

Week 8

AP Macroeconomics

Homework bundle for this week

本周作业合集

exercises.lol

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AP Macroeconomics

Name: _____ Score: _____

1. The aggregate demand curve slopes downward mainly because of the wealth, interest rate, and:
 - ☐ exchange rate effect
 - ☐ substitution to other goods
 - ☐ tax effect
 - ☐ population effect
2. The marginal propensity to consume plus the marginal propensity to save equals _____.

3. SRAS slopes upward mainly because, in the short run:
 - ☐ nominal wages are sticky, so a higher price level raises profit per unit
 - ☐ wages adjust instantly
 - ☐ demand falls
 - ☐ the government sets output
4. The long-run aggregate supply curve is:
 - ☐ vertical at full-employment output
 - ☐ upward-sloping
 - ☐ downward-sloping
 - ☐ horizontal
5. Short-run macroeconomic equilibrium is where:
 - ☐ AD crosses SRAS
 - ☐ AD crosses LRAS only
 - ☐ the price level is highest
 - ☐ output is zero
6. A rightward shift in AD causes, in the short run:
 - ☐ a higher price level and higher output
 - ☐ a lower price level and lower output
 - ☐ higher prices, lower output
 - ☐ no change

7. Aggregate demand equals $C + I + G + (X - \text{_____})$.

8. If $MPC = 0.75$, what is the spending multiplier?

9. Costs that are fixed by contracts and slow to change in the short run are called _____.

10. LRAS sits at the economy's maximum sustainable output, called potential _____.

1. exchange rate effect

AD covers every good, so there is no substitution — the three macro effects explain the slope.

2. 1

Every extra dollar is either spent or saved, so $MPC + MPS = 1$.

3. nominal wages are sticky, so a higher price level raises profit per unit

With wages locked in, a higher price level means more profit per unit, so firms produce more.

4. vertical at full-employment output

In the long run output depends on real resources, not the price level, so LRAS is vertical.

5. AD crosses SRAS

Where AD meets SRAS, the output demanded equals the output supplied in the short run.

6. a higher price level and higher output

Along the upward SRAS, more demand raises both price and output — price and output move together.

7. M

$AD = C + I + G + \text{net exports } (X - M)$.

8. 4

Spending multiplier $= 1 \div (1 - 0.75) = 1 \div 0.25 = 4$.

9. sticky

Sticky nominal wages are the key reason SRAS slopes upward.

10. GDP

Potential GDP is the output at full employment, at the natural rate of unemployment.

3.1 Aggregate Demand (AD)

Name: _____ Class: _____ Date: _____

Total: 10 marks

KEY WORDS aggregate demand 总需求 • price level 价格水平 • wealth effect 财富效应

Objective

Build the skills to answer exam questions on **aggregate demand (AD)**.

You must be able to:

- define **aggregate demand** 总需求 as total real output demanded at each price level
- explain the downward slope using the **wealth**, **interest rate**, and **exchange rate** effects
- identify the components: consumption, investment, government spending, net exports
- distinguish a movement along AD from a **shift** of AD

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Aggregate demand

The total quantity of real output all buyers want at each price level.

■ Why AD slopes down

- **Wealth effect** — a lower price level raises the real value of money.
- **Interest rate effect** — lower prices lower interest rates, boosting investment.
- **Exchange rate effect** — lower prices make exports cheaper.

■ Components and shifts

$AD = C + I + G + (X - M)$. A change in any component (e.g. confidence, interest rates, expectations) **shifts** the whole AD curve.

2 Practice

2.1 Define aggregate demand.

[1]

2.2 Name the three effects that explain the downward slope of AD. [2]

2.3 List the four components of aggregate demand. [2]

3 Exam-style questions

3.1 The AD curve slopes downward partly because of the [1]

- **A** wealth effect
- **B** law of supply
- **C** menu costs
- **D** multiplier

3.2 A rise in consumer confidence shifts AD [1]

- **A** to the left
- **B** to the right
- **C** not at all
- **D** vertically

3.3 Investment spending falls sharply across the economy.

(a) State the effect on aggregate demand. [1]

(b) State the direction AD shifts. [1]

(c) Name one other component of AD. [1]

Solutions

2.1 the total quantity of real output demanded in an economy at each price level.

2.2 the wealth effect, the interest rate effect, the exchange rate effect.

2.3 consumption, investment, government spending, net exports.

3.1 A.

3.2 B.

3.3 (a) AD falls. (b) to the left. (c) any one of: consumption, government spending, net exports.

1. The economy of Micanapy is in short-run equilibrium and is experiencing an inflationary gap.

Part A

Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Micanapy, and show each of the following.

- i. The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
- ii. The full-employment real output, labeled Y_F

Part B

Assume that policymakers take no action to close the inflationary gap. Explain how Micanapy's economy will self-adjust to full employment in the long run.

Part C

Suppose instead that Micanapy's central bank is considering using monetary policy to close the inflationary gap in the short run. The banking system in Micanapy has limited reserves.

- i. Identify a specific open-market operation that the central bank of Micanapy would implement to close the inflationary gap in the short run.
- ii. Draw a correctly labeled graph of the money market in Micanapy, and show the effect of the open-market operation identified in part C (i) on the nominal interest rate.

Part D

Based solely on the interest rate change shown on your graph in part C (ii), will each of the following increase, decrease, or remain the same in the short run?

- i. International financial capital flows into Micanapy. Explain.
- ii. The price of previously issued bonds in Micanapy
- iii. Private domestic investment spending in Micanapy

Part E

Based solely on the change in private domestic investment spending identified in part D (iii), will the unemployment rate in Micanapy increase, decrease, or remain the same in the short run? Explain.

1. Assume that the economy of Vortania is in long-run equilibrium.
- A. Draw a correctly labeled graph of the short-run and long-run Phillips curves for the economy of Vortania, and label the long-run equilibrium point as P.
 - B. Assume that new residential construction projects are being implemented in Vortania.
 - i. Will real output in Vortania increase, decrease, or remain the same in the short run? Explain.
 - ii. Assuming no change in inflationary expectations, on your graph in part A, show the short-run effect of the new residential construction projects on Vortania's economy, labeling the new short-run equilibrium point as S.
 - C. Vortania and Rhodara are trading partners with flexible exchange rates. The currency of Vortania is the Vortanian crown (VTC), and the currency of Rhodara is the Rhodaran mark (RHM). Assume that Vortania's capital and financial account (CFA) balance is zero. Now assume that Vortania imposes new tariffs on imports from Rhodara. Draw a correctly labeled graph of the foreign exchange market for the Vortanian crown, and show the effect of the tariffs on the SUPPLY of the Vortanian crown and the international value of the Vortanian crown.
 - D. Based solely on the change in the international value of the Vortanian crown shown in part C, will Vortania's net exports increase, decrease, or remain the same in the short run?
 - E. Based on the change in net exports identified in part D, what will happen to each of the following in the short run?
 - i. The capital and financial account (CFA) balance in Vortania. Explain.
 - ii. Employment in Vortania
 - F. Assume the central bank of Vortania wants to return the Vortanian crown to its international value before the imposition of the tariffs. Would the central bank buy or sell Vortanian crowns in the foreign exchange market? Explain.

2. Assume the economy of Jenland is in short-run equilibrium at a real output level above full-employment real output.
- A. The banking system in Jenland has ample reserves. Identify a specific monetary policy action that the central bank of Jenland would implement to return the economy to full employment in the short run.
 - B. Draw a correctly labeled graph of the reserve market for Jenland, and show the effect of the central bank's action identified in part A on the policy rate.
 - C. Based on the change in the interest rate shown on your graph in part B, will each of the following increase, decrease, or remain the same in Jenland in the short run?
 - i. The price of previously issued bonds
 - ii. The price level. Explain.

1. Assume that the economy of Moneyland is in equilibrium with an actual unemployment rate equal to the natural rate of unemployment.
 - (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full employment output, labeled Y_F
 - (b) Assume that consumer spending in Moneyland decreases from \$110,000 to \$100,000 as a result of a decrease in disposable income in Moneyland from \$135,000 to \$110,000.
 - (i) Calculate the marginal propensity to consume in Moneyland. Show your work.
 - (ii) Show the short-run effect of the decrease in consumer spending in Moneyland on your graph in part (a), labeling the new equilibrium real output and price level Y_2 and PL_2 , respectively.
 - (c) Following the decrease in consumer spending, explain how the economy would adjust in the long run in the absence of any policy actions.
 - (d) The central bank of Moneyland is concerned about the short-run effects of the decrease in consumer spending on the broader economy and is considering taking action rather than waiting for the long-run adjustment process. Assuming the banking system in Moneyland has ample reserves, identify a specific monetary policy action the central bank of Moneyland would take to increase consumer spending.
 - (e) Draw a correctly labeled graph of the reserve market in Moneyland, and show the effect of the monetary policy action identified in part (d) on the policy rate.
 - (f) How would the change in the policy rate shown on your graph in part (e) affect each of the following in Moneyland in the short run?
 - (i) The quantity of national savings
 - (ii) Unemployment. 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.

3. Assume that the economy of country Zen is in long-run macroeconomic equilibrium.

(a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.

(i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively

(ii) The full-employment output, labeled Y_F

(b) On your graph in part (a), show the short-run effect of an increase in consumer confidence. Label the new equilibrium real output Y_2 and the new equilibrium price level PL_2 .

(c) Assume that the banking system in Zen has ample reserves. Suppose that the central bank's goal is to maintain a stable price level at PL_1 . Based on the change in the price level shown in part (b), identify one specific monetary policy action the central bank would take to achieve its goal.

(d) Based on the monetary policy action identified in part (c), will real output increase, decrease, or stay the same in the short run? 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

1. Assume a country's economy is operating below full employment.

(a) Draw a correctly labeled graph of aggregate demand, short-run aggregate supply, and long-run aggregate supply, and show each of the following.

- (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
- (ii) The full-employment output, labeled as Y_F

(b) Identify one fiscal policy action the country's government can take to restore full employment.

(c) Assume instead that no fiscal policy action is taken. Suppose a change in investment spending causes real GDP to increase by \$200 billion. Calculate the minimum change in investment spending that could have caused this increase in real GDP if the marginal propensity to save is 0.25. Show your work.

(d) Assume the output gap was initially \$800 billion. On your graph in part (a), show the short-run effect of the change in investment spending identified in part (c), labeling the new equilibrium real output as Y_2 and the new equilibrium price level as PL_2 .

(e) Given your answer to part (d), is the actual rate of unemployment greater than, less than, or equal to the natural rate of unemployment? Explain.

(f) Assume that private savings now increase. Draw a correctly labeled graph of the loanable funds market and show the effect of the increase in private savings on the real interest rate.

(g) Based solely on the change in the real interest rate shown in part (f), what will happen to each of the following?

- (i) Real GDP in the short run. Explain.
- (ii) Long-run aggregate supply. 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.

3. Flowerland is an open economy with a flexible exchange rate regime. The natural rate of unemployment is 5%, the frictional rate of unemployment is 4%, and the actual rate of unemployment is 7%.

- (a) What is the numerical value of the cyclical rate of unemployment in Flowerland?
- (b) Assume the foreign demand for lavender oil produced in Flowerland increases. What will happen to each of the following in Flowerland in the short run?
- (i) Aggregate demand. Explain.
 - (ii) Cyclical unemployment.

The table shows the market basket quantities and prices of lavender oil and roses, the only two goods produced in Flowerland.

Goods	Quantity (in units)	2019 Price per Unit	2020 Price per Unit
Lavender oil	40	\$3	\$4
Roses	4	\$20	\$25

- (c) Assume 2019 is the base year. Based on the data in the table, calculate the price index for year 2020 in Flowerland. Show your work.
- (d) If nominal income in Flowerland increased by 20% from 2019 to 2020, will the standard of living of the average citizen of Flowerland increase, decrease, or stay the same from 2019 to 2020? 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.

