

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) (10 points) For EITHER the event in Part A OR the event in Part B, determine what happens to M1, and M2. Explain your logic.

- A) You withdraw \$100 cash from your savings account.
- B) You pay for \$40 worth of clothing on a credit card.

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

- A) What do you feel is the biggest problem with the government's owing almost as much as the entire output of our country? Explain why that big problem is caused by the debt. (So large that if you got 6/10 of a penny every minute since the start of the solar system or 1 cent every 5 minutes since the big bang you could not quite pay it off.)
- B) How does the government deficit cause the trade deficit?

3) (12 points) Answer EITHER Part A OR Part B.

- A) Suppose the MPC for most people is 0.8. What is the size of the government spending multiplier? If the government increased its spending by \$200, then how much would the ultimate change in GDP be? Show all work and explain both of your answers.
- B) When we estimated the government spending multiplier, we made an assumption about interest rates. What was that assumption? How would relaxing that assumption affect the size of the multiplier?

4) (12 points) For EITHER *direct expenditure offset* OR *lags*, explain what it is and why it might mean that we do not want to use fiscal policy to alter the economy.

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

- A) What are the two general ways of reducing the government's deficit? Why are they so hard to do?
- B) Currently, the government is borrowing \$0.41 of every dollar they spend. If you were going to advise them how to not borrow so much, what two actions would you propose? Be specific and explain how that would reduce the deficit.

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

- A) What is *moral hazard*? How does the FDIC insurance make it worse?
- B) What is *adverse selection*? Give two examples of it.

7) (20 points) Answer EITHER Part A OR Part B.

- A) Draw an LRAS/SRAS/AD diagram. Illustrate the effects of an increase in government spending. Explain why the curve(s) moved as drawn. What happens to GDP and the price level? How will the change in the price level affect the size of the government spending multiplier? Explain your logic.
- B) Draw the LRAS/SRAS/AD diagram for a country with an inflationary gap. Explain how you know it is an inflationary gap. What should the government do about this problem? Illustrate the effects of that government action on the graph. Explain why the curve(s) moved as drawn.