

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 and is scheduled to take 50 minutes. Therefore, expect to spend 1 minute for every 2 points. For example, a 16-point question should take 8 minutes. I will give a few extra minutes, but probably no later than about 5 minutes, i.e., until the end of the hour.

1) (10 points) For EITHER the event in part A OR the event in part B, determine what happens to M1 and M2. Explain why they change or fail to change.

A) You use a credit card to buy a \$1200 computer.

B) While at the ATM, you remove \$100 cash from your savings account.

2) (14 points) This question refers to the balance sheet below. How much should go in “Stockholders’ Equity”? How much excess reserves does this firm have? Show all work and give a one-sentence explanation for each part.

Assets		Liabilities and Net Worth	
Deposits at Fed	100	Demand Deposits	900
Cash in Vault	50	Savings Accounts	400
Loans	1500	Loans	10
Bonds	150	Misc.	500
Misc	200	Stockholders’ Equity	???

3) (14 points) Do EITHER part A OR part B.

A) What is meant by *medium of exchange* and *unit of account*? Give an example where money has one quality, but not the other.

B) We say that the central bank wants to know the volume of liquid money. Is that M1 or M2? Why do they want to know the volume of the liquid money and why did you say M1 or M2?

4) (16 points) Do EITHER part A OR part B.

A) Before Kennedy cut taxes, the top marginal income tax rate was 92%. Afterwards, it was 75%. What happened to the tax revenue? Why?

B) The following came from an article yesterday about Greenspan’s speech: “*The study, released late last week, said that interest rates rose 0.25 percentage point for every projected one percentage point increase in the ratio of the federal deficit to gross domestic product (GDP). Thus, if the federal deficit balloons to 3 percent of GDP by 2004 as a result of the president’s tax plan, as a recent Congressional Budget Office study found it might, then interest rates could rise 0.75 percentage point.*” What is the reason for the interest rate increases? What is the problem it causes? How does it cause that problem?

5) (22 points) Do EITHER part A OR part B.

A) In some countries, car insurance is not required. Given that, what are the problems with adverse selection and moral hazard that the insurance companies face? Given those problems, do you think insurance is high or low in those countries? Explain your logic.

B) The Fed has three tools to affect the money supply. Other than open market operations, state what the other two tools are and how changing them will change the money supply and the money multiplier.

6) (24 points) Do EITHER part A OR part B.

A) Suppose the government proposed a government spending cut to reduce borrowing. Assuming that Ricardian Equivalence holds, illustrate the effects of that proposal on the SRAS/LRAS/AD diagram. Explain why the curve(s) moved as drawn.

B) Draw an SRAS/LRAS/AD diagram for an economy in a recessionary gap. Explain how you know it is in a recessionary gap. What type of tax change would fix it? Illustrate that tax change and explain why the curve(s) moved as drawn.