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. 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 operating below full employment.
 - (a) Draw a correctly labeled graph of long-run aggregate supply, short-run aggregate supply, and aggregate demand, and show each of the following.
 - (i) Current equilibrium output and price level, labeled as Y_1 and PL_1
 - (ii) Full-employment output, labeled as Y_f
 - (b) Assume that the Federal Reserve targets a new federal funds rate to reach full employment. Should the Federal Reserve target a higher or lower federal funds rate?
 - (c) Given the Federal Reserve action you identified in part (b), draw a correctly labeled graph of the money market and show the effect on the nominal interest rate.
 - (d) The policy makers pursue a fiscal policy rather than the monetary policy in part (b). Assume that the marginal propensity to consume is 0.8 and the value of the recessionary gap is \$300 billion.
 - (i) If the government changes its spending without changing taxes to eliminate the recessionary gap, calculate the minimum required change in government spending.
 - (ii) If the government changes taxes without changing government spending to eliminate the recessionary gap, will the minimum required change in taxes be greater than, smaller than, or equal to the minimum required change in government spending in part (d)(i) ? Explain.
 - (e) Assume the government lowers income tax rates to eliminate the recessionary gap. Will each of the following increase, decrease, or stay the same?
 - (i) Aggregate demand. Explain.
 - (ii) Long-run aggregate supply. Explain.

2. The Federal Reserve can influence the supply of money.
- (a) Assume that the Federal Reserve targets a lower federal funds rate.
 - (i) What open market operation can the Federal Reserve use to achieve the lower target?
 - (ii) Given your answer to part (a)(i), what will happen to the price of government bonds?
 - (b) Using a correctly labeled graph of the money market, show the effect of the open market operation from part (a)(i) on the nominal interest rate.
 - (c) Assume that the Federal Reserve buys government bonds from commercial banks. Based only on this transaction, will the level of required reserves in the commercial banks increase, decrease, or remain the same?
 - (d) Another monetary policy action involves changing the discount rate. Define the discount rate.
-
3. The United States and South Korea are trading partners, and the United States has a zero current account balance. Assume now that the inflation rate in the United States decreases relative to the inflation rate in South Korea.
- (a) Based on the decrease in the inflation rate in the United States, will United States exports to South Korea increase or decrease?
 - (b) Based on the change in United States exports in part (a), answer each of the following.
 - (i) Will the United States current account balance remain at zero, be in surplus, or be in deficit?
 - (ii) What will happen to real gross domestic product in the United States in the short run? Explain.
 - (c) The South Korean currency is the won. Draw a correctly labeled graph of the foreign exchange market for the United States dollar. Show the effect of the lower inflation rate in the United States on the won price per United States dollar.

STOP

END OF EXAM

3.2 Multipliers

Name: _____ Class: _____ Date: _____

Total: 11 marks**KEY WORDS** marginal propensity to consume 边际消费倾向 • to save (mps) 边际储蓄倾向

Objective

Build the skills to answer exam questions on **multipliers**.**You must be able to:**

- define the **marginal propensity to consume (MPC)** 边际消费倾向 and **to save (MPS)** 边际储蓄倾向, with $MPC + MPS = 1$
- calculate the **spending multiplier** $\frac{1}{1 - MPC} = \frac{1}{MPS}$
- explain why the **tax multiplier** is smaller in magnitude
- find the change in equilibrium real GDP from an initial change in spending or taxes

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ MPC and MPS

MPC is the fraction of extra income **spent**; MPS is the fraction **saved**; $MPC + MPS = 1$.

■ The spending multiplier

$$\text{multiplier} = \frac{1}{1 - MPC} = \frac{1}{MPS}$$

A higher MPC gives a larger multiplier.

■ Change in GDP

 $\Delta GDP = \text{multiplier} \times (\text{initial change in spending})$. With $MPC = 0.8$, the multiplier is $\frac{1}{0.2} = 5$.

2 Practice

2.1 If $MPC = 0.75$, find the MPS. [1]

2.2 Find the spending multiplier when $MPC = 0.8$. [2]

2.3 Using that multiplier, find the change in GDP from \$10 billion of new spending. [2]

3 Exam-style questions

3.1 The spending multiplier is [1]

- **A** $\frac{1}{1 - MPC}$
 - **B** $1 - MPC$
 - **C** MPC
 - **D** $\frac{MPC}{MPS}$
-

3.2 The tax multiplier is _____ the spending multiplier. [1]

- **A** larger than
 - **B** smaller in magnitude than
 - **C** exactly equal to
 - **D** unrelated to
-

3.3 An economy has $MPC = 0.9$.

(a) Find the spending multiplier. [2]

(b) Find the change in GDP from a \$5 billion rise in government spending. [2]

Solutions

2.1 $MPS = 1 - 0.75 = 0.25$.

2.2 $\frac{1}{1 - 0.8} = \frac{1}{0.2} = 5$.

2.3 $\Delta GDP = 5 \times 10 = \50 billion .

3.1 A.

3.2 B.

3.3 (a) $\frac{1}{1 - 0.9} = \frac{1}{0.1} = 10$. (b) $\Delta GDP = 10 \times 5 = \50 billion .

3. Lizland is a small island nation, and its currency is the Lizland crown (LIZ). The economy of Lizland is in short-run macroeconomic equilibrium with a 600 million crown recessionary gap.

Part A

Policymakers in Lizland are considering taking action to close the recessionary gap in the short run.

- i. The central bank of Lizland is considering implementing monetary policy. The banking system of Lizland has ample reserves. Identify a specific monetary policy action the central bank of Lizland would implement to close the recessionary gap in the short run.
- ii. The government of Lizland is also considering changing its spending, and the marginal propensity to consume is 0.75. Calculate the minimum change in government spending and identify the direction of the change required to fully close the 600 million crown recessionary gap in the short run. Show your work.

Part B

Assume that the government of Lizland decides to change its spending as calculated in part A (ii). Based solely on this change, will the price level in Lizland increase, decrease, or remain the same in the short run? Explain.

Part C

The nations of Lizland and Andoh are trading partners with flexible exchange rates. The currency of Andoh is the Andoh note (AND). Draw a correctly labeled graph of the foreign exchange market for the Lizland crown (LIZ). Based solely on the change in the price level in part B, show the change in the international value of the Lizland crown on your graph.

STOP
END OF EXAM

3. The table provided shows the quantities and unit prices of shirts, bread, and pants, the only three goods produced in the country of Middleland in 2021 and 2022. Assume that 2021 was the base year.

	Shirts	Bread	Pants
Unit Prices in 2021	\$11	\$4	\$12
Unit Prices in 2022	\$10	\$5	\$15
Quantities Produced in 2021 and 2022	50	70	30

- A. Was the real GDP in 2021 in Middleland greater than, less than, or equal to the nominal GDP in 2021? Explain.
- B. Calculate the real GDP in Middleland in 2022. Show your work.
- C. Assume that Middleland was in short-run equilibrium in 2022 and that POTENTIAL real GDP was \$1,150 in 2022. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Middleland in 2022, and show each of the following.
- The equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- D. Assume the marginal propensity to consume in Middleland is 0.8. Calculate the minimum change and state the direction of change in government spending required to close the output gap in the short run in Middleland. Show your work.

STOP
END OF EXAM

3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.
- A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.
- The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2 .
- C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
- D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM

1. Assume that the economy of Moneyland is in equilibrium with an actual unemployment rate equal to the natural rate of unemployment.
 - (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full employment output, labeled Y_F
 - (b) Assume that consumer spending in Moneyland decreases from \$110,000 to \$100,000 as a result of a decrease in disposable income in Moneyland from \$135,000 to \$110,000.
 - (i) Calculate the marginal propensity to consume in Moneyland. Show your work.
 - (ii) Show the short-run effect of the decrease in consumer spending in Moneyland on your graph in part (a), labeling the new equilibrium real output and price level Y_2 and PL_2 , respectively.
 - (c) Following the decrease in consumer spending, explain how the economy would adjust in the long run in the absence of any policy actions.
 - (d) The central bank of Moneyland is concerned about the short-run effects of the decrease in consumer spending on the broader economy and is considering taking action rather than waiting for the long-run adjustment process. Assuming the banking system in Moneyland has ample reserves, identify a specific monetary policy action the central bank of Moneyland would take to increase consumer spending.
 - (e) Draw a correctly labeled graph of the reserve market in Moneyland, and show the effect of the monetary policy action identified in part (d) on the policy rate.
 - (f) How would the change in the policy rate shown on your graph in part (e) affect each of the following in Moneyland in the short run?
 - (i) The quantity of national savings
 - (ii) Unemployment. 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.

1. Assume the economy of Vanderlandia is in short-run equilibrium with a real GDP of \$500 million. The full-employment level of real GDP is \$550 million.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (b) Assume no policy action is taken to restore full employment.
- (i) Explain how the economy will adjust in the long run.
 - (ii) Following the long-run adjustment process, will the price level in Vanderlandia be greater than, less than, or equal to PL_1 shown on your graph in part (a)?
- (c) Assume instead that policymakers in Vanderlandia are considering changing government spending to restore full employment in the short run and that the marginal propensity to save is 0.2.
- (i) Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
 - (ii) On your graph in part (a), show the short-run effect of the change in government spending in part (c)(i), labeling the new equilibrium price level PL_2 .
- (d) Draw a correctly labeled graph of the loanable funds market, and show the effect of the change in government spending in part (c)(i) on the equilibrium real interest rate.
- (e) Based on the change in the real interest rate shown on your graph in part (d), what will happen to each of the following?
- (i) The price of previously issued bonds
 - (ii) The rate of economic growth in the long run. 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.

1. The economy of Northland is in short-run equilibrium with an actual unemployment rate of 7% and an actual inflation rate of 1%. The natural unemployment rate in Northland is 5%.
- (a) Using the relevant numerical values given, draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium point as X. Plot the relevant numerical values provided on the graph.
- (b) Is the expected inflation rate greater than, less than, or equal to 1% ? Explain.
- (c) Assume the marginal propensity to consume is 0.9.
- (i) If the government decreases income taxes by \$20 billion, calculate the maximum change in aggregate demand. Show your work.
 - (ii) If instead the government increases spending by \$20 billion, calculate the maximum change in aggregate demand. Show your work.
- (d) On your graph in part (a), show a possible new short-run equilibrium point labeled Z that would result if the government increases spending and there is no change in inflationary expectations.
- (e) How would an increase in unemployment compensation affect aggregate demand in the short run? Explain.
- (f) Assume instead the government takes none of the preceding policy actions. (Northland is still in short-run equilibrium; the actual unemployment rate is 7%, the actual inflation rate is 1%, and the natural unemployment rate is 5%.) What will happen to each of the following in the long run?
- (i) The short-run aggregate supply curve. Explain.
 - (ii) The short-run Phillips curve
 - (iii) The actual unemployment rate

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.

1. Assume a country's economy is operating below full employment.

(a) Draw a correctly labeled graph of aggregate demand, short-run aggregate supply, and long-run aggregate supply, and show each of the following.

- (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
- (ii) The full-employment output, labeled as Y_F

(b) Identify one fiscal policy action the country's government can take to restore full employment.

(c) Assume instead that no fiscal policy action is taken. Suppose a change in investment spending causes real GDP to increase by \$200 billion. Calculate the minimum change in investment spending that could have caused this increase in real GDP if the marginal propensity to save is 0.25. Show your work.

(d) Assume the output gap was initially \$800 billion. On your graph in part (a), show the short-run effect of the change in investment spending identified in part (c), labeling the new equilibrium real output as Y_2 and the new equilibrium price level as PL_2 .

(e) Given your answer to part (d), is the actual rate of unemployment greater than, less than, or equal to the natural rate of unemployment? Explain.

(f) Assume that private savings now increase. Draw a correctly labeled graph of the loanable funds market and show the effect of the increase in private savings on the real interest rate.

(g) Based solely on the change in the real interest rate shown in part (f), what will happen to each of the following?

- (i) Real GDP in the short run. Explain.
- (ii) Long-run aggregate supply. 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.

