

14. Crowding out refers to the decrease in
- (A) national output caused by higher taxes
 - (B) domestic production caused by increased imports
 - (C) private investment due to increased borrowing by the government
 - (D) employment caused by higher inflation
 - (E) exports caused by an appreciating currency of a country

50. When an economy is at full employment, which of the following will most likely create demand-pull inflation in the short run?

- (A) An increase in the discount rate
- (B) An increase in personal income taxes
- (C) A decrease in the real rate of interest
- (D) A decrease in government spending
- (E) A decrease in the money supply

38. An increase in the government budget deficit is most likely to result in an increase in which of the following?

- (A) The marginal propensity to consume
- (B) Exports
- (C) The real interest rate
- (D) The money supply
- (E) The simple multiplier

Suppose that a national government increased deficit spending on goods and services, increasing its demand for loanable funds. In the long run, this policy would most likely result in which of the following changes in this country?

	<u>Real Interest Rate</u>	<u>Investment</u>
(A)	Decrease	Decrease
(B)	Decrease	Increase
(C)	Increase	Decrease
(D)	Increase	No change
(E)	No change	Increase

1. Assume the U.S. has a balanced budget. Using correctly labeled graph of the loanable funds market, show the effect of a \$100 billion increase in government spending on the real interest rate.
2. Assume that personal savings in the U.S. increase. Using a correctly labeled graph of the loanable funds market, show the impact of the increase in personal savings on the real interest rate.
3. Assume that as a result of increased political instability, investors move their funds out of the U.S. Using a correctly labeled graph of the loanable funds market in the U.S., show the impact of this decision by investors on the real interest rate.
4. Suppose Japan attracts an increased amount of investment from the E.U. Using a correctly labeled graph of the loanable funds market in Japan, show the effect of the increase in foreign investment on the real interest rate in Japan.
5. The U.S. government reduces the tax rate on household interest earnings. Draw a correctly labeled graph of the loanable funds market and show the effect of the change on the equilibrium real interest rate.

Let's Compare and Contrast the Money Market and Loanable Funds Graphs

1. Why is the supply of money vertical?
2. What shifts the supply of money?
3. Why is the supply of loanable funds upward sloping?
4. What shifts the supply of loanable funds?
5. Why is the demand of money downward sloping?
6. What shifts the demand of money?
7. Why is the demand of loanable funds downward sloping?
8. What shifts the demand of loanable funds?
9. What kind of interest rate is on the money market graph?
10. What kind of interest rate is on the loanable funds graph?

2010 FRQ #1

1. Assume that the United States economy is currently in long-run equilibrium.
 - (a) Draw a correctly labeled graph of aggregate demand and aggregate supply and show each of the following.
 - (i) The long-run aggregate supply curve
 - (ii) The current equilibrium output and price levels, labeled as Y_E and PL_E , respectively
 - (b) Assume that the government increases spending on national defense without raising taxes.
 - (i) On your graph in part (a), show how the government action affects aggregate demand.
 - (ii) How will this government action affect the unemployment rate in the short run? Explain.
 - (c) Assume that the economy adjusts to a new long-run equilibrium after the increase in government spending.
 - (i) How will the short-run aggregate supply curve in the new long-run equilibrium compare with that in the initial long-run equilibrium in part (a)? Explain.
 - (ii) On your graph in part (a), label the new long-run equilibrium price level as PL_2 .
 - (d) In order to finance the increase in government spending on national defense from part (b), the government borrows funds from the public. Using a correctly labeled graph of the loanable funds market, show the effect of the government's borrowing on the real interest rate.
 - (e) Given the change in the real interest rate in part (d), what is the impact on each of the following?
 - (i) Investment
 - (ii) Economic growth rate. Explain.

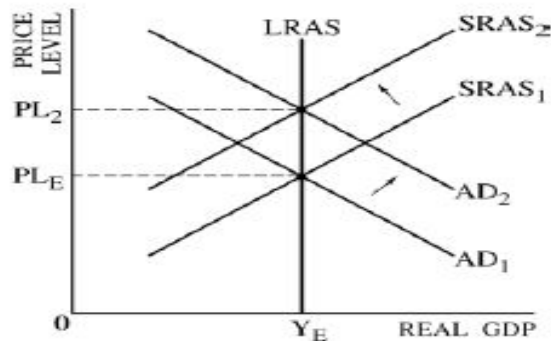
2007B Practice FRQ

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.

2010 FRQ #1 Rubric

Question 1

10 Points (2 + 2 + 2 + 2 + 2)



(a) 2 points:

- One point is earned for a correctly labeled graph with a downward-sloping AD curve, an upward-sloping SRAS curve, and the points PL_x and Y_x on the vertical and horizontal axes.
- One point is earned for showing a vertical LRAS curve at Y_x .

