MACROECONOMICS

Section II

Planning time—10 minutes

Writing time—50 minutes

Directions: You have fifty minutes to answer all three of the following questions. It is suggested that you spend approximately half your time on the first question and divide the remaining time equally between the next two questions. In answering the questions, you should emphasize the line of reasoning that generated your results; it is not enough to list the results of your analysis. Include correctly labeled diagrams, if useful or required, in explaining your answers. A correctly labeled diagram must have all axes and curves clearly labeled and must show directional changes. Use a pen with black or dark blue ink.

1. Assume that the United States economy is currently in equilibrium at the full-employment level of real gross domestic product.

   (a) Draw a correctly labeled graph of aggregate demand and aggregate supply showing each of the following in the United States.

      (i) Output level

      (ii) Price level

   (b) Japan is a major importer of United States products. Assume that the Japanese economy goes into a recession.

      (i) Explain the impact of the Japanese recession on the United States equilibrium output and price levels.

      (ii) Show these effects on your graph in part (a).

   (c) Assume that the Federal Reserve takes action to curb the effects of the Japanese recession on the United States economy.

      (i) What open-market operation would the Federal Reserve undertake?

      (ii) Use a correctly labeled graph of the money market to show how the Federal Reserve policy action will affect the nominal interest rate.

      (iii) Explain how the change in the nominal interest rate in part (c) (ii) will affect aggregate demand, price level, and real output in the United States.

   (d) Define the real interest rate.

   (e) Indicate the effect of the open-market operation you identified in part (c) (i) on the real interest rate in the United States.

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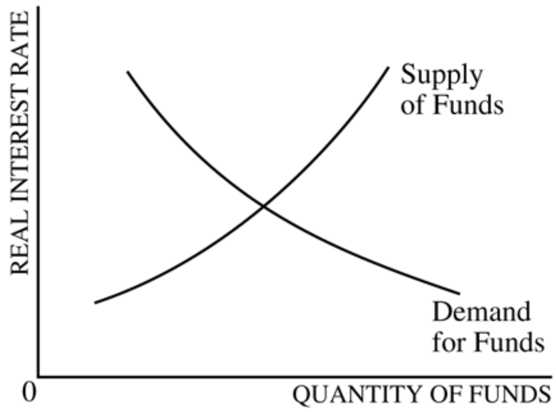

2. The graph above shows the loanable funds market for a country.

   (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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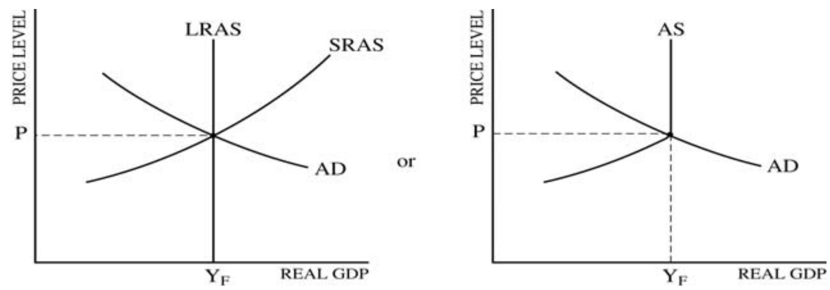
Question 1

13 points (3 + 3 + 5 + 1 + 1)

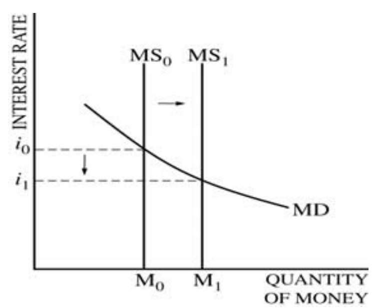


(a) 3 points:

- One point is earned for a correctly labeled AD/AS graph.
- One point is earned for showing the equilibrium at full-employment output indicated by a vertical LRAS or an AS curve with a vertical section.
- One point is earned for correctly labeled equilibrium price and output levels.

(b) 3 points:

- One point is earned for stating that U.S. exports fall.
- One point is earned for showing a decrease in AD on graph in (a).
- One point is earned for indicating a decrease in equilibrium output and price levels.



(c) 5 points:

- One point is earned for prescribing purchase of government bonds.
- One point is earned for a correctly labeled graph of the money market.
- One point is earned for showing a shift of the money supply curve to the right producing a decrease in the interest rate.
- One point is earned for explaining that the decrease in interest rate leads to an increase in business investment demand (or an increase in consumption by households), which increases aggregate demand.
- One point is earned for explaining that the increase in aggregate demand increases equilibrium price and output levels.

Question 1 (continued)

(d) 1 point:

- One point is earned for stating that the real interest rate is the nominal rate minus inflation (or expected inflation), or that the real interest rate is the nominal rate adjusted for inflation.

(e) 1 point:

- One point is earned for indicating that the real interest rate falls because the nominal interest rate falls and the price level increases.