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AP MACROECONOMICS · COURSE REVIEW AND PRACTICE

Bonus Practice Exam.

A second full-length AP Macroeconomics exam: multiple choice and free response, with full explanations and scoring guidance.

INSIDE

Section I Multiple Choice · Section II Free Response · Answers and Explanations · Scoring Guide



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A bonus full-length practice exam with explanations and scoring.

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Each section has an explanation, worked examples, and practice problems. Answers and explanations close every chapter. Click any entry to jump to that page.

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Welcome to the **Bonus Exam.**

Take it under timed conditions, then study every explanation.

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How to Use This Exam

Take the exam in one sitting under AP timing, without notes. Score Section I with the answer key, then score each free-response question against the point-by-point guide.

After the exam

Read the explanation for every question, including the ones you got right. Log each miss by unit and by reason (content gap, careless error, misread graph) and revisit those sections in the main book.

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Bonus Practice Exam.

A second full-length practice exam in the AP format: multiple choice and free response, with full explanations and scoring guidance.

E2 Practice Exam 2

A second full-length AP Macroeconomics practice exam, with extra weight on the financial sector, stabilization policy, and the open economy.

This exam covers the same course as Practice Exam 1 but emphasizes different skills: more money, banking, and loanable funds questions, more policy evaluation, more open-economy graphs, and more calculations from data. Section I has 60 multiple-choice questions for 70 minutes. Section II has three free-response questions for 60 minutes: one long question worth 10 points and two short questions worth 4 points each. Label every graph fully and show your work for every calculation. A calculator is allowed.

Section	Questions	Time	Raw points	Weight in composite (150)
I: Multiple choice	60	70 min	60 (1 each)	100 (multiply correct by 1.667)
II: Question 1 (long)	1	about 25 min	10	25 (multiply by 2.5)
II: Questions 2 and 3 (short)	2	about 17 min each	4 each	12.5 each (multiply by 3.125)

Add the three weighted parts for a composite out of 150. Compare it with your Practice Exam 1 composite and look for the units where you lost the most points. Official cut points change from year to year, so treat any conversion as a rough guide only. Read the explanation for every item you missed, including those you guessed correctly.

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SECTION I, PART 1 Multiple Choice, Questions 1-20

Choose the best answer for each question. Graphs use the standard axes; a vertical gold line marks long-run aggregate supply or the natural rate.

1. The table shows production possibilities for an economy that makes tractors and wheat. What is the opportunity cost of increasing tractor production from 20 to 30?

Combination	Tractors	Wheat
A	0	60
B	10	50
C	20	30
D	30	0

- (A) 10 units of wheat (B) 20 units of wheat (C) 30 units of wheat
 (D) 50 units of wheat (E) 60 units of wheat
2. In one hour, country X can make 0.5 shirts or 0.25 radios, and country Y can make 0.33 shirts or 0.33 radios. Which statement is correct?

Country	Shirts per hour	Radios per hour
X	0.5	0.25
Y	0.33	0.33

- (A) X has the comparative advantage in shirts, and Y has the comparative advantage in radios.
 (B) Y has the comparative advantage in shirts because it is the more efficient radio producer.
 (C) Neither country can gain from trade.
 (D) X has the comparative advantage in radios because it has an absolute advantage in shirts.
 (E) X has the comparative advantage in both goods.
3. In the circular flow model, which of the following occurs in the factor (resource) market?
- (A) Firms sell output to the government.
 (B) Households pay wages to firms.
 (C) Households buy goods and services from firms.
 (D) Firms pay taxes to households.
 (E) Households sell labor to firms in exchange for wages.

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4. The graph shows a country's production possibilities curve, its production at point P, and a consumption point C. How can the country consume at C?



- (A) By producing at a point inside the curve
 (B) By reducing unemployment
 (C) By increasing the price level
 (D) By having the central bank lower interest rates
 (E) By specializing in what it produces at the lowest opportunity cost and trading with other countries
5. Which of the following is counted as government purchases (G) in GDP?
- (A) Monthly Social Security benefits
 (B) Unemployment insurance payments
 (C) The salary of a public school teacher
 (D) Medicaid payments made to households
 (E) Interest paid on the national debt
6. Consumption is \$2,400 billion, investment is \$600 billion, government purchases are \$800 billion, exports are \$500 billion, and imports are \$600 billion. GDP is
- (A) \$2,700 billion
 (B) \$3,700 billion
 (C) \$3,800 billion
 (D) \$4,300 billion
 (E) \$4,900 billion
7. The table shows nominal GDP and a price index. What is the percentage change in real GDP from Year 2 to Year 3?

