

2. The economy of Noralandia is in short-run equilibrium with an actual inflation rate that is currently higher than the expected inflation rate.
- (a) Draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium point as X.
- (b) The banking system in Noralandia has ample reserves. Identify a specific monetary policy action that the central bank of Noralandia would take to bring the inflation rate closer to the expected inflation rate.
- (c) Noralandia has an open economy and a flexible exchange rate. Based solely on the effect of the monetary policy action identified in part (b) on interest rates in Noralandia, will there be an increase, a decrease, or no change in the flow of international financial capital into Noralandia? Explain.
- (d) Based on your answer to part (c), what will happen to the international value of Noralandia's currency? 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.

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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