hard to balance the government's budget. Make sure you mention the two general ways to balance the budget and why both are hard to do.

B) What is the full-employment budget deficit? How does it differ from the government's budget deficit? Which is more important? Explain your logic.

7) (18 points) For EITHER *adverse selection* OR *moral hazard*, define it. Use an example to illustrate the problem. How do banks reduce the problem? Explain how that reduces the problem.

8) (48 points) Draw the 45° diagram (a.k.a. Keynesian Cross), LRAS/SRAS/AD diagram, and the MS/MD diagram. Illustrate the effects of EITHER the event in Part A OR the event in Part B on all three graphs. Explain why the curves moved as drawn. What happens to GDP, price level, and interest rates?

A) The government spends more.

B) The Federal Reserve increases the money supply.