

Unit 5 Progress Check: FRQ

1. 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. If the question prompts you to “Calculate,” you must show how you arrived at your final answer.

An economy is currently in a recession.

- (a) Draw a single correctly labeled graph with both the short-run and long-run Phillips curves. Label the current short-run equilibrium as point X.
- (b) Is the expected inflation rate greater than, less than, or equal to the actual inflation rate?
- (c) Will borrowers on fixed-rate loans benefit from the situation that you identified in part (b)? Explain.
- (d) Assume the government budget is balanced. In the absence of any discretionary policy action, will the government budget move into surplus, deficit, or remain in balance? Explain.
- (e) On your graph in part (a), show how the economy will adjust in the long run in the absence of any discretionary policy action.
- (f) Now assume instead the government increases spending without changing taxes to close the recessionary gap. What effect will this policy have on the national debt?
- (g) Draw a correctly labeled graph of the loanable funds market and show the effect of the change in the national debt on the equilibrium real interest rate.
- (h) Based on the change in the equilibrium real interest rate identified in part (g), what will happen to economic growth in the country in the long run? Explain.

 Please respond on separate paper, following directions from your teacher.

Part (a)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.

0	1	2
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The response accurately includes both of the criteria below.

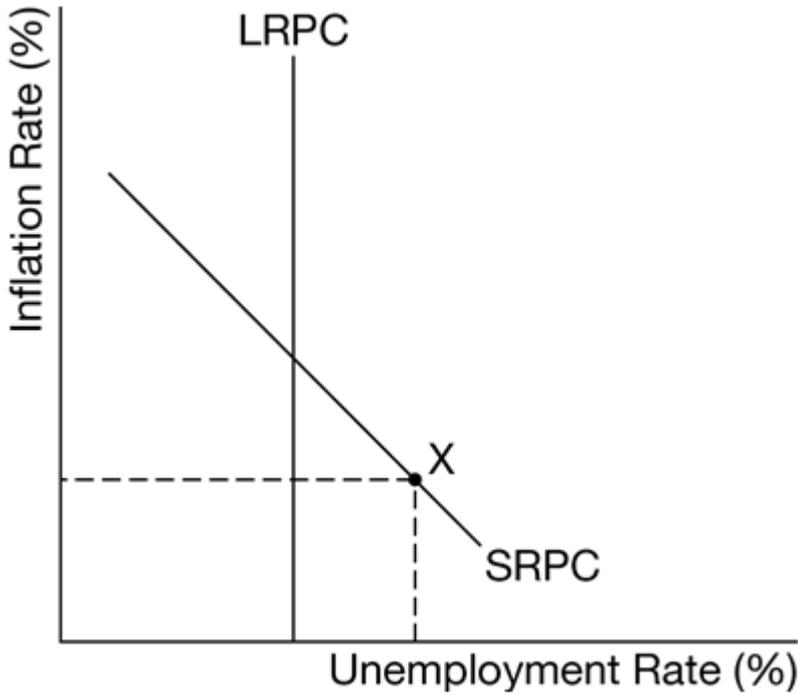
- A correctly labeled graph of the short-run Phillips curve (**SRPC**).



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- A correctly labeled long-run Phillips curve (**LRPC**) and shows point X on the **SRPC** to the right of the **LRPC**.

Solution



Part (b)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.

The response should be consistent with point X shown on the graph in part (a).



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The response states that the expected inflation rate is greater than the actual inflation rate.

Part (c)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.



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The response should be consistent with the answer to part (b).

The response must both state no and explain why in order to receive the point.



0	1
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The response states that no, borrowers on fixed-rate loans will not benefit from the expected inflation rate being higher than the actual inflation rate because they will pay a higher real interest rate.

Part (d)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.

The response must both state that the government budget will move into deficit and explain why in order to receive the point.



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The response states that the government budget will move into deficit and explains that automatic stabilizers such as transfer payments and progressive income-taxes will increase government spending and decrease government revenues.

