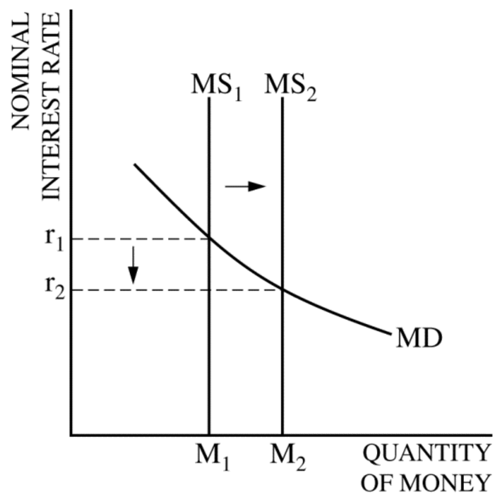
Question 2

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.

2A

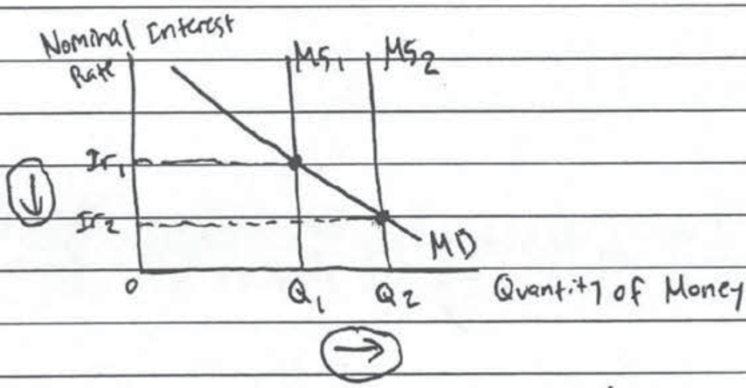
(2)

(a)

(i) The Federal Reserve should buy bonds in the open market.

(ii) The price of government bonds will increase.

(b)



* Nominal Interest Rate Will Fall

(c) The level of required reserves in the commercial banks will remain the same.

(d) The discount rate is the interest rates that banks pay, when they borrow money from the central bank.

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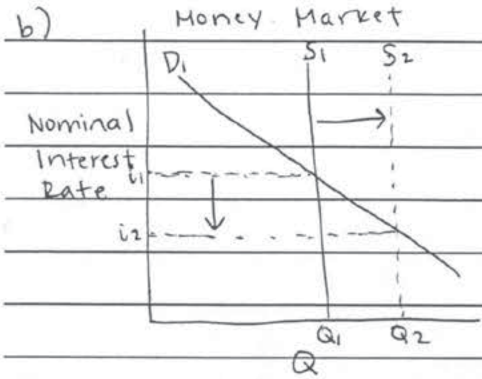
2B

ANSWER PAGE FOR QUESTION 2

a) i) The Federal Reserve can buy bonds/government securities.

ii) Price of government bonds will increase.

b)



nominal interest rate ↓

c) Required reserves in commercial banks will increase

d) Discount rate is the rate of interest that banks charge other banks when lending money for a period of time.

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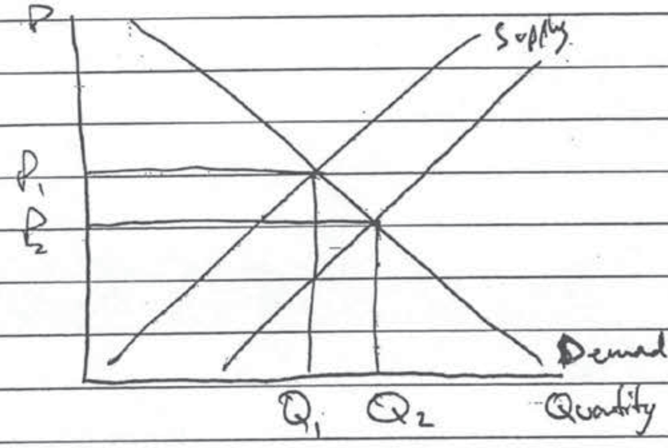
2 C

a) i) The Federal Reserve can sell government bonds to acheive the lower target.

ii) This will make the price of government bonds go down.

b)



c) The level of required reserves in the comericial bank would decrease.

d). The discount rate is the rate at which costumers of a commercial bank can save.

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Question 2

Overview

The question asked students to identify and explain the effects of monetary policy. Part (a) asked students to identify an open market operation necessary to target a lower federal funds rate and indicate how that open market operation will affect the price of government bonds. Part (b) required students to draw a money supply and money demand graph to show the effect of the open market operation identified in part (a) on the nominal interest rate. Part (c) asked students to identify the effect of the open market operation on required reserves. Part (d) asked for a definition of the discount rate.

Sample: 2A
Score: 6

The response answered all parts of the question correctly.

Sample: 2B
Score: 4

The response did not earn 1 point in part (c) for stating that required reserves will increase. The response did not earn 1 point in part (d) for an incorrect definition of the discount rate.

Sample: 2C
Score: 1

The response earned 1 point in part (a)(ii) for stating that the price of bonds will decrease, because it is consistent with the incorrect answer in part (a)(i), where the response stated that the Federal Reserve will sell bonds.