Year	Nominal GDP (billions)	Price index
1	500	100
2	660	120
3	770	140

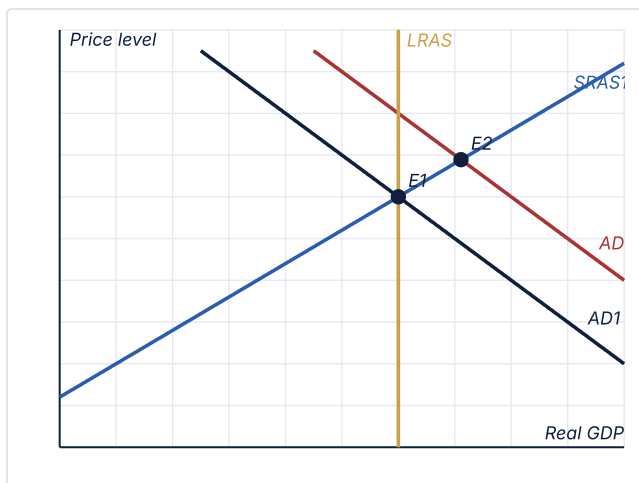
- (A) 0%
 (B) 5%
 (C) 16.7%
 (D) 20%
 (E) 40%
8. The consumer price index rises from 125 to 130. The inflation rate is approximately
- (A) 3.8%
 (B) 4.0%
 (C) 5.0%
 (D) 25%
 (E) 30%
9. Which worker would be counted as structurally unemployed?
- (A) A recent graduate searching for a first job
 (B) A worker who gave up searching for a job
 (C) A retail worker laid off during a recession
 (D) A worker who is employed part time but wants full-time work
 (E) A typewriter repair technician whose skills are no longer in demand because of technological change

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10. Suppose many discouraged workers stop looking for jobs and leave the labor force. What happens to the measured unemployment rate and the labor force participation rate?
- (A) The unemployment rate falls, and the labor force participation rate falls.
 - (B) Both rates are unchanged.
 - (C) The unemployment rate falls, and the participation rate rises.
 - (D) The unemployment rate falls, and the participation rate is unchanged.
 - (E) The unemployment rate rises, and the participation rate falls.
11. Which statement correctly compares the GDP deflator and the consumer price index?
- (A) Both exclude imported goods.
 - (B) The deflator uses a fixed basket, but the CPI does not.
 - (C) The deflator is the same as the CPI in every year.
 - (D) The CPI covers investment goods, but the deflator does not.
 - (E) The GDP deflator covers all domestically produced final goods and services, while the CPI covers a fixed basket purchased by consumers, including imports.
12. Which of the following is a cost of fully anticipated inflation?
- (A) Redistribution from lenders to borrowers
 - (B) A lower unemployment rate in the long run
 - (C) A decrease in nominal wages
 - (D) A fall in real GDP in every case
 - (E) Menu costs, because firms must frequently change posted prices
13. Because consumers shift toward cheaper goods when relative prices change, a fixed-basket CPI tends to
- (A) overstate the true increase in the cost of living
 - (B) measure only investment prices
 - (C) understate the increase in the cost of living
 - (D) exclude food and energy
 - (E) have no bias
14. An appreciation of the domestic currency will most likely
- (A) shift aggregate demand to the left by reducing net exports
 - (B) shift SRAS to the left
 - (C) shift aggregate demand to the right by increasing net exports
 - (D) have no effect on aggregate demand
 - (E) shift LRAS to the right
15. The graph shows a shift in AD from AD1 to AD2. Which of the following is the most likely cause?



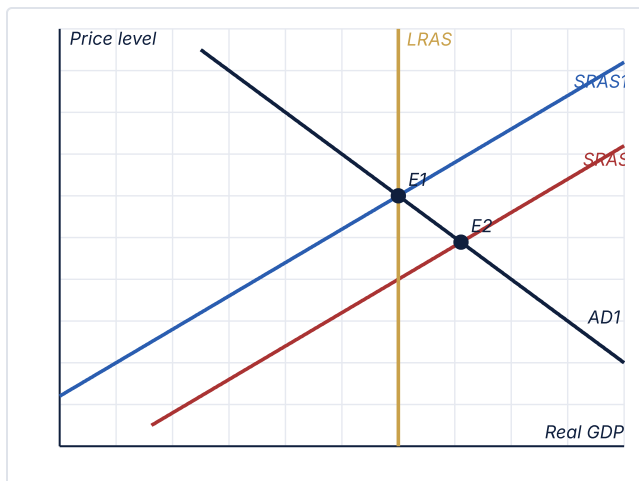
- (A) A decrease in household wealth
- (B) An appreciation of the currency
- (C) An increase in input prices
- (D) An increase in the real interest rate
- (E) An increase in expected future income

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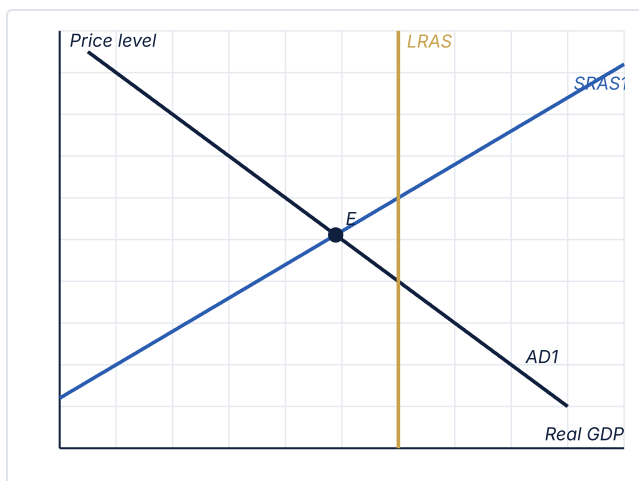
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16. The graph shows the economy moving from E1 to E2. Which of the following would most likely cause this change?



