

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) For ONE of the following events, determine what happens to M1 and M2. Explain your logic.

- A) You transfer \$400 from a money market deposit account to a checking account.
- B) You pay your tuition with a check.

2) (14 points) Answer EITHER Part A OR Part B.

- A) What is *crowding out*? Explain how that can be both a long-term and a short-term problem with the government deficit and debt?
- B) What are TWO of the three lags in fiscal policy? Explain what causes them. (You do not need to explain why they are a problem.)

3) (16 points) For EITHER *adverse selection* OR *moral hazard*, state what it is. Explain how banks reduce the problem.

4) (18 points) Draw 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 why the curve(s) moved as drawn. What happens to real GDP?

- A) The marginal propensity to consume increases.
- B) We decide that we like foreign goods more than we used to.

5) (20 points) Answer EITHER Part A OR Part B.

- A) What was our estimate for the government spending multiplier? What does that mean? We made several assumptions when we made that estimate. What did we assume about the price level? If we relaxed that assumption, what would happen to the size of the multiplier? Why would that occur?
- B) Suppose a person's consumption function is given by  $C = 200 + 0.9(Y-T)$ . If their disposable income is \$100,000, then how much are their MPC, APC, MPS, and APS? Show all work and if there is no work, then explain what you did.

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

- A) Draw the LRAS/SRAS/AD diagram for an economy in an inflationary gap. Explain how you know it is a recessionary gap. If the government was to do fiscal policy, what should they do? Illustrate the effects of that on the graph. Explain why the curve(s) moved as drawn.
- B) Suppose that a government was spending \$400, paid out \$300 in transfer payments, paid \$100 in interest, and received tax revenue of \$850. How much is the government deficit or surplus? Show all work and explain how you did it. Suppose I told you that this country had an unemployment rate of 10%, would you expect that the full-employment deficit or surplus would be bigger or smaller than the deficit or surplus you found? Explain your logic.

According to the Treasury, as of 2014/4/23, the government owes \$17,525,948,567,766 (\$17.5 trillion). According to NASA's estimation of the time of the big bang (13.77 billion years ago) and the age of the universe (4.5 billion years), if you were paid one penny every four minutes starting at the big bang or 3/4 of a penny every minute from the start of the universe, you would barely be able to pay the debt.

<http://www.treasurydirect.gov/NP/debt/current> [http://wmap.gsfc.nasa.gov/universe/uni\\_age.html](http://wmap.gsfc.nasa.gov/universe/uni_age.html)