1. Assume the economy of Sweden is in long-run equilibrium and has a surplus in its current account.

   (a) Is the Swedish capital and financial account in deficit, in surplus, or in balance? Explain.

   (b) Draw a correctly labeled graph of short-run aggregate supply, long-run aggregate supply, and aggregate demand curves for Sweden, and show the current equilibrium real output, labeled Y_1, and the current equilibrium price level, labeled PL_1.

   (c) Assume the United Kingdom decreases its imports from Sweden. On your graph in part (b), show the new equilibrium real output, labeled Y_2, and the new equilibrium price level, labeled PL_2, as a result of this change.

   (d) As a result of the decrease in the United Kingdom's imports from Sweden, would policy makers in Sweden be more concerned about cyclical unemployment or inflationary pressures in the short run? Explain.

   (e) If the Swedish central bank's goal is to return the economy to long-run equilibrium, what open-market operation should it use?

   (f) The currency of the United Kingdom is the pound, and the currency of Sweden is the krona. Draw a correctly labeled graph of the foreign exchange market for the krona, and show the impact of the decrease in the United Kingdom's imports from Sweden on the value of the krona in the foreign exchange market.

   (g) If the Swedish central bank's goal is to reverse the exchange rate change shown in part (f) by changing the interest rate, what open-market operation should it use?

   (h) Explain how the open-market operation identified in part (g) would reverse the change in the exchange rate.

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.

2. Assume a country's economy is currently operating below full employment.

(a) Identify a fiscal policy action the country's government could implement to restore full employment.

(b) Draw a correctly labeled graph of the loanable funds market, and show the effect of the fiscal policy action identified in part (a) on the equilibrium real interest rate.

(c) Based solely on the real interest rate change shown in part (b), what will happen to each of the following?

(i) Net exports. Explain.
(ii) The stock of physical capital. Explain.

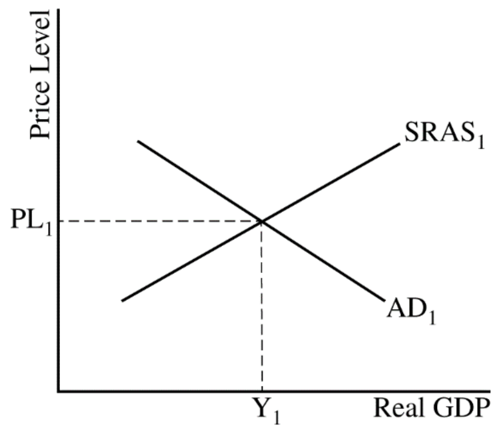
Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.

GO ON TO THE NEXT PAGE.

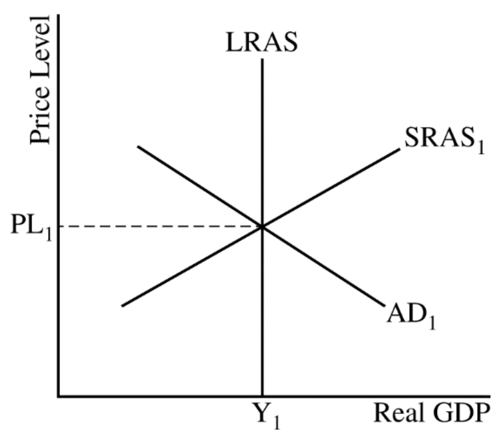
Question 1: Long — 10 points

(a) State that the Swedish capital and financial account is in deficit and explain that the current account is in surplus and the sum of the current account and the capital and financial account must equal zero (CA + CFA = 0). **1 point**

(b) Draw a correctly labeled aggregate demand–aggregate supply graph that shows PL_1 and Y_1 at the intersection of AD and SRAS. **1 point**

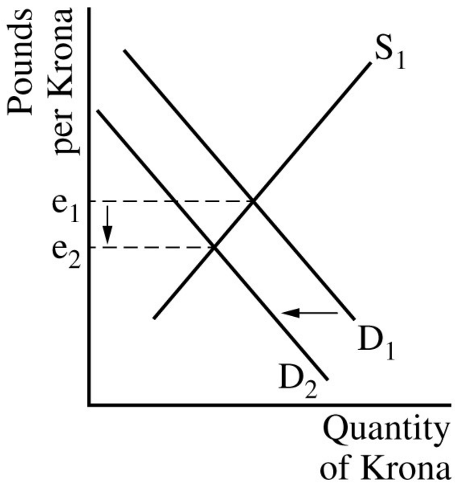


For the second point, the graph must show a vertical LRAS curve at equilibrium real output Y_1. **1 point**



Total for part (b) — **2 points**

	For the second point, the graph must show a leftward shift of the demand curve for the krona, resulting in a decrease in the value of the krona.	**1 point**



	Total for part (f)	**2 points**
(g)	State that Sweden's central bank should sell bonds.	**1 point**
(h)	Explain that selling bonds would decrease the money supply and increase interest rates in Sweden, which would increase financial capital inflows into Sweden and increase the demand for the krona, thereby leading to an appreciation of the krona.	**1 point**
	Total for question 1	**10 points**