

MACROECONOMICS

Section II

Planning Time—10 minutes

Writing Time—50 minutes

Directions: You have 10 minutes to read all of the questions in this booklet, to sketch graphs, to make notes, and to plan your answers. You will then 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 the United States economy is currently operating below the full-employment level of real gross domestic product with a balanced budget.
 - (b) The United States government increases spending on goods and services by \$100 billion, which is financed by borrowing. How will the increase in government spending affect each of the following?
 - (i) Cyclical unemployment
 - (ii) The natural rate of unemployment
 - (c) If the marginal propensity to consume is equal to 0.75, calculate the maximum possible change in real gross domestic product that could result from the \$100 billion increase in government spending.
 - (d) Using a correctly labeled graph of the loanable funds market, show the effect of the \$100 billion increase in government spending on the real interest rate.
 - (e) Based on the real interest rate change in part (d), what is the effect on the long-run economic growth rate? Explain.
 - (f) Now assume that instead of financing the \$100 billion increase in government spending by borrowing, the United States government increases taxes by \$100 billion. With this equal increase in government spending and taxes, will the real gross domestic product increase, decrease, or remain the same? Explain.