- (A) A tax increase
(B) An increase in the minimum wage
(C) A decrease in the world price of oil
(D) An increase in government purchases
(E) A decrease in the money supply
17. An economy is in long-run macroeconomic equilibrium when
- (A) the unemployment rate is zero
(B) SRAS is vertical
(C) real GDP is above potential output
(D) AD intersects SRAS at the level of output on the LRAS curve
(E) the price level is constant over time
18. The economy in the graph is at E. Which of the following policies would be most appropriate to restore full employment through fiscal means?



- (A) An increase in personal income taxes
(B) A decrease in government transfer payments
(C) An increase in the reserve requirement
(D) An increase in government purchases
(E) A sale of bonds by the central bank
19. The marginal propensity to save is 0.2. If the government increases transfer payments by \$30 billion, the maximum increase in real GDP is
- (A) \$24 billion
(B) \$30 billion
(C) \$120 billion
(D) \$150 billion
(E) \$240 billion
20. The MPC is 0.75. The government raises both purchases and taxes by \$40 billion. The change in real GDP is
- (A) \$0
(B) \$40 billion
(C) \$120 billion
(D) \$160 billion
(E) \$280 billion

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SECTION I, PART 2 Multiple Choice, Questions 21-40

Choose the best answer for each question. Graphs use the standard axes; a vertical gold line marks long-run aggregate supply or the natural rate.

21. Deficit-financed increases in government purchases may raise interest rates. This reduces the effect on aggregate demand because
- (A) the multiplier becomes larger
 - (B) SRAS shifts to the right
 - (C) the exchange rate depreciates
 - (D) higher interest rates increase consumer spending
 - (E) higher interest rates crowd out private investment
22. Which of the following correctly describes the effect of a negative supply shock shown by the move from E1 to E2?



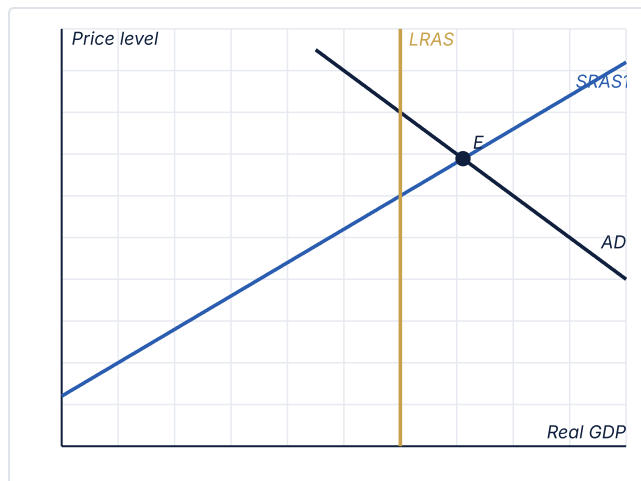
- (A) The price level rises, and the unemployment rate falls.
 - (B) The price level falls, and the unemployment rate falls.
 - (C) The price level rises, and the unemployment rate rises.
 - (D) The price level is unchanged, and unemployment falls.
 - (E) The price level falls, and the unemployment rate rises.
23. A progressive income tax acts as an automatic stabilizer because during an expansion
- (A) tax revenue falls, which increases spending
 - (B) unemployment benefits increase
 - (C) the price level automatically falls
 - (D) the government must pass new laws to raise rates
 - (E) tax revenue rises faster than income, which dampens the growth of disposable income and spending

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24. The economy is at E in the graph. Which policy mix is most appropriate?



- (A) An increase in government purchases
(B) A decrease in taxes
(C) A decrease in the reserve requirement
(D) A decrease in government purchases
(E) A purchase of bonds by the central bank
25. Real GDP is \$940 billion and potential output is \$1,000 billion. The MPC is 0.75 and the price level is constant. The increase in government purchases needed to reach potential is
(A) \$15 billion
(B) \$20 billion
(C) \$45 billion
(D) \$60 billion
(E) \$240 billion
26. Which of the following best explains the interest-rate effect that gives the aggregate demand curve its negative slope?
(A) A lower price level raises the real wage and increases hiring
(B) A lower price level raises nominal interest rates, which attracts foreign savers
(C) A lower price level reduces money demand, lowering interest rates and raising investment and consumption
(D) A lower price level reduces the real value of household wealth
(E) A lower price level makes domestic goods cheaper than foreign goods only
27. Which of the following is the most liquid asset?
(A) A savings account
(B) A house
(C) A certificate of deposit
(D) Currency in a wallet
(E) A share of stock
28. Households deposit \$800 in currency into banks. The reserve requirement is 25 percent, banks hold no excess reserves, and no currency is held outside banks. The maximum amount of new loans the banking system can make is
(A) \$600
(B) \$800
(C) \$2,400
(D) \$3,200
(E) \$4,000
29. The central bank buys \$50 million in government bonds from a commercial bank. Which of the following is the immediate effect?
(A) The bank's loans decrease by \$50 million.
(B) The bank's reserves decrease by \$50 million.
(C) The bank's deposits increase by \$50 million.
(D) The bank's reserves increase by \$50 million, creating excess reserves it can lend.
(E) The required reserve ratio rises.

