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

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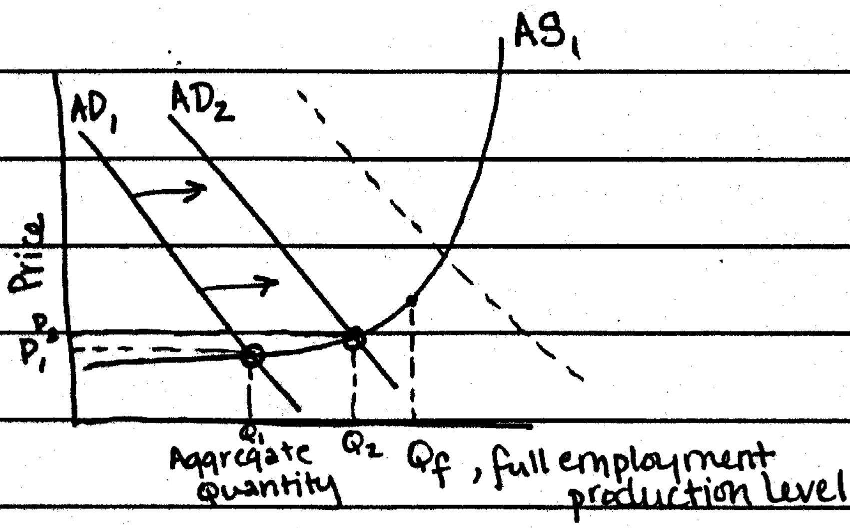
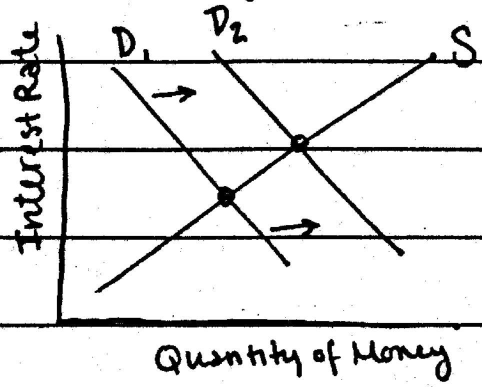
IMACCLA,

a.



An increase in government spending will shift aggregate demand to the right, increasing the level of real output from Q_1 to Q_2. The price level will also increase, but the amount of its increase will ~~xxxx~~ depend on how far the aggregate demand shifts. In the diagram shown, a large increase in output is accompanied by relatively little increase in price, but the increase in government spending could push aggregate demand to a position indicated by the dashed line which illustrates a substantial price increase.

b. The increase in government expenditures will ~~increase~~ shift the demand for money to the right. Since interest rate represents the "price" of money this situation can be represented by a supply-demand graph for money.



As pictured in the graph, the increase in government spending will cause interest rates to rise.

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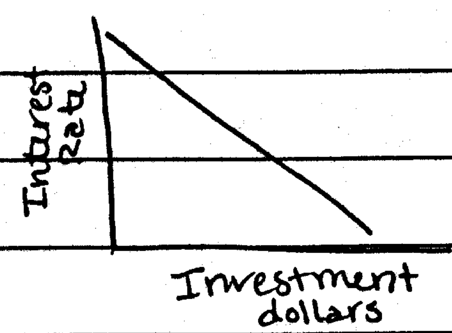
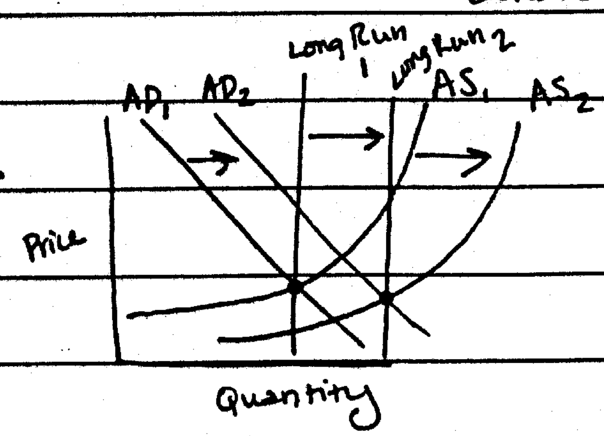
1MACCLA2

