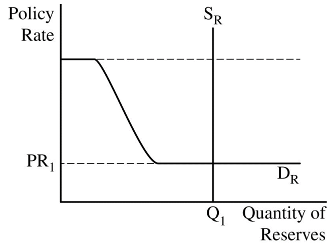
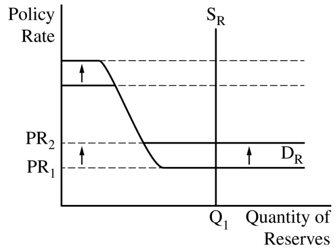
Question 2: Short — 5 points

A
Point 1 — State that the central bank would increase its administered interest rates or increase interest on reserves. — **1 point**

B
Point 2 — Draw a correctly labeled graph of the reserve market with the supply curve intersecting the demand curve in the range of ample reserves. — **1 point**

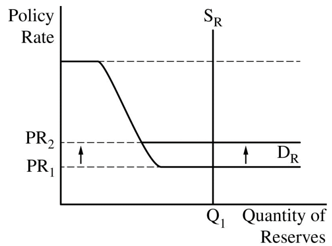


Point 3 — The graph must show an increase in the administered interest rates, resulting in an increase in the policy rate. — **1 point**



OR

The graph must show an increase in the lower bound of the demand curve for reserves, resulting in an increase in the policy rate.



C (i)
Point 4 — State that the price of previously issued bonds will decrease. — **1 point**

(ii)
Point 5 — State that the price level will decrease and explain that the increase in interest rates will decrease interest-sensitive spending (consumption, investment, or net exports), which will decrease aggregate demand. — **1 point**

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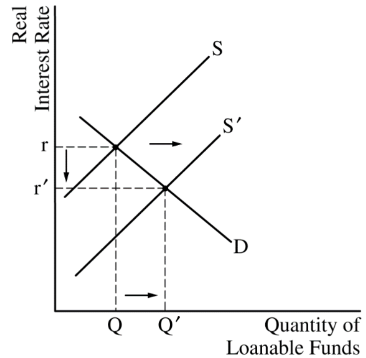
Question 2

5 points (1 + 2 + 2)

(a) 1 point:

- One point is earned for stating that private savings will increase.



(b) 2 points:

- One point is earned for drawing a correctly labeled graph of the loanable funds market showing a downward sloping demand curve and an upward sloping supply curve.
- One point is earned for showing a rightward shift in the supply curve (increased private savings) and for showing a decrease in the equilibrium real interest rate.

(c) 2 points:

- One point is earned for stating that aggregate demand will increase and for explaining that the decrease in the real interest rate will result in an increase in interest-sensitive spending (consumption or investment or net exports).
- One point is earned for stating that potential real gross domestic product (GDP) will increase as a result of an increase in capital formation brought about by the increase in investment spending (or because capital formation increased the long-run aggregate supply).