

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 take \$500 cash from a savings account.
- B) You buy a \$40 hat with cash.

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 is direct expenditure offset? How does that cause problems for doing fiscal policy?

3) (16 points) For EITHER *adverse selection* OR *moral hazard*, state what it is. Explain how insurance companies 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 income tax increases.
- B) The interest rates increase.

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

- A) What was our estimate for the government spending multiplier? Given that number, if the government wanted to increase GDP by \$100 million, then how much more would they have to spend? We made several assumptions when we made that estimate. What did we assume about imports? 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.