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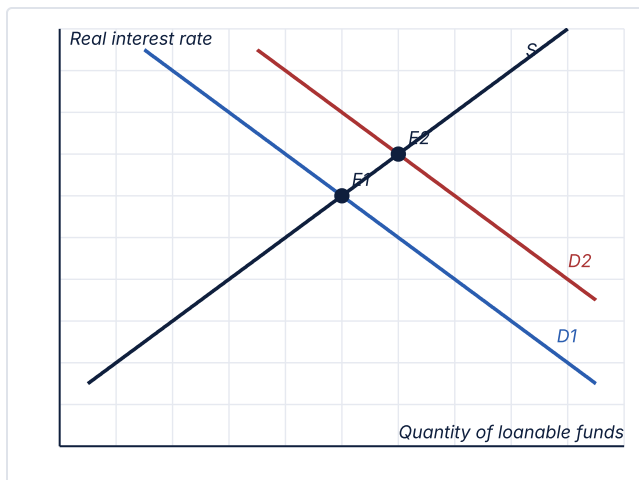
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30. The graph shows a shift in money demand from MD1 to MD2 with the money supply fixed. Which could cause this?



- (A) A decrease in the discount rate
(B) A purchase of bonds by the central bank
(C) An increase in the interest rate
(D) An increase in the price level
(E) A decrease in nominal GDP
31. The graph shows the loanable funds market. The shift from D1 to D2 could be caused by



- (A) firms becoming more optimistic about the profitability of new capital
(B) a decrease in expected profits
(C) a decrease in government borrowing
(D) an increase in household saving
(E) a decrease in the real interest rate
32. The nominal interest rate is 9 percent and the real interest rate is 4 percent. Expected inflation is
(A) 4 percent (B) 5 percent (C) 9 percent
(D) 13 percent (E) 36 percent
33. The interest rate is 10 percent. The present value of \$5,000 to be received in two years is approximately
(A) \$ 4,000 (B) \$ 4,132 (C) \$ 4,545 (D) \$ 4,750 (E) \$ 6,050
34. Market interest rates rise. What happens to the market price of an existing bond with a fixed coupon?
(A) It rises, because its yield falls
(B) It rises, because the coupon is fixed
(C) It is unchanged
(D) It falls only if the bond defaults
(E) It falls, because new bonds offer higher returns

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35. The federal funds rate is the interest rate
(A) paid on checking accounts
(B) on Treasury bonds issued for ten years
(C) the central bank charges the public
(D) on 30-year mortgages
(E) that banks charge one another for short-term loans of reserves
36. A bank makes a \$500 loan by crediting the borrower's checking account. What are the immediate effects?
(A) Only the borrower's assets change.
(B) The bank's assets fall by \$ 500.
(C) The bank's loans and deposit liabilities both rise by \$ 500, and the money supply increases.
(D) The bank's reserves fall by \$ 500, and the money supply is unchanged.
(E) The money supply decreases.
37. An increase in the reserve requirement will most likely
(A) reduce the money multiplier and the money supply
(B) decrease the discount rate
(C) increase excess reserves
(D) lower the federal funds rate
(E) increase the money multiplier
38. According to the concept of long-run money neutrality, a permanent increase in the money supply will, in the long run, increase
(A) employment permanently
(B) real GDP permanently
(C) the real interest rate permanently
(D) the price level and nominal wages in the same proportion, with real variables unchanged
(E) potential output
39. Prices in a country are quoted in dollars. This illustrates which function of money?
(A) Unit of account
(B) Medium of exchange
(C) Fractional reserve
(D) Store of value
(E) Barter
40. Which of the following is a liability of a commercial bank?
(A) Checkable deposits
(B) Excess reserves
(C) Loans to customers
(D) Holdings of government bonds
(E) Required reserves

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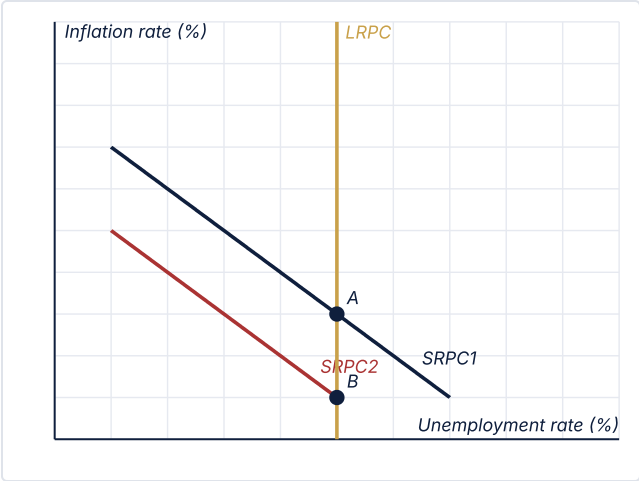
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SECTION I, PART 3 **Multiple Choice, Questions 41-60**

Choose the best answer for each question. Graphs use the standard axes; a vertical gold line marks long-run aggregate supply or the natural rate.

