FRQ 11

1. Assume that the United States economy is in a severe recession with no inflation.

(a) Using a correctly labeled aggregate demand and aggregate supply graph, show each of the following for the economy.

(i) Full-employment output

(ii) Current output level

(iii) Current price level

(b) The federal government announces a major decrease in spending. Using your graph in part (a), show how the decrease in spending will affect each of the following.

(i) Level of output

(ii) Price level

(c) Explain the mechanism by which the decrease in government spending will affect the unemployment rate.

(d) The Federal Reserve purchases bonds through its open-market operations.

(i) Using a correctly labeled graph, show the effect of this purchase on the interest rate.

(ii) Explain how the change in the interest rate will affect output and the price level.

(e) Explain how the change in the interest rate you identified in pard (d) will affect each of the following.

(i) International value of the dollar relative to other currencies

(ii) United States exports

(iii) United States imports

2. Country Y is experiencing severe and unanticipated inflation.

(a) Explain the effect of this inflation on each of the following.

(i) A family with savings in a fixed-interest-rate time deposit account

(ii) A business repaying a long-term, fixed-interest-rate loan.

(b) Identify one fiscal policy action that could be implemented to reduce inflation.

(c) Identify an open-market operation that could be implemented to reduce inflation.

(d) Suppose that Country Y continues to experience high inflation in the long run. Indicate the effect of this inflation on the nominal interest rate in Country Y.

(e) If Country Y's inflation is high relative to that of other countries, explain the effect of this inflation on the international value of Country Y's currency.

3. Assume that two countries, Atlantis and Xanadu, have equal amounts of resources. Atlantis can produce 30 cars or 10 tractors. Xanadu can produce 20 cars or 40 tractors. Both nations have linear production-possibility curves defining the combinations of production between those two extremes.

(z) Construct a production-possibility graph showing Atlantis' and Xanadu's production-possibility curves for car and tractor production.

(a) Which country has an absolute advantage in the production of tractors? Explain how you determined your answer.

(b) Which country has a comparative advantage in the production of cars? Using the concept of opportunity cost, explain how you determined your answer.

(c) If the two countries specialize and trade with each other, which country will import cars? Explain why.

(d) If the terms of trade are such that one car can be exchanged for one tractor, explain how Atlantis will benefit from such trade.