Part (e)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.

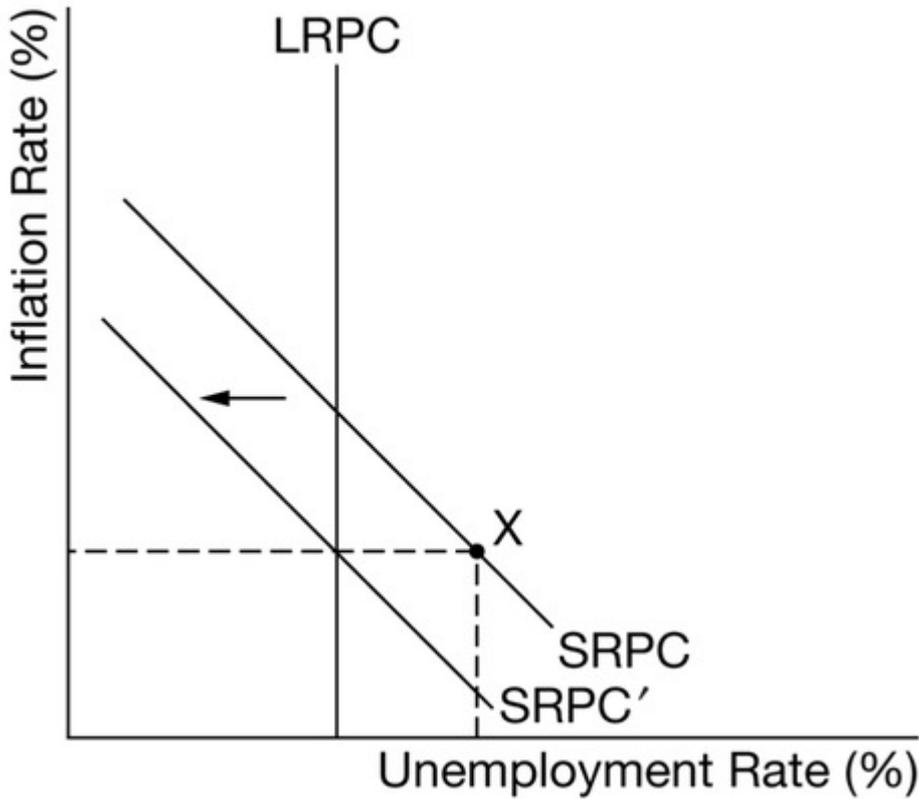


0	1
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The response shows a leftward shift of the **SRPC** (see below).



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Part (f)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.



0	1
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The response states that the national debt will increase.

Part (g)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.

The response should be consistent with the change in the national debt identified in part (f).



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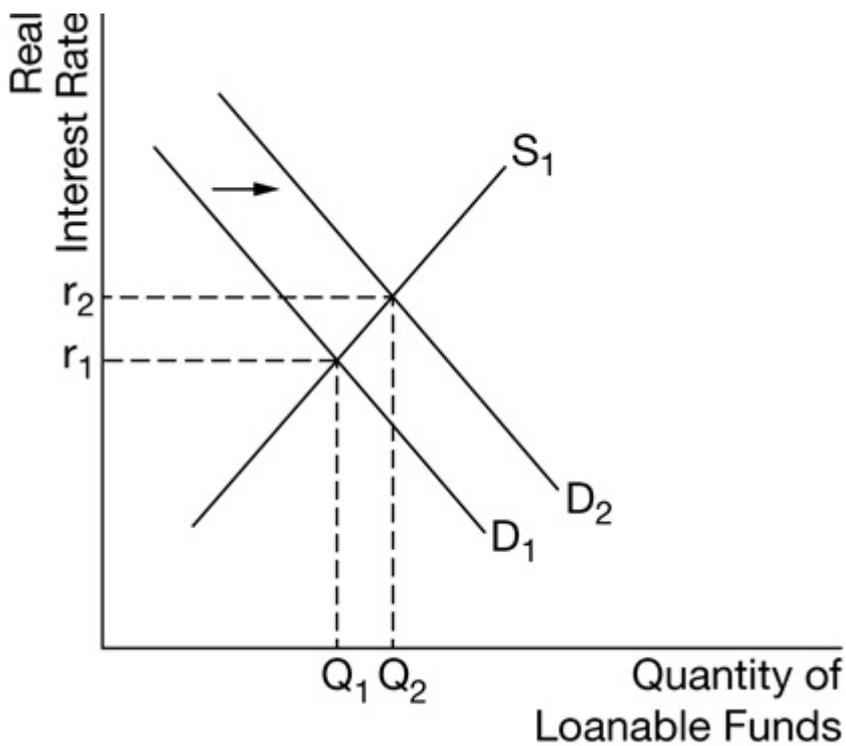
The response accurately includes both of the criteria below.

