

Write your name on the cover of the test booklet and nowhere else. 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 16-point question should take 8 minutes. I can give some extra time, but not much.

1) (10 points each) Answer TWO of the following questions using the balance sheet on the right.

A) What number should replace the “?”?

How did you get that?

B) What is this bank’s excess reserves?

How did you get that?

C) What does the \$10 in loans represent?

Assets		Liabilities and Net Worth	
Cash	100	Demand deposits	2000
Deposits at Fed.	150	Savings accounts	1000
Loans	3000	Loans	10
Bonds	500	Other	?
Other	250	Equity	800

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

A) Are savings accounts in M1, M2 or neither? Explain why the Federal Reserve put them in that category or why they were excluded.

B) Which is a better medium of exchange, M1 or M2? Which is a better store of value, M1 or M2? Briefly explain both of your answers.

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

A) Assuming the government runs a balanced budget when we are at full employment, what would happen to the budget deficit/surplus when the unemployment rate goes to 4%? Explain your logic. (How unrealistic is the assumption?)

B) Suppose the government buys \$500 worth of goods, pays employees \$400, gives out \$300 in welfare and unemployment benefits, and collects \$1100 in taxes. How much would the deficit or surplus be? Show all calculations and briefly explain your logic.

4) (16 points) Explain the process of the autonomous expenditure multiplier. I.e., why does a \$10 increase in government spending cause GDP to increase by more than \$10. Referring to EITHER the income tax OR the price level, explain why our estimate is too large.

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

A) Suppose the Federal Reserve wants to decrease the money supply. They have three tools to achieve this. For TWO of these tools, explain how they would use that tool to decrease the money supply and explain how that would cause a decrease in the money supply.

B) In the real world, the size of the money multiplier is not what we calculated. Is it smaller or larger than we calculated? Explain your logic.

6) (22 points) Answer EITHER Part A OR Part B.

A) Draw a **recessionary gap** on the LRAS/SRAS/AD diagram. Explain how you knew it was a recessionary gap. Assuming that the government **believes** in Ricardian Equivalence, what fiscal policy should the government do? Why did you make that choice? Do NOT show the policy on the graph.

B) Draw an **inflationary gap** on the LRAS/SRAS/AD diagram. Explain how you knew it was a recessionary gap. Assuming that the government does **not believe** in Ricardian Equivalence, what fiscal policy should the government do? Why did you make that choice? Do NOT show the policy on the graph.