3. Assume that Nepal is in long-run macroeconomic equilibrium and has an open economy.

A. Draw a correctly labeled graph of the aggregate demand, short-run aggregate supply, and long-run aggregate supply curves for Nepal, and show each of the following.

i. The current equilibrium real output and price level, labeled Y_1 and PL_1, respectively

ii. The full-employment output, labeled Y_F

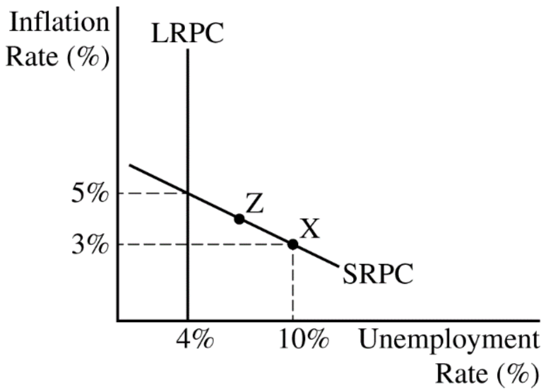
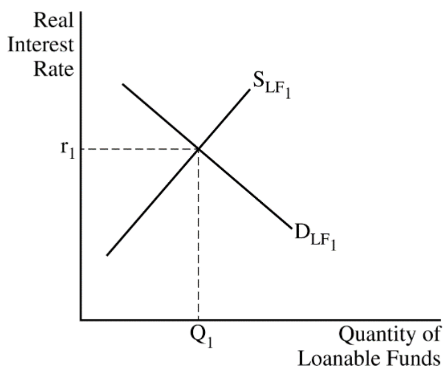
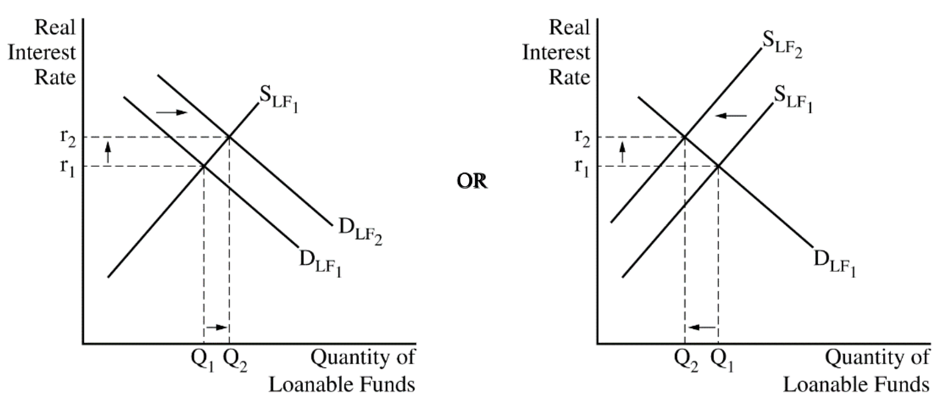
B. Nepal and Thailand are trading partners. Assume that Thailand experiences an increase in real income. On your graph in part A, show the short-run effect of the increase in real income in Thailand on real output and the price level in Nepal, labeling the new short-run equilibrium real output Y_2 and the new short-run equilibrium price level PL_2.

C. Assume that at the short-run equilibrium shown on your graph in part B, Nepal is experiencing a 400 million rupee output gap. Policymakers in Nepal want to use discretionary fiscal policy to return the economy to full employment, and the marginal propensity to consume is 0.75. Calculate the minimum change and state the direction of change in government spending required to completely close the output gap in the short run. Show your work.

D. Assume instead that no discretionary policy actions are taken. Explain how automatic stabilizers in the short run would reduce the effect of the change in real output shown on your graph in part B.

