



AP[®] Macroeconomics 2003 Sample Student Responses

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Write in the box the number of the question you are answering on this page as it is designated in the examination.

- a) (i) A family with savings in a fixed-interest-rate time deposit account would be hurt by severe inflation. The interest earned on the savings, while remaining nominally the same, in real terms decreases as inflation increases. In fact, if the rate of inflation exceeds the interest on the account, the family loses real value of assets.
- (ii) A business repaying a long-term, fixed-interest-rate loan is helped by this inflation, as the value of the money they must pay is decreased by the fact that money is worth less. If the rate of inflation exceeds the interest rate, the business must pay back money worth less than that which they borrowed.
- b) The government could decrease spending in the public sector to attempt to reduce the inflation.
- c) The Central Bank of Country Y would be able to sell bonds, decreasing the money supply, in an attempt to control inflation.
- d) The nominal interest rate in Country Y would be forced upwards in order to keep real interest rates the same, because inflation decreases the value of dollars paid back from a loan.
- e) If Country Y's inflation rate is high relative to that of other countries, the value of the currency would depreciate on international markets. As more and more of the currency is needed for transactions because inflation causes those transactions to ~~require~~^{use} more currency, the supply of the currency for sale on international markets increases, causing value to decrease.

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a. i. As a result of severe unanticipated inflation a family with a fixed-interest-rate time deposit account will not benefit. During times of inflation the relative cost of living will rise, as will interest rates. Since the family is locked in at a specific rate their money will ultimately be worth less relative to price levels.

ii. A business repaying a fixed-interest-rate loan will benefit from severe unanticipated inflation, as the inflation rate will likely outpace the interest rate that they are paying. Since their rate is fixed they will benefit as it becomes ~~relatively~~ less expensive for them to repay their loan.

b. To combat inflation the government could take the fiscal policy action of raising taxes. This contractionary fiscal policy will slow the rate of inflation and help to bring the economy back to normal levels.

c. The Federal Reserve could sell bonds on the open market, thus decreasing the money supply, slowing the economy and reducing inflation.

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2

d. Should Country Y experience high inflation in the long run nominal interest rates in country Y would return to an equilibrium level as price increases would match the inflation rate.

e. The high inflation in country Y will cause higher interest rates in that country. The value of country Y's currency will appreciate relative to that of other countries, as the demand for country Y's currency will increase with the higher interest rates.