1. Assume the United States economy is in short-run macroeconomic equilibrium at an output level greater than potential output.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled as Y_F
- (b) Assume government spending increases by \$100 billion. On your graph in part (a), show the short-run effect of the change in government spending on the equilibrium real output and price level. Label the new equilibrium output as Y_2 and the new equilibrium price level as PL_2 .
- (c) Assume the marginal propensity to consume is 0.8. As a result of the increase in government spending, what is the numerical value of the maximum change in each of the following in the short run?
- (i) Real output
 - (ii) Household savings
- (d) Draw a correctly labeled graph of the money market and show the effect of the change in real output identified in part (c)(i) on the equilibrium nominal interest rate.
- (e) Based on the change in the nominal interest rate shown in part (d), what will happen to the prices of previously issued bonds in the short run?
- (f) The United States and the European Union are trading partners with flexible exchange rates. The currency in the United States is the dollar, and the currency in the European Union is the euro. Assume the inflation rate in the United States increases relative to the inflation rate in the European Union. As a result of the change in the United States inflation rate, what will happen to each of the following in the foreign exchange market?
- (i) The demand for dollars. Explain.
 - (ii) The international value of the dollar
- (g) Suppose the Federal Reserve attempts to keep the value of the dollar constant in the foreign exchange market. Based on the change in the value of the dollar in part (f)(ii), should the Federal Reserve buy or sell each of the following?
- (i) The euro
 - (ii) The dollar

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. An economy is currently in short-run equilibrium with a recessionary output gap of \$600 billion.

(a) Draw a single correctly labeled graph with both the short-run and long-run Phillips curves. Label the initial short-run equilibrium point X.

(b) Suppose the government implements fiscal policy in order to achieve full-employment output and the marginal propensity to consume is 0.75.

(i) Calculate the minimum change in government spending required to increase aggregate demand by the amount of the output gap of \$600 billion. Show your work.

(ii) Suppose instead the government wants to change taxes rather than government spending. Calculate the minimum change in taxes required to increase aggregate demand by the amount of the output gap of \$600 billion. Show your work.

(c) Assume instead the government takes no policy action to close the output gap shown in part (a). Explain how the economy will adjust in the long run.

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.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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. Canada is an open economy that is currently in a recessionary output gap.
 - (a) Draw a correctly labeled graph of the long-run aggregate supply, short-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) Full-employment output, labeled Y_f
 - (b) The central bank and the government do not take any policy actions to close the output gap.
 - (i) Explain how the economy will adjust to full employment in the long run.
 - (ii) On your graph in part (a), show how the economy adjusts to full employment in the long run.
 - (c) Suppose the Canadian government is unwilling to wait for the long-run adjustment process. The marginal propensity to consume is 0.8. The equilibrium real output is \$500 billion and the full-employment output is \$540 billion.
 - (i) Calculate the minimum change and indicate the direction of change in government spending required to shift the aggregate demand curve by the amount of the output gap.
 - (ii) Calculate the minimum change and indicate the direction of change in taxes required to shift the aggregate demand curve by the amount of the output gap.
 - (d) Assume instead that the Canadian central bank takes actions to restore the economy to full-employment output by influencing investment spending. Draw a correctly labeled graph of the money market, and show the effect of the actions taken by the central bank on the equilibrium interest rate.
 - (e) Canada and Mexico are trading partners. Draw a correctly labeled graph of the foreign exchange market of the Canadian dollar, and show the effect of the change in the interest rate in part (d) on the value of the Canadian dollar with respect to the Mexican peso.

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. 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 operating below full employment.
 - (a) Draw a correctly labeled graph of long-run aggregate supply, short-run aggregate supply, and aggregate demand, and show each of the following.
 - (i) Current equilibrium output and price level, labeled as Y_1 and PL_1
 - (ii) Full-employment output, labeled as Y_f
 - (b) Assume that the Federal Reserve targets a new federal funds rate to reach full employment. Should the Federal Reserve target a higher or lower federal funds rate?
 - (c) Given the Federal Reserve action you identified in part (b), draw a correctly labeled graph of the money market and show the effect on the nominal interest rate.
 - (d) The policy makers pursue a fiscal policy rather than the monetary policy in part (b). Assume that the marginal propensity to consume is 0.8 and the value of the recessionary gap is \$300 billion.
 - (i) If the government changes its spending without changing taxes to eliminate the recessionary gap, calculate the minimum required change in government spending.
 - (ii) If the government changes taxes without changing government spending to eliminate the recessionary gap, will the minimum required change in taxes be greater than, smaller than, or equal to the minimum required change in government spending in part (d)(i) ? Explain.
 - (e) Assume the government lowers income tax rates to eliminate the recessionary gap. Will each of the following increase, decrease, or stay the same?
 - (i) Aggregate demand. Explain.
 - (ii) Long-run aggregate supply. Explain.

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.
 - (a) Draw a correctly labeled graph of aggregate demand, short-run aggregate supply, and long-run aggregate supply, and show each of the following in the United States.
 - (i) Current output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) Full-employment output, labeled as Y_f
 - (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.

3.3 Short-Run Aggregate Supply (SRAS)

Name: _____ Class: _____ Date: _____

Total: 9 marks

KEY WORDS sticky 粘性 • short-run aggregate supply 短期总供给 • price level 价格水平

Objective

Build the skills to answer exam questions on **short-run aggregate supply (SRAS)**.

You must be able to:

- define **short-run aggregate supply** 短期总供给 and explain its upward slope from sticky wages
- distinguish a movement along SRAS from a **shift**
- identify the determinants: **input prices**, productivity, and supply shocks
- analyse how a **negative supply shock** shifts SRAS leftward

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ SRAS and its slope

The total output firms supply at each price level. It slopes **upward** because wages and some prices are **sticky** in the short run, so a higher price level raises profit and output.

■ Determinants

Input prices, **productivity**, and **supply shocks**. A change in any of these **shifts** SRAS.

■ Negative supply shock

A rise in resource prices (e.g. oil) raises costs and shifts SRAS **leftward** — higher prices with lower output.

2 Practice

2.1 State why SRAS slopes upward.

[1]

2.2 State the effect of a sharp rise in oil prices on SRAS. [1]

2.3 Name two determinants of SRAS. [2]

3 Exam-style questions

3.1 SRAS slopes upward because wages and prices are [1]

- **A** perfectly flexible
- **B** sticky in the short run
- **C** always zero
- **D** always falling

3.2 A negative supply shock shifts SRAS [1]

- **A** to the right
- **B** to the left
- **C** up along itself
- **D** not at all

3.3 The price of oil doubles across the economy.

(a) State the direction SRAS shifts. [1]

(b) State the effect on the price level. [1]

(c) State the effect on output. [1]

Solutions

2.1 wages and some prices are sticky, so a higher price level raises profits and encourages more output.

2.2 it shifts SRAS to the left.

2.3 any two of: input prices, productivity, supply shocks.

3.1 B.

3.2 B.

3.3 (a) to the left. (b) the price level rises. (c) output falls.

3.4 Long-Run Aggregate Supply (LRAS)

Name: _____ Class: _____ Date: _____

Total: 8 marks

KEY WORDS long-run aggregate supply 长期总供给 • potential gdp 潜在 • price level 价格水平
• sticky 粘性

Objective

Build the skills to answer exam questions on **long-run aggregate supply (LRAS)**.

You must be able to:

- define **long-run aggregate supply** 长期总供给 as vertical at full-employment output
- explain why LRAS is independent of the **price level** (flexible wages and prices)
- relate LRAS to **potential GDP** 潜在 GDP and the natural rate of unemployment
- analyse how **economic growth** shifts LRAS rightward

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ LRAS is vertical

In the long run, wages and prices are **fully flexible**, so output returns to its **full-employment** (potential) level regardless of the price level — a **vertical** line.

■ Determinants

The quantity and quality of **resources**, the **capital stock**, and **technology**.

■ Growth

An increase in any of these shifts LRAS **rightward** — long-run economic growth.

2 Practice

2.1 State the shape of the LRAS curve. [1]

2.2 State what determines the position of the LRAS curve. [1]

2.3 State the effect of economic growth on LRAS.

[1]

3 Exam-style questions

3.1 The LRAS curve is

[1]

- **A** upward-sloping
 - **B** downward-sloping
 - **C** vertical
 - **D** horizontal
-

3.2 LRAS is vertical because, in the long run, wages and prices are

[1]

- **A** sticky
 - **B** fully flexible
 - **C** fixed by law
 - **D** zero
-

3.3 A country's capital stock and technology both improve.

(a) State the effect on LRAS.

[1]

(b) State the direction LRAS shifts.

[1]

(c) Name this process.

[1]

Solutions

2.1 vertical (at potential output).

2.2 the quantity and quality of resources, the capital stock, and technology.

2.3 it shifts LRAS to the right.

3.1 C.

3.2 B.

3.3 (a) LRAS increases. (b) to the right. (c) (long-run) economic growth.

1. The economy of Micanapy is in short-run equilibrium and is experiencing an inflationary gap.

Part A

Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Micanapy, and show each of the following.

- i. The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
- ii. The full-employment real output, labeled Y_F

Part B

Assume that policymakers take no action to close the inflationary gap. Explain how Micanapy's economy will self-adjust to full employment in the long run.

Part C

Suppose instead that Micanapy's central bank is considering using monetary policy to close the inflationary gap in the short run. The banking system in Micanapy has limited reserves.

- i. Identify a specific open-market operation that the central bank of Micanapy would implement to close the inflationary gap in the short run.
- ii. Draw a correctly labeled graph of the money market in Micanapy, and show the effect of the open-market operation identified in part C (i) on the nominal interest rate.

Part D

Based solely on the interest rate change shown on your graph in part C (ii), will each of the following increase, decrease, or remain the same in the short run?

- i. International financial capital flows into Micanapy. Explain.
- ii. The price of previously issued bonds in Micanapy
- iii. Private domestic investment spending in Micanapy

Part E

Based solely on the change in private domestic investment spending identified in part D (iii), will the unemployment rate in Micanapy increase, decrease, or remain the same in the short run? Explain.

3. The table provided shows the quantities and unit prices of shirts, bread, and pants, the only three goods produced in the country of Middleland in 2021 and 2022. Assume that 2021 was the base year.

	Shirts	Bread	Pants
Unit Prices in 2021	\$11	\$4	\$12
Unit Prices in 2022	\$10	\$5	\$15
Quantities Produced in 2021 and 2022	50	70	30

- A. Was the real GDP in 2021 in Middleland greater than, less than, or equal to the nominal GDP in 2021? Explain.
- B. Calculate the real GDP in Middleland in 2022. Show your work.
- C. Assume that Middleland was in short-run equilibrium in 2022 and that POTENTIAL real GDP was \$1,150 in 2022. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Middleland in 2022, and show each of the following.
- The equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- D. Assume the marginal propensity to consume in Middleland is 0.8. Calculate the minimum change and state the direction of change in government spending required to close the output gap in the short run in Middleland. Show your work.

STOP
END OF EXAM

3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.
- A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.
- The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2 .
- C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
- D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM

1. Assume that the economy of Moneyland is in equilibrium with an actual unemployment rate equal to the natural rate of unemployment.
 - (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full employment output, labeled Y_F
 - (b) Assume that consumer spending in Moneyland decreases from \$110,000 to \$100,000 as a result of a decrease in disposable income in Moneyland from \$135,000 to \$110,000.
 - (i) Calculate the marginal propensity to consume in Moneyland. Show your work.
 - (ii) Show the short-run effect of the decrease in consumer spending in Moneyland on your graph in part (a), labeling the new equilibrium real output and price level Y_2 and PL_2 , respectively.
 - (c) Following the decrease in consumer spending, explain how the economy would adjust in the long run in the absence of any policy actions.
 - (d) The central bank of Moneyland is concerned about the short-run effects of the decrease in consumer spending on the broader economy and is considering taking action rather than waiting for the long-run adjustment process. Assuming the banking system in Moneyland has ample reserves, identify a specific monetary policy action the central bank of Moneyland would take to increase consumer spending.
 - (e) Draw a correctly labeled graph of the reserve market in Moneyland, and show the effect of the monetary policy action identified in part (d) on the policy rate.
 - (f) How would the change in the policy rate shown on your graph in part (e) affect each of the following in Moneyland in the short run?
 - (i) The quantity of national savings
 - (ii) Unemployment. 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.

3. Assume that the economy of country Zen is in long-run macroeconomic equilibrium.

(a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.

(i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively

(ii) The full-employment output, labeled Y_F

(b) On your graph in part (a), show the short-run effect of an increase in consumer confidence. Label the new equilibrium real output Y_2 and the new equilibrium price level PL_2 .

(c) Assume that the banking system in Zen has ample reserves. Suppose that the central bank's goal is to maintain a stable price level at PL_1 . Based on the change in the price level shown in part (b), identify one specific monetary policy action the central bank would take to achieve its goal.

