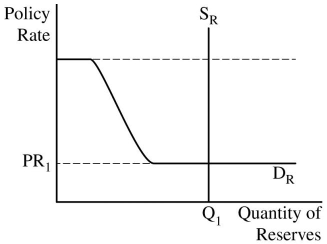
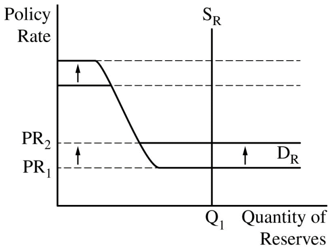
Question 2: Short — 5 points

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**

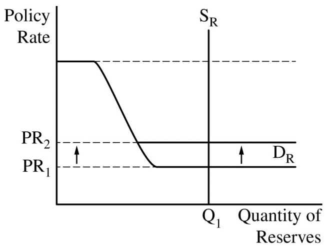


Point 3 — The graph must show an increase in the administered interest rates, resulting in an increase in the policy rate. **1 point**



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**

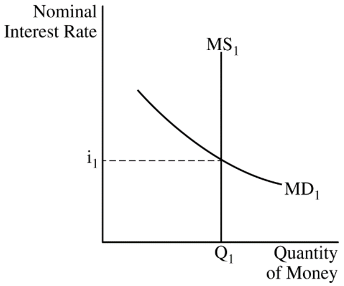
(ii)
Point 5 — State that the price level will decrease and explain that the increase in interest rates will decrease interest-sensitive spending (consumption, investment, or net exports), which will decrease aggregate demand. **1 point**

Question 2: Short — 5 points

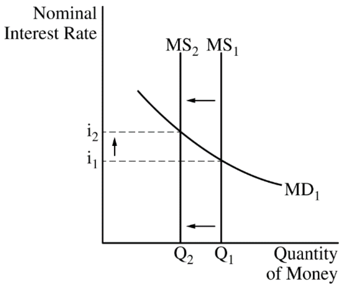
(a) Calculate the maximum change in the money supply as a decrease of \$500,000 and show your work. — **1 point**

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

(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**

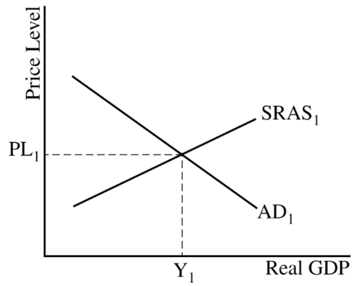
(c) State that nominal gross domestic product will decrease and explain that according to the quantity theory of money (MV=PY), a decrease in the money supply will decrease nominal gross domestic product for a given velocity. — **1 point**

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

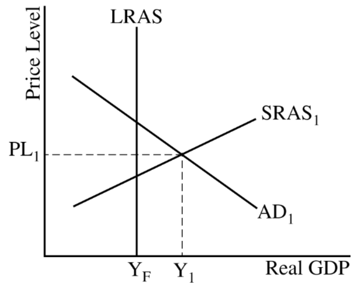
Total for question 2 — **5 points**

Question 1: Long — 10 points

(a) Draw a correctly labeled aggregate demand–aggregate supply graph that shows PL_1 and Y_1 at the intersection of AD and SRAS. — **1 point**

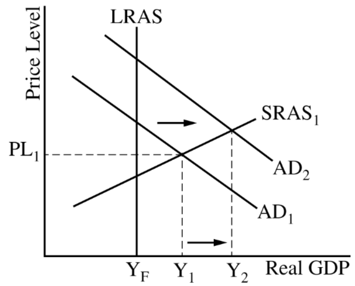


For the second point, the graph must show a vertical LRAS curve to the left of Y_1 and label the full employment output Y_F. — **1 point**

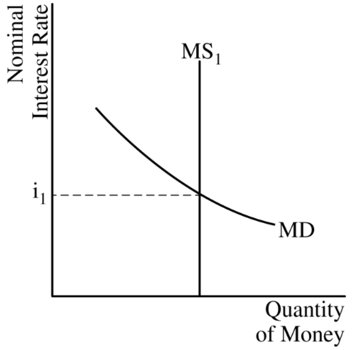


Total for part (a) — **2 points**

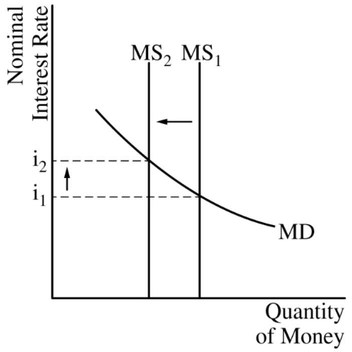
(b) On the graph from part (a), show the impact of the government's action with a rightward shift of the AD curve and an increase in short-run equilibrium real output labeled Y_2. — **1 point**



(c) (i)	State that the natural rate of unemployment will not change.	**1 point**
(ii)	State that nominal interest rates will increase and explain that this is because the increase in real output will increase the demand for money.	**1 point**
	Total for part (c)	**2 points**
(d)	State that the central bank should sell bonds.	**1 point**
(e)	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 (e)	**2 points**
(f)	State that Smithland's currency will appreciate and explain that this is because there will be financial capital inflows as foreign investors seek higher returns in Smithland, which will increase the demand for Smithland's currency or decrease the supply of Smithland's currency.	**1 point**

(g)	State that Smithland's imports will increase and explain that this is because the appreciation of Smithland's currency means that foreign goods will be relatively less expensive.	**1 point**
	Total for question 1	**10 points**