

3. The economy of Country Zeta is in long-run equilibrium; however, the government is concerned about the size of the national debt.
- (a) Identify one specific fiscal policy action the government could take to reduce the national debt.
 - (b) Draw a correctly labeled graph of the loanable funds market, and show the effect of the fiscal policy action identified in part (a) on the real interest rate.
 - (c) Based on the change in the real interest rate identified in part (b), what will happen to each of the following?
 - (i) Aggregate demand in the short run. Explain.
 - (ii) Potential real output. 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.

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END OF EXAM