- A correctly labeled graph of the loanable funds market.
- A rightward shift of the demand curve for loanable funds and a higher real interest rate.

OR

A leftward shift of the supply curve of loanable funds and a higher real interest rate.

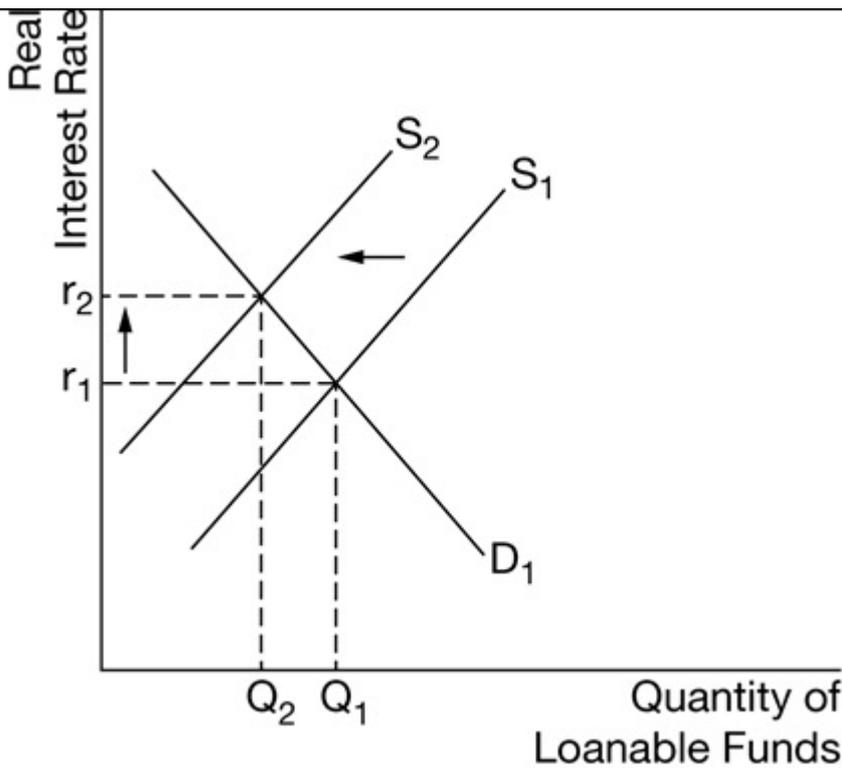
Solution



OR



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Part (h)

Select a point value to view scoring criteria, solutions, and/or examples and to score the response.

The response should be consistent with the change in the equilibrium real interest rate shown in part (g).

The response must both state that economic growth will slow in the long run and explain why – linking the change in the equilibrium real interest rate to a change in investment in physical capital – in order to receive the point.



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The response states that the country’s economic growth will slow in the long run and explains that an increase in real interest rates will increase the cost of borrowing, which decreases investment spending on plant and equipment and reduces capital formation.