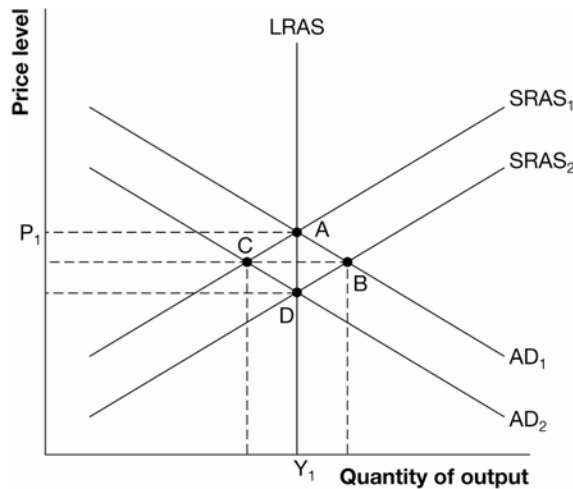


Chapter 38

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?