1. The spreadsheet sent to the class list-serve on Nov. 13 shows the relationship between income and aggregate expenditures, holding all other things (including prices) fixed.
   a. According to the values in the chart, what is the current level of equilibrium spending/income? Why?
   b. Suppose something occurs to cause investment spending to rise to 700 at all levels of income (change the value for investment in row 2 from 300 to 700). What is the new level of equilibrium income?
   c. What is the relationship between the change in equilibrium income and the initial change in investment?

2. The Fed’s current target for the federal funds rate is 1.25%.
   a. Assume that the actual federal funds rate currently equals the Fed’s target. Now assume that the demand by banks to hold reserves increases. How will the Fed respond in the open market (i.e. will it buy t-bills or sell t-bills) to keep the actual interest rate equal to the target rate? Illustrate your answer using a graph of the market for bank reserves.
   b. Suppose the Fed observes the inflation starting to rise. According to the policy rule discussed in class, how will the Fed alter its target fed funds rate? Will the Fed buy or sell t-bills on the open market to implement this change? Illustrate.

3. According to the aggregate fluctuations model discussed in class, changes in the rate of inflation affect aggregate demand because of how the Fed responds to inflation. Complete the following description of the AD curve: “Suppose the rate of inflation decreases. The Fed responds by _______ (raising, lowering) its target federal funds rate by _______ (more than, less than) the change in inflation. The real interest rate thus _______ (falls, rises). This causes the aggregate expenditure schedule (E) to _______ (shift up, shift down), and therefore the level of income demanded (Y) to _______ (fall, rise). Note that the change in demand is _______ (greater than, less than) the shift in E. In sum, all this describes a _______ (negative, positive) relationship between inflation and aggregate demand, and a _______ (shift in, movement along) the aggregate demand curve.” Repeat the above for an increase in inflation.

4. Describe how each of the following affects the aggregate demand curve.
   a. A decrease in government purchases
   b. A decrease in tax revenues according to the i) conventional view of tax policy; ii) Ricardian view of tax policy.
   c. An upward shift in the Fed’s monetary policy rule.
5. Assume the economy is initially at its full-employment level of real output (GDP) at some given rate of inflation.
   a. Use the aggregate fluctuations model to describe the effects on GDP and inflation of a permanent increase in government expenditures in the short-run and the long-run, assuming the Fed allows its target rate of inflation to adjust to the new level (that is, the Fed doesn’t shift its policy rule).
   b. At the new long-run equilibrium, will the real interest rate be greater than or less than its initial level? What about consumption and investment? Is your answer consistent with the predictions of the spending shares model discussed earlier?

6. Suppose the Fed’s target federal funds rate is 1.75%. At its current meeting, the FOMC observes that the rate of inflation has held steady over the past few months, but that it is likely that real GDP is below its potential level.
   a. How could the Fed alter its monetary policy rule to bring output back to its full-employment level? Explain using the aggregate fluctuations model.
   b. What if the economists providing information to the FOMC are wrong – output is actually equal to its potential level, not below it. What would happen to output and inflation if the Fed acts as in part (a)?

7. When is deflation a “good” thing, and when is it a “bad” thing?