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. (a) Using a correctly labeled aggregate supply and aggregate demand graph, show the impact of a sudden, large decrease in private investment spending on each of the following.

    (i) Output

    (ii) Price level

   (b) Using the results in part (a), explain how employment is affected.

   (c) Identify one specific fiscal policy that might be implemented to offset the effects of the decrease in investment, and explain how the policy would affect each of the following in the short run.

    (i) Aggregate demand

    (ii) Output and the price level

    (iii) Real interest rates

   (d) Identify an open-market operation that the central bank might implement to offset the effects of the decrease in investment, and explain how the policy would affect each of the following in the short run.

    (i) Real interest rates

    (ii) Aggregate demand

    (iii) Output and the price level

   (e) If the central bank continues the open-market operation described in (d), explain the long-run effects on each of the following.

    (i) Inflation

    (ii) Value of the domestic currency in foreign exchange markets

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2. The government replaces the income tax with a national sales tax that generates the same revenue. Assume throughout the question that the economy stays at full employment.

   (a) What is the effect of the change in tax policy on each of the following?

      (i) Consumption

      (ii) National saving

   (b) Using a correctly labeled graph of the loanable-funds market, explain how the change in tax policy will affect each of the following.

      (i) Real interest rate

      (ii) Investment

   (c) Explain how this change in policy will affect long-run economic growth.

3. Country X has a flexible exchange rate and international capital mobility. Political turmoil outside of Country X generates capital flow into Country X.

   (a) Using a correctly labeled foreign-exchange market graph, explain the impact of the capital inflow on the international value of the currency of Country X.

   (b) For Country X, explain the effect of the change in the international value of its currency on each of the following.

      (i) Exports

      (ii) Imports

END OF EXAMINATION