MODULE 45: PUTTING IT ALL TOGETHER

The purpose of this module is to show students how to tackle long free-response questions that combine elements of multiple macroeconomic models. The instructor can use this framework to greatly assist students in their preparation.

An additional FRQ is provided below. The instructor is encouraged to follow the "Structure for Macroeconomic Analysis" provided in the textbook.
Assume that the United States economy is in a long-run equilibrium.

(a) Draw a correctly labeled long run graph of aggregate demand and aggregate supply and show each of the following for the United States.
   (i) The current equilibrium output level, labeled Ye, and the current equilibrium price level, labeled PLe.

(b) Suppose that consumer confidence in the United States experiences a significant downturn. In the graph drawn in part (a), show the impact of weakened consumer confidence. In the graph, show any changes to the equilibrium price level and the equilibrium output level.

(c) Assume that the central bank of the United States is prepared to take action to reverse the economic impacts shown in part (b).
   (i) Should the central bank buy or sell bonds in an open market operation?
   (ii) How does the central bank's action in part (c)(i) affect the nominal interest rate? Explain.

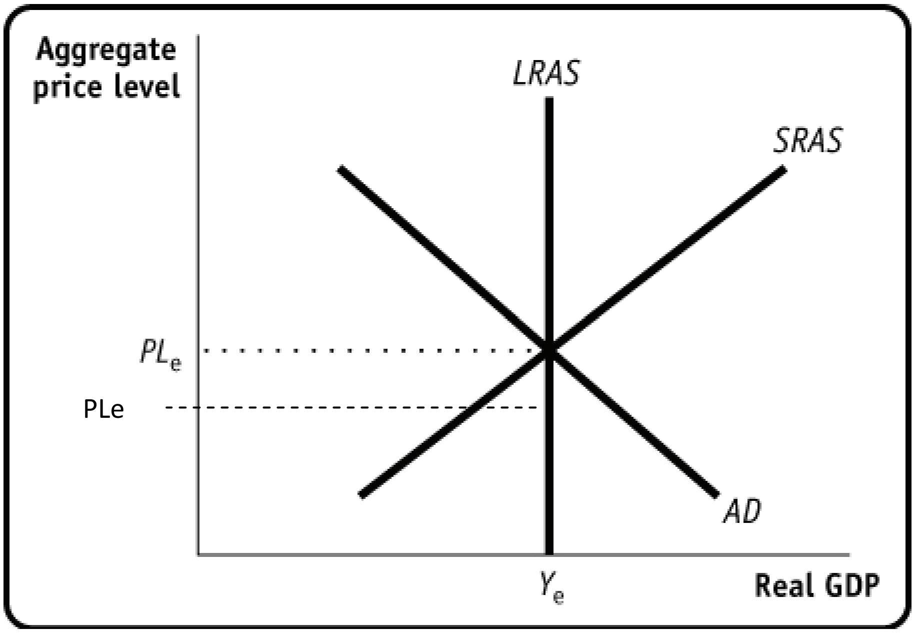
(d) The United States and Mexico are major trading partners. How would the weak consumer confidence in the United States affect the balance of payments current account with Mexico? Explain.

(e) Consider the foreign exchange market for the United States dollar. Based only upon your response to part (d), how are each of the following affected?
   (i) The supply of the United States dollar relative to the Mexican peso.
   (ii) The value of the dollar relative to the peso.

