

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) Answer EITHER Part A OR Part B.

A) What does it mean the money should be a good store of value? Does M1 or M2 do a better job at that? Explain your logic.

B) What does it mean the money should be a good medium of exchange? Does M1 or M2 do a better job at that? Explain your logic.

2) (12 points) Draw EITHER the Keynesian SRAS Curve OR the Classical SRAS Curve. Explain why it takes its shape.

3) (12 points) For EITHER lags OR crowding out, explain what that term means and why it may mean that the government should not do counter-cyclical fiscal policy.

4) (12 points) Answer EITHER Part A OR Part B.

A) Explain the *twin deficits*.

B) Explain the difference between the *gross public debt* and *net public debt*. Which do you think is more likely to cause problems for the economy? Explain your logic.

5) (16 points) Answer EITHER Part A OR Part B.

A) Suppose the government's spending is \$400, transfers are \$300 - .1Y, tax receipts are .2Y, and interest payments on the debt are \$100. If the GDP is \$2000, then how much is the government's budget deficit or surplus? Show all work and tell me, "The deficit is..." or "The surplus is...". If the full employment level of GDP is \$3000, then how much is the deficit or surplus? Show all work and tell me, "The full employment deficit is..." or "The full employment surplus is...".

B) One of the problems with the large debt is that we owe foreigners money. Why is that a problem? Is that a problem more likely to be caused by Paul O'Neill's debt, the gross public debt, or the net public debt? Explain your logic.

6) (16 points) Answer EITHER Part A OR Part B.

A) Define *moral hazard*. Give an example of it. Use your example to explain why we use financial intermediaries like banks OR insurance companies.

B) Define *adverse selection*. Give an example of it. Use your example to explain why we use financial intermediaries like banks OR insurance companies.

7) (20 points) Answer EITHER Part A OR Part B.

A) The USA is currently in an inflationary gap. Draw the LRAS/SRAS/AD diagram for an economy in an inflationary gap. Explain how you know your diagram shows an inflationary gap. If the economy is left alone, what will happen? Illustrate that on the diagram. Explain why the curve(s) moved as drawn.

B) Draw the LRAS/SRAS/AD diagram for an economy in a recessionary gap. Explain how you know your diagram shows a recessionary gap. What is the best fiscal policy for that problem? Illustrate that on the diagram. Explain why the curve(s) moved as drawn.