FRQ 4

1. Following an increase in the demand for money, an open economy is experiencing a significant increase in real interest rates relative to the rest of the world.

A. Explain how this increase in interest rates will affect each of the following for the country.
   i. Investment
   ii. The international value of its currency
   iii. Exports

B. Using a correctly labeled aggregate demand and aggregate supply diagram, show how the change in investment you identified in part (a) will affect each of the following in the short run.
   i. Output
   ii. The price level

C. Identify one fiscal policy action that could counter the effects identified in part (B). Explain how this policy will affect each of the following.
   i. Output
   ii. The price level
   iii. Nominal interest rates
   iv. The price of bonds.

D. Identify one monetary policy action that could counter effects identified in part (B). Using a correctly labeled money market graph, show how this policy will affect nominal interest rates.

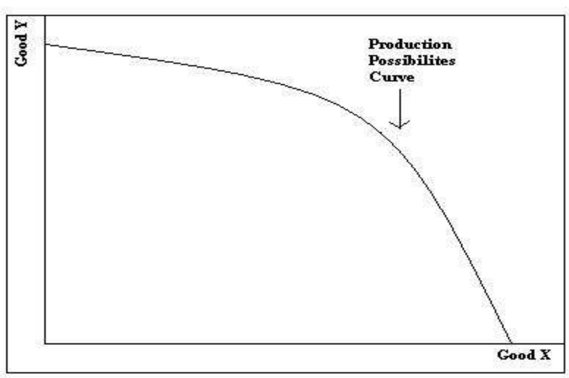
2. Assume an open economy with a public sector.

• Identify two methods of calculating gross domestic product for this economy.
• Explain why the two methods you identified in part (A) must yield the same value of gross domestic product.
• Identify one shortcoming of using gross domestic product as an indicator of the actual level of national output.
• If nominal gross domestic product increased by 4 percent in 1996, identify two additional pieces of information you need before you can conclude that the living standard of the typical person increased by 4 percent during that year.

3. Assume that an economy is at full employment.

A. Explain how an increase in net investment will affect each of the following.
   i. Aggregate demand
   ii. Capital stock
   iii. Long-run aggregate supple
   iv. Output

B. Explain how the increase in net investment will affect the country's production possibilities curve shown below.



When dealing with international currency markets, treat them like a normal supply and demand graph: there won't be bends like in an AS line. Other than that, interest rates are the price of money. Remember that. In the money market graph, the supply line is always vertical. Remember that, too.