41. The movement from SRPC1 to SRPC2 is most likely caused by



- (A) a negative supply shock
(B) an increase in the natural rate of unemployment
(C) a decrease in expected inflation
(D) a reduction in the money supply
(E) an increase in government purchases
42. Which event would most likely shift the long-run Phillips curve to the right?
- (A) A decrease in government purchases
(B) A reduction in the money supply
(C) A growing mismatch between worker skills and available jobs
(D) A recession caused by a fall in AD
(E) An increase in expected inflation
43. According to the table, reducing unemployment from 6 percent to 4 percent along this short-run Phillips curve would cost how many percentage points of additional inflation?
- | Unemployment (%) | 8 | 6 | 5 | 4 | 3 |
|------------------|---|---|---|---|---|
| Inflation (%) | 0 | 2 | 3 | 4 | 5 |
- (A) 1 (B) 2 (C) 3 (D) 4 (E) 8
44. The government adopts contractionary fiscal policy while the central bank adopts contractionary monetary policy. Which is the most likely result?
- (A) Aggregate demand increases, with a higher interest rate
(B) Aggregate demand decreases, with a definite fall in the interest rate
(C) Aggregate demand decreases, with a definite rise in the interest rate
(D) Aggregate demand decreases, with an uncertain change in the interest rate
(E) No change in aggregate demand
45. Which sequence best describes how a central bank closes an inflationary gap?
- (A) Sell bonds, money supply rises, interest rates fall, AD shifts left
(B) Buy bonds, money supply rises, interest rates fall, AD shifts right
(C) Sell bonds, interest rates fall, investment rises, AD shifts right
(D) Buy bonds, interest rates rise, AD shifts left
(E) Sell bonds, money supply falls, interest rates rise, investment falls, AD shifts left

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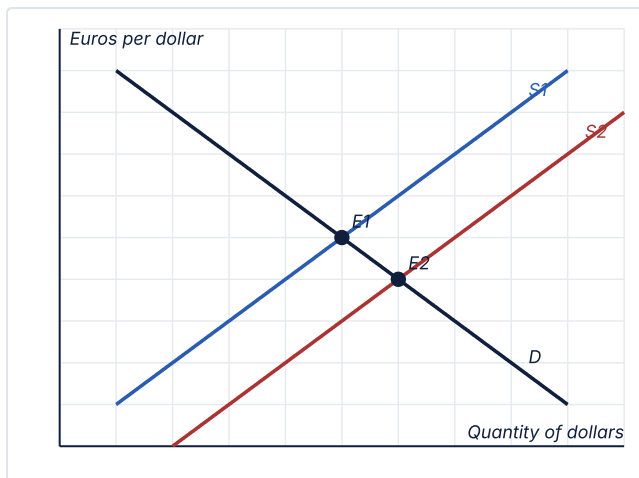
46. The economy is at potential output. The central bank unexpectedly lowers the interest rate. Which is the most likely long-run result?
- (A) A rightward shift of LRAS
 - (B) A higher price level, with real GDP at potential output
 - (C) A permanently higher natural rate of unemployment
 - (D) A permanently lower price level
 - (E) Permanently higher real GDP
47. Real GDP grows by 4.0 percent in a year in which the population grows by 1.5 percent. Real GDP per capita grows by approximately
- (A) 1.5 percent
 - (B) 2.5 percent
 - (C) 4.0 percent
 - (D) 5.5 percent
 - (E) 6.0 percent
48. Which of the following is most likely to raise a country's long-run economic growth rate?
- (A) A one-time increase in the money supply
 - (B) A temporary tax holiday
 - (C) Higher import tariffs on capital goods
 - (D) Stronger property rights and rule of law that encourage investment and innovation
 - (E) Larger consumer transfer payments
49. The ratio of government debt to GDP will fall if
- (A) GDP grows faster than the debt
 - (B) debt grows faster than GDP
 - (C) the deficit is positive
 - (D) inflation is zero
 - (E) the deficit equals zero
50. Which is an advantage of monetary policy over discretionary fiscal policy in responding to a recession?
- (A) The central bank can change policy quickly without waiting for legislation.
 - (B) It does not affect interest rates.
 - (C) It always works instantly.
 - (D) It directly changes government purchases.
 - (E) It has no lags.
51. The central bank's dual mandate is
- (A) low interest rates and high wages
 - (B) a fixed exchange rate and low debt
 - (C) maximum employment and a trade surplus
 - (D) balanced budgets and low taxes
 - (E) maximum employment and stable prices
52. When a central bank credibly commits to reducing inflation, the cost in lost output may be smaller because
- (A) wages and prices become more rigid
 - (B) the long-run Phillips curve shifts left
 - (C) unemployment falls immediately
 - (D) expected inflation falls, shifting the short-run Phillips curve downward
 - (E) aggregate supply becomes vertical in the short run
53. Which of the following transactions is recorded in the financial account of the U.S. balance of payments as an inflow of capital?
- (A) A U.S. tourist stays at a hotel in Germany.
 - (B) A German company builds a factory in the United States.
 - (C) A U.S. resident buys a car made in Germany.
 - (D) A U.S. firm sells software to Germany.
 - (E) A U.S. resident receives a gift from relatives abroad.

