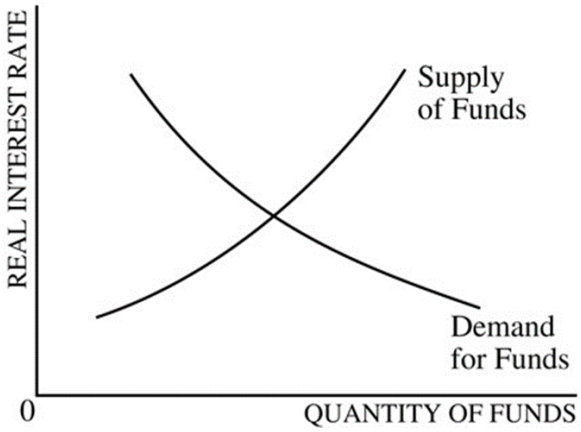
Macro Unit 4+5 Practice FRQs

FRQ #1



The graph above shows the loanable funds market for a country.

(a) Assume that the country's government increases deficit spending.
i. Explain what happens to the loanable funds market graph.

Ii. Explain how the increase in deficit spending will affect the real interest rate.

(b) Indicate how the real interest rate change you identified in part (a) will affect investment in plant and equipment.

(c) Explain how the real interest rate change you identified in part (a) will affect long-term economic growth.

FRQ #2

A country is at full employment and produces two types of goods: consumer goods and capital goods.

(a) Draw a correctly labeled graph of the production possibilities curve, with consumer goods on the horizontal axis and capital goods on the vertical axis. Indicate a point on your graph, labeled X that represents full employment and a possible combination in which both goods are being produced.

(b) Assume there is an increase in the country's national savings. Draw a correctly labeled graph of the loanable funds market, showing the change in the real interest rate from the increase in savings.

(c) On the same graph from part (a), show another point, labeled Z that represents full employment and a new combination of consumer goods and capital goods consistent with the increase in the country's national savings.

(d) Referring to your answer to part (c), will the long-run aggregate supply curve shift to the right, shift to the left, or remain the same? Explain.

FRQ #3

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.

FRQ #4

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.

FRQ #5

Assume that a country's economy is currently in recession.

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

(b) Assume banks in the country hold no excess reserves and the public's holding of currency is constant. The required reserve ratio is 25%. The central bank of the country buys $100 billion in bonds from the nonbank public.
   i. By how much will the monetary base of the country change?
   ii. Calculate the change in the amount of loans in the banking system in the country. Show your work.
   iii. Calculate the change in the money supply in the country. Show your work.

(c) Draw a correctly labeled graph of the money market and show the effect of the change in the money supply identified in part (b)(iii) on the nominal interest rate.

(d) Assume there is no change in inflationary expectations. On your graph in part (a), label point W that is consistent with the effect of the change in the nominal interest rate identified in part (c).

FRQ #6

The loanable funds market in Country Z is in equilibrium.

(a) Draw a correctly labeled graph of the loanable funds market showing the equilibrium real interest rate and the equilibrium quantity of loanable funds.

(b) Assume household savings in Country Z increases.
   i. Will this cause a shortage or a surplus in the loanable funds market at the current equilibrium real interest rate?
   ii. On your graph in part (a), show the effect of the increase in household savings on the equilibrium real interest rate.

(c) Based on your answer to part (b)(ii), will lenders be better off or worse off?

(d) Based on your answer to part (b)(ii), what will happen to investment spending in Country Z? Explain.

FRQ #7

Country Y is experiencing severe and unanticipated inflation.

(a) Explain the effect of this inflation on each of the following.
   i. A family with savings in a fixed-interest-rate time deposit account
   ii. A business repaying a long-term, fixed-interest-rate loan

(b) Identify one fiscal policy action that could be implemented to reduce inflation.
   i. Identify an open-market operation that could be implemented to reduce inflation.

(c) Suppose that Country Y continues to experience high inflation in the long run. Indicate the effect of this inflation on the nominal interest rate in Country Y.

FRQ #8

Assume that the current unemployment rate in Country A is lower than the natural rate of unemployment.

(a) Draw a single correctly labeled graph with both the long-run Phillips curve and the short-run Phillips curve. Label the current short-run equilibrium point Z.

(b) Identify a specific fiscal policy action that would bring the economy to full employment.

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

(d) Now assume instead that there is no fiscal policy action. Will the short-run Phillips curve shift to the right, shift to the left, or remain the same over time? Explain.

FRQ #9

Over the past two years, the unemployment rate in Country X has risen from 5 percent to 9 percent. As the leader of Country X, you have been presented with two policy options to address the unemployment problem.

-Policy 1: Use tariffs and quotas to restrict imports and thus protect jobs in Country X

-Policy 2: Use monetary and fiscal policies to solve the unemployment problem without resorting to trade restrictions

(a) Explain two disadvantages of selecting Policy 1.

(b) Describe one specific monetary policy action and one specific fiscal policy action you would take to reduce unemployment. Explain how each of these actions would affect each of the following in the short run.
   i. Aggregate demand
   ii. Output and the price level
   iii. Real interest rates

(c) If the interest rate effects you identified in part (b) (iii) continue in the long run, explain the impact of these effects on economic growth.