

1. Assume the United States economy is in short-run macroeconomic equilibrium at an output level greater than potential output.
 - (b) Assume government spending increases by \$100 billion. On your graph in part (a), show the short-run effect of the change in government spending on the equilibrium real output and price level. Label the new equilibrium output as Y_2 and the new equilibrium price level as PL_2 .
 - (c) Assume the marginal propensity to consume is 0.8. As a result of the increase in government spending, what is the numerical value of the maximum change in each of the following in the short run?
 - (i) Real output
 - (ii) Household savings
 - (e) Based on the change in the nominal interest rate shown in part (d), what will happen to the prices of previously issued bonds in the short run?
 - (f) The United States and the European Union are trading partners with flexible exchange rates. The currency in the United States is the dollar, and the currency in the European Union is the euro. Assume the inflation rate in the United States increases relative to the inflation rate in the European Union. As a result of the change in the United States inflation rate, what will happen to each of the following in the foreign exchange market?
 - (i) The demand for dollars. Explain.
 - (ii) The international value of the dollar
 - (g) Suppose the Federal Reserve attempts to keep the value of the dollar constant in the foreign exchange market. Based on the change in the value of the dollar in part (f)(ii), should the Federal Reserve buy or sell each of the following?
 - (i) The euro
 - (ii) The dollar

Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.