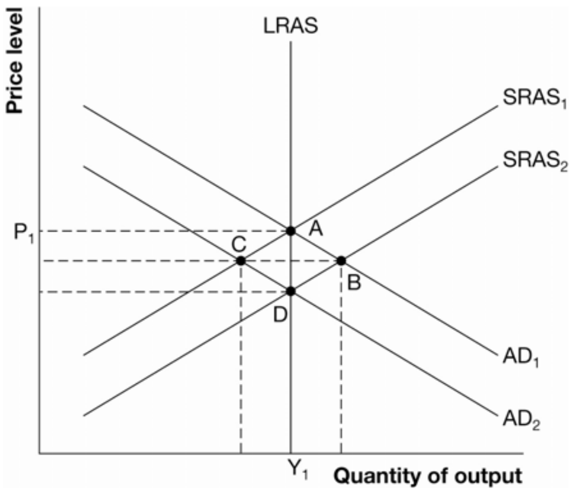
Chapter 36

1. Use the aggregate supply and aggregate demand diagram in Exhibit 1 to answer the following questions.

Exhibit 1



a. Suppose the economy is at long-run equilibrium at point A. Suppose that the economy suffers a macroeconomic shock in the form of a reduction in demand for its exports, but the shock is asymmetric – other economies are not affected similarly. If the exchange rate can adjust, what is the path followed by the economy as a result of this shock?

b. Suppose the same macroeconomic shock occurs but this time the economy concerned has joined a currency union that includes all its main trading partners. What is the path followed by the economy as a result of the macroeconomic shock now?

c. Referring to part (b) above, why might the government of the country illustrated in Exhibit 1 find itself in disagreement with the other countries in the currency union over monetary policy?

2. Suppose that the German economy is experiencing a recession while other countries in the Eurozone are in long-run macroeconomic equilibrium.

a. What would happen to interest rates on long-term government bonds issued by Eurozone governments if the German government were to increase its budget deficit dramatically to finance additional government spending? Explain your answer.

b. What might the members of a currency union do to counter this problem?

c. What might reduce the need for the German government to increase its budget deficit in these circumstances?