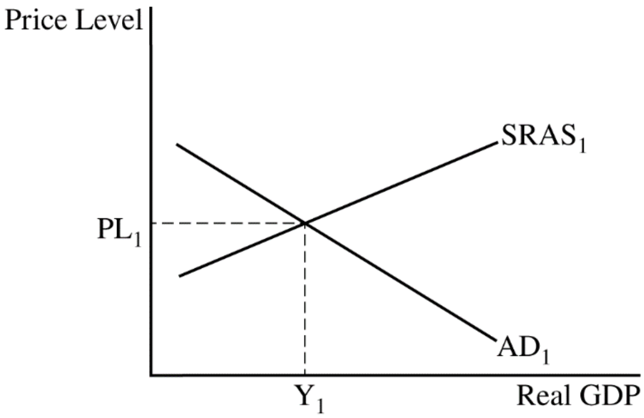
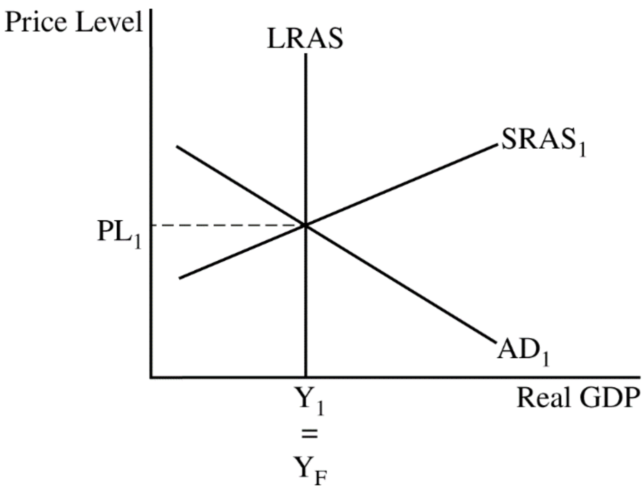
Question 3: Short — 5 points

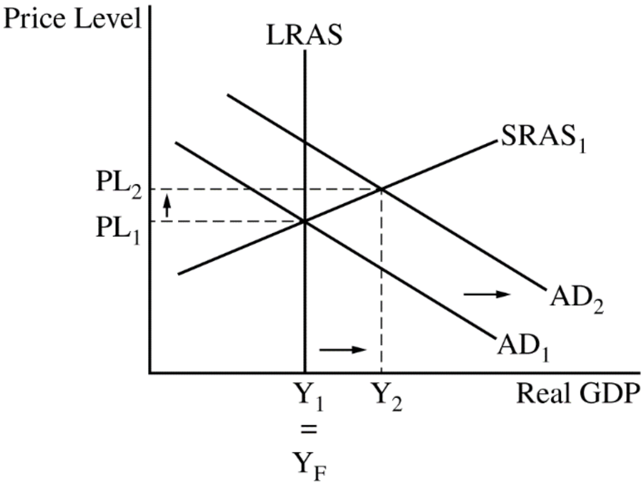
A Point 1	Draw a correctly labeled aggregate demand–aggregate supply graph that shows PL_1 and Y_1 at the intersection of the aggregate demand (AD) and short-run aggregate supply (SRAS) curves.	**1 point**



Point 2	The graph must show a vertical long-run aggregate supply (LRAS) curve at equilibrium real output $Y_1 = Y_F$.	**1 point**



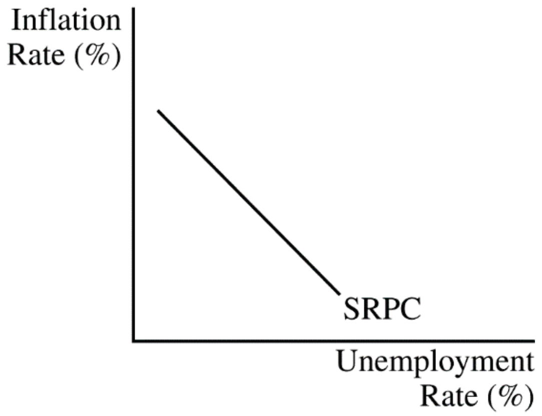
B Point 3	On the graph from part A, show the short-run effect of the increase in real income in Thailand as a rightward shift of Nepal's aggregate demand curve, resulting in an increase in real output, labeled Y_2, and an increase in the price level, labeled PL_2.	**1 point**



