

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 14-point question should take 7 minutes. I cannot give extra time because some students have a class after your class.

1) (14 points) Answer EITHER Part A OR Part B.

A) What are the three tools of the Fed for affecting the money supply? For the most used tool, explain how the Fed could use it to increase the money supply.

B) Use the equation from the Quantity Theory of Money to explain what the long-term effects of increasing the money supply faster will be. Explain how the economists who believe that theory reached that conclusion.

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

A) There are four uses of money. (Not to be confused the three components of money demand.) What are TWO of them? For ONE of those two, is M1 or M2 better for that use? Explain your logic.

B) If you were President of the United States, what would you do to decrease the size of the deficit? Explain how that reduces the deficit and explain why you think that is a good way to do it.

3) (16 points) For EITHER the argument in Part A OR the argument in Part B, explain why people say it is a problem with the debt. Then determine if this is a strong argument or a weak argument and explain your logic.

A) "Crowding out now will hurt us in the future."

B) "We have a large debt to foreigners."

4) (18 points) Answer EITHER Part A OR Part B.

A) What is meant by *direct expenditure offset*? Explain why it might cause problems for counter-cyclical fiscal policy? Is that a strong argument? Explain your logic.

B) What is meant by *Ricardian Equivalence*? Explain why it might cause problems for counter-cyclical fiscal policy? Is that a strong argument? Explain your logic.

5) (18 points) For EITHER *moral hazard* OR *adverse selection*, define the term, give an example of it from banking, and explain one way banks reduce the problem. Make sure you explain how the actions reduce the problem.

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

A) What is meant by *crowding out*? Explain why it happens. Use the MS/MD diagram to explain the key step we left out when we first discussed it. Explain why the curve(s) moved as drawn.

B) Use the MS/MD diagram to prove the Fed cannot control both the money supply and interest rates at the same time. What is the economic reason this is true?