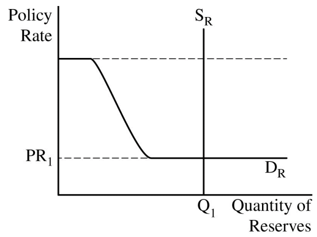
Question 2: Short — 5 points

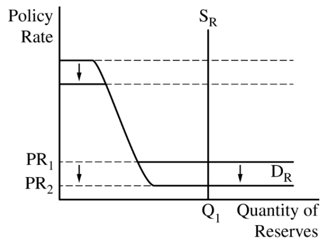
A Point 1 — State that the central bank of Country L would buy bonds. — **1 point**

B Point 2 — State that the central bank of Country A would decrease its administered interest rates or decrease interest on reserves. — **1 point**

C Point 3 — 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**

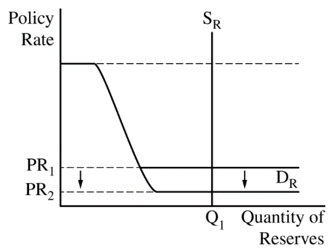


Point 4 — The graph must show a decrease in the administered interest rates, resulting in a decrease in the policy rate. — **1 point**



OR

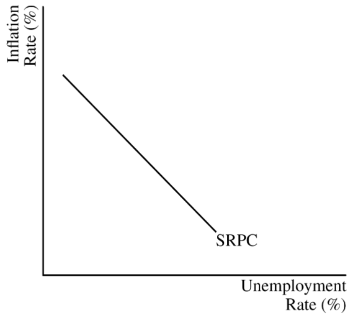
The graph must show a decrease in the lower bound of the demand curve for reserves, resulting in a decrease in the policy rate.



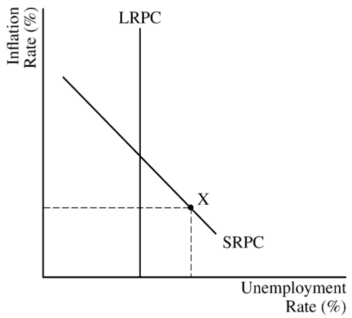
D Point 5 — State that short-run aggregate supply will increase until it reaches full employment and explain that the increase in short-run aggregate supply in the long run will be caused by a decrease in input prices (e.g., nominal wages) and/or inflationary expectations. — **1 point**

Question 2: Short — 5 points

(a) Draw a correctly labeled graph of the SRPC. **1 point**



For the second point, the graph must include a correctly labeled LRPC and show point X on the SRPC to the right of the LRPC. **1 point**



Total for part (a) — 2 points

(b) (i) Calculate the minimum change in government spending as $150 billion and show your work. **1 point**

$$\frac{\text{Change in GDP}}{\text{Spending Multiplier}} = \frac{\$600 \text{ billion}}{1/(1-0.75)} = \frac{\$600 \text{ billion}}{4} = \$150 \text{ billion}$$

(ii) Calculate the minimum change in taxes as $200 billion and show your work. **1 point**

$$\frac{\text{Change in GDP}}{\text{Tax Multiplier}} = \frac{\$600 \text{ billion}}{-0.75/(1-0.75)} = \frac{\$600 \text{ billion}}{-3} = -\$200 \text{ billion}$$

Total for part (b) — 2 points

(c) Explain that SRAS will increase in the long run due to a decrease in nominal wages, input prices, or inflationary expectations. **1 point**

Total for question 2 — 5 points