Section II

Free-Response Questions

MACROECONOMICS

Section II

Planning Time—10 minutes

Writing Time—50 minutes

Directions: You 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. The country of Freedonia introduces an attractive tax concession for foreign investors. As a result, effective real returns in Freedonia rise compared with those in other countries.
   (a) Attracted by the tax concession, many United States investors decide to invest in Freedonia. Using a correctly labeled graph of the foreign exchange market for Freedonia's currency (the nia), show the impact on the demand for nias and the United States dollar price of the nia.
   (b) Given your answer in part (a), what would happen to Freedonia's exports and imports to and from the United States? Explain.
   (c) Draw a correctly labeled graph of aggregate demand and aggregate supply, and show the impact of your answer to part (b) on Freedonia's real output and price level.
   (d) Given your answer in part (c), what would happen to employment in Freedonia? Explain.
   (e) Draw a correctly labeled graph of the money market and show how your answer to part (c) would affect nominal interest rates in Freedonia?

2. Assume that the loanable funds market in Country X is currently in equilibrium.
   (a) Draw a correctly labeled graph of the loanable funds market for Country X, and label the equilibrium interest rate as r* and the quantity of funds as QF*.
   (b) Assume that the government of Country X, which had a balanced budget, now increases its spending while holding taxes constant. Assume that the government funds the increase in spending with increased borrowing.
      (i) What will be the impact of this policy action on the government's budget balance?
      (ii) On your graph in part (a), show the impact of this policy action on the interest rate and quantity of funds.
   (c) Given your answer in part (b) (ii), how will private-sector interest-sensitive expenditures be affected?
   (d) Given your answer in part (c), what will be the impact on the long-run growth rate of the economy? Explain.

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3. Assume that the economy of Hopeton is currently in long-run equilibrium, with a natural rate of unemployment equal to 5 percent and an inflation rate of 2 percent.

   (a) Draw a correctly labeled graph of the short-run Phillips curve, and label the curve as “SRPC.” Indicate the point on the SRPC corresponding to the current unemployment and inflation rates, labeled as “R.”

   (b) On your graph in part (a), draw the long-run Phillips curve, and label it as “LRPC.”

   (c) Assume that the government of Hopeton increases spending to finance repairs and maintenance of the country’s infrastructure. How will such an increase in spending affect unemployment and inflation in the short run? Explain.

   (d) Show on your graph in part (a) the new point on the SRPC corresponding to the results you stated in part (c), labeled as “S.”

   (e) Following the increase in government spending, workers demand and receive a higher wage. What happens to the SRPC as a result of the higher wage? Explain.

STOP

END OF EXAM