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54. The graph shows the market for dollars. The shift from S_1 to S_2 is most likely caused by



- (A) a U.S. tariff on all imports
 (B) foreign demand for U.S. exports increasing
 (C) U.S. interest rates rising relative to those abroad
 (D) U.S. residents increasing their demand for European goods
 (E) foreign investors buying U.S. assets
55. A country's currency appreciates. Which of the following is most likely?
 (A) Exports rise, and imports fall.
 (B) Net exports rise, and aggregate demand increases.
 (C) The price level necessarily increases.
 (D) Net exports fall, and aggregate demand decreases.
 (E) Net exports are unchanged.
56. The exchange rate is 150 yen per U.S. dollar. A car in Japan costs 3,000,000 yen. Its price in dollars is
 (A) \$ 2,000 (B) \$ 20,000 (C) \$ 30,000
 (D) \$ 200,000 (E) \$ 450,000,000
57. What is a difference between an import tariff and an import quota?
 (A) A quota raises revenue for the government in all cases.
 (B) A tariff limits quantity directly, while a quota is a tax.
 (C) There is no difference in effects.
 (D) A tariff raises revenue for the government, while a quota may give license holders the extra revenue.
 (E) A tariff lowers the domestic price.
58. Interest rates abroad rise relative to U.S. rates. What will most likely happen to the U.S. dollar and U.S. net exports?
 (A) The dollar appreciates, and net exports rise.
 (B) Neither changes.
 (C) The dollar depreciates, and net exports rise.
 (D) The dollar appreciates, and net exports fall.
 (E) The dollar depreciates, and net exports fall.
59. A persistent U.S. current account deficit implies that
 (A) the financial account must be in deficit
 (B) net exports are positive
 (C) the U.S. is running a government budget surplus
 (D) U.S. residents are net lenders to the world
 (E) foreigners are acquiring more U.S. financial and real assets

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60. An import quota on sugar is most likely to hurt
- (A) foreign sugar producers who hold import licenses
 - (B) domestic firms and consumers who buy sugar
 - (C) domestic sugar producers
 - (D) no one in the domestic economy
 - (E) the government

QUESTION 1 Inflationary Gap and Stabilization (10 points)

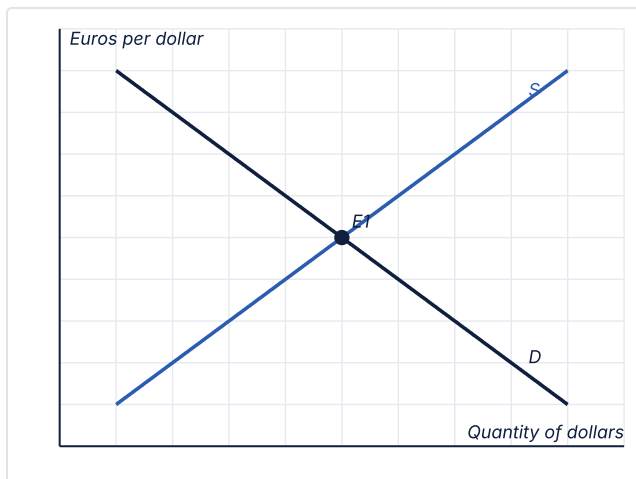
Country Y is in short-run equilibrium with real GDP above potential output and a rising price level. The banking system faces a required reserve ratio of 20 percent. Policymakers want to return the economy to potential output.

61. (a) Draw a correctly labeled graph of AD, SRAS, and LRAS showing the economy of Country Y. Label the equilibrium price level PL1, real GDP Y1, and potential output Yf.
62. (b) How does the unemployment rate in Country Y compare with the natural rate of unemployment? Explain.
63. (c) Identify one fiscal policy action the government should take to close the gap.
64. (d) The government's budget moves toward surplus, so it borrows less. Draw a correctly labeled graph of the loanable funds market showing the effect on the real interest rate.
65. (e) Explain the effect of the change in the real interest rate on private investment.
66. (f) Suppose instead the central bank sells \$200 million of government securities to banks. Calculate the maximum change in the money supply, assuming banks hold no excess reserves and there is no cash drain.
67. (g) If no policy is used, describe what happens to nominal wages, SRAS, the price level, and real GDP in the long run.

QUESTION 2 Foreign Exchange Market (4 points)

The graph shows the market for U.S. dollars, with the exchange rate measured in euros per dollar. Suppose real interest rates in the euro area rise while U.S. interest rates stay the same.

68. (a) Show on the graph the effect of the higher euro-area interest rates. Describe how you would draw the shift (curve and direction).



Market for U.S. dollars, initial equilibrium

69. (b) What happens to the exchange rate of the dollar? Identify it as appreciation or depreciation.
70. (c) What happens to U.S. net exports as a result? Explain.
71. (d) What happens to U.S. aggregate demand and real GDP in the short run?

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QUESTION 3 Labor Market Measures (4 points)

In a country, the working-age population is 300 million. There are 171 million employed workers and 9 million unemployed workers actively seeking jobs. The rest of the working-age population is not in the labor force.

72. (a) Calculate the labor force and the unemployment rate. Show your work.
73. (b) Calculate the labor force participation rate.
74. (c) One million of the unemployed workers become discouraged and stop searching, and no jobs are created. Calculate the new unemployment rate, rounded to one decimal place.
75. (d) Explain why the change in part (c) might give a misleading picture of the labor market.

Key Practice Exam 2: Answers and Explanations

Complete solutions. Free-response keys show the scoring breakdown.

