FRQ 6

1. Assume that the economy is operating below the full-employment level of output and that the government's budget is balanced.

a. Using a correctly labeled aggregate demand and aggregate supply graph, show how an increase in government spending will affect each of the following in the short run.
i. Real output
ii. Price level

b. Explain how this increase in government spending will affect each of the following in the short run.
i. Real interest rates
ii. Investment

Now assume that instead of increasing government spending, the government decreases corporate-profits taxes.

c. Using a correctly labeled aggregate demand and aggregate supply graph, show and explain how this decrease in corporate-profits taxes will affect each of the following.
i. Aggregate demand
ii. Long-run aggregate supply
iii. Real output
iv. Price level

d. Assume that this country produces two goods, X and Y. Draw a correctly labeled production possibilities curve for this economy. Now show on the graph how this decrease in corporate-profits taxes will affect this economy's production possibilities curve.

2. A movement toward a unified monetary policy within the European Union has led to an increase in real interest rates in member countries, but not in the United States. Explain how this increase in real interest rates will affect each of the following.
a. Purchases of Unites States Financial assets by foreigners
b. The international value of the United States dollar
c. United States exports
d. United States imports

3. Janet Smith deposits $1,000 of her cash holdings in her checking account at First Federal Bank. The reserve requirement is 20 percent and the bank has no excess reserves.
a. What is the immediate effect of her deposit on the money supply? Explain why.
b. What is the maximum amount of money First Federal can initially loan out? Explain how you determined this amount.
c. What is the maximum amount of money the entire banking system can create? Explain how you determined this amount.
d. Give one reason why the money supply may not increase by the amount you identified in (c).