(d) Based on the monetary policy action identified in part (c), will real output increase, decrease, or stay the same in the short run? 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

1. Assume a country's economy is operating below full employment.

(a) Draw a correctly labeled graph of aggregate demand, short-run aggregate supply, and long-run aggregate supply, and show each of the following.

- (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
- (ii) The full-employment output, labeled as Y_F

(b) Identify one fiscal policy action the country's government can take to restore full employment.

(c) Assume instead that no fiscal policy action is taken. Suppose a change in investment spending causes real GDP to increase by \$200 billion. Calculate the minimum change in investment spending that could have caused this increase in real GDP if the marginal propensity to save is 0.25. Show your work.

(d) Assume the output gap was initially \$800 billion. On your graph in part (a), show the short-run effect of the change in investment spending identified in part (c), labeling the new equilibrium real output as Y_2 and the new equilibrium price level as PL_2 .

(e) Given your answer to part (d), is the actual rate of unemployment greater than, less than, or equal to the natural rate of unemployment? Explain.

(f) Assume that private savings now increase. Draw a correctly labeled graph of the loanable funds market and show the effect of the increase in private savings on the real interest rate.

(g) Based solely on the change in the real interest rate shown in part (f), what will happen to each of the following?

- (i) Real GDP in the short run. Explain.
- (ii) Long-run aggregate supply. 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.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 the economy of Artland is currently operating above full employment.
 - (a) Draw a correctly labeled graph of the short-run aggregate supply, long-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled as Y_f
 - (b) Assume the central bank and the government do not take any policy actions to close the output gap.
 - (i) On your graph in part (a), show how the economy automatically adjusts in the long run and label the new equilibrium price level PL_2 .
 - (ii) Explain the cause of the adjustment shown in part (b)(i).
 - (c) Alternatively, suppose the government wants to close the output gap using fiscal policy.
 - (i) Identify a fiscal policy action the government could implement to close the output gap.
 - (ii) How will the fiscal policy action identified in part (c)(i) affect the following?
 - The unemployment rate
 - The natural rate of unemployment
 - (iii) In closing the output gap, will the automatic adjustment identified in part (b)(i) produce a higher, a lower, or the same price level compared to the fiscal policy identified in part (c)(i) ?
 - (d) Draw a correctly labeled graph of the market for loanable funds. Show the effect of the fiscal policy action identified in part (c)(i) on the equilibrium real interest rate.
 - (e) Given the interest rate change identified in part (d), will the long-run aggregate supply curve shift to the right, shift to the left, or remain the same in the long run? Explain.

2. Assume that an economy is in long-run equilibrium. Assume that consumers wish to hold less money because they use credit cards more frequently to purchase goods and services than cash.
- (a) Draw a correctly labeled graph of the money market and show the effect of the reduced holdings of money on the equilibrium nominal interest rate in the short run.
 - (b) Based on the change in the interest rate in part (a), what will happen to each of the following in the short run?
 - (i) Prices of previously issued bonds
 - (ii) The price level and real income. Explain.
 - (c) With a constant money supply, based on your answer to part b(ii), will the velocity of money increase, decrease, or remain the same, or is the change indeterminate?
 - (d) If the central bank wishes to reverse the change in the interest rate identified in part (a), what open market operation would it use?
-
3. A country is at full employment and produces two types of goods: consumer goods and capital goods.
- (a) Draw a correctly labeled graph of the production possibilities curve, with consumer goods on the horizontal axis and capital goods on the vertical axis. Indicate a point on your graph, labeled X, that represents full employment and a possible combination in which both goods are being produced.
 - (b) Assume there is an increase in the country's national savings. Draw a correctly labeled graph of the loanable funds market, showing the change in the real interest rate from the increase in savings.
 - (c) On the same graph from part (a), show another point, labeled Z, that represents full employment and a new combination of consumer goods and capital goods consistent with the increase in the country's national savings.
 - (d) Referring to your answer to part (c), will the long-run aggregate supply curve shift to the right, shift to the left, or remain the same? Explain.

STOP

END OF EXAM

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. 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 operating below full employment.
 - (a) Draw a correctly labeled graph of long-run aggregate supply, short-run aggregate supply, and aggregate demand, and show each of the following.
 - (i) Current equilibrium output and price level, labeled as Y_1 and PL_1
 - (ii) Full-employment output, labeled as Y_f
 - (b) Assume that the Federal Reserve targets a new federal funds rate to reach full employment. Should the Federal Reserve target a higher or lower federal funds rate?
 - (c) Given the Federal Reserve action you identified in part (b), draw a correctly labeled graph of the money market and show the effect on the nominal interest rate.
 - (d) The policy makers pursue a fiscal policy rather than the monetary policy in part (b). Assume that the marginal propensity to consume is 0.8 and the value of the recessionary gap is \$300 billion.
 - (i) If the government changes its spending without changing taxes to eliminate the recessionary gap, calculate the minimum required change in government spending.
 - (ii) If the government changes taxes without changing government spending to eliminate the recessionary gap, will the minimum required change in taxes be greater than, smaller than, or equal to the minimum required change in government spending in part (d)(i) ? Explain.
 - (e) Assume the government lowers income tax rates to eliminate the recessionary gap. Will each of the following increase, decrease, or stay the same?
 - (i) Aggregate demand. Explain.
 - (ii) Long-run aggregate supply. Explain.

3.5 Equilibrium in the Aggregate Demand–Aggregate Supply (AD–AS) Model

Name: _____ Class: _____ Date: _____

Total: 8 marks

KEY WORDS inflationary gap 通胀缺口 • short-run macroeconomic equilibrium 短期宏观均衡
 • recessionary gap 衰退缺口 • price level 价格水平

Objective

Build the skills to answer exam questions on **equilibrium in the AD–AS model**.

You must be able to:

- locate **short-run macroeconomic equilibrium** 短期宏观均衡 where AD meets SRAS
- determine the equilibrium **price level** and **real output**
- identify a **recessionary gap** or an **inflationary gap** by comparing with full-employment output

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Short-run equilibrium

Where the **AD** curve crosses the **SRAS** curve — this fixes the equilibrium **price level** and **real output**.

■ Spotting a gap

Compare equilibrium output with **full-employment** output (the LRAS line):

- below full employment → **recessionary gap**;
- above full employment → **inflationary gap**.

2 Practice

2.1 State where short-run macroeconomic equilibrium occurs.

[1]

2.2 State how to identify a recessionary gap on the AD–AS diagram. [1]

2.3 Define an inflationary gap. [1]

3 Exam-style questions

3.1 Short-run macroeconomic equilibrium is where AD meets [1]

- **A** LRAS
 - **B** SRAS
 - **C** the price axis
 - **D** the origin
-

3.2 If equilibrium output is below full-employment output, there is a [1]

- **A** inflationary gap
 - **B** recessionary gap
 - **C** trade surplus
 - **D** boom
-

3.3 An economy's short-run equilibrium output is **above** its potential output.

(a) Name the gap. [1]

(b) State what is likely happening to the price level. [1]

(c) State whether unemployment is above or below the natural rate. [1]

Solutions

2.1 where the AD curve intersects the SRAS curve.

2.2 equilibrium output lies to the left of (below) full-employment output.

2.3 the gap when equilibrium output is above potential (full-employment) output.

3.1 B.

3.2 B.

3.3 (a) an inflationary gap. (b) it is rising. (c) below the natural rate.

1. The economy of Micanapy is in short-run equilibrium and is experiencing an inflationary gap.

Part A

Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Micanapy, and show each of the following.

- i. The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
- ii. The full-employment real output, labeled Y_F

Part B

Assume that policymakers take no action to close the inflationary gap. Explain how Micanapy's economy will self-adjust to full employment in the long run.

Part C

Suppose instead that Micanapy's central bank is considering using monetary policy to close the inflationary gap in the short run. The banking system in Micanapy has limited reserves.

- i. Identify a specific open-market operation that the central bank of Micanapy would implement to close the inflationary gap in the short run.
- ii. Draw a correctly labeled graph of the money market in Micanapy, and show the effect of the open-market operation identified in part C (i) on the nominal interest rate.

Part D

Based solely on the interest rate change shown on your graph in part C (ii), will each of the following increase, decrease, or remain the same in the short run?

- i. International financial capital flows into Micanapy. Explain.
- ii. The price of previously issued bonds in Micanapy
- iii. Private domestic investment spending in Micanapy

Part E

Based solely on the change in private domestic investment spending identified in part D (iii), will the unemployment rate in Micanapy increase, decrease, or remain the same in the short run? Explain.

3. The table provided shows the quantities and unit prices of shirts, bread, and pants, the only three goods produced in the country of Middleland in 2021 and 2022. Assume that 2021 was the base year.

	Shirts	Bread	Pants
Unit Prices in 2021	\$11	\$4	\$12
Unit Prices in 2022	\$10	\$5	\$15
Quantities Produced in 2021 and 2022	50	70	30

- A. Was the real GDP in 2021 in Middleland greater than, less than, or equal to the nominal GDP in 2021? Explain.
- B. Calculate the real GDP in Middleland in 2022. Show your work.
- C. Assume that Middleland was in short-run equilibrium in 2022 and that POTENTIAL real GDP was \$1,150 in 2022. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Middleland in 2022, and show each of the following.
- The equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- D. Assume the marginal propensity to consume in Middleland is 0.8. Calculate the minimum change and state the direction of change in government spending required to close the output gap in the short run in Middleland. Show your work.

STOP
END OF EXAM

3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.
- A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.
- The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2 .
- C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
- D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM

1. The economy of Alpha is in short-run equilibrium with a cyclical unemployment rate of 3%, a frictional unemployment rate of 4%, and an actual unemployment rate of 8%.
- (a) Calculate Alpha's natural rate of unemployment. Show your work.
- (b) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Alpha, and show each of the following.
- (i) The current equilibrium output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (c) Assume that policymakers take no action to close the output gap.
- (i) Explain how Alpha's economy will adjust to full employment in the long run.
 - (ii) On your graph in part (b), show how Alpha's economy will adjust to full employment in the long run, labeling the new equilibrium price level PL_2 .
- (d) Assume instead that Alpha's central bank is considering using monetary policy to close a recessionary output gap. The banking system in Alpha has ample reserves. Identify a specific monetary policy action the central bank of Alpha would take to close the output gap in the short run.
- (e) Draw a correctly labeled graph of the reserve market in Alpha, and show the effect of the action taken by the central bank identified in part (d) on the policy rate.
- (f) Based on the change in the policy rate shown in part (e), what would happen to each of the following in the short run in Alpha?
- (i) The price of previously issued bonds
 - (ii) The price level. 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.

1. Assume that the economy of Moneyland is in equilibrium with an actual unemployment rate equal to the natural rate of unemployment.
 - (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full employment output, labeled Y_F
 - (b) Assume that consumer spending in Moneyland decreases from \$110,000 to \$100,000 as a result of a decrease in disposable income in Moneyland from \$135,000 to \$110,000.
 - (i) Calculate the marginal propensity to consume in Moneyland. Show your work.
 - (ii) Show the short-run effect of the decrease in consumer spending in Moneyland on your graph in part (a), labeling the new equilibrium real output and price level Y_2 and PL_2 , respectively.
 - (c) Following the decrease in consumer spending, explain how the economy would adjust in the long run in the absence of any policy actions.
 - (d) The central bank of Moneyland is concerned about the short-run effects of the decrease in consumer spending on the broader economy and is considering taking action rather than waiting for the long-run adjustment process. Assuming the banking system in Moneyland has ample reserves, identify a specific monetary policy action the central bank of Moneyland would take to increase consumer spending.
 - (e) Draw a correctly labeled graph of the reserve market in Moneyland, and show the effect of the monetary policy action identified in part (d) on the policy rate.
 - (f) How would the change in the policy rate shown on your graph in part (e) affect each of the following in Moneyland in the short run?
 - (i) The quantity of national savings
 - (ii) Unemployment. 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.