E2 Practice Exam 2**SECTION I, PART 1 · MULTIPLE CHOICE, QUESTIONS 1-20**

1. C. Wheat falls from 30 to 0 as tractors rise from 20 to 30, so the cost is 30 units of wheat. The extra cost per tractor rises from 1 to 2 to 3, showing increasing opportunity cost.
2. A. X gives up 0.5 radio per shirt while Y gives up 1 radio per shirt, so X has the lower cost of shirts; Y gives up 1 shirt per radio versus 2 for X, so Y has the lower cost of radios. Both can gain by specializing.
3. E. Factor markets exchange resources for income: households supply labor, land, and capital, and firms pay wages, rent, and interest. Purchases of output occur in product markets.
4. E. Point C lies outside the domestic PPC, which is possible only through trade at terms of trade that differ from domestic opportunity costs. Reducing unemployment only moves production to the curve.
5. C. G counts government spending on currently produced goods and services, including wages for government employees. Transfer payments and interest on debt do not buy output directly.
6. B. $GDP = C + I + G + X - M = 2,400 + 600 + 800 + 500 - 600 = 3,700$. Adding imports gives 4,900, and omitting net exports gives 3,800.
7. A. Real GDP is nominal GDP divided by the index: $660/1.20 = 550$ in Year 2 and $770/1.40 = 550$ in Year 3, so real GDP did not change. The 16.7% figure is nominal growth.
8. B. $Inflation = (130 - 125)/125 = 4.0\%$. Dividing by the new index gives 3.8%, and 5 is the point change, not the percent.
9. E. Structural unemployment results from a mismatch between workers' skills or location and available jobs. The recession layoff is cyclical, the graduate frictional, and the others are not counted as unemployed.
10. A. People who stop searching leave the labor force, shrinking both the unemployed count and the labor force. This lowers the measured unemployment rate without any new jobs.
11. E. The deflator's basket changes with current output and excludes imports, while the CPI uses a fixed basket of consumer purchases including imported items.
12. E. Even when inflation is expected, firms bear menu costs and people bear shoe-leather costs from economizing on cash. Unexpected inflation, not anticipated inflation, redistributes between lenders and borrowers.
13. A. A fixed basket fails to account for substitution, so it overstates the cost-of-living increase. This is substitution bias.
14. A. A stronger currency makes exports costlier abroad and imports cheaper at home, so net exports and AD fall.
15. E. Higher expected income raises consumption at every price level and shifts AD right. Input prices affect SRAS.
16. C. At E2 the price level is lower and real GDP is higher, which signals a rightward SRAS shift from a positive supply shock such as cheaper energy.
17. D. In long-run equilibrium actual output equals potential output, so cyclical unemployment is zero but the natural rate remains positive.
18. D. At E output is below potential. Expansionary fiscal policy raises AD. Higher taxes and lower transfers are contractionary, and the other two are monetary tools that also contract.
19. C. The transfer multiplier is $MPC/MPS = 0.8/0.2 = 4$, so $30 \times 4 = 120$. The 150 figure applies the spending multiplier of 5, which would overstate because the first round of transfers is not spent entirely.
20. B. Spending adds $40 \times 4 = 160$ and taxes subtract $40 \times 3 = 120$, for a net of 40, the balanced budget multiplier of 1.

SECTION I, PART 2 · MULTIPLE CHOICE, QUESTIONS 21-40

21. E. Crowding out partly offsets the initial rise in AD as interest-sensitive investment falls.
22. C. A leftward SRAS shift raises the price level and lowers real GDP, which raises cyclical unemployment: stagflation.
23. E. Because average tax rates rise with income, taxes absorb a larger share of income in expansions and ease the boom, with no new legislation.
24. D. At E output exceeds potential and the price level is rising. Contractionary fiscal policy shifts AD left toward potential output.
25. A. The gap is 60 billion and the multiplier is 4, so $60/4 = 15$. The 45 billion figure multiplies the gap by the MPC.
26. C. A lower price level means people need less money for transactions, so the interest rate falls and interest-sensitive spending rises along AD. The wealth and exchange-rate effects are separate explanations.

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27. D. Liquidity is how easily an asset can be used to buy goods without loss of value. Cash is already the medium of exchange.
29. D. The bank swaps bonds for reserves, which raises reserves without changing deposits, so excess reserves rise.
31. A. Better investment prospects increase demand for loanable funds, raising the real rate and the quantity. A lower real rate moves along the demand curve.
33. B. $PV = 5,000 / (1.10)^2 = 5,000 / 1.21 = \text{about } 4,132$. Discounting only one year gives 4,545, and 6,050 is the future value.
35. E. It is an overnight interbank rate and the central bank's main policy target.
37. A. A higher requirement leaves banks less to lend per dollar of reserves, so the multiplier and money supply fall.
39. A. A common measuring unit lets prices be compared. Medium of exchange refers to payment, and store of value to holding purchasing power.
28. C. The multiplier is $1/0.25 = 4$, so deposits can reach 3,200; the initial 800 is not a loan, so loans total $3,200 - 800 = 2,400$.
30. D. Higher prices raise the amount of money needed for transactions, shifting MD right and raising the nominal interest rate. A change in the interest rate moves along MD.
32. B. Expected inflation = nominal - real = $9 - 4 = 5$ percent. Adding gives 13, the opposite relationship.
34. E. Bond prices and yields move inversely; a bond with a lower coupon must sell at a discount to compete with new higher-rate bonds.
36. C. The new checkable deposit is money, and the loan is an asset; the balance sheet expands on both sides.
38. D. In the long run nominal variables adjust and money does not change real output or real interest rates.
40. A. Deposits are owed to customers. Loans, bonds, and reserves are assets.

