

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. I will not grade what is written on this sheet.

1) (12 points) Answer EITHER Part A OR Part B.

- A) Suppose you transferred \$200 from your checking account to your money market account and then paid for a \$300 textbook with a credit card. What would happen to M1 and M2? Explain your logic.
B) Would M1 or M2 be a better medium of exchange? Explain your logic.

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

- A) What is crowding out? Explain why it would make counter-cyclical fiscal policy less effective.
B) We said there were two problems with the argument, "When we pay off the debt, it will hurt tax payers." What were the two problems?

3) (14 points) For EITHER the Classical SRAS Curve OR the Modern SRAS Curve, draw it and explain why it takes its shape.

4) (14 points) Answer EITHER Part A OR Part B.

- A) One of the arguments that the debt is a problem is, "Having a large debt will reduce the government's ability to spend as they like in the future." Is that a bigger problem for the net public debt, gross public debt, or the debt Paul O'Neill talked about? Explain your logic.
B) Suppose that at the current GDP, government spending was \$300, transfer payments were \$100, and tax revenue was \$350. How much is the government deficit or surplus? Show all work. Suppose that at the full employment level of GDP, government spending would be \$300, transfer payments would be \$80, and tax revenue would be \$400. How much is the full employment government deficit or surplus? Show all work.

5) (18 points) ANSWER EITHER Part A OR Part B.

- A) Draw an LRAS/SRAS/AD diagram in a recessionary gap. State how you know it was in a recessionary gap. What type of fiscal policy should be done? Illustrate the effects of that policy on the graph. Explain why the curve(s) moved as drawn.
B) Draw an LRAS/SRAS/AD diagram in an inflationary gap. State how you know it was in an inflationary gap. If the economy is left alone, how would the economy correct itself without intervention? Explain why that occurs and why it moves the curve(s). Draw the effects of the self-correction on the graph.

6) (30 points) For EITHER the event in Part A OR the event in Part B, illustrate the effects of the event on BOTH the SRAS/LRAS/AD diagram AND the MS/MD diagram. Use the SAME event on BOTH graphs. Explain why the curves moved as drawn. What happens to interest rates, inflation, real GDP, and the unemployment rate.

- A) The Federal Reserve sells bonds.
B) The MPC increases.