

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) (12 points) For EITHER “direct expenditure offset” OR for “lags”, define the term and explain how it impacts expansionary fiscal policy. (You do **not** need to explain the possible errors in the logic.)

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

A) We said that “crowding out” has long-run and short-run effects. What are the negative **long-run** impacts of crowding out? Explain how it causes that problem.

B) We said that the government does not have to pay back its debt. Why is this true?

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

A) Explain why a movement of the LRAS Curve causes the SRAS Curve to move, but not vice versa.

B) Explain how Ricardian Equivalence will result in fiscal policy, designed to increase GDP, actually causing no change in GDP. In other words, why can’t fiscal policy move any curve if Ricardian Equivalence holds?

4) (12 points) Answer EITHER Part A OR Part B.

A) Explain how a government deficit can cause a trade deficit. I.e., explain the “twin deficits.”

B) Why does Paul O’Neill feel that the government owes more than it borrowed.

5) (14 points) Answer EITHER Part A OR Part B.

A) Suppose the government spends \$1010 per year. The tax revenue is 20% of GDP. If GDP is \$4500, then how much is the government deficit or surplus. Suppose the full-employment level GDP is \$5500. How much is the full-employment deficit or surplus? Show all calculations. Is the government doing good fiscal policy? Explain your logic.

B) Use the terms “stocks” and “flows” to explain the difference between the government debt and the government surplus. What is the difference between the “gross public debt” and the “net public debt”?

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

A) Draw the SRAS/LRAS/AD diagram showing that there is high unemployment. Explain how your graph shows high unemployment. What type of fiscal policy should be done? Illustrate the effects of that policy on the diagram. Explain how that policy moves the curve(s). What happens to GDP and price level?

B) Draw the “Modern SRAS Curve” and the LRAS Curve. Explain why the SRAS Curve takes that shape.

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

A) Draw the SRAS/LRAS/AD diagram for a country in an inflationary gap. How does the economy get back to equilibrium if the government does nothing? Illustrate the effects of that on the diagram. Explain why the curve(s) moved as drawn. Which of the two types of inflation is created? State how you can tell that.

B) Draw the SRAS/LRAS/AD diagram for an economy at full employment. Give an example of cost-push inflation. Illustrate the effects of that on the diagram. Explain why the curve(s) moved as drawn.