SECTION I, PART 3 · MULTIPLE CHOICE, QUESTIONS 41-60

41. C. A downward shift in the short-run Phillips curve reflects lower expected inflation or a positive supply shock. The other changes are movements along the curve or shifts in the opposite direction.
43. B. Inflation rises from 2 to 4 percent, a 2-point increase. Reading the 4 percent level as the cost confuses a level with a change.
45. E. Contractionary monetary policy reduces reserves and money supply, raising rates and reducing interest-sensitive spending.
47. B. Per capita growth is about $4.0 - 1.5 = 2.5$ percent. Adding the rates is the error.
49. A. The ratio depends on both numerator and denominator; faster GDP growth reduces it even if debt grows.
51. E. In the United States, the mandate directs the Fed to promote maximum employment and stable prices.
53. B. Foreign direct investment is a capital inflow. The others are current account items (goods, services, transfers).
55. D. Domestic goods become relatively expensive abroad and imports cheaper, reducing net exports and AD.
57. D. Both raise domestic prices and cut imports, but a tariff is a tax collected by the government.
59. E. The balance of payments sums to zero, so the deficit is financed by net capital inflows.
42. C. The LRPC sits at the natural rate, so it shifts only when structural or frictional unemployment changes.
44. D. Both policies reduce AD. Less government borrowing lowers rates while tighter money raises them, so the net effect on rates is ambiguous.
46. B. Short-run output rises above potential, but SRAS shifts left as wages rise, leaving only a higher price level.
48. D. Institutions that protect investment raise capital accumulation and technology adoption.
50. A. Central bank committees can act at once, while fiscal policy requires legislative action, though both still have lags.
52. D. Credible policy lowers expectations, so wages and prices adjust sooner and less unemployment is needed.
54. D. More imports require more foreign currency, so the supply of dollars rises and the dollar depreciates. The other events raise demand for dollars or reduce imports.
56. B. Dollars = $3,000,000 / 150 = 20,000$. Multiplying by 150 gives the 450 million figure.
58. C. Capital flows toward higher returns abroad, lowering demand for dollars and making U.S. goods cheaper abroad.
60. B. The quota raises the domestic price of sugar, harming buyers, while domestic producers gain.

QUESTION 1 · INFLATIONARY GAP AND STABILIZATION (10 POINTS)

61. 2 points. 1 point: axes labeled price level and real GDP, with downward-sloping AD, upward-sloping SRAS, and vertical LRAS at Yf. 1 point: the equilibrium Y1 is to the RIGHT of Yf, with PL1 and Y1 marked on the axes. (Model: $AD\ y = 14 - x$ and $SRAS\ y = 1.2 + 0.8x$ cross at $x = 7.1$, to the right of LRAS at 6.)
62. 1 point: Unemployment is below the natural rate, because output above potential means cyclical unemployment is negative (the labor market is tight).
63. 1 point: Decrease government purchases, or increase taxes (either contractionary action is acceptable).
64. 2 points. 1 point: loanable funds axes labeled real interest rate and quantity of loanable funds, with upward-sloping supply and downward-sloping demand. 1 point: demand shifts LEFT because of lower government borrowing, and the real interest rate falls.
65. 1 point: A lower real interest rate reduces the cost of borrowing, so private investment increases (the crowding-out effect shrinks), which partly offsets the fall in AD and supports capital accumulation.
66. 1 point: The money multiplier is $1/0.20 = 5$, so the money supply falls by up to $200 \times 5 = \$1,000$ million.
67. 2 points. 1 point: Tight labor markets push nominal wages up, so SRAS shifts LEFT. 1 point: The price level rises and real GDP falls back to potential output Yf, ending the inflationary gap.

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QUESTION 2 · FOREIGN EXCHANGE MARKET (4 POINTS)

- 68.** 1 point: Investors move funds into euro assets, so they sell dollars: the SUPPLY of dollars shifts right (S to S₂). (Accept a leftward shift of demand for dollars as well, since foreign demand for dollar assets also falls; either shift lowers the dollar's value.) The new equilibrium is at a lower exchange rate.
- 69.** 1 point: The dollar depreciates (fewer euros per dollar).
- 70.** 1 point: Net exports increase, because U.S. goods become cheaper to euro-area buyers and euro-area goods become more expensive to U.S. buyers.
- 71.** 1 point: Aggregate demand shifts right as net exports rise, so real GDP and the price level increase in the short run.

QUESTION 3 · LABOR MARKET MEASURES (4 POINTS)

- 72.** 1 point: Labor force = $171 + 9 = 180$ million; unemployment rate = $9/180 = 5$ percent.
- 73.** 1 point: Participation rate = $180/300 = 60$ percent.
- 74.** 1 point: The labor force becomes 179 million and unemployed workers 8 million, so the rate is $8/179 = 4.5$ percent.
- 75.** 1 point: The rate falls only because people left the labor force, not because they found jobs; discouraged workers are not counted as unemployed, so the rate understates labor market weakness (and participation falls).

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