2017

AP Macroeconomics

Free-Response Questions

MACROECONOMICS
Section II
Total Time—60 minutes
Reading Period—10 minutes
Writing Period—50 minutes

Directions: You are advised to spend the first 10 minutes reading all of the questions and planning your answers. You will then have 50 minutes to answer all three of the following questions. You may begin writing your responses before the reading period is over. <u>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</u>. 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. <u>Use a pen with black or dark blue ink</u>.

1. Assume that the economy of Country X has an actual unemployment rate of 7%, a natural rate of unemployment of 5%, and an inflation rate of 3%.

   (a) Using the numerical values given above, draw a correctly labeled graph of the short-run and long-run Phillips curves. Label the current short-run equilibrium as point B. Plot the numerical values above on the graph.

   (b) Assume that the government of Country X takes no policy action to reduce unemployment. In the long run, will each of the following shift to the right, shift to the left, or remain the same?

      (i) Short-run aggregate supply curve. Explain.

      (ii) Long-run Phillips curve

   (c) Identify a fiscal policy action that could be used to reduce the unemployment rate in the short run.

   (d) Draw a correctly labeled graph of aggregate demand and short-run aggregate supply, and show the impact on the equilibrium price level and real gross domestic product (GDP) of the fiscal policy action identified in part (c).

   (e) Based on the change in real GDP identified in part (d), will the supply of Country X's currency in the foreign exchange market increase, decrease, or remain the same? Explain.

   (f) Based on your answer to part (e) and assuming a flexible exchange rate system, will Country X's currency appreciate, depreciate, or remain the same in the foreign exchange market?

2. Assume that an economy is in long-run equilibrium. Assume that consumers wish to hold less money because they use credit cards more frequently to purchase goods and services than cash.

   (a) Draw a correctly labeled graph of the money market and show the effect of the reduced holdings of money on the equilibrium nominal interest rate in the short run.

   (b) Based on the change in the interest rate in part (a), what will happen to each of the following in the short run?

   (i) Prices of previously issued bonds

   (ii) The price level and real income. Explain.

   (c) With a constant money supply, based on your answer to part b(ii), will the velocity of money increase, decrease, or remain the same, or is the change indeterminate?

   (d) If the central bank wishes to reverse the change in the interest rate identified in part (a), what open market operation would it use?

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3. 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.

STOP

END OF EXAM