MACROECONOMICS

Section II

Planning Time—10 minutes

Writing Time—50 minutes

Directions: You have fifty 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.

1. Assume that the economy is operating below the full-employment level of output and that the government's budget is balanced.

   (a) Using a correctly labeled aggregate demand and aggregate supply graph, show how an increase in government spending will affect each of the following in the short run.

   (i) Real output

   (ii) Price level

   (b) Explain how this increase in government spending will affect each of the following in the short run.

   (i) Real interest rates

   (ii) Investment

   Now assume that instead of increasing government spending, the government decreases corporate-profits taxes.

   (c) Using a correctly labeled aggregate demand and aggregate supply graph, show and explain how this decrease in corporate-profits taxes will affect each of the following.

   (i) Aggregate demand

   (ii) Long-run aggregate supply

   (iii) Real output

   (iv) Price level

   (d) Assume that this country produces two goods, X and Y. Draw a correctly labeled production possibilities curve for this economy. Now show on the graph how this decrease in corporate-profits taxes will affect this economy's production possibilities curve.

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2. A movement toward a unified monetary policy within the European Union has led to an increase in real interest rates in member countries, but not in the United States. Explain how this increase in real interest rates will affect each of the following.

    (a) Purchases of United States financial assets by foreigners
    (b) The international value of the United States dollar
    (c) United States exports
    (d) United States imports

3. Janet Smith deposits $1,000 of her cash holdings in her checking account at First Federal Bank. The reserve requirement is 20 percent and the bank has no excess reserves.

    (a) What is the immediate effect of her deposit on the money supply? Explain why.
    (b) What is the maximum amount of money First Federal can initially loan out? Explain how you determined this amount.
    (c) What is the maximum amount of money the entire banking system can create? Explain how you determined this amount.
    (d) Give one reason why the money supply may not increase by the amount you identified in (c).

END OF EXAMINATION