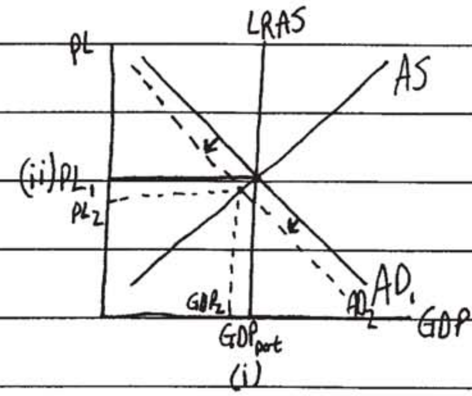
1A

Write in the box the number of the question you are answering on this page as it is designated in the examination. | 1 |

(a)



(b) (i) The Japanese recession will cause a fall in Japanese AD. This will decrease demand for US exports. Because net Exports (X_n) is a component of AD, back in America, American AD will shift left. When AD shifts left, PL falls and output falls.

(ii) See graph.

(C)(i) The Federal Reserve should buy bonds. When people sell their bonds to the Fed, the Fed deposits the money in banks. Therefore, the reserves of the bank increase. When the reserves increase, the amant of loanable funds increases and that means the supply of money increases.

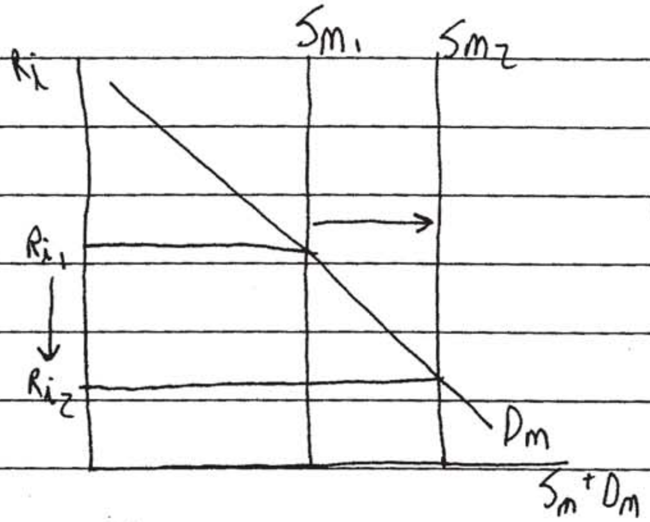
CONTINUED ON BACK

1A

1

Write in the box the number of the question you are answering on this page as it is designated in the examination.

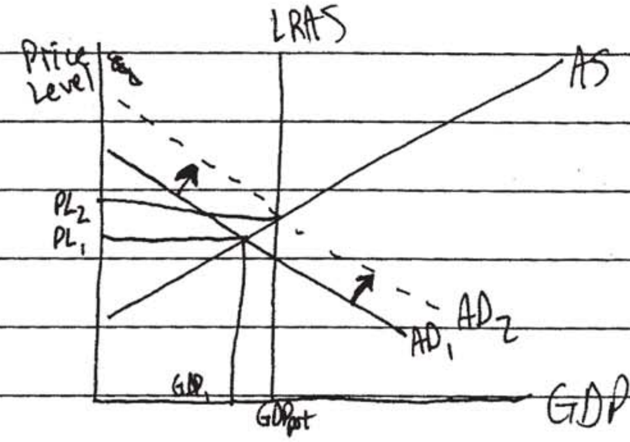
(ii)



NOMINAL Ri ↓.

MONEY MARKET

(iii) Interest rate is the number 1 determinant of Ig (a component of AD). ~~Therefore~~ Because they are inversely related, decreasing Ri will increase Ig and thus increase AD. An increase in AD increases price level and output - see below.



PL ↑, GDP ↑

1A

Write in the box the number of the question you are answering on this page as it is designated in the examination.

1

(d) Real interest rate is defined as the nominal interest rate minus inflation:

Real R_i = Nominal R_i - Inflation.

(e) The real interest rate will increase, but by less than the nominal interest rate because there will be inflation. Increasing AD causes demand-pull inflation because there is too much money chasing too few goods so prices increase.