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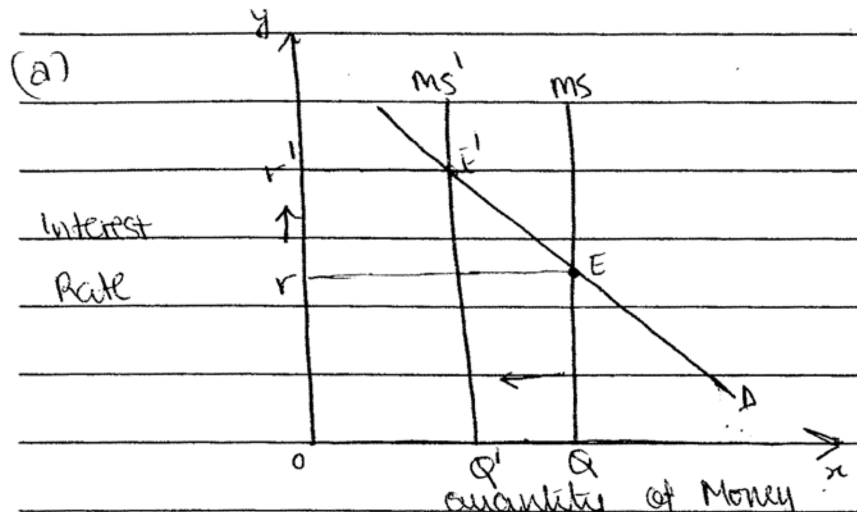
(a)



Loanable Funds market

Taking Quantity of Money on x axis and Interest rate on Y axis. Money Supply (MS) is represented by a vertical curve since quantity of Money supplied is fixed for a given time period. As a result of an open-market sale of government bonds by the central bank, being a contractionary monetary policy, Money Supply decreases and shifts left to MS'. At this new equilibrium E' the Interest rate increases to r'.

(b) The new increased Interest rate r' is a nominal rate.

(C) If the inflation rate is not equal to zero (or Inflation rate is greater than or less than zero) ie.

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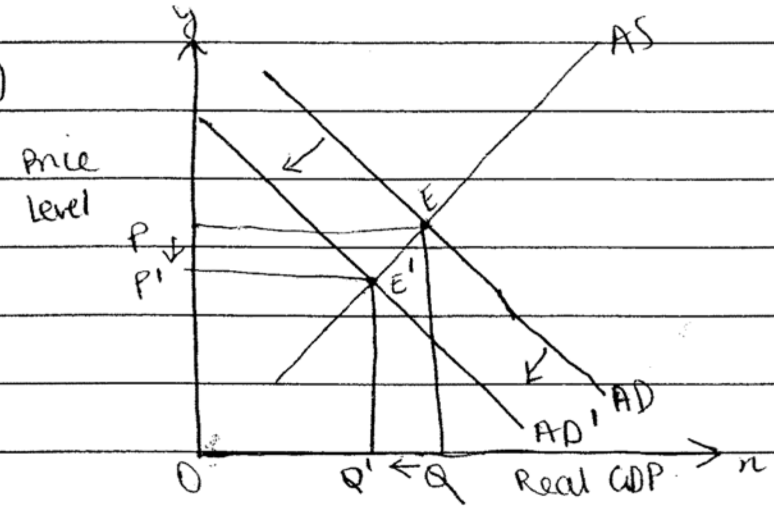
when there is inflation or deflation, then the nominal rate differs from real interest rate.

(d)



Taking Real GDP on x axis and Price level on Y axis. Initially Aggregate Demand (AD) curve and Aggregate Supply (AS) curve intersect at E where initial equilibrium output is OQ and Price level is OP.

As a result of the open market operation, Money supply decreases ∴ disposable income drops and Consumption reduces. Since interest rates go up, Investment and consumption is discouraged and imports increase ∴ Aggregate Demand decreases and shifts left to AD'.

At this Short Run equilibrium E'

(i) Real output decreases to OQ'

(ii) Price level drops to OP'

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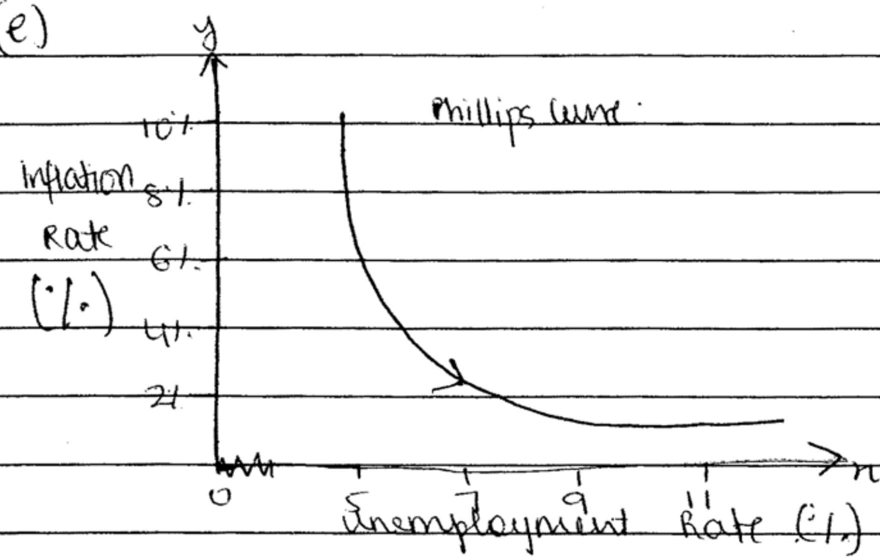
(e)



The Open Market Operation, reduces output and price level ∴ Unemployment increases and Inflation reduces ∴ there is movement down the Phillips curve.

(f) The fiscal policy action of increased government spending and reduction in income tax would increase Aggregate Demand and offset the impact on real output and price level caused by the open market operation