3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.

A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.

i. The current equilibrium real output and price level, labeled $\mathrm{Y_1}$ and $\mathrm{PL_1}$, respectively

ii. The full-employment output, labeled $\mathrm{Y_F}$

B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output $\mathrm{Y_2}$ and the new short-run equilibrium price level $\mathrm{PL_2}$.

C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.

D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM