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 150 points (to be scaled up to 210 points) and is scheduled to take 75 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) Answer EITHER Part A OR Part B.
A) We mentioned four uses of money. State ONE of them and tell me if M1 or M2 does a better job with that. Explain your logic.
B) Most of the examples we gave of events which affect the money supply did not change M2. Why did M2 not change in most examples? Explain your logic.

2) (10 points) For EITHER the problem in Part A OR the problem in Part B, explain what it means and explain how it could reduce the effectiveness of fiscal policy.
A) Direct expenditure offset
B) Crowding out

3) (16 points) Answer EITHER Part A OR Part B.
A) Draw 45° diagram, a.k.a. the Keynesian Cross diagram. Illustrate the effects of an increase in the price level. Explain why the curve(s) moved as drawn. What happens to GDP and the unemployment rate?
B) Draw 45° diagram, a.k.a. the Keynesian Cross diagram. Illustrate the effects of an increase in the interest rates. Explain why the curve(s) moved as drawn. What happens to GDP and the unemployment rate?

4) (16 points) Answer EITHER Part A OR Part B.
A) Suppose the government is spending $500. It pays out $400 in transfer payments and collects $800 in tax revenue. How much is the government deficit or surplus? Show all work and briefly explain how you know whether it is a deficit or a surplus. Suppose the unemployment rate was 8%. How would the full employment deficit or surplus compare to what you just calculated? You do not need to tell me a number, just tell me if it is bigger or smaller than what you calculated.
B) As of yesterday, the government debt was $16,798,952,599,955.59 and the government deficit for last year was $1,100,000,000,000.00 (http://www.treasurydirect.gov/NP/BPDLogin?application=np and http://money.cnn.com/2012/10/05/news/economy/us-deficit/index.html) How are those two numbers calculated? What do they mean? (Yes, both of them are in the trillions of dollars.)

5) (16 points) Answer EITHER Part A OR Part B.
A) What do you consider to be the biggest problem caused by the large government deficit and large government debt? Explain how the deficit and debt combine to cause that problem and why that is a major problem.
B) There are many false arguments that deficit and debt are a problem. Which false argument do you feel is the weakest? Explain the argument and why it is a false argument.

6) (16 points) Answer EITHER Part A OR Part B.
A) The book argues that our government debt is overestimated. Explain their logic. For what situation is this argument accurate? Explain your logic. (Some examples of situations could be discussing the effect

of the debt upon interest rates, the effect upon the government's budget, the effect upon GDP, or the effect upon any other macroeconomic variable.)

B) Paul O'Neill argues that our government debt is underestimated. Explain his logic. For what situation is his argument accurate? Explain your logic. (Some examples of situations could be discussing the effect of the debt upon interest rates, the effect upon the government's budget, the effect upon GDP, or the effect upon any other macroeconomic variable.)

7) (18 points) Answer EITHER Part A OR Part B.
A) Draw the SRAS/LRAS/AD diagram with the economy in a recessionary gap. State how you know it is a recessionary gap. Illustrate the effects of what will happen if the government takes no action. Explain why the curve(s) moved as drawn. What happens to GDP, the unemployment rate, and the price level?
B) Draw the SRAS/LRAS/AD diagram with the economy at full employment. Illustrate the effects of what will happen if the price of oil increases. Explain why the curve(s) moved as drawn. What happens to GDP, the unemployment rate, and the price level?

8) (18 points) Answer EITHER Part A OR Part B.
A) What is *adverse selection*? Give an example from the banking industry. Explain how banks reduce that problem.
B) What is *moral hazard*? Give an example from the insurance industry. Explain how insurance companies reduce the problem.

9) (30 points) Draw the SRAS/LRAS/AD diagram and the $45°$ diagram, a.k.a. the Keynesian Cross diagram. Illustrate the effects of EITHER the event in Part A OR the event in Part B. Explain the curves moved as drawn. What happens to GDP, unemployment rate, and the price level? Use the same event for both graphs.
A) The marginal propensity to consume increases.
B) The income tax rate increases.