

2. The economy of Noralandia is in short-run equilibrium with an actual inflation rate that is currently higher than the expected inflation rate.
- (a) Draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium point as X.
- (b) The banking system in Noralandia has ample reserves. Identify a specific monetary policy action that the central bank of Noralandia would take to bring the inflation rate closer to the expected inflation rate.
- (c) Noralandia has an open economy and a flexible exchange rate. Based solely on the effect of the monetary policy action identified in part (b) on interest rates in Noralandia, will there be an increase, a decrease, or no change in the flow of international financial capital into Noralandia? Explain.
- (d) Based on your answer to part (c), what will happen to the international value of Noralandia’s currency? Explain.

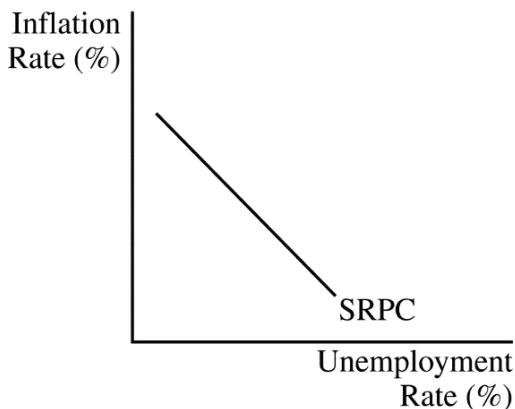
Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.

3. Assume that in the country of Zeta, the civilian noninstitutional population aged 16 and over is 1,000,000. The labor force participation rate is 70%, the unemployment rate is 9%, and the natural rate of unemployment is 5%.
- (a) Calculate the number of people in Zeta that are unemployed. Show your work.
- (b) Is the economy of Zeta currently experiencing a recessionary gap, an inflationary gap, or no output gap? Explain.
- (c) Consumer goods and capital goods are produced in the country of Zeta. Draw a correctly labeled graph of the production possibilities curve for Zeta. Indicate a point, labeled A, that represents the current state of Zeta's economy.
- (d) If some individuals who are counted as unemployed in Zeta stop looking for work, what will happen to each of the following?
- (i) The labor force participation rate. Explain.
(ii) The unemployment rate

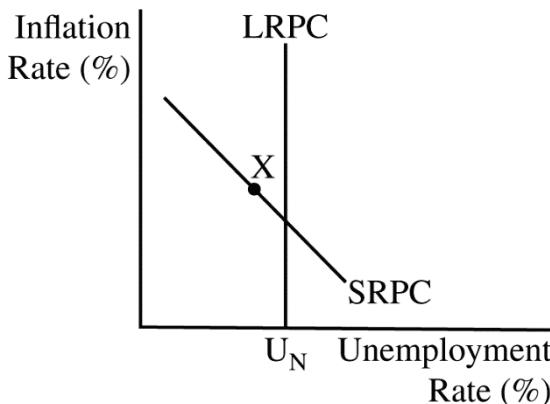
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Question 2: Short**5 points**

- (a) Draw a correctly labeled graph of the short-run Phillips curve (SRPC).

1 point

For the second point, the graph must include a correctly labeled long-run Phillips curve (LRPC) and show point X on the SRPC to the left of the LRPC.

1 point**Total for part (a) 2 points**

- (b) State that the central bank would increase its administered interest rates or increase interest on reserves.

1 point

- (c) State that there will be an increase in the flow of international financial capital into Noralandia and explain that international investors will seek higher returns on financial capital in Noralandia.

1 point

- (d) State that Noralandia's currency will appreciate and explain there will be an increase in the demand for Noralandia's currency (or a decrease in the supply of Noralandia's currency).

1 point**Total for question 2 5 points**