STOP

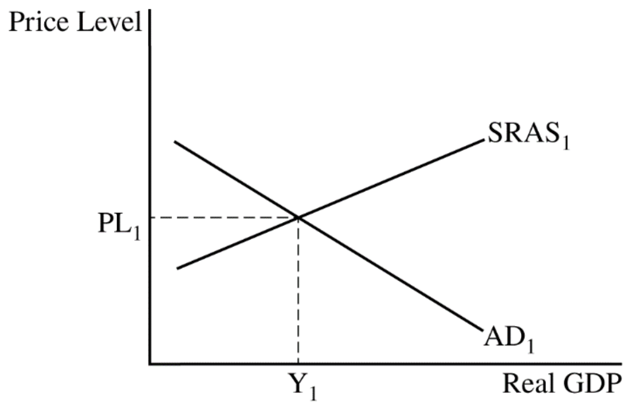
END OF EXAM

D Point 5	**(i)**	State that the government budget will move into deficit and explain that government outlays exceed revenue.	**1 point**
Point 6	**(ii)**	On the graph from part B, show a point labeled Z on the SRPC to the left of point X. 	**1 point**
Point 7	**(iii)**	Draw a correctly labeled graph of the loanable funds market. 	**1 point**
Point 8		The graph must show an increase in the demand for loanable funds (or a decrease in the supply of loanable funds), resulting in an increase in the equilibrium real interest rate. 	**1 point**
E Point 9		State that Barrikos' capital and financial account (CFA) will move into surplus and explain that international investors will seek higher returns on financial capital in Barrikos, which will increase financial capital inflows into Barrikos.	**1 point**

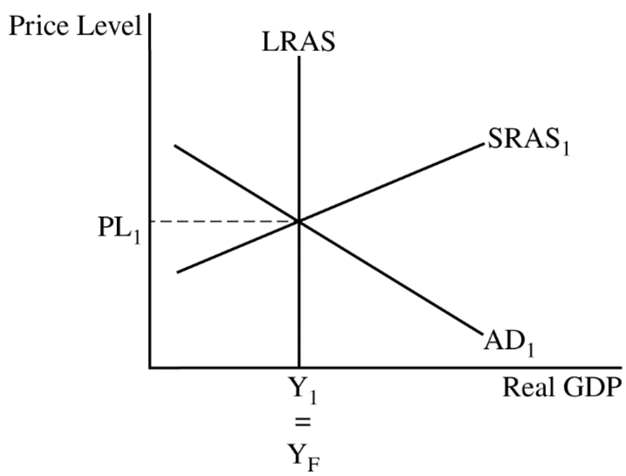
F Point 10	State that Barrikos' currency will appreciate and explain that demand for the currency will increase (or the supply of the currency will decrease).	**1 point**

Question 3: Short — 5 points

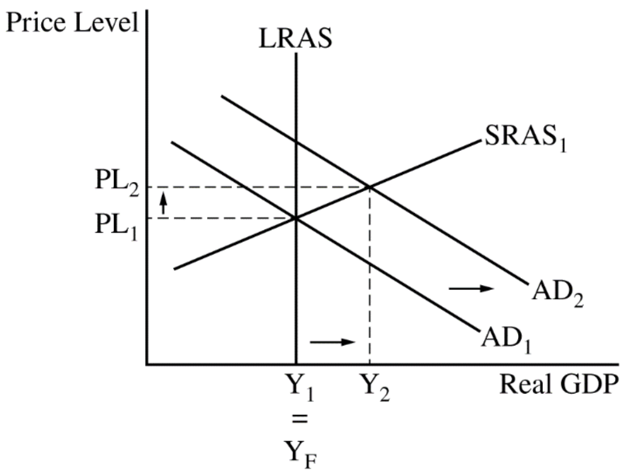
A Point 1	Draw a correctly labeled aggregate demand–aggregate supply graph that shows PL_1 and Y_1 at the intersection of the aggregate demand (AD) and short-run aggregate supply (SRAS) curves.	**1 point**



Point 2	The graph must show a vertical long-run aggregate supply (LRAS) curve at equilibrium real output $Y_1 = Y_F$.	**1 point**



B Point 3	On the graph from part A, show the short-run effect of the increase in real income in Thailand as a rightward shift of Nepal's aggregate demand curve, resulting in an increase in real output, labeled Y_2, and an increase in the price level, labeled PL_2.	**1 point**



C Point 4	Calculate the minimum change in government spending as a decrease of 100 million rupees and show your work.	**1 point**

$$\text{Min Change} = \frac{-400 \text{ million rupees}}{\frac{1}{(1-0.75)}} = \frac{-400 \text{ million rupees}}{4} = -100 \text{ million rupees}$$

D Point 5	Explain that as real income rises, tax revenues will increase automatically (and/or transfer payments will decrease automatically), thereby slowing the rate at which disposable income is increasing, which will slow consumption growth.	**1 point**