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 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. 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

2. The economy of Noralandia is in short-run equilibrium with an actual inflation rate that is currently higher than the expected inflation rate.

   (a) Draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium point as X.

   (b) The banking system in Noralandia has ample reserves. Identify a specific monetary policy action that the central bank of Noralandia would take to bring the inflation rate closer to the expected inflation rate.

   (c) Noralandia has an open economy and a flexible exchange rate. Based solely on the effect of the monetary policy action identified in part (b) on interest rates in Noralandia, will there be an increase, a decrease, or no change in the flow of international financial capital into Noralandia? Explain.

   (d) Based on your answer to part (c), what will happen to the international value of Noralandia's currency? 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. Italy and Japan are trading partners and have flexible exchange rates. The Italian currency is the euro and the Japanese currency is the yen.

   (a) Suppose that the exchange rate between the euro and the yen is 1 euro = 100 yen. What is the price of an Italian coat in yen if the coat costs 120 euros in Italy?

   (b) Assume that real interest rates increase in Japan. Identify what will happen to net financial capital flows between Italy and Japan.

   (c) Draw a correctly labeled graph of the foreign exchange market for the yen and show the effect of the increase in real interest rates in Japan on the value of the yen.

   (d) Based solely on the change in the exchange rate identified in part (c), what will happen to Italy's exports to Japan? 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.

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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.

2. Assume the expected inflation rate in a country is 3%, the current unemployment rate is 6%, and the natural rate of unemployment is 4%.
   (a) Draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium as point X and plot the numerical values above on the graph.
   (b) Is the actual inflation rate greater than, less than, or equal to the expected inflation rate of 3%?
   (c) Assume loans were made taking into account the expected inflation rate of 3%. Will lenders be better off or worse off after they realize the actual inflation rate identified in part (b) ? Explain.
   (d) Based on the relationship between the actual and the expected inflation rates identified in part (a), what will happen to the natural rate of unemployment in the long run?

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3. Assume that households in Econland increase their savings for retirement.
   (a) Using a correctly labeled graph of the loanable funds market, show how the increase in savings will affect the equilibrium real interest rate.
   (b) Based solely on the real interest rate change identified in part (a), what will happen to Econland's purchases of foreign assets? Explain.
   (c) Consider the foreign exchange market for Econland's currency.
      (i) Based on your answer to part (b), what will happen to the international value of Econland's currency?
      (ii) Based on your answer to part c (i), would Econland's central bank buy or sell its currency in the foreign exchange market to offset the change in the value of its currency?

STOP

END OF EXAM

2. The European Union and the United States are trading partners.

   (a) If the current account balance is zero, will an increase in United States real income result in a current account surplus, deficit, or no change? Explain.

   (b) Draw a correctly labeled graph of the foreign exchange market for the euro. On your graph, show the effect of the increase in United States real income on the value of the euro relative to the United States dollar.

   (c) Now assume interest rates increase in the European Union.

      (i) What is the effect of the increase in interest rates in the European Union on the demand for the United States dollar? Explain.

      (ii) Based on your answer to part (c)(i), what is the effect on the value of the United States dollar relative to the euro?
