2. The Federal Reserve can influence the supply of money.

   (a) Assume that the Federal Reserve targets a lower federal funds rate.

      (i) What open market operation can the Federal Reserve use to achieve the lower target?

      (ii) Given your answer to part (a)(i), what will happen to the price of government bonds?

   (b) Using a correctly labeled graph of the money market, show the effect of the open market operation from part (a)(i) on the nominal interest rate.

   (c) Assume that the Federal Reserve buys government bonds from commercial banks. Based only on this transaction, will the level of required reserves in the commercial banks increase, decrease, or remain the same?

   (d) Another monetary policy action involves changing the discount rate. Define the discount rate.

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3. The United States and South Korea are trading partners, and the United States has a zero current account balance. Assume now that the inflation rate in the United States decreases relative to the inflation rate in South Korea.

   (a) Based on the decrease in the inflation rate in the United States, will United States exports to South Korea increase or decrease?

   (b) Based on the change in United States exports in part (a), answer each of the following.

      (i) Will the United States current account balance remain at zero, be in surplus, or be in deficit?

      (ii) What will happen to real gross domestic product in the United States in the short run? Explain.

   (c) The South Korean currency is the won. Draw a correctly labeled graph of the foreign exchange market for the United States dollar. Show the effect of the lower inflation rate in the United States on the won price per United States dollar.

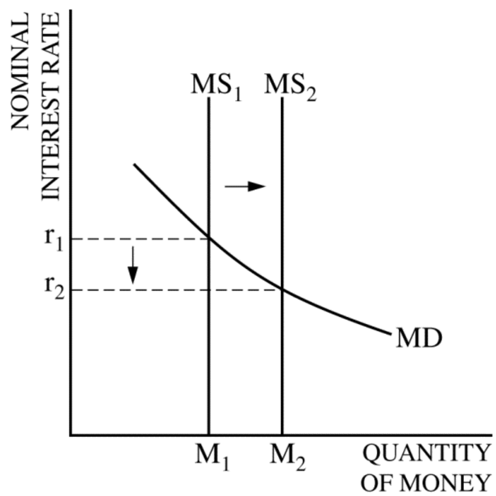
STOP

END OF EXAM

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.