A rise in interest rates will cause a decrease in the amount of investment, since new capital will yield relatively less profit. Since investment requires the loaning of money, companies find it more profitable to invest when interest rates are low and they have to pay back less to borrow the money. If the interest rate is high enough, increased profit from investment may be consumed in interest payments. This relationship is modeled below:

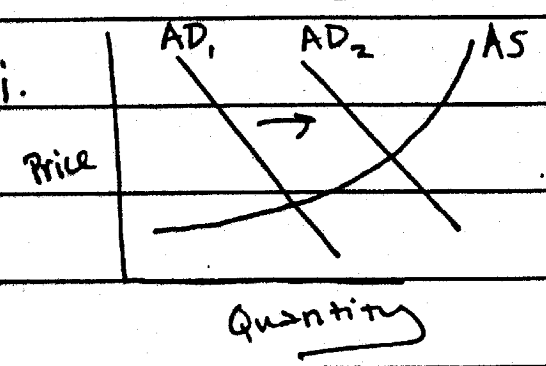


c.



Full graph ←

i.



Just looking @ Aggregate Demand

i. A decrease in corporate taxes will leave companies with more money to spend or invest in capital, either way causing aggregate demand to shift right.

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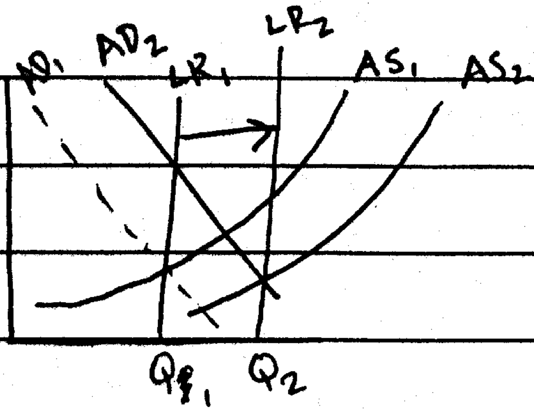
ii.

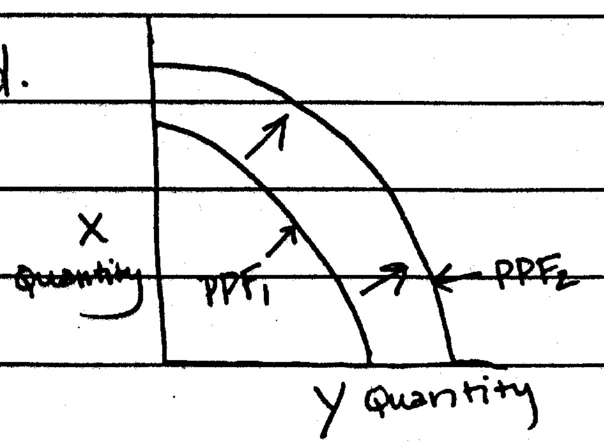


But the increase in aggregate demand also causes ~~a~~ shift right in aggregate supply since some of the new spending is in capital. The intersection of AS_2 and AD_2 actually represents a point on the right shifted vertical long-run aggregate supply graph. As a result of the capital investment the economy can physically produce more, represented by a shift in the long-run aggregate supply to the right.

iii. With the rightward shift in aggregate supply (long-run and short run) the quantity or real output increases.

iv. As shown the the full graph on the opposite page, the price level may remain relatively stable. The right shift in AD tends to increase price, but the right shift in AS tends to decrease price. The final price level will depend on the relative effects ~~of~~ these two forces.

d.



Like the shift in long run aggregate supply this indicates increased production capacity of both products X and Y.