1. Assume the economy of Vanderlandia is in short-run equilibrium with a real GDP of \$500 million. The full-employment level of real GDP is \$550 million.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (b) Assume no policy action is taken to restore full employment.
- (i) Explain how the economy will adjust in the long run.
 - (ii) Following the long-run adjustment process, will the price level in Vanderlandia be greater than, less than, or equal to PL_1 shown on your graph in part (a)?
- (c) Assume instead that policymakers in Vanderlandia are considering changing government spending to restore full employment in the short run and that the marginal propensity to save is 0.2.
- (i) Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
 - (ii) On your graph in part (a), show the short-run effect of the change in government spending in part (c)(i), labeling the new equilibrium price level PL_2 .
- (d) Draw a correctly labeled graph of the loanable funds market, and show the effect of the change in government spending in part (c)(i) on the equilibrium real interest rate.
- (e) Based on the change in the real interest rate shown on your graph in part (d), what will happen to each of the following?
- (i) The price of previously issued bonds
 - (ii) The rate of economic growth in the long run. 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.

1. Assume the economy of Sweden is in long-run equilibrium and has a surplus in its current account.
- (a) Is the Swedish capital and financial account in deficit, in surplus, or in balance? Explain.
 - (b) Draw a correctly labeled graph of short-run aggregate supply, long-run aggregate supply, and aggregate demand curves for Sweden, and show the current equilibrium real output, labeled Y_1 , and the current equilibrium price level, labeled PL_1 .
 - (c) Assume the United Kingdom decreases its imports from Sweden. On your graph in part (b), show the new equilibrium real output, labeled Y_2 , and the new equilibrium price level, labeled PL_2 , as a result of this change.
 - (d) As a result of the decrease in the United Kingdom's imports from Sweden, would policy makers in Sweden be more concerned about cyclical unemployment or inflationary pressures in the short run? Explain.
 - (e) If the Swedish central bank's goal is to return the economy to long-run equilibrium, what open-market operation should it use?
 - (f) The currency of the United Kingdom is the pound, and the currency of Sweden is the krona. Draw a correctly labeled graph of the foreign exchange market for the krona, and show the impact of the decrease in the United Kingdom's imports from Sweden on the value of the krona in the foreign exchange market.
 - (g) If the Swedish central bank's goal is to reverse the exchange rate change shown in part (f) by changing the interest rate, what open-market operation should it use?
 - (h) Explain how the open-market operation identified in part (g) would reverse the change in the exchange rate.

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.

1. Assume Smithland is in short-run equilibrium at a level of output that exceeds the full-employment level of output.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (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?
- (e) Draw a correctly labeled graph of the money market, and show the effect of the open-market operation identified in part (d) on the nominal interest rate.
- (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.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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. Canada is an open economy that is currently in a recessionary output gap.
 - (a) Draw a correctly labeled graph of the long-run aggregate supply, short-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) Full-employment output, labeled Y_f
 - (b) The central bank and the government do not take any policy actions to close the output gap.
 - (i) Explain how the economy will adjust to full employment in the long run.
 - (ii) On your graph in part (a), show how the economy adjusts to full employment in the long run.
 - (c) Suppose the Canadian government is unwilling to wait for the long-run adjustment process. The marginal propensity to consume is 0.8. The equilibrium real output is \$500 billion and the full-employment output is \$540 billion.
 - (i) Calculate the minimum change and indicate the direction of change in government spending required to shift the aggregate demand curve by the amount of the output gap.
 - (ii) Calculate the minimum change and indicate the direction of change in taxes required to shift the aggregate demand curve by the amount of the output gap.
 - (d) Assume instead that the Canadian central bank takes actions to restore the economy to full-employment output by influencing investment spending. Draw a correctly labeled graph of the money market, and show the effect of the actions taken by the central bank on the equilibrium interest rate.
 - (e) Canada and Mexico are trading partners. Draw a correctly labeled graph of the foreign exchange market of the Canadian dollar, and show the effect of the change in the interest rate in part (d) on the value of the Canadian dollar with respect to the Mexican peso.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 the United States economy is in recession.
 - (a) Draw a correctly labeled graph of the long-run aggregate supply, short-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) Current price level, labeled PL_1
 - (ii) Current output, labeled Y_1
 - (b) Now assume the euro zone, a major trading partner of the United States, enters into a recession.
 - (i) What will be the effect on United States exports to the euro zone? Explain.
 - (ii) On your graph in part (a), show the effect of the change identified in part (b)(i) on real output in the United States.
 - (iii) What will be the effect of the change identified in part (b)(ii) on unemployment in the United States?
 - (c) Assume the euro zone recession causes a decrease in the demand for United States dollars in the foreign exchange market.
 - (i) Will the euro appreciate, depreciate, or remain unchanged against the dollar? Explain.
 - (ii) Draw a correctly labeled graph of the foreign exchange market for dollars, and show the effect of the decrease in the demand for dollars on the exchange rate for dollars.
 - (d) Assume the United States implements a combination of expansionary fiscal and monetary policies. In the absence of complete crowding out, what will be the effect of these policies on each of the following?
 - (i) Aggregate demand in the United States
 - (ii) The price level in the United States
 - (iii) Interest rates in the United States. Explain.

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. 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 operating below full employment.
 - (a) Draw a correctly labeled graph of long-run aggregate supply, short-run aggregate supply, and aggregate demand, and show each of the following.
 - (i) Current equilibrium output and price level, labeled as Y_1 and PL_1
 - (ii) Full-employment output, labeled as Y_f
 - (b) Assume that the Federal Reserve targets a new federal funds rate to reach full employment. Should the Federal Reserve target a higher or lower federal funds rate?
 - (c) Given the Federal Reserve action you identified in part (b), draw a correctly labeled graph of the money market and show the effect on the nominal interest rate.
 - (d) The policy makers pursue a fiscal policy rather than the monetary policy in part (b). Assume that the marginal propensity to consume is 0.8 and the value of the recessionary gap is \$300 billion.
 - (i) If the government changes its spending without changing taxes to eliminate the recessionary gap, calculate the minimum required change in government spending.
 - (ii) If the government changes taxes without changing government spending to eliminate the recessionary gap, will the minimum required change in taxes be greater than, smaller than, or equal to the minimum required change in government spending in part (d)(i) ? Explain.
 - (e) Assume the government lowers income tax rates to eliminate the recessionary gap. Will each of the following increase, decrease, or stay the same?
 - (i) Aggregate demand. Explain.
 - (ii) Long-run aggregate supply. Explain.

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.
 - (a) Draw a correctly labeled graph of aggregate demand, short-run aggregate supply, and long-run aggregate supply, and show each of the following in the United States.
 - (i) Current output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) Full-employment output, labeled as Y_f
 - (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.

3.6 Changes in the AD–AS Model in the Short Run

Name: _____ Class: _____ Date: _____

Total: 9 marks

KEY WORDS stagflation 滞胀 • supply shock 供给冲击 • price level 价格水平

Objective

Build the skills to answer exam questions on **changes in the AD–AS model in the short run**.

You must be able to:

- analyse how a shift in **aggregate demand** changes the price level and output
- analyse how a **supply shock** 供给冲击 changes the price level and output
- explain **stagflation** 滞胀 as the result of an adverse supply shock

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ An AD shift

- AD **right** → higher price level, higher output.
- AD **left** → lower price level, lower output.

■ A supply shock

SRAS **left** (e.g. costlier oil) → higher price level **and** lower output — the combination called **stagflation**.

■ Stagflation

Rising prices together with falling output (and rising unemployment), the tell-tale sign of an adverse supply shock.

2 Practice

2.1 State the effect of an increase in AD on the price level and output. [2]

2.2 Define stagflation. [1]

2.3 State what causes stagflation. [1]

3 Exam-style questions

3.1 A fall in AD in the short run causes [1]

- **A** higher price level and output
 - **B** lower price level and output
 - **C** higher price level, lower output
 - **D** no change
-

3.2 Stagflation is [1]

- **A** high growth and low inflation
 - **B** high inflation with falling output
 - **C** deflation
 - **D** full employment
-

3.3 A severe drought sharply raises food and input prices across the economy.

(a) State which curve shifts and in which direction. [1]

(b) State the effect on the price level. [1]

(c) Name the resulting condition. [1]

Solutions

2.1 the price level rises and output rises.

2.2 rising prices together with falling output.

2.3 an adverse (negative) supply shock.

3.1 B.

3.2 B.

3.3 (a) SRAS shifts to the left. (b) it rises. (c) stagflation.

1. The economy of Micanapy is in short-run equilibrium and is experiencing an inflationary gap.

Part A

Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Micanapy, and show each of the following.

- i. The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
- ii. The full-employment real output, labeled Y_F

Part B

Assume that policymakers take no action to close the inflationary gap. Explain how Micanapy's economy will self-adjust to full employment in the long run.

Part C

Suppose instead that Micanapy's central bank is considering using monetary policy to close the inflationary gap in the short run. The banking system in Micanapy has limited reserves.

- i. Identify a specific open-market operation that the central bank of Micanapy would implement to close the inflationary gap in the short run.
- ii. Draw a correctly labeled graph of the money market in Micanapy, and show the effect of the open-market operation identified in part C (i) on the nominal interest rate.

Part D

Based solely on the interest rate change shown on your graph in part C (ii), will each of the following increase, decrease, or remain the same in the short run?

- i. International financial capital flows into Micanapy. Explain.
- ii. The price of previously issued bonds in Micanapy
- iii. Private domestic investment spending in Micanapy

Part E

Based solely on the change in private domestic investment spending identified in part D (iii), will the unemployment rate in Micanapy increase, decrease, or remain the same in the short run? Explain.

3. Lizland is a small island nation, and its currency is the Lizland crown (LIZ). The economy of Lizland is in short-run macroeconomic equilibrium with a 600 million crown recessionary gap.

Part A

Policymakers in Lizland are considering taking action to close the recessionary gap in the short run.

- i. The central bank of Lizland is considering implementing monetary policy. The banking system of Lizland has ample reserves. Identify a specific monetary policy action the central bank of Lizland would implement to close the recessionary gap in the short run.
- ii. The government of Lizland is also considering changing its spending, and the marginal propensity to consume is 0.75. Calculate the minimum change in government spending and identify the direction of the change required to fully close the 600 million crown recessionary gap in the short run. Show your work.

Part B

Assume that the government of Lizland decides to change its spending as calculated in part A (ii). Based solely on this change, will the price level in Lizland increase, decrease, or remain the same in the short run? Explain.

Part C

The nations of Lizland and Andoh are trading partners with flexible exchange rates. The currency of Andoh is the Andoh note (AND). Draw a correctly labeled graph of the foreign exchange market for the Lizland crown (LIZ). Based solely on the change in the price level in part B, show the change in the international value of the Lizland crown on your graph.

STOP
END OF EXAM



3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.
- A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.
- The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2 .
- C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
- D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM

1. The economy of Alpha is in short-run equilibrium with a cyclical unemployment rate of 3%, a frictional unemployment rate of 4%, and an actual unemployment rate of 8%.
- (a) Calculate Alpha's natural rate of unemployment. Show your work.
- (b) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Alpha, and show each of the following.
- (i) The current equilibrium output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (c) Assume that policymakers take no action to close the output gap.
- (i) Explain how Alpha's economy will adjust to full employment in the long run.
 - (ii) On your graph in part (b), show how Alpha's economy will adjust to full employment in the long run, labeling the new equilibrium price level PL_2 .
- (d) Assume instead that Alpha's central bank is considering using monetary policy to close a recessionary output gap. The banking system in Alpha has ample reserves. Identify a specific monetary policy action the central bank of Alpha would take to close the output gap in the short run.
- (e) Draw a correctly labeled graph of the reserve market in Alpha, and show the effect of the action taken by the central bank identified in part (d) on the policy rate.
- (f) Based on the change in the policy rate shown in part (e), what would happen to each of the following in the short run in Alpha?
- (i) The price of previously issued bonds
 - (ii) The price level. 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.

1. Assume that the economy of Moneyland is in equilibrium with an actual unemployment rate equal to the natural rate of unemployment.
 - (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full employment output, labeled Y_F
 - (b) Assume that consumer spending in Moneyland decreases from \$110,000 to \$100,000 as a result of a decrease in disposable income in Moneyland from \$135,000 to \$110,000.
 - (i) Calculate the marginal propensity to consume in Moneyland. Show your work.
 - (ii) Show the short-run effect of the decrease in consumer spending in Moneyland on your graph in part (a), labeling the new equilibrium real output and price level Y_2 and PL_2 , respectively.
 - (c) Following the decrease in consumer spending, explain how the economy would adjust in the long run in the absence of any policy actions.
 - (d) The central bank of Moneyland is concerned about the short-run effects of the decrease in consumer spending on the broader economy and is considering taking action rather than waiting for the long-run adjustment process. Assuming the banking system in Moneyland has ample reserves, identify a specific monetary policy action the central bank of Moneyland would take to increase consumer spending.
 - (e) Draw a correctly labeled graph of the reserve market in Moneyland, and show the effect of the monetary policy action identified in part (d) on the policy rate.
 - (f) How would the change in the policy rate shown on your graph in part (e) affect each of the following in Moneyland in the short run?
 - (i) The quantity of national savings
 - (ii) Unemployment. 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.

