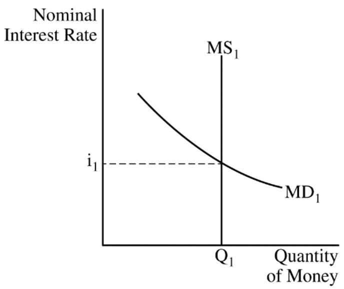
Question 2: Short — 5 points

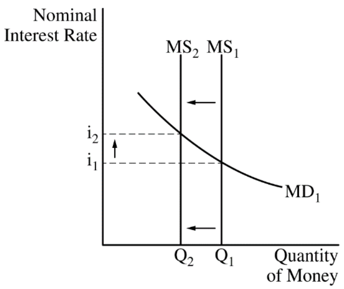
(a)	Calculate the maximum change in the money supply as a decrease of \$500,000 and show your work.	**1 point**

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

(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

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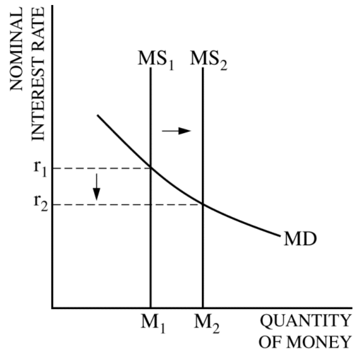
Question 2

6 points (2+2+1+1)

(a) 2 points:

- One point is earned for stating that the Federal Reserve will buy government bonds.
- One point is earned for stating that the price of government bonds will increase.



(b) 2 points:

- One point is earned for drawing a correctly labeled graph of the money market.
- One point is earned for shifting the money supply curve to the right and showing a decrease in the nominal interest rate.

(c) 1 point:

- One point is earned for stating that the Federal Reserve purchase will not initially affect commercial banks' required reserves.

(d) 1 point:

- One point is earned for defining the discount rate as the interest rate that the Federal Reserve charges banks for borrowing from its discount window.

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