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.

i. Will the government budget in Barrikos move into surplus, move into deficit, or remain balanced? Explain.

ii. 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.

iii. 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. The economy of Country Zeta is in long-run equilibrium; however, the government is concerned about the size of the national debt.

(a) Identify one specific fiscal policy action the government could take to reduce the national debt.

(b) Draw a correctly labeled graph of the loanable funds market, and show the effect of the fiscal policy action identified in part (a) on the real interest rate.

(c) Based on the change in the real interest rate identified in part (b), what will happen to each of the following?

(i) Aggregate demand in the short run. Explain.
(ii) Potential real output. Explain.

Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.

STOP

END OF EXAM

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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

2. Country X and Country Y are trading partners, and both produce furnaces and solar panels. The countries can produce the following amounts using equal amounts of resources.

   Country X: 6 furnaces <u>or</u> 8 solar panels

   Country Y: 6 furnaces <u>or</u> 12 solar panels

   (a) Which country has an absolute advantage in producing solar panels?

   (b) Calculate the opportunity cost of a furnace in Country Y.

   (c) Which country has the comparative advantage in producing furnaces? Explain.

   (d) If the terms of trade were that 2 furnaces are exchanged for 1 solar panel, should Country X produce solar panels domestically or import solar panels from Country Y?

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3. Exchange rates and interest rates are important for macroeconomic decision making.

   (a) How does an increase in Japan's government budget deficit affect each of the following?

      (i) The real interest rate in the short run in Japan. Explain.

      (ii) Private domestic investment in plant and equipment in Japan

   (b) Draw a correctly labeled graph of the foreign exchange market for the euro, and show the effect of the change in the real interest rate in Japan from part (a)(i) on each of the following.

      (i) Supply of euros. Explain.

      (ii) Yen price of the euro

   (c) To reverse the change in the yen price of the euro identified in part (b)(ii), should the European Central Bank buy or sell euros in the foreign exchange market?

STOP

END OF EXAM