

2. Assume a country's economy is currently operating below full employment.
- (a) Identify a fiscal policy action the country's government could implement to restore full employment.
- (b) Draw a correctly labeled graph of the loanable funds market, and show the effect of the fiscal policy action identified in part (a) on the equilibrium real interest rate.
- (c) Based solely on the real interest rate change shown in part (b), what will happen to each of the following?
- (i) Net exports. Explain.
- (ii) The stock of physical capital. 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. Flowerland is an open economy with a flexible exchange rate regime. The natural rate of unemployment is 5%, the frictional rate of unemployment is 4%, and the actual rate of unemployment is 7%.

(a) What is the numerical value of the cyclical rate of unemployment in Flowerland?

(b) Assume the foreign demand for lavender oil produced in Flowerland increases. What will happen to each of the following in Flowerland in the short run?

(i) Aggregate demand. Explain.

(ii) Cyclical unemployment.

The table shows the market basket quantities and prices of lavender oil and roses, the only two goods produced in Flowerland.

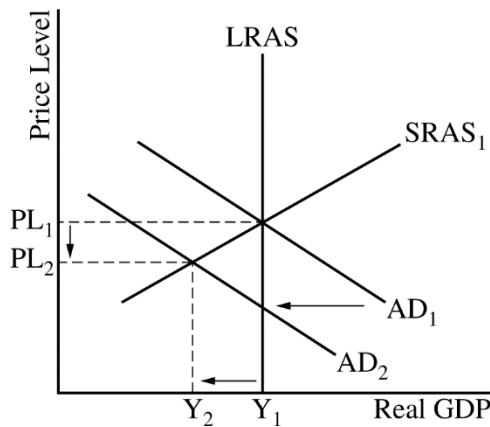
Goods	Quantity (in units)	2019 Price per Unit	2020 Price per Unit
Lavender oil	40	\$3	\$4
Roses	4	\$20	\$25

(c) Assume 2019 is the base year. Based on the data in the table, calculate the price index for year 2020 in Flowerland. Show your work.

(d) If nominal income in Flowerland increased by 20% from 2019 to 2020, will the standard of living of the average citizen of Flowerland increase, decrease, or stay the same from 2019 to 2020? Explain.

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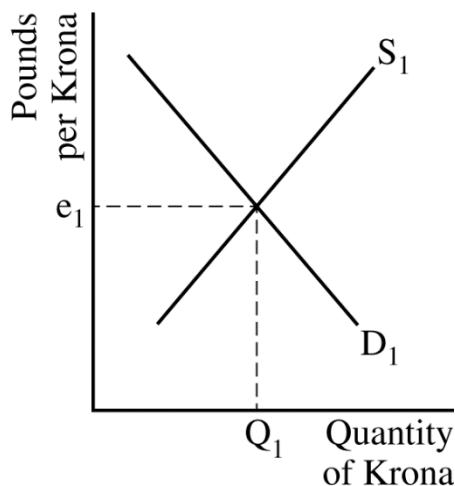
- (c) On the graph from part (b), show the impact of the decrease in imports with a leftward shift of the AD curve, a decrease in real output to Y_2 , and a decrease in the price level to PL_2 . **1 point**



- (d) State that policymakers would be more concerned about cyclical unemployment than inflationary pressures and explain that the decline in exports to the United Kingdom lowered real output below full employment, resulting in unemployment above the natural rate of unemployment. **1 point**

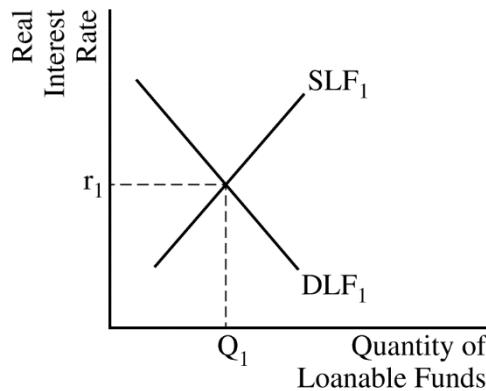
- (e) State that the Swedish central bank should buy bonds. **1 point**

- (f) Draw a correctly labeled graph of the foreign exchange market for the krona. **1 point**

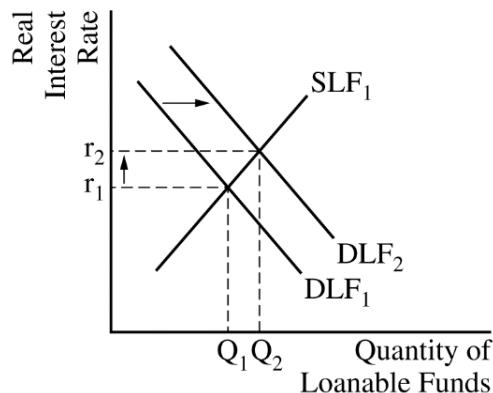


Question 2: Short**5 points**

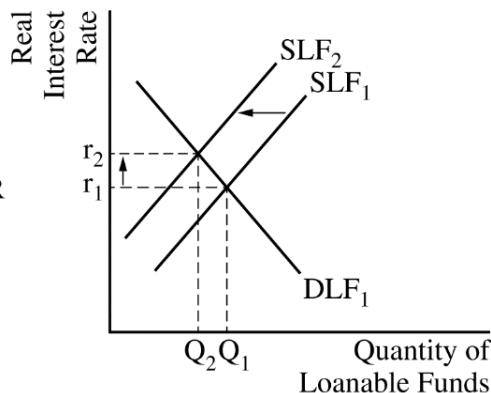
- (a) State that the country could implement one of the following fiscal policy actions: increase government spending, increase transfer payments, or decrease taxes. **1 point**
- (b) Draw a correctly labeled graph of the loanable funds market. **1 point**



For the second point, the graph must show a rightward shift in the demand for loanable funds curve (or a leftward shift in the supply of loanable funds curve), resulting in an increase in the equilibrium real interest rate. **1 point**



OR



Total for part (b) **2 points**

(c) (i)	State that net exports will decrease and explain that the increase in the real interest rate will increase the demand for the country's currency, which will cause the country's currency to appreciate and make domestic goods relatively more expensive than foreign goods, thereby decreasing exports.	1 point
(ii)	State that the stock of physical capital will decrease and explain that the increase in the real interest rate will discourage investment spending in physical capital.	1 point
Total for part (c)		2 points
Total for question 2		5 points