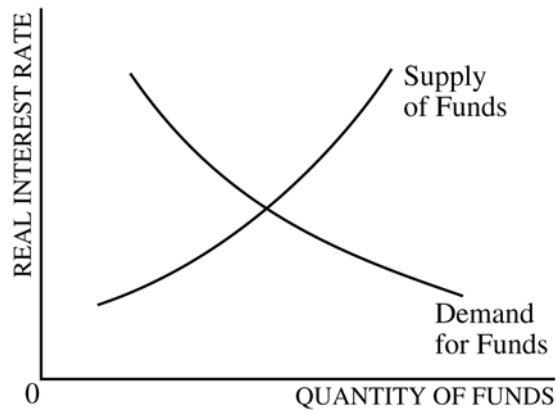


2005 AP[®] MACROECONOMICS FREE-RESPONSE QUESTIONS



2. The graph above shows the loanable funds market for a country.
- (a) Assume that now the country's government increases deficit spending. Explain how the increase in deficit spending will affect the real interest rate.
 - (b) Indicate how the real interest rate change you identified in part (a) will affect investment in plant and equipment.
 - (c) Explain how the real interest rate change you identified in part (a) will affect long-term economic growth.
 - (d) Explain how the real interest rate change you identified in part (a) will affect each of the following in the foreign exchange market.
 - (i) The demand for the country's currency
 - (ii) The value of the country's currency

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3. Assume that the table below shows the unemployment and inflation data in Country X as a result of a shift in aggregate demand.

| Period | Unemployment Rate | Inflation Rate |
|-----------|-------------------|----------------|
| Last year | 2% | 8% |
| This year | 5% | 4% |

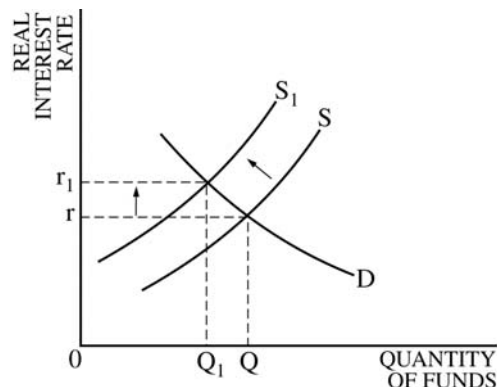
- (a) Draw a correctly labeled graph of a short-run Phillips curve for Country X, showing the actual unemployment and inflation rates for both years. Label the Phillips curve as SRPC.
- (b) Now assume that the short-run aggregate supply curve has shifted to the left.
 - (i) Identify one factor that could cause the aggregate supply curve to shift to the left.
 - (ii) On the graph, show how this shift would affect the short-run Phillips curve.
- (c) Assume that the natural rate of unemployment in Country X is 5 percent. Draw a correctly labeled graph of the long-run Phillips curve and label it as LRPC.
- (d) What is the relationship between the unemployment rate and the inflation rate in the long run?

END OF EXAM

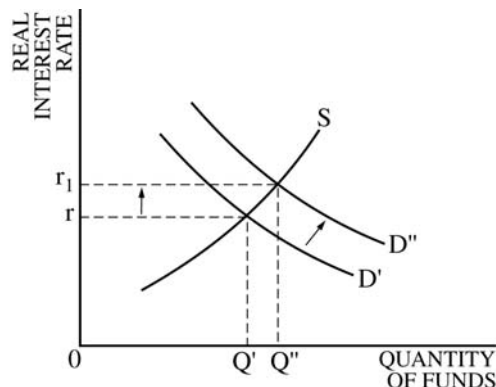
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Question 2

8 points (2 + 1 + 2 + 3)



OR



(a) 2 points:

- One point is earned for indicating that the demand-for-funds curve shifts to the right or that the supply-of-funds curve shifts to the left.
- One point is earned for concluding that the real interest rate will increase.

(b) 1 point:

- One point is earned for indicating that the investment in plant and equipment will decrease because of the higher real interest rate.

(c) 2 points:

- One point is earned for stating that the decrease in investment in plant and equipment will decrease the growth of the capital stock (or reduce capital stock).
- One point is earned for concluding that long-term economic growth will decrease.

(d) 3 points:

- One point is earned for indicating that the real interest-rate increase from part (a) will increase the demand for the country's financial assets.
- One point is earned for stating that the demand for the country's currency will increase.
- One point is earned for stating that the country's currency will appreciate.