1. Assume the economy of Vanderlandia is in short-run equilibrium with a real GDP of \$500 million. The full-employment level of real GDP is \$550 million.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (b) Assume no policy action is taken to restore full employment.
- (i) Explain how the economy will adjust in the long run.
 - (ii) Following the long-run adjustment process, will the price level in Vanderlandia be greater than, less than, or equal to PL_1 shown on your graph in part (a)?
- (c) Assume instead that policymakers in Vanderlandia are considering changing government spending to restore full employment in the short run and that the marginal propensity to save is 0.2.
- (i) Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
 - (ii) On your graph in part (a), show the short-run effect of the change in government spending in part (c)(i), labeling the new equilibrium price level PL_2 .
- (d) Draw a correctly labeled graph of the loanable funds market, and show the effect of the change in government spending in part (c)(i) on the equilibrium real interest rate.
- (e) Based on the change in the real interest rate shown on your graph in part (d), what will happen to each of the following?
- (i) The price of previously issued bonds
 - (ii) The rate of economic growth in the long run. 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.

3. Assume that the economy of country Zen is in long-run macroeconomic equilibrium.

(a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.

(i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively

(ii) The full-employment output, labeled Y_F

(b) On your graph in part (a), show the short-run effect of an increase in consumer confidence. Label the new equilibrium real output Y_2 and the new equilibrium price level PL_2 .

(c) Assume that the banking system in Zen has ample reserves. Suppose that the central bank's goal is to maintain a stable price level at PL_1 . Based on the change in the price level shown in part (b), identify one specific monetary policy action the central bank would take to achieve its goal.

(d) Based on the monetary policy action identified in part (c), will real output increase, decrease, or stay the same in the short run? 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

1. Assume the economy of Sweden is in long-run equilibrium and has a surplus in its current account.
- (a) Is the Swedish capital and financial account in deficit, in surplus, or in balance? Explain.
 - (b) Draw a correctly labeled graph of short-run aggregate supply, long-run aggregate supply, and aggregate demand curves for Sweden, and show the current equilibrium real output, labeled Y_1 , and the current equilibrium price level, labeled PL_1 .
 - (c) Assume the United Kingdom decreases its imports from Sweden. On your graph in part (b), show the new equilibrium real output, labeled Y_2 , and the new equilibrium price level, labeled PL_2 , as a result of this change.
 - (d) As a result of the decrease in the United Kingdom's imports from Sweden, would policy makers in Sweden be more concerned about cyclical unemployment or inflationary pressures in the short run? Explain.
 - (e) If the Swedish central bank's goal is to return the economy to long-run equilibrium, what open-market operation should it use?
 - (f) The currency of the United Kingdom is the pound, and the currency of Sweden is the krona. Draw a correctly labeled graph of the foreign exchange market for the krona, and show the impact of the decrease in the United Kingdom's imports from Sweden on the value of the krona in the foreign exchange market.
 - (g) If the Swedish central bank's goal is to reverse the exchange rate change shown in part (f) by changing the interest rate, what open-market operation should it use?
 - (h) Explain how the open-market operation identified in part (g) would reverse the change in the exchange rate.

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.

1. Assume Smithland is in short-run equilibrium at a level of output that exceeds the full-employment level of output.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (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?
- (e) Draw a correctly labeled graph of the money market, and show the effect of the open-market operation identified in part (d) on the nominal interest rate.
- (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.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 the United States economy is in recession.
 - (a) Draw a correctly labeled graph of the long-run aggregate supply, short-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) Current price level, labeled PL_1
 - (ii) Current output, labeled Y_1
 - (b) Now assume the euro zone, a major trading partner of the United States, enters into a recession.
 - (i) What will be the effect on United States exports to the euro zone? Explain.
 - (ii) On your graph in part (a), show the effect of the change identified in part (b)(i) on real output in the United States.
 - (iii) What will be the effect of the change identified in part (b)(ii) on unemployment in the United States?
 - (c) Assume the euro zone recession causes a decrease in the demand for United States dollars in the foreign exchange market.
 - (i) Will the euro appreciate, depreciate, or remain unchanged against the dollar? Explain.
 - (ii) Draw a correctly labeled graph of the foreign exchange market for dollars, and show the effect of the decrease in the demand for dollars on the exchange rate for dollars.
 - (d) Assume the United States implements a combination of expansionary fiscal and monetary policies. In the absence of complete crowding out, what will be the effect of these policies on each of the following?
 - (i) Aggregate demand in the United States
 - (ii) The price level in the United States
 - (iii) Interest rates in the United States. Explain.

2. Assume that an economy is in long-run equilibrium. Assume that consumers wish to hold less money because they use credit cards more frequently to purchase goods and services than cash.
- (a) Draw a correctly labeled graph of the money market and show the effect of the reduced holdings of money on the equilibrium nominal interest rate in the short run.
 - (b) Based on the change in the interest rate in part (a), what will happen to each of the following in the short run?
 - (i) Prices of previously issued bonds
 - (ii) The price level and real income. Explain.
 - (c) With a constant money supply, based on your answer to part b(ii), will the velocity of money increase, decrease, or remain the same, or is the change indeterminate?
 - (d) If the central bank wishes to reverse the change in the interest rate identified in part (a), what open market operation would it use?
-

MACROECONOMICS**Section II****Total Time—60 minutes****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 in a short-run equilibrium with the actual unemployment rate above the natural rate of unemployment.
- (a) Draw a single correctly labeled graph with both the long-run Phillips curve and short-run Phillips curve. Label the current short-run equilibrium point P.
 - (b) Assuming no policy actions are taken, will the short-run Phillips curve shift to the right (upward), shift to the left (downward), or remain the same in the long run? Explain.
 - (c) If the Federal Reserve Bank wants to lower unemployment, what expansionary open-market operation should it use?
 - (d) How will the open-market operation you identified in part (c) affect each of the following?
 - (i) Federal funds rate. Explain.
 - (ii) Real interest rate in the short run.
 - (e) Given your answer in part (d)(ii), what is the effect on real gross domestic product (GDP) in the short run? Explain.
 - (f) Japan and the United States are major trading partners. Indicate how the change in real GDP you identified in part (e) will affect the demand for the Japanese yen in the foreign exchange market.
 - (g) Draw a correctly labeled graph of the foreign exchange market for the Japanese yen, showing the effect of the change in demand identified in part (f) on the value of the Japanese yen relative to the United States dollar.

3.7 Long-Run Self-Adjustment

Name: _____ Class: _____ Date: _____

Total: 9 marks

KEY WORDS price level 价格水平 • inflationary gap 通胀缺口 • nominal wages 名义工资
 • recessionary gap 衰退缺口

Objective

Build the skills to answer exam questions on **long-run self-adjustment**.

You must be able to:

- explain how an economy in a **recessionary** or **inflationary gap** returns to full employment on its own
- describe how changes in **nominal wages** shift SRAS during self-adjustment
- compare the long-run outcome (output back at potential) with the short-run effect on the price level

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Closing a recessionary gap

High unemployment pushes **nominal wages down**, lowering costs, so SRAS shifts **right** until output returns to potential — at a **lower** price level.

■ Closing an inflationary gap

Low unemployment pushes **nominal wages up**, raising costs, so SRAS shifts **left** until output returns to potential — at a **higher** price level.

■ Long-run outcome

Either way, output returns to **potential**; only the price level is permanently changed.

2 Practice

2.1 Explain how an economy in a recessionary gap self-corrects.

[2]

2.2 State what happens to nominal wages during a recessionary gap. [1]

2.3 State the long-run level of output after self-adjustment. [1]

3 Exam-style questions

3.1 In a recessionary gap, self-correction happens as nominal wages [1]

- **A** rise
 - **B** fall
 - **C** stay fixed
 - **D** disappear
-

3.2 After long-run self-adjustment, output returns to [1]

- **A** zero
 - **B** potential output
 - **C** above potential
 - **D** below potential
-

3.3 An economy has an inflationary gap.

(a) State what happens to nominal wages over time. [1]

(b) State the direction SRAS shifts. [1]

(c) State the long-run level of output. [1]

Solutions

2.1 high unemployment lowers nominal wages, which lowers costs and shifts SRAS right until output is back at potential.

2.2 they fall.

2.3 potential (full-employment) output.

3.1 B.

3.2 B.

3.3 (a) they rise. (b) to the left. (c) potential output.

1. The economy of Micanapy is in short-run equilibrium and is experiencing an inflationary gap.

Part A

Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Micanapy, and show each of the following.

- i. The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
- ii. The full-employment real output, labeled Y_F

Part B

Assume that policymakers take no action to close the inflationary gap. Explain how Micanapy's economy will self-adjust to full employment in the long run.

Part C

Suppose instead that Micanapy's central bank is considering using monetary policy to close the inflationary gap in the short run. The banking system in Micanapy has limited reserves.

- i. Identify a specific open-market operation that the central bank of Micanapy would implement to close the inflationary gap in the short run.
- ii. Draw a correctly labeled graph of the money market in Micanapy, and show the effect of the open-market operation identified in part C (i) on the nominal interest rate.

Part D

Based solely on the interest rate change shown on your graph in part C (ii), will each of the following increase, decrease, or remain the same in the short run?

- i. International financial capital flows into Micanapy. Explain.
- ii. The price of previously issued bonds in Micanapy
- iii. Private domestic investment spending in Micanapy

Part E

Based solely on the change in private domestic investment spending identified in part D (iii), will the unemployment rate in Micanapy increase, decrease, or remain the same in the short run? Explain.

2. The economies of Country L and Country A are currently in short-run equilibrium at output levels below full employment. Both countries intend to use monetary policy to close their output gaps. Country L has a banking system with limited reserves, and Country A has a banking system with ample reserves.

- A. What open-market operation would Country L implement to move the economy toward full employment in the short run?
- B. What specific monetary policy action would Country A implement to move the economy toward full employment in the short run?
- C. Draw a correctly labeled graph of the reserve market in Country A, and show the effect of the monetary policy action identified in part B on the policy rate.
- D. Assume instead that no policy actions are taken in Country A and that the economy remains in short-run equilibrium at an output level below full employment. Will short-run aggregate supply in Country A increase, decrease, or remain the same as the economy self-adjusts in the long run? Explain.

1. The economy of Alpha is in short-run equilibrium with a cyclical unemployment rate of 3%, a frictional unemployment rate of 4%, and an actual unemployment rate of 8%.
- (a) Calculate Alpha's natural rate of unemployment. Show your work.
- (b) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Alpha, and show each of the following.
- (i) The current equilibrium output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (c) Assume that policymakers take no action to close the output gap.
- (i) Explain how Alpha's economy will adjust to full employment in the long run.
 - (ii) On your graph in part (b), show how Alpha's economy will adjust to full employment in the long run, labeling the new equilibrium price level PL_2 .
- (d) Assume instead that Alpha's central bank is considering using monetary policy to close a recessionary output gap. The banking system in Alpha has ample reserves. Identify a specific monetary policy action the central bank of Alpha would take to close the output gap in the short run.
- (e) Draw a correctly labeled graph of the reserve market in Alpha, and show the effect of the action taken by the central bank identified in part (d) on the policy rate.
- (f) Based on the change in the policy rate shown in part (e), what would happen to each of the following in the short run in Alpha?
- (i) The price of previously issued bonds
 - (ii) The price level. 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.

