3. The economy of Country Zeta is in long-run equilibrium; however, the government is concerned about the size of the national debt.

   (a) Identify one specific fiscal policy action the government could take to reduce the national debt.

   (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 real interest rate.

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

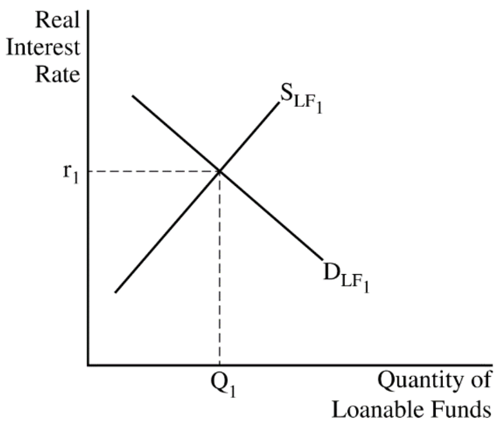
      (i) Aggregate demand in the short run. Explain.
      (ii) Potential real output. Explain.

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.

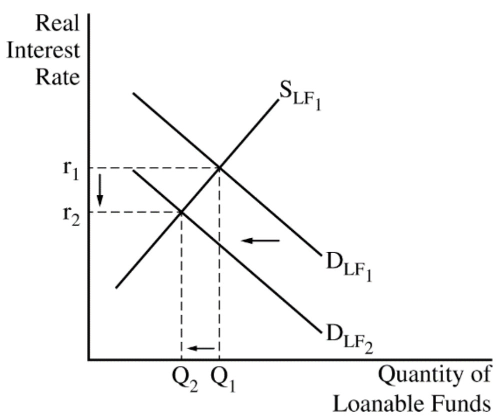
Question 3: Short — 5 points

(a) State increase taxes, decrease government spending, or decrease transfer payments. **1 point**

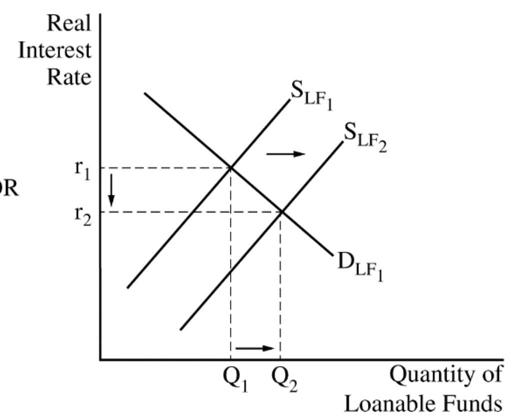
(b) Draw a correctly labeled graph of the loanable funds market. **1 point**



For the second point, the graph must show a leftward shift of the demand for loanable funds curve (or a rightward shift of the supply of loanable funds curve), resulting in a decrease in the real interest rate. **1 point**



OR



Total for part (b) 2 points

(c) (i) State that aggregate demand will increase and explain that interest-sensitive spending (consumption, investment, or net exports) will increase. **1 point**

(ii) State that potential real output will increase and explain that the decrease in the real interest rate means the cost of borrowing has decreased, which increases investment spending on plant and equipment and increases capital formation. **1 point**

Total for part (c) 2 points

Total for question 3 5 points