CollegeBoard
Advanced Placement Program

AP® Macroeconomics
2006 Free-Response Questions
Form B

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MACROECONOMICS
Section II
Planning Time—10 minutes
Writing Time—50 minutes

Directions: You have 50 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 a country's economy is operating at less than full employment.

   (a) Draw a correctly labeled graph of aggregate demand and aggregate supply, and show each of the following.

   (i) Long-run aggregate supply curve

   (ii) Current output and price level

   (b) Assume that policy makers take no policy action and that prices and wages are flexible. Explain what will happen to each of the following.

   (i) Short-run aggregate supply

   (ii) Employment

   (c) Now assume that instead of taking no policy action, the government implements a special tax incentive to encourage individuals to increase saving for retirement. Draw a correctly labeled graph of the loanable funds market. Show how the real interest rate is affected.

   (d) Given your answer in part (c), explain how aggregate supply is affected in the long run.

2. Banks play an important role in determining changes in the money supply.

   (a) Assume that a bank receives a cash deposit of $9,000 from a customer. What is the immediate impact of this transaction on the money supply? Explain.

   (b) Suppose that the reserve requirement is 10 percent and banks voluntarily keep an additional 10 percent in reserves. Calculate each of the following.

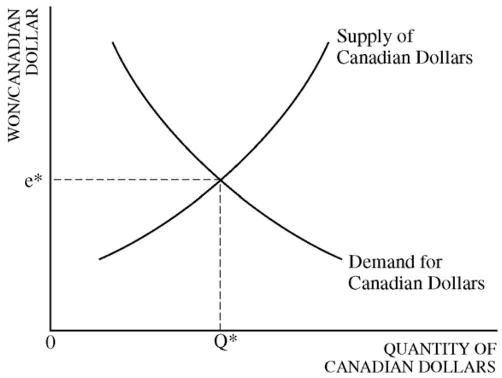
   (i) The maximum amount by which this bank will increase its loans from the transaction in part (a)

   (ii) The maximum increase in the money supply that will be generated from the transaction in part (a)

   (c) Assume that the government increases spending by $9,000, which is financed by a sale of bonds to the central bank.

   (i) Indicate what will happen to the money supply.

   (ii) Explain what will happen to the money demand.



3. Assume that South Korea and Canada are trading partners. The equilibrium exchange rate between the Canadian dollar and the South Korean currency, the won, is shown in the graph of the foreign exchange market, above.

(a) Explain how each of the following will affect the demand for the Canadian dollar.

(i) The inflation rate in Canada is higher than the inflation rate in South Korea.

(ii) Real interest rates in Canada fall relative to real interest rates in South Korea.

(b) Given your answer to part (a)(ii), indicate how the value of the Canadian dollar is affected.

(c) As a result of the currency change in part (b), what will happen to Canadian exports to South Korea? Explain.

STOP

END OF EXAM