1. Assume that the economy of Moneyland is in equilibrium with an actual unemployment rate equal to the natural rate of unemployment.
 - (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full employment output, labeled Y_F
 - (b) Assume that consumer spending in Moneyland decreases from \$110,000 to \$100,000 as a result of a decrease in disposable income in Moneyland from \$135,000 to \$110,000.
 - (i) Calculate the marginal propensity to consume in Moneyland. Show your work.
 - (ii) Show the short-run effect of the decrease in consumer spending in Moneyland on your graph in part (a), labeling the new equilibrium real output and price level Y_2 and PL_2 , respectively.
 - (c) Following the decrease in consumer spending, explain how the economy would adjust in the long run in the absence of any policy actions.
 - (d) The central bank of Moneyland is concerned about the short-run effects of the decrease in consumer spending on the broader economy and is considering taking action rather than waiting for the long-run adjustment process. Assuming the banking system in Moneyland has ample reserves, identify a specific monetary policy action the central bank of Moneyland would take to increase consumer spending.
 - (e) Draw a correctly labeled graph of the reserve market in Moneyland, and show the effect of the monetary policy action identified in part (d) on the policy rate.
 - (f) How would the change in the policy rate shown on your graph in part (e) affect each of the following in Moneyland in the short run?
 - (i) The quantity of national savings
 - (ii) Unemployment. 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.

1. Assume the economy of Vanderlandia is in short-run equilibrium with a real GDP of \$500 million. The full-employment level of real GDP is \$550 million.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (b) Assume no policy action is taken to restore full employment.
- (i) Explain how the economy will adjust in the long run.
 - (ii) Following the long-run adjustment process, will the price level in Vanderlandia be greater than, less than, or equal to PL_1 shown on your graph in part (a)?
- (c) Assume instead that policymakers in Vanderlandia are considering changing government spending to restore full employment in the short run and that the marginal propensity to save is 0.2.
- (i) Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
 - (ii) On your graph in part (a), show the short-run effect of the change in government spending in part (c)(i), labeling the new equilibrium price level PL_2 .
- (d) Draw a correctly labeled graph of the loanable funds market, and show the effect of the change in government spending in part (c)(i) on the equilibrium real interest rate.
- (e) Based on the change in the real interest rate shown on your graph in part (d), what will happen to each of the following?
- (i) The price of previously issued bonds
 - (ii) The rate of economic growth in the long run. 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.

1. The economy of Northland is in short-run equilibrium with an actual unemployment rate of 7% and an actual inflation rate of 1%. The natural unemployment rate in Northland is 5%.
- (a) Using the relevant numerical values given, draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium point as X. Plot the relevant numerical values provided on the graph.
- (b) Is the expected inflation rate greater than, less than, or equal to 1% ? Explain.
- (c) Assume the marginal propensity to consume is 0.9.
- (i) If the government decreases income taxes by \$20 billion, calculate the maximum change in aggregate demand. Show your work.
 - (ii) If instead the government increases spending by \$20 billion, calculate the maximum change in aggregate demand. Show your work.
- (d) On your graph in part (a), show a possible new short-run equilibrium point labeled Z that would result if the government increases spending and there is no change in inflationary expectations.
- (e) How would an increase in unemployment compensation affect aggregate demand in the short run? Explain.
- (f) Assume instead the government takes none of the preceding policy actions. (Northland is still in short-run equilibrium; the actual unemployment rate is 7%, the actual inflation rate is 1%, and the natural unemployment rate is 5%.) What will happen to each of the following in the long run?
- (i) The short-run aggregate supply curve. Explain.
 - (ii) The short-run Phillips curve
 - (iii) The actual unemployment rate

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. An economy is currently in short-run equilibrium with a recessionary output gap of \$600 billion.

(a) Draw a single correctly labeled graph with both the short-run and long-run Phillips curves. Label the initial short-run equilibrium point X.

(b) Suppose the government implements fiscal policy in order to achieve full-employment output and the marginal propensity to consume is 0.75.

(i) Calculate the minimum change in government spending required to increase aggregate demand by the amount of the output gap of \$600 billion. Show your work.

(ii) Suppose instead the government wants to change taxes rather than government spending. Calculate the minimum change in taxes required to increase aggregate demand by the amount of the output gap of \$600 billion. Show your work.

(c) Assume instead the government takes no policy action to close the output gap shown in part (a). Explain how the economy will adjust in the long run.

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.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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. Canada is an open economy that is currently in a recessionary output gap.
 - (a) Draw a correctly labeled graph of the long-run aggregate supply, short-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) Full-employment output, labeled Y_f
 - (b) The central bank and the government do not take any policy actions to close the output gap.
 - (i) Explain how the economy will adjust to full employment in the long run.
 - (ii) On your graph in part (a), show how the economy adjusts to full employment in the long run.
 - (c) Suppose the Canadian government is unwilling to wait for the long-run adjustment process. The marginal propensity to consume is 0.8. The equilibrium real output is \$500 billion and the full-employment output is \$540 billion.
 - (i) Calculate the minimum change and indicate the direction of change in government spending required to shift the aggregate demand curve by the amount of the output gap.
 - (ii) Calculate the minimum change and indicate the direction of change in taxes required to shift the aggregate demand curve by the amount of the output gap.
 - (d) Assume instead that the Canadian central bank takes actions to restore the economy to full-employment output by influencing investment spending. Draw a correctly labeled graph of the money market, and show the effect of the actions taken by the central bank on the equilibrium interest rate.
 - (e) Canada and Mexico are trading partners. Draw a correctly labeled graph of the foreign exchange market of the Canadian dollar, and show the effect of the change in the interest rate in part (d) on the value of the Canadian dollar with respect to the Mexican peso.

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 the economy of Artland is currently operating above full employment.
 - (a) Draw a correctly labeled graph of the short-run aggregate supply, long-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) The current equilibrium real output and price level, labeled as Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled as Y_f
 - (b) Assume the central bank and the government do not take any policy actions to close the output gap.
 - (i) On your graph in part (a), show how the economy automatically adjusts in the long run and label the new equilibrium price level PL_2 .
 - (ii) Explain the cause of the adjustment shown in part (b)(i).
 - (c) Alternatively, suppose the government wants to close the output gap using fiscal policy.
 - (i) Identify a fiscal policy action the government could implement to close the output gap.
 - (ii) How will the fiscal policy action identified in part (c)(i) affect the following?
 - The unemployment rate
 - The natural rate of unemployment
 - (iii) In closing the output gap, will the automatic adjustment identified in part (b)(i) produce a higher, a lower, or the same price level compared to the fiscal policy identified in part (c)(i) ?
 - (d) Draw a correctly labeled graph of the market for loanable funds. Show the effect of the fiscal policy action identified in part (c)(i) on the equilibrium real interest rate.
 - (e) Given the interest rate change identified in part (d), will the long-run aggregate supply curve shift to the right, shift to the left, or remain the same in the long run? Explain.

MACROECONOMICS**Section II****Total Time—60 minutes****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 economy of Country X has an actual unemployment rate of 7%, a natural rate of unemployment of 5%, and an inflation rate of 3%.
 - (a) Using the numerical values given above, draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium as point B. Plot the numerical values above on the graph.
 - (b) Assume that the government of Country X takes no policy action to reduce unemployment. In the long run, will each of the following shift to the right, shift to the left, or remain the same?
 - (i) Short-run aggregate supply curve. Explain.
 - (ii) Long-run Phillips curve
 - (c) Identify a fiscal policy action that could be used to reduce the unemployment rate in the short run.
 - (d) Draw a correctly labeled graph of aggregate demand and short-run aggregate supply, and show the impact on the equilibrium price level and real gross domestic product (GDP) of the fiscal policy action identified in part (c).
 - (e) Based on the change in real GDP identified in part (d), will the supply of Country X's currency in the foreign exchange market increase, decrease, or remain the same? Explain.
 - (f) Based on your answer to part (e) and assuming a flexible exchange rate system, will Country X's currency appreciate, depreciate, or remain the same in the foreign exchange market?

3.8 Fiscal Policy

Name: _____ Class: _____ Date: _____

Total: 8 marks

KEY WORDS fiscal policy 财政政策 • expansionary 扩张性 • contractionary 紧缩性
 • recessionary gap 衰退缺口 • inflationary gap 通胀缺口

Objective

Build the skills to answer exam questions on **fiscal policy**.

You must be able to:

- define **fiscal policy** 财政政策 as government spending and taxes
- distinguish **expansionary** 扩张性 from **contractionary** 紧缩性 fiscal policy
- apply the **spending** and **tax multipliers** to estimate the change in output
- relate a fiscal choice to closing a recessionary or inflationary gap

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Fiscal policy

The government's use of **spending** and **taxes** to influence aggregate demand.

■ Expansionary vs contractionary

- **Expansionary** (more spending or lower taxes) → AD **right**; used to close a **recessionary gap**.
- **Contractionary** (less spending or higher taxes) → AD **left**; used to close an **inflationary gap**.

■ Sizing the policy

Use the spending multiplier: the spending change needed = $\frac{\text{output gap}}{\text{multiplier}}$.

2 Practice

2.1 Define fiscal policy.

[1]

2.2 State the type of fiscal policy used to close a recessionary gap. [1]

2.3 State the effect of expansionary fiscal policy on AD. [1]

3 Exam-style questions

3.1 Expansionary fiscal policy involves [1]

- **A** cutting government spending
 - **B** raising taxes
 - **C** increasing government spending
 - **D** raising interest rates
-

3.2 To fight high inflation, the government should use _____ fiscal policy. [1]

- **A** expansionary
 - **B** contractionary
 - **C** monetary
 - **D** no
-

3.3 An economy is in a recessionary gap of \$100 billion, with $MPC = 0.8$.

(a) Name a fiscal tool that could close it. [1]

(b) State the effect on AD. [1]

(c) Find the rise in government spending needed. [1]

Solutions

2.1 the government's use of spending and taxes to influence the economy.

2.2 expansionary fiscal policy.

2.3 it increases (shifts right) AD.

3.1 C.

3.2 B.

3.3 (a) increase government spending (or cut taxes). (b) AD shifts right. (c) multiplier $= \frac{1}{1 - 0.8} = 5$, so spending $= \frac{100}{5} = \$20$ billion.

3. Lizland is a small island nation, and its currency is the Lizland crown (LIZ). The economy of Lizland is in short-run macroeconomic equilibrium with a 600 million crown recessionary gap.

Part A

Policymakers in Lizland are considering taking action to close the recessionary gap in the short run.

- i. The central bank of Lizland is considering implementing monetary policy. The banking system of Lizland has ample reserves. Identify a specific monetary policy action the central bank of Lizland would implement to close the recessionary gap in the short run.
- ii. The government of Lizland is also considering changing its spending, and the marginal propensity to consume is 0.75. Calculate the minimum change in government spending and identify the direction of the change required to fully close the 600 million crown recessionary gap in the short run. Show your work.

Part B

Assume that the government of Lizland decides to change its spending as calculated in part A (ii). Based solely on this change, will the price level in Lizland increase, decrease, or remain the same in the short run? Explain.

Part C

The nations of Lizland and Andoh are trading partners with flexible exchange rates. The currency of Andoh is the Andoh note (AND). Draw a correctly labeled graph of the foreign exchange market for the Lizland crown (LIZ). Based solely on the change in the price level in part B, show the change in the international value of the Lizland crown on your graph.

STOP
END OF EXAM

3. The table provided shows the quantities and unit prices of shirts, bread, and pants, the only three goods produced in the country of Middleland in 2021 and 2022. Assume that 2021 was the base year.

	Shirts	Bread	Pants
Unit Prices in 2021	\$11	\$4	\$12
Unit Prices in 2022	\$10	\$5	\$15
Quantities Produced in 2021 and 2022	50	70	30

- A. Was the real GDP in 2021 in Middleland greater than, less than, or equal to the nominal GDP in 2021? Explain.
- B. Calculate the real GDP in Middleland in 2022. Show your work.
- C. Assume that Middleland was in short-run equilibrium in 2022 and that POTENTIAL real GDP was \$1,150 in 2022. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Middleland in 2022, and show each of the following.
- The equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- D. Assume the marginal propensity to consume in Middleland is 0.8. Calculate the minimum change and state the direction of change in government spending required to close the output gap in the short run in Middleland. Show your work.

STOP
END OF EXAM

1. Assume that the economy of Barrikos is in short-run equilibrium, with its economic data summarized in the table provided. The government budget is balanced, and the capital and financial account (CFA) balance is zero.

