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) Answer EITHER Part A OR Part B.
A) On Homework #9, I gave the following statistics: The unemployment rate at the end of September was 3.5%.   The government deficit for the fiscal year which ended September 30th was $1.4 trillion. Is the full-employment deficit $1.4 trillion, more that $1.4 trillion, or less than $1.4 trillion? Explain your logic.
B) How can we use the full-employment deficit to determine whether or not the government is doing smart fiscal policy? Explain your logic.

2) (16 points) Answer EITHER Part A OR Part B.
A) What is meant by *adverse selection*? Explain how insurance companies reduce the problem..
B) Draw the Classical SRAS Curve. Explain why it looks as drawn.

3) (16 points) We said the counter-cyclical monetary policy might not work as intended. For EITHER *Keynesian Liquidity Trap*, OR *labs*, explain the problem that causes for expansionary monetary policy to not work well during a recession. Use an appropriate graph in your explanation.

4) (18 points) Answer EITHER Part A OR Part B.
A) What are the automatic stabilizers? Why are they called that?
B) We said that the Fed cannot control both the money supply and the interest rates at the same time. Use an appropriate graph to explain this statement. Make sure you explain what is happening.

5) (38 points) Answer EITHER Part A OR part B.
A) Draw the LRAS/SRAS/AD diagram and the MS/MD diagram for an economy with 7% unemployment. State how your graph shows 7% unemployment. What is the best fiscal policy for that problem? Illustrate the effects of that policy on the graphs. Explain why the curves moved as drawn. What happens to GDP, inflation, unemployment rate, money supply, and interest rates?
B) Draw the LRAS/SRAS/AD diagram and the MS/MD diagram for an economy with 7% unemployment. State how your graph shows 7% unemployment. If the economy is left alone, how will it get back to full employment? Illustrate the effects of that event on the graphs. Explain why the curves moved as drawn. What happens to GDP, inflation, unemployment rate, money supply, and interest rates?