FRQ 10

1. Assume that a country's economy is operating below full employment and has a balanced trade, and that the government is running a budget deficit.

(a) Draw a correctly labeled aggregate demand and aggregate supply graph and show the economy's current output and price level.

(b) Suppose that the country's government increases spending to achieve full-employment output. On your graph in part (a), show the short-run effect that the increased deficit spending would have on each of the following.

(i) Aggregate demand
(ii) Output
(iii) Price level

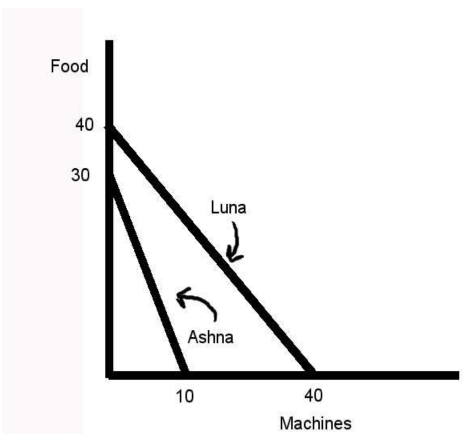
(c) Using a correctly labeled loanable-funds market graph, show the effect of the increase in deficit spending on the real interest rate.

(d) Given your answer in part (c), explain how the international value of the country's currency will be affected.

(e) Based on you answer in part (d), respond to each of the following.

(i) Explain the effects on the country's exports and imports.
(ii) Identify the effect on the country's trade balance.

(f) Given the results in the loanable-funds market discussed in part (c), explain how this government deficit spending would influence long-run growth.



2. Using equal amounts of resources, the countries of Ashna and Luna can each produce any combination of food and machines described by their production possibilities curves above.

(a) Which country has an absolute advantage in the production of machines? Explain.
(b) Which country has an absolute advantage in the production of food? Explain.
(c) Which country has a comparative advantage in the production of machines? Explain.
(d) With trade between these two countries, which country will import food? Explain.
(e) Give an example of terms of trade acceptable to both countries.

3. (a) Draw a correctly labeled graph showing the short-run and long-run Phillips curves for Country X.

(b) Identify how each of the following affects inflation, unemployment, and the short-run Phillips curve.

(i) An increase in government spending
(ii) A drop in inflationary expectations

(c) Identify the effect of increased unemployment-insurance benefits on the long-run Phillips curve.