

PRINCIPLES OF MACROECONOMICS

Economics 105 / Section 4 / Binder

ASSIGNMENT #7 DUE ON THURSDAY, NOVEMBER 15 (note change in due date):
Do Chapter 15 in the Study Guide. Hand in pp. 279-89.

CLASS PROBLEMS (DO NOT HAND IN) on:

UNDERSTANDING HOW THE FED USES MONETARY POLICY TO STIMULATE OR CURB IN AGGREGATE DEMAND

1. a) Use a graph of the supply and demand for money with respect to the interest rate to show how the Fed reaches a target interest rate of 5.5%, if the interest rate is currently 5.0%.

Note: the interest rate the Fed targets is the federal funds rate the rate banks charge each other on short-term loans.

b) In the long run this move will reduce the price level. In the short run (because prices are sticky), the price level is unchanged. In the long run, what effect does a reduction in money supply have on P and money demand?

c) Using a graph of supply and demand for money with respect to the interest rate, show how the Fed reaches a target interest rate of 4.5%, if the interest rate is currently at 4.75%.

2. a) Suppose that the Fed increases the money supply. What is the effect on Aggregate Demand? Explain.

b) Why might politicians prefer a policy that increases the money supply?

c) Why is this not a good idea in the long run?

3. Consumer confidence was shaken by the Sept. 11 terrorist attacks.

a) Using AS and AD analysis, show the effect on the economy.

b) If the Fed wants to reverse the effect of loss of consumer confidence, what should it do to the interest rate?

c) Using a graph of the supply and demand for money with respect to the interest rate, show how the Fed changes the interest rate.

d) Explain the connection between the interest rate and Aggregate Demand.