1. Assume Smithland is in short-run equilibrium at a level of output that exceeds the full-employment level of output.

(b) Assume Smithland's government cuts individual income taxes. On your graph in part (a), show the short-run effect of the tax cut on equilibrium real output, labeling the new short-run equilibrium real output Y_2.

(c) Based solely on the change in real output on your graph in part (b), what will happen to each of the following in the short run?

(i) The natural rate of unemployment
(ii) Nominal interest rates. Explain.

(d) Assume instead the central bank intervenes to correct an inflationary output gap. What open-market operation should the central bank take?

(f) Based solely on the interest rate change identified in part (e), what will happen to the international value of Smithland's currency in the foreign exchange market? Explain.

(g) Based solely on the exchange rate change identified in part (f), will Smithland's imports increase, decrease, or remain the same? 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.