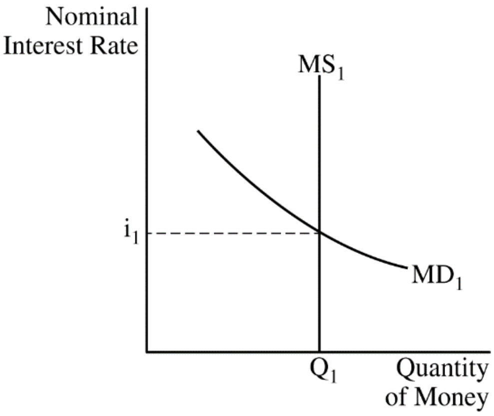
Question 2: Short — 5 points

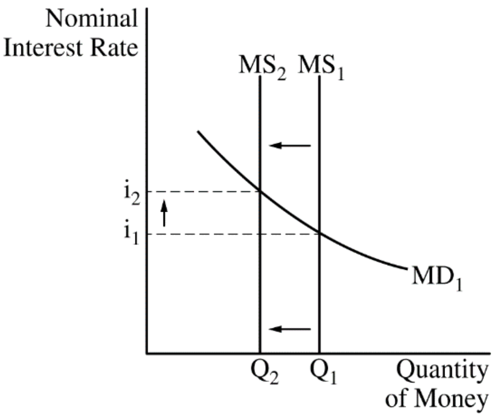
(a) Calculate the maximum change in the money supply as a decrease of $500,000 and show your work. **1 point**

$$\text{Change in MS} = \text{Bond Sale} \times \text{Money Multiplier} = -\$100{,}000 \times \frac{1}{0.2} = -\$500{,}000$$

(b) Draw a correctly labeled graph of the money market. **1 point**



For the second point, the graph must show a leftward shift in the money supply curve, resulting in a higher nominal interest rate. **1 point**



Total for part (b) 2 points

(c) State that nominal gross domestic product will decrease and explain that according to the quantity theory of money (MV=PY), a decrease in the money supply will decrease nominal gross domestic product for a given velocity. **1 point**

(d) State that the price level decreases. **1 point**

Total for question 2 5 points