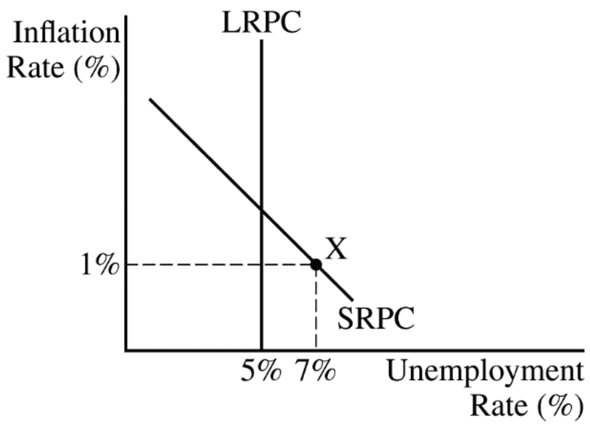
C Point 4	Calculate the minimum change in government spending as a decrease of 100 million rupees and show your work. $\text{Min Change} = \frac{-400 \text{ million rupees}}{\frac{1}{(1-0.75)}} = \frac{-400 \text{ million rupees}}{4} = -100 \text{ million rupees}$	**1 point**
D Point 5	Explain that as real income rises, tax revenues will increase automatically (and/or transfer payments will decrease automatically), thereby slowing the rate at which disposable income is increasing, which will slow consumption growth.	**1 point**

Question 1: Long — 10 points

(a)	Draw a correctly labeled graph of the short-run Phillips curve (SRPC).	**1 point**



For the second point, the graph must include a vertical long-run Phillips curve (LRPC) at the natural rate of unemployment (5%) and must include point X on the SRPC to the right of the LRPC at the actual unemployment rate (7%) and the actual inflation rate (1%). **1 point**



Total for part (a) 2 points

(b)	State that the expected inflation rate is greater than 1% and explain that the actual unemployment rate (7%) is greater than the natural rate of unemployment (5%); or explain that the economy is in a recession.	**1 point**
(c) (i)	Calculate the maximum change in aggregate demand as \$180 billion and show your work.	**1 point**

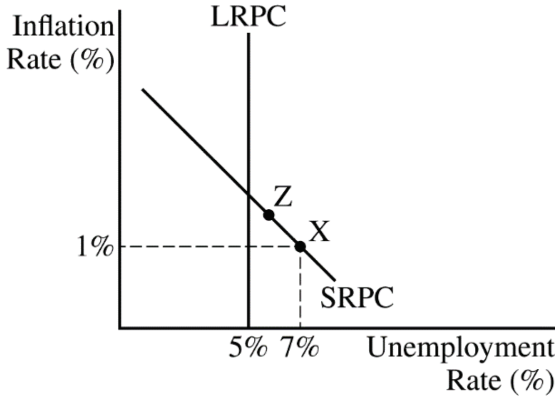
$$\text{Maximum } \Delta \text{ in AD} = -\$20 \text{ billion} \times \frac{-0.9}{1-0.9} = -\$20 \text{ billion} \times -9 = \$180 \text{ billion}$$

(ii)	Calculate the maximum change in aggregate demand as \$200 billion and show your work.	**1 point**

$$\text{Maximum } \Delta \text{ in AD} = \$20 \text{ billion} \times \frac{1}{1-0.9} = \$20 \text{ billion} \times 10 = \$200 \text{ billion}$$

Total for part (c) 2 points

(d)	On the graph from part (a), show point Z on the SRPC to the left of point X.	**1 point**



(e)	State that aggregate demand would increase and explain that the increase in disposable income would increase consumption spending.	**1 point**
(f) (i)	State that the short-run aggregate supply curve will shift to the right and explain that input prices (e.g., nominal wages) and/or inflationary expectations will decrease.	**1 point**
(ii)	State that the short-run Phillips curve will shift to the left.	**1 point**
(iii)	State that the actual unemployment rate will decrease.	**1 point**
	Total for part (f)	**3 points**
	Total for question 1	**10 points**

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Question 3: Short — 5 points

(a) (i)	State that the government budget will move into deficit in the short run and explain that tax revenues (T) will decrease and transfer payments (TR) will increase.	**1 point**
(ii)	State that the government debt will increase.	**1 point**
	Total for part (a)	**2 points**
(b)	Identify an increase in taxes or a decrease in government spending.	**1 point**
(c)	State that the actual unemployment rate will increase in the short run and explain that aggregate demand will decrease, which will decrease real output.	**1 point**
(d)	State that the government's efforts to maintain a balanced budget made Geeland's recession more severe in the short run and explain that in order to maintain a balanced budget, the government had to implement contractionary fiscal policy during a recession. (It is also acceptable to explain that the government's efforts to maintain a balanced budget will decrease real output or aggregate demand and that unemployment will increase.)	**1 point**
	Total for question 3	**5 points**