FRQ 2

1. Assume the US is operating normally: inflation is at 3% annually and unemployment is at 5%.

(a) Using a correctly labeled AS/AD graph, show the following:

(i) Full-employment output

(ii) Current output

(iii) Current price level

(b) If a hurricane struck the United States Gulf Coast and disrupted a major portion of the oil industry, explain what effect would that have on aggregate supply.

(c) Using a correctly labeled AS/AD graph, show how the change in aggregate supply you identified in part (b) affects the price level and output level in the short run.

(d) Are there any fiscal policies that the government could employ to reduce the overall price level in the short run? Explain your answer.

2. Assume the US is operating normally: inflation is at 3% annually and unemployment is at 5%.

(a) Draw a production-possibilities curve representing the US economy.

(b) If the US economy is favoring consumption production over capital goods production, label a point on the graph from part (a) and explain how it satisfies the criteria given.

(c) If a major hurricane destroys a significant percentage of US oil production and refining, draw a new PPC showing the effect that would have on the US economy.

(d) Would the situation described in (c) have a greater effect on consumption production or capital goods production? Explain.

3. Assume the US economy is operating normally: inflation is at 3% annually and unemployment is at 5%. Then the hurricane hits, like we mentioned. China raises its interest rates and strengthens its currency so gas is cheaper there.

(a) What effect will this have on US exports to China?

(b) What effect will this have on US imports to China?

(c) What effect will this have on interest rates in the US?

(d) How will the interest rate change you identified in (c) affect aggregate demand in the US? Explain.

(e) If AD and AS both decrease, draw an AS/AD graph showing the resultant short-run mess.

When inflation is within 3-5% and unemployment within 4-6%, the economy is normal: AD will intersect AS in the curved, or classical, section of the line. When unemployment is at 4-5%, consider the economy to be at full-employment output.

When the price level increases, inflation increases. When quantity produced decreases, unemployment increases.

When inflation increases, nominal interest rates also increase, but real interest rates remain constant. The exception to this is in an ***unanticipated*** *increase in inflation. In that case, real interest rates decline, as inflation erodes the gap between the nominal interest rate faster than the nominal interest rate can be adjusted.*