AP® Macroeconomics
2005 Free-Response Questions

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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. Use a pen with black or dark blue ink.

1. Assume that the United States economy is currently in equilibrium at the full-employment level of real gross domestic product.

   (a) Draw a correctly labeled graph of aggregate demand and aggregate supply showing each of the following in the United States.

      (i) Output level

      (ii) Price level

   (b) Japan is a major importer of United States products. Assume that the Japanese economy goes into a recession.

      (i) Explain the impact of the Japanese recession on the United States equilibrium output and price levels.

      (ii) Show these effects on your graph in part (a).

   (c) Assume that the Federal Reserve takes action to curb the effects of the Japanese recession on the United States economy.

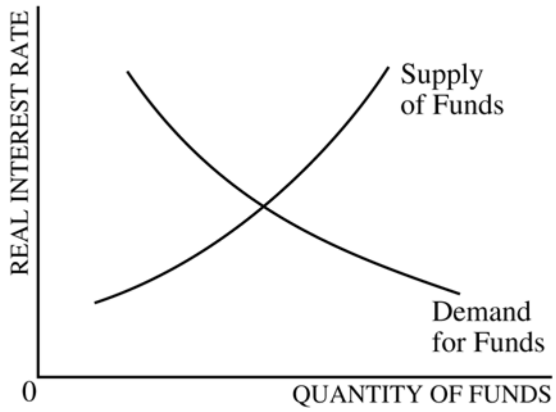
      (i) What open-market operation would the Federal Reserve undertake?

      (ii) Use a correctly labeled graph of the money market to show how the Federal Reserve policy action will affect the nominal interest rate.

      (iii) Explain how the change in the nominal interest rate in part (c) (ii) will affect aggregate demand, price level, and real output in the United States.

   (d) Define the real interest rate.

   (e) Indicate the effect of the open-market operation you identified in part (c) (i) on the real interest rate in the United States.



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

   (a) Assume that now the country's government increases deficit spending. 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.

   (d) Explain how the real interest rate change you identified in part (a) will affect each of the following in the foreign exchange market.

      (i) The demand for the country's currency

      (ii) The value of the country's currency

3. Assume that the table below shows the unemployment and inflation data in Country X as a result of a shift in aggregate demand.

Period	Unemployment Rate	Inflation Rate
Last year	2%	8%
This year	5%	4%

(a) Draw a correctly labeled graph of a short-run Phillips curve for Country X, showing the actual unemployment and inflation rates for both years. Label the Phillips curve as SRPC.

(b) Now assume that the short-run aggregate supply curve has shifted to the left.

(i) Identify one factor that could cause the aggregate supply curve to shift to the left.

(ii) On the graph, show how this shift would affect the short-run Phillips curve.

(c) Assume that the natural rate of unemployment in Country X is 5 percent. Draw a correctly labeled graph of the long-run Phillips curve and label it as LRPC.

(d) What is the relationship between the unemployment rate and the inflation rate in the long run?

END OF EXAM