

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.

STOP

END OF EXAM

2. Assume the economy of Ucheland is currently at full employment. The government of Ucheland reduces the tax rate on household interest earnings.
- (a) What will happen to private savings in Ucheland?
 - (b) Draw a correctly labeled graph of the loanable funds market, and show the effect of the change in private savings identified in part (a) on the equilibrium real interest rate.
 - (c) Given the real interest rate change identified in part (b), answer the following questions.
 - (i) What is the short-run effect on aggregate demand? Explain.
 - (ii) What is the long-run effect on potential real gross domestic product in Ucheland? Explain.
-