AP® Macroeconomics
2007 Free-Response Questions
Form B

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MACROECONOMICS

Section II

Planning Time—10 minutes

Writing Time—50 minutes

Directions: You have 50 minutes to answer all three of the following questions. It is suggested that you spend approximately half your time on the first question and divide the remaining time equally between the next two questions. In answering the questions, you should emphasize the line of reasoning that generated your results; it is not enough to list the results of your analysis. Include correctly labeled diagrams, if useful or required, in explaining your answers. A correctly labeled diagram must have all axes and curves clearly labeled and must show directional changes. Use a pen with black or dark blue ink.

1. Assume that Australia and New Zealand are trading partners. Australia's economy is currently in recession.

   (a) Now assume that Australia begins to recover from its recession. Using a correctly labeled graph of aggregate demand and aggregate supply for New Zealand, show the impact of Australia's rising income on each of the following in the short run.

   (i) Aggregate demand in New Zealand. Explain.

   (ii) Output in New Zealand

   (b) Using a correctly labeled graph of the money market for New Zealand, show the effect of the output change in part (a)(ii) on the following.

   (i) Demand for money. Explain.

   (ii) The nominal interest rate

   (c) Assume that the price level in New Zealand rises. Given your answer to part (b)(ii), explain what will happen to real interest rates.

   (d) Although recovering, Australia remains in recession and its government takes no action. Indicate whether each of the following curves will shift to the left, shift to the right, or remain unchanged in the long run in Australia.

   (i) Aggregate supply

   (ii) Aggregate demand

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2. (a) Assume that businesses are granted a tax credit on spending for machinery. Using a correctly labeled graph of the loanable funds market, show the effect of the business sector's response on the real interest rate.

   (b) Now assume instead that the tax rate on interest income from household savings is lowered and there is no change in government budget deficit. Using a second correctly labeled graph of the loanable funds market, show the effect of the households' response on the real interest rate.

   (c) Given your answer to part (b), explain what will happen to the country's production possibilities curve in the long run.

3. Assume that the real interest rate in both the United States and the European Union equals 4.5 percent.

   (a) Assume that the real interest rate in the United States falls to 3.75 percent.

      (i) How will the flow of financial capital between the United States and the European Union be affected? Explain.

      (ii) Using a correctly labeled graph of the foreign exchange market for the euro, show how the value of the euro would change relative to the United States dollar in a flexible exchange rate system.

   (b) Explain how the change in the value of the euro in part (a)(ii) would affect the European Union's net exports.

STOP

END OF EXAM