

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 16-point question should take 8 minutes. Because of the class that follows your class, I cannot give you extra time.

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

A) How much should be in the missing entry of the balance sheet on the right? Explain how you got that number. How much are the excess reserves? Explain how you got that answer.

B) The required reserve ratio in Russia is 20%. Suppose that the Fed decided that was a better number than the current value and changed it to 20%. What would be the impact on the money multiplier and the money supply? Explain your logic.

Assets	Bank A	Liabilities & NW	
Cash	20	Checking deposits	360
Deposits at Fed	40	Savings deposits	140
Bonds	440	Loans	100
Loans	1000	Misc.	?
Misc.	200	Equity	920

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

A) Are credit cards considered part of the money supply?

If yes, then tell me which part of the money supply it is in and why it is there. If no, then tell me why it is not part of the money supply.

B) When looking at the different items in M1 and M2, where are savings accounts? Why are they listed in that part of the money supply rather than the other?

3) (16 points) Answer EITHER Part A OR Part B.

A) Use a balance sheet for a bank to illustrate open market operations. Illustrate just the first step. Explain your entries. What happens to M1 and M2? Explain your logic.

B) Illustrate on the balance sheet of a bank, the bank loaning \$100. Explain the entries. What happens to M1 and M2? Explain your logic.

4) (16 points) Answer EITHER Part A OR Part B.

A) Ricardian Equivalence is debated among economists. What is it? Do you think it is an accurate theory? Explain your logic.

B) To be part of the euro area, the European Union requires that a government have a government debt of less than 60% of GDP and a government deficit of less than 3% of GDP because larger values are considered to be too large. What is the problem with a large deficit and a large debt? (Of interest, the debt for the USA is currently about 64% of GDP and the projected government deficit for 2004 is 4.2% of GDP.)

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

A) Draw the SRAS/LRAS/AD diagram for an economy with an inflationary gap. Explain how you know the graph shows an inflationary gap. If the government does **nothing**, then illustrate how the curve(s) will move over time. Explain why the curve(s) moved as drawn.

B) Draw the SRAS/LRAS/AD diagram for an economy with a recessionary (deflationary) gap. Explain how you know the graph shows a recessionary gap. What type of fiscal policy should the government do? Illustrate that policy on the graph. Explain why the curve(s) moved as drawn. Ignore both Ricardian Equivalence and crowding out.

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

A) Give an example of *moral hazard* in the banking industry. Be very specific in your explanation of how that is *moral hazard*.

B) Give an example of *adverse selection* in the banking industry. Be very specific in your explanation of how that is *adverse selection*.