

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) On Homework #9, I gave the following statistics: The unemployment rate at the end of September was 3.5%. The government deficit for the fiscal year which ended September 30th was \$1.4 trillion. Is the full-employment deficit \$1.4 trillion, more than \$1.4 trillion, or less than \$1.4 trillion? Explain your logic.

B) How can we use the full-employment deficit to determine whether or not the government is doing smart fiscal policy? Explain your logic.

2) (16 points) Answer EITHER Part A OR Part B.

A) What is meant by *moral hazard*? Explain how collateral reduces that problem for loans.

B) We said that the existence of the FDIC can lead to a *moral hazard* problem for the banks. State what the FDIC is and does, and then explain the moral hazard problem that banks have because of it.

3) (16 points) We said the counter-cyclical fiscal policy might not work as intended. For EITHER *lags*, OR *crowding out*, explain the problem that causes for expansionary fiscal policy during a recession.

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

A) We said the counter-cyclical monetary policy might not work as intended. The Keynesian Liquidity Trap is one reason expansionary monetary policy might not work. Explain the problem caused by it using an appropriate graph.

B) We said that the Fed cannot control both the money supply and the interest rates at the same time. Use an appropriate graph to explain this statement. Make sure you explain what is happening.

5) (38 points) Answer EITHER Part A OR part B.

A) Draw the LRAS/SRAS/AD diagram and the MS/MD diagram for an economy with 7% unemployment. State how your graph shows 7% unemployment. What is the best monetary policy for that problem? Illustrate the effects of that policy on the graphs. Explain why the curves moved as drawn. What happens to GDP, inflation, unemployment rate, money supply, and interest rates?

B) Draw the LRAS/SRAS/AD diagram and the MS/MD diagram for an economy with 7% unemployment. State how your graph shows 7% unemployment. If the economy is left alone, how will it get back to full employment? Illustrate the effects of that event on the graphs. Explain why the curves moved as drawn. What happens to GDP, inflation, unemployment rate, money supply, and interest rates?