

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) Answer EITHER Part A OR Part B.

A) The LRAS is virtually the same as a graph from early in the semester. Which graph is it and why are they virtually the same?

B) The AD is virtually the same as a graph from the previous test. Which graph is it and why are they virtually the same?

2) (10 points) Draw EITHER the LRAS OR the AD curve and explain why it takes its shape.

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

A) The government debt is huge as is the government deficit. Why is it difficult to eliminate the deficit? Make sure you mention the two general ways to cut it and why those are difficult to do.

B) What do you consider to be the biggest problem caused by the debt? Explain how the debt causes that problem.

4) (12 points) We said that *lags* and *crowding out* can cause problems for countercyclical fiscal policy. For EITHER *lags* OR *crowding out*, explain why it might make countercyclical fiscal policy either less effective or possibly counterproductive.

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

A) Draw the SRAS/LRAS/AD diagram. Illustrate the effects of an increase in the amount of capital. Explain why the curve(s) moved as drawn. What happens to the price level and real GDP?

B) Draw the SRAS/LRAS/AD diagram. Illustrate the effects of an increase in the MPC. Explain why the curve(s) moved as drawn. What happens to the price level and real GDP?

6) (20 points) Answer EITHER Part A OR Part B.

A) Draw an SRAS/LRAS/AD diagram for an economy in an **inflationary gap**. State how you know there is an inflationary gap. What type of fiscal policy should be done in this situation? Explain why the curve(s) moved as drawn.

B) Draw an SRAS/LRAS/AD diagram for an economy in a **recessionary gap**. State how you know there is a recessionary gap. If the government did nothing, how would the economy correct itself. Explain why that occurs. Illustrate the effects on the diagram. Explain why the curve(s) moved as drawn.

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

A) Suppose the government spending was \$1000, transfer payments are $\$950 - .05 * \text{GDP}$, and tax revenue is $.15 * \text{GDP}$. If GDP is \$10,000 then how much is the government deficit or surplus. If Y_{FE} is \$9,000 then how much is the full-employment deficit? Show all work. Is the government doing good fiscal policy? Explain your logic.

B) Draw an SRAAS/LRAS/AD diagram. Illustrate the effects of an increase in government spending. Explain why the curve(s) moved as drawn. Explain how this can cause the twin deficits. Illustrate the effects of that on the diagram and explain why the curve(s) moved as drawn.