2. Assume the expected inflation rate in a country is 3%, the current unemployment rate is 6%, and the natural rate of unemployment is 4%.

   (a) Draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium as point X and plot the numerical values above on the graph.

   (b) Is the actual inflation rate greater than, less than, or equal to the expected inflation rate of 3%?

   (c) Assume loans were made taking into account the expected inflation rate of 3%. Will lenders be better off or worse off after they realize the actual inflation rate identified in part (b) ? Explain.

   (d) Based on the relationship between the actual and the expected inflation rates identified in part (a), what will happen to the natural rate of unemployment in the long run?

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3. Assume that households in Econland increase their savings for retirement.

   (a) Using a correctly labeled graph of the loanable funds market, show how the increase in savings will affect the equilibrium real interest rate.

   (b) Based solely on the real interest rate change identified in part (a), what will happen to Econland's purchases of foreign assets? Explain.

   (c) Consider the foreign exchange market for Econland's currency.

      (i) Based on your answer to part (b), what will happen to the international value of Econland's currency?

      (ii) Based on your answer to part c (i), would Econland's central bank buy or sell its currency in the foreign exchange market to offset the change in the value of its currency?
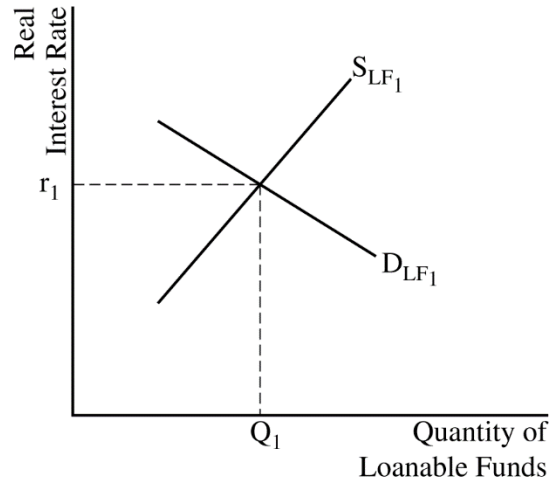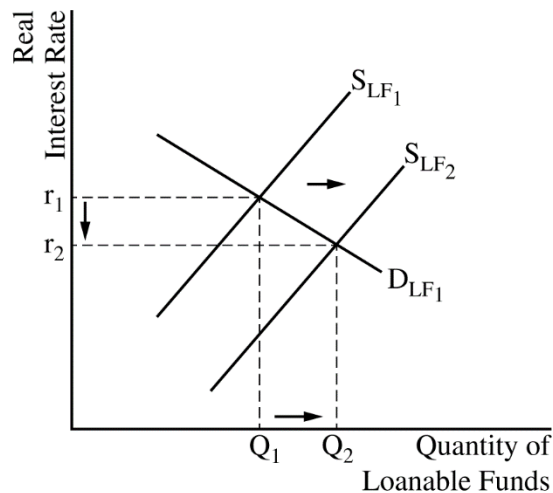
STOP

END OF EXAM

Question 3

5 Points (2 + 1 + 2)

(a) 2 points

- One point is earned for drawing a correctly labeled graph of the loanable funds market and identifying the equilibrium real interest rate and quantity of loanable funds.

- One point is earned for showing a rightward shift of the supply curve for loanable funds and for showing a lower equilibrium real interest rate.

(b) 1 point

- One point is earned for stating that Econland's purchases of foreign assets will increase and for explaining that Econland's investors will seek higher returns in other countries, which increases Econland's demand for foreign assets.

(c) 2 points

- One point is earned for stating that Econland's currency will depreciate.

- One point is earned for stating that Econland's central bank would buy its currency in the foreign exchange market.