

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) For EITHER the event in Part A OR the event in Part B. Determine what happens to M1 and M2. Explain your logic.

- A) Somebody writes a check to you for \$100 and you deposit it in your savings account.
- B) You buy a \$50 pair of pants with a credit card.

2) (12 points) For EITHER the assumption of *no income tax* OR the assumption of *no change in the interest rate*, explain how relaxing that assumption will affect the size of the government spending multiplier.

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

A) Suppose the government spending is \$300, transfer payments are \$150, tax revenue is \$400, the bonds outstanding at the beginning of the year total \$1200, and the interest rate is 10%. How much is the government deficit and how much is the government debt at the end of the year? Explain your answer and show all work.

B) Explain the difference between the government's full-employment deficit and the actual government deficit. Why do economists worry more about the former?

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

A) We mentioned several reasons why fiscal policy may not work. In your opinion, which problem is the biggest? Explain why that result may prevent fiscal policy from working?

B) We mentioned several reasons why a big government debt is bad for the economy in the future. In your opinion, which problem is the biggest? Explain why that result may prevent fiscal policy from working?

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

A) What is *moral hazard*? Give an example from insurance and explain how insurance companies reduce it. Why does that action reduce the moral hazard?

B) What is *adverse selection*? Give an example from banking and explain how banks reduce it. Why does that action reduce the adverse selection?

6) (30 points) Answer EITHER Part A OR Part B.

A) Illustrate the effects of a decrease in government spending on the LRAS/SRAS/AD and the MS/MD diagrams. Explain why the curve(s) moved as drawn. What happens to the GDP, price level, and interest rates?

B) Illustrate the effects of a decrease in the income tax on the LRAS/SRAS/AD and the MS/MD diagrams. Explain why the curve(s) moved as drawn. What happens to the GDP, price level, and interest rates?