

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 each) For TWO of the events below, determine how it affects M1 and M2. Explain your logic.

- A) You transfer \$1000 from a savings account to a checking account.
- B) You pay a \$300 gas bill with a credit card.
- C) You give a \$20 check to a store to purchase a DVD.

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

- A) What is meant by “lags”? How can they cause fiscal policy to have undesirable effects?
- B) What is meant by the full-employment government deficit? How is it different from the government deficit?

3) (14 points) Answer EITHER Part A OR Part B.

- A) Explain how a government deficit can have desirable effects in the short run, but undesirable effects in the long run.
- B) Why is it hard to get rid of the current budget deficit? Explain at least two methods of cutting it and reasons those two methods are difficult to do.

4) (16 points) Answer EITHER Part A OR Part B.

- A) What does the FDIC do? What is *moral hazard*? How can the existence of the FDIC lead to a bigger problem with moral hazard?
- B) What does the FDIC do? What is *adverse selection*? How can the existence of the FDIC lead to a bigger problem with adverse selection?

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

- A) Draw the 45° diagram, a.k.a. the Keynesian Cross diagram. Illustrate an increase in interest rates on the diagram. Explain why the curve(s) moved as drawn. What happens to the GDP?
- B) Draw the 45° diagram, a.k.a. the Keynesian Cross diagram. Illustrate an increase in the marginal propensity to consume on the diagram. Explain why the curve(s) moved as drawn. What happens to the GDP?

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

- A) Draw an increase in government spending on the LRAS/SRAS/AD diagram under two circumstances. The first is that crowding out exists while the second is if there is no crowding out. Draw just the immediate effects – do not worry about the long-run effects which are even bigger. Explain why the curve(s) moved. Under which case is there a bigger effect upon GDP? What is the economic reason for it? (FYI, I got the idea for this question from a question a student asked at the review session.)
- B) Draw the 45° diagram, a.k.a. the Keynesian Cross diagram. Illustrate an increase in government spending on the diagram. Explain why the curve(s) moved as drawn. Given your diagram, what is your estimate of the government spending multiplier? Show all work and explain how you did the calculations.