FRQ 5

1. Suppose that the United States economy is in a deep recession.

a. Using a correctly labeled aggregate demand and aggregate supply graph, show the equilibrium price level and real gross domestic product.

b. There is a debate in Congress as to whether to decrease personal income taxes by a given amount or to increase government purchases by this amount. Which of these two fiscal policies will have a larger impact on real gross domestic product? Explain.

c. Explain how a decrease in personal income taxes will affect each of the following in the short run.

i. Consumption

ii. Real gross domestic product and the price level

iii. Imports

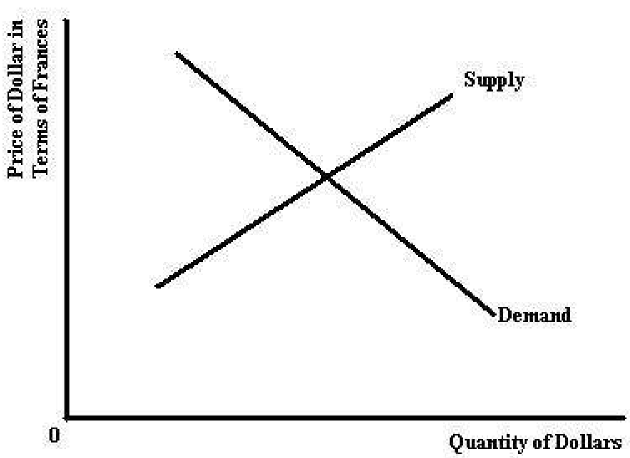
iv. Exports

d. Explain the mechanism by which an increase in net investment will cause each of the following to change.

i. Aggregate demand

ii. Long-run aggregate supply

2. Assume that the United States and France are the only two countries in the world that exchange rates between the two countries are flexible.



a. Assume that there is an increase in the real interest rates in the United States, but not in France. Explain how this increase in interest rates will affect each of the following.

i. The supply of dollars

ii. The international value of the dollar

b. Assume that there is an increase in real interest rates in the United States, but not in France. Explain how this increase in interest rates will affect each of the following.

i. The international value of the dollar in the foreign exchange market

ii. The quantity of dollars supplied in the foreign exchange market

3. Assume an economy with no international sector.

a. Using a correctly labeled money-market graph, show how a decrease in the money supply will affect interest rates.

b. Explain how the change in the interest rate you identified in a part (a) will directly affect each of the three components of aggregate demand for this closed economy.

c. Using a correctly labeled aggregate demand and aggregate supply graph, show how the change in the interest rate you identified in part (a) will affect each of the following in the short run.

i. Output

ii. Price level