Cyclical unemployment rate	6%
Natural unemployment rate	4%
Structural unemployment rate	1%
Actual inflation rate	3%
Expected inflation rate	5%

- A. What is the numerical value of the actual unemployment rate in Barrikos?
- B. Using the relevant numerical values, draw a correctly labeled graph of the short-run and long-run Phillips curves for Barrikos. Indicate the current short-run equilibrium with a point labeled X. Plot the relevant numerical values on the graph.
- C. Based on your graph in part B, identify one specific fiscal policy action that the government of Barrikos would take to move the economy toward long-run equilibrium.
- D. Assume that the fiscal policy action identified in part C is implemented.
- Will the government budget in Barrikos move into surplus, move into deficit, or remain balanced? Explain.
 - Assume there is no change in inflationary expectations. On your graph in part B, show a possible new short-run equilibrium point, labeled Z, that would result from the fiscal policy action identified in part C.
 - Draw a correctly labeled graph of the loanable funds market, and show the effect of the fiscal policy action identified in part C on the real interest rate.
- E. Barrikos has an open economy and a flexible exchange rate. Based solely on the change in the real interest rate in Barrikos shown on your graph in part D (iii), will Barrikos' capital and financial account (CFA) balance move into surplus, move into deficit, or remain the same? Explain.
- F. Based on the change in Barrikos' capital and financial account (CFA) balance identified in part E, what will happen to the international value of Barrikos' currency? Explain.

3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.
- A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.
- The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2 .
- C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
- D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM

3. Assume Malaysia's economy is in a recession and its government currently has a balanced budget.
- (a) Identify a specific fiscal policy action that the government of Malaysia would implement to address the recession.
- (b) How will the fiscal policy action identified in part (a) affect the real interest rate in Malaysia? Explain.
- (c) Malaysia and Japan are trading partners with flexible exchange rates. Malaysia's currency is the ringgit (MYR), and Japan's currency is the yen (JPY). Draw a correctly labeled graph of the foreign exchange market for the ringgit relative to the yen. Show the effect of the change in the real interest rate identified in part (b) on the international value of the ringgit.
- (d) As a result of the change in the value of the ringgit shown in part (c), will Malaysia'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.

STOP

END OF EXAM

3. Assume that Jamaica has a cyclical unemployment rate of 4% and a balanced capital and financial account (CFA).
- (a) Identify a specific fiscal policy action that Jamaica's government would take to bring its economy to full employment.
- (b) Based solely on the short-run change in real output resulting from the fiscal policy action identified in part (a), what will happen to Jamaica's net exports? Explain.
- (c) Assume that Jamaica and Turkey are trading partners with flexible exchange rates. Jamaica's currency is the Jamaican dollar (JMD), and Turkey's currency is the lira (TRY). Draw a correctly labeled graph of the foreign exchange market for the Jamaican dollar relative to the lira, and show the effect of the change in net exports identified in part (b) on the supply of the Jamaican dollar and the international value of the Jamaican dollar.
- (d) How will the change in net exports identified in part (b) affect Jamaica's capital and financial account (CFA)? 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



1. Assume the economy of Vanderlandia is in short-run equilibrium with a real GDP of \$500 million. The full-employment level of real GDP is \$550 million.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (b) Assume no policy action is taken to restore full employment.
- (i) Explain how the economy will adjust in the long run.
 - (ii) Following the long-run adjustment process, will the price level in Vanderlandia be greater than, less than, or equal to PL_1 shown on your graph in part (a)?
- (c) Assume instead that policymakers in Vanderlandia are considering changing government spending to restore full employment in the short run and that the marginal propensity to save is 0.2.
- (i) Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
 - (ii) On your graph in part (a), show the short-run effect of the change in government spending in part (c)(i), labeling the new equilibrium price level PL_2 .
- (d) Draw a correctly labeled graph of the loanable funds market, and show the effect of the change in government spending in part (c)(i) on the equilibrium real interest rate.
- (e) Based on the change in the real interest rate shown on your graph in part (d), what will happen to each of the following?
- (i) The price of previously issued bonds
 - (ii) The rate of economic growth in the long run. 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 a country's economy is currently operating below full employment.
- (a) Identify a fiscal policy action the country's government could implement to restore full employment.
- (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 equilibrium real interest rate.
- (c) Based solely on the real interest rate change shown in part (b), what will happen to each of the following?
- (i) Net exports. Explain.
 - (ii) The stock of physical capital. 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.

1. Assume Smithland is in short-run equilibrium at a level of output that exceeds the full-employment level of output.
- (a) Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves, and show each of the following.
- (i) The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - (ii) The full-employment output, labeled Y_F
- (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?
- (e) Draw a correctly labeled graph of the money market, and show the effect of the open-market operation identified in part (d) on the nominal interest rate.
- (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.

3. The government budget of the country of Geeland is currently balanced. The government budget is composed of tax revenues (T), transfer payments (TR), and government spending (G).
- (a) Assume the economy moves into a recession and there is no discretionary policy action.
- (i) Will the government budget move into a deficit or a surplus in the short run? Explain using the appropriate components of the government budget identified above.
 - (ii) Based on your answer to part (a)(i), what will happen to the government debt?
- (b) Based on your answer to part (a)(i), identify one specific fiscal policy action that will balance the budget.
- (c) How will the fiscal policy action from part (b) affect the actual unemployment rate in the short run? Explain.
- (d) Did the government efforts to maintain a balanced budget make Geeland's recession more severe or less severe in the short run? 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

MACROECONOMICS**Section II****Total Time—1 hour****Reading Period—10 minutes****Writing Period—50 minutes**

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. 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. 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 the United States economy is in recession.
 - (a) Draw a correctly labeled graph of the long-run aggregate supply, short-run aggregate supply, and aggregate demand curves, and show each of the following.
 - (i) Current price level, labeled PL_1
 - (ii) Current output, labeled Y_1
 - (b) Now assume the euro zone, a major trading partner of the United States, enters into a recession.
 - (i) What will be the effect on United States exports to the euro zone? Explain.
 - (ii) On your graph in part (a), show the effect of the change identified in part (b)(i) on real output in the United States.
 - (iii) What will be the effect of the change identified in part (b)(ii) on unemployment in the United States?
 - (c) Assume the euro zone recession causes a decrease in the demand for United States dollars in the foreign exchange market.
 - (i) Will the euro appreciate, depreciate, or remain unchanged against the dollar? Explain.
 - (ii) Draw a correctly labeled graph of the foreign exchange market for dollars, and show the effect of the decrease in the demand for dollars on the exchange rate for dollars.
 - (d) Assume the United States implements a combination of expansionary fiscal and monetary policies. In the absence of complete crowding out, what will be the effect of these policies on each of the following?
 - (i) Aggregate demand in the United States
 - (ii) The price level in the United States
 - (iii) Interest rates in the United States. Explain.

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. 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 operating below full employment.
 - (a) Draw a correctly labeled graph of long-run aggregate supply, short-run aggregate supply, and aggregate demand, and show each of the following.
 - (i) Current equilibrium output and price level, labeled as Y_1 and PL_1
 - (ii) Full-employment output, labeled as Y_f
 - (b) Assume that the Federal Reserve targets a new federal funds rate to reach full employment. Should the Federal Reserve target a higher or lower federal funds rate?
 - (c) Given the Federal Reserve action you identified in part (b), draw a correctly labeled graph of the money market and show the effect on the nominal interest rate.
 - (d) The policy makers pursue a fiscal policy rather than the monetary policy in part (b). Assume that the marginal propensity to consume is 0.8 and the value of the recessionary gap is \$300 billion.
 - (i) If the government changes its spending without changing taxes to eliminate the recessionary gap, calculate the minimum required change in government spending.
 - (ii) If the government changes taxes without changing government spending to eliminate the recessionary gap, will the minimum required change in taxes be greater than, smaller than, or equal to the minimum required change in government spending in part (d)(i) ? Explain.
 - (e) Assume the government lowers income tax rates to eliminate the recessionary gap. Will each of the following increase, decrease, or stay the same?
 - (i) Aggregate demand. Explain.
 - (ii) Long-run aggregate supply. Explain.

3.9 Automatic Stabilizers

Name: _____ Class: _____ Date: _____

Total: 9 marks

KEY WORDS discretionary 相机抉择 • automatic stabilizers 自动稳定器
 • transfer payments 转移支付 • progressive taxes 累进税 • fiscal policy 财政政策

Objective

Build the skills to answer exam questions on **automatic stabilizers**.

You must be able to:

- define **automatic stabilizers** 自动稳定器 as features that dampen the cycle without new laws
- explain how **progressive taxes** 累进税 and **transfer payments** 转移支付 act automatically
- distinguish automatic stabilizers from **discretionary** 相机抉择 fiscal policy

1 Worked examples

Study these first. Each one shows the method for a question type used later.

■ Automatic stabilizers

Built-in features that soften the business cycle **without any new legislation**.

■ How they work

- **Progressive taxes** — in a boom, incomes and tax revenue rise automatically, cooling AD.
- **Transfers** — in a recession, unemployment benefits rise automatically, supporting AD.

■ Vs discretionary policy

Discretionary fiscal policy needs a **deliberate new law** (e.g. a stimulus package); stabilizers act on their own.

2 Practice

2.1 Define an automatic stabilizer.

[1]

2.2 Give two examples of automatic stabilizers. [2]

2.3 State the difference between automatic and discretionary fiscal policy. [1]

3 Exam-style questions

3.1 An automatic stabilizer works [1]

- **A** only when a new law is passed
- **B** without any new legislation
- **C** through the central bank
- **D** by changing interest rates

3.2 Which of these is an automatic stabilizer? [1]

- **A** a newly passed stimulus law
- **B** unemployment benefits
- **C** an interest-rate cut
- **D** a new tariff

3.3 The economy enters a recession.

(a) State what happens to unemployment-benefit payments. [1]

(b) State the effect on AD. [1]

(c) State whether this required new legislation. [1]

Solutions

2.1 a feature of the economy that dampens the business cycle automatically, without new laws.

2.2 progressive taxes; transfer payments such as unemployment benefits.

2.3 automatic stabilizers act without new laws; discretionary policy requires deliberate new legislation.

3.1 B.

3.2 B.

3.3 (a) they rise. (b) AD is supported (does not fall as far). (c) no.

3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.
- A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.
- The current equilibrium real output and price level, labeled Y_1 and PL_1 , respectively
 - The full-employment output, labeled Y_F
- B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2 .
- C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.
- D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

END OF EXAM

1. The economy of Northland is in short-run equilibrium with an actual unemployment rate of 7% and an actual inflation rate of 1%. The natural unemployment rate in Northland is 5%.
- (a) Using the relevant numerical values given, draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium point as X. Plot the relevant numerical values provided on the graph.
- (b) Is the expected inflation rate greater than, less than, or equal to 1% ? Explain.
- (c) Assume the marginal propensity to consume is 0.9.
- (i) If the government decreases income taxes by \$20 billion, calculate the maximum change in aggregate demand. Show your work.
 - (ii) If instead the government increases spending by \$20 billion, calculate the maximum change in aggregate demand. Show your work.
- (d) On your graph in part (a), show a possible new short-run equilibrium point labeled Z that would result if the government increases spending and there is no change in inflationary expectations.
- (e) How would an increase in unemployment compensation affect aggregate demand in the short run? Explain.
- (f) Assume instead the government takes none of the preceding policy actions. (Northland is still in short-run equilibrium; the actual unemployment rate is 7%, the actual inflation rate is 1%, and the natural unemployment rate is 5%.) What will happen to each of the following in the long run?
- (i) The short-run aggregate supply curve. Explain.
 - (ii) The short-run Phillips curve
 - (iii) The actual unemployment rate

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.

3. The government budget of the country of Geeland is currently balanced. The government budget is composed of tax revenues (T), transfer payments (TR), and government spending (G).
- (a) Assume the economy moves into a recession and there is no discretionary policy action.
- (i) Will the government budget move into a deficit or a surplus in the short run? Explain using the appropriate components of the government budget identified above.
- (ii) Based on your answer to part (a)(i), what will happen to the government debt?
- (b) Based on your answer to part (a)(i), identify one specific fiscal policy action that will balance the budget.
- (c) How will the fiscal policy action from part (b) affect the actual unemployment rate in the short run? Explain.
- (d) Did the government efforts to maintain a balanced budget make Geeland's recession more severe or less severe in the short run? 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