The Starting Point

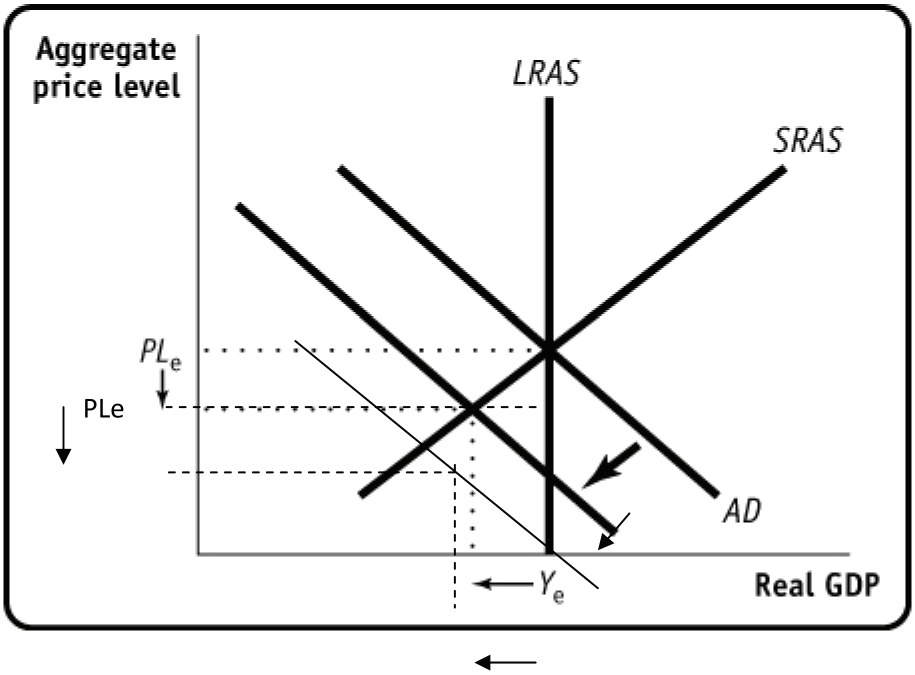
(a) Every question such as this gives the student a starting point. The student must demonstrate that he/she can understand, and usually graph, the situation that is given. In this case, the economy is in long-run equilibrium. If necessary, the instructor should review the implications of long-run equilibrium in the *AD*/*AS* model. The student must be aware that, given this starting point, there is neither an inflationary or a recessionary gap. Equilibrium output is current at full-employment output.

1 point: A correctly labeled graph with the *AD*, *SRAS*, and *LRAS* curves all intersecting.
1 point: The equilibrium output level is shown at *LRAS*.
1 point: The equilibrium price level is shown at the intersection of *AD* and *SRAS*.



The Pivotal Event

(b) In this part of the problem, consumer confidence has significantly fallen. Students should know the factors that shift *AD*, *SRAS*, and *LRAS* and that weaker consumer confidence causes a decrease in *AD*. This is a great opportunity for the instructor to review all of these "shifters" in the *AD*/*AS* model.
1 point: The graph shows a leftward shift of the *AD* curve.
1 point: The graph indicates a decrease in both the price level and real GDP.



Secondary and Long-Run Effects

(c) The central bank, given the weakened demand shown in part (b), should be pursuing expansionary monetary policy. The instructor should take this time to review the tools of the Fed. In the case of this question, the student is asked to focus on open market operations. To expand the money supply, the central bank should buy bonds.
(i) 1 point: Buy bonds

The student who understands monetary policy in the face of a recessionary gap also knows why buying bonds is the correct policy prescription.
(ii) 1 point: The nominal interest rate decreases.
1 point: Buying bonds shifts the money supply curve to the right. In the money market, this causes the interest rate to fall.

(d) This part of the problem tests the student's understanding of the balance of payments accounts and how international business cycles begin to affect the international flow of goods and money.
1 point: The current account balance in the U.S. will begin to rise.
1 point: A recession in the U.S. (caused by the weak consumer confidence) will decrease imports from Mexico. As fewer U.S. dollars are flowing to Mexico, the balance of payments in the current account rises.

(e) Finally, the question requires the student to demonstrate understanding of foreign exchange markets. The question has led the students to the conclusion that American consumers are buying fewer Mexican-made products. As the demand for Mexican products is falling, the demand for the peso would be falling, thus the supply of the dollar should also be falling.
1 point: Supply of the dollar is decreasing.
1 point: The dollar is appreciating relative to the peso.

Toward the end of the semester, as the instructor begins to intensively review for the AP Macro exam by using released Macro FRQs, it is suggested that this approach be followed. It will help the students to review critical material presented in earlier modules, and it will help the students acquire a straightforward approach to taking the test itself.

Best of luck!