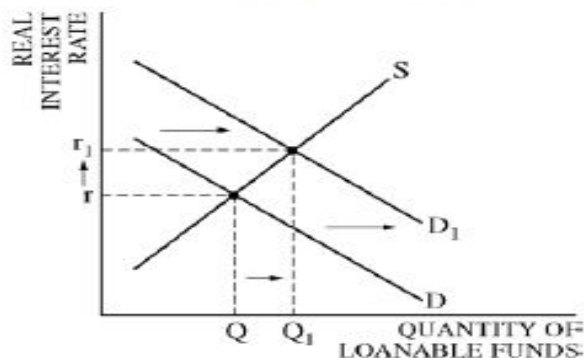
(b) 2 points:

- One point is earned for showing a rightward shift of the AD curve on the graph in part (a).
- One point is earned for stating that the unemployment rate would fall and explaining that this is because real output increases.

(c) 2 points:

- One point is earned for stating that the short-run aggregate supply curve will shift to the left and showing PL_2 correctly on the graph in part (a).
- One point is earned for explaining that the actual price level is higher than was expected or that wages and commodity prices adjust to the higher price level, causing the SRAS curve to shift to the left.

Question 1 (continued)



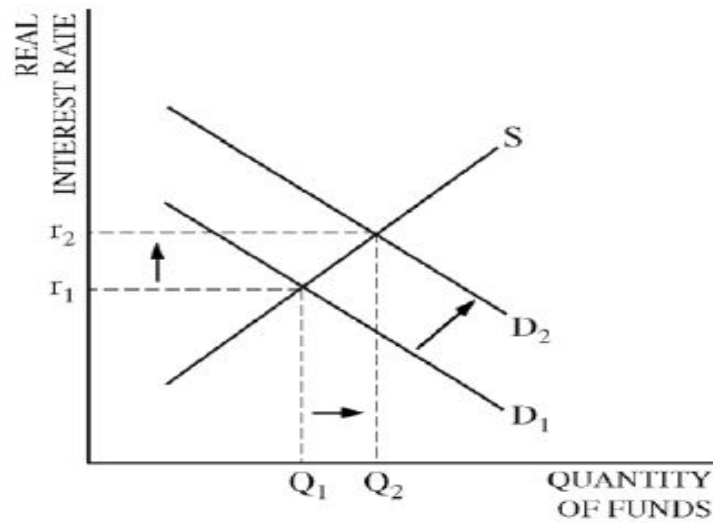
(d) 2 points:

- One point is earned for a correctly labeled graph of the loanable funds market.
- One point is earned for showing a rightward shift of the demand curve, resulting in a higher interest rate OR a leftward shift of the supply curve, resulting in a higher interest rate.

(e) 2 points:

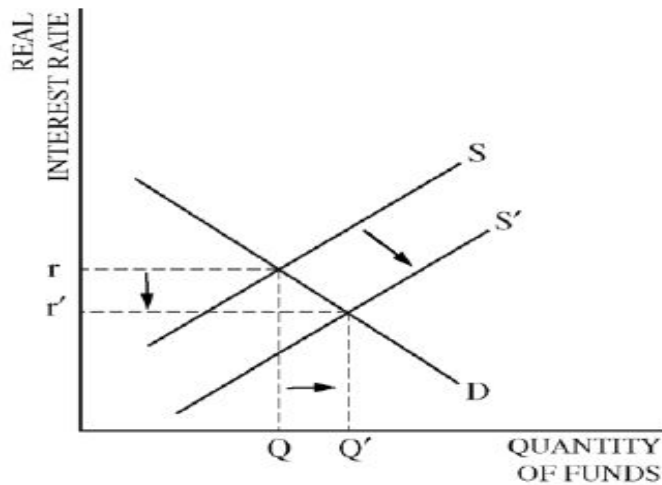
- One point is earned for stating that investment spending will decrease.
- One point is earned for explaining that the decrease in investment slows down capital formation, leading to a reduction in the economic growth rate.

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(a) 3 points:

- One point is earned for a correctly labeled graph of the loanable funds market.
- One point is earned for shifting the demand for funds curve to the right.
- One point is earned for concluding that the real interest rate rises.



(b) 2 points:

- One point is earned for shifting the supply of funds curve to the right.
- One point is earned for concluding that the real interest rate falls.

(c) 2 points:

- One point is earned for stating that the production possibilities curve (PPC) will shift to the right.
- One point is earned for the explanation that the country's capital stock increases.