

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) Draw EITHER the MD curve OR the classical SRAS curve. Explain why it takes its shape.
- 2) (12 points) Answer EITHER Part A OR Part B.
 - A) In my opinion, the government's large deficit and debt is one our country's biggest long term hindrances to growth of the GDP. However, there are many false arguments about the harm caused by the deficit and debt. State one false argument and explain why that argument is false.
 - B) Explain why the "twin deficits" got their name.
- 3) (14 points) Answer EITHER Part A OR Part B.
 - A) Some economists use the quantity theory of money ($MV=PY$) to conclude that in the long run, the only effect of an increase in the money supply is inflation. Explain their logic.
 - B) Monetarists do not like monetary policy because of *lags*. These are the same lags as fiscal policy except they have different lengths of time. For ONE of the lags, explain what that lag is and determine whether monetary or fiscal policy would have a longer lag. Explain your logic.
- 4) (14 points) If you have followed the news this month, you have heard about the "fiscal cliff." That is automatic tax increases and spending cuts which will occur Jan. 1 if Congress has not approved of a budget with a smaller deficit. Answer EITHER Part A OR Part B.
 - A) What is an economic reason some people are afraid of the country going over the fiscal cliff? Explain the bad results of going over the fiscal cliff.
 - B) What is an economic reason some people want the country to go over the fiscal cliff? Explain the good results of going over the fiscal cliff.
- 5) (16 points) There are several explanations as to why expansionary fiscal policy MAY not work when trying to fix the economy. Name TWO of the reasons fiscal policy may not work. Explain ONE of those two.
- 6) (20 points) For EITHER *adverse selection* OR *moral hazard*, define the term, give an example from banking, and explain how banks reduce the problem. Make sure you explain how the action of the banks reduces the problem.
- 7) (20 points) Answer EITHER Part A OR Part B.
 - A) Draw the LRAS/SRAS/AD diagram for an economy in a recessionary gap. State how you know there is a recessionary gap. If the government takes no action, then how will the economy move back to equilibrium automatically? Show the movement(s) of the curve(s) and explain the cause(s) of the movement(s).
 - B) Draw the Keynesian Cross (45°) diagram. Illustrate the effects of an increase in government

spending. Explain why the curve(s) moved as drawn. Given your diagram, what is the size of the government spending multiplier? Explain your logic and show any calculations.

8) (42 points) Illustrate EITHER the event in Part A OR the event in Part B on the MS/MD, Keynesian Cross (45°) diagram AND the LRAS/SRAS/AD diagram. Use the SAME EVENT in all THREE graphs. Explain why the curves moved. What happens to real GDP, the price level, and interest rates.

A) The Federal Reserve buys bonds on the open market.

B) Congress raises the income tax.