

- 1) Suppose the Fed reduces the money supply by 5 percent.
  - a) What happens to the aggregate demand curve?
  - b) What happens to the level of output and the price level in the short run and in the long run?
  - c) According to Okun's law (this was referred to back in Chapter 2 – check it out), what happens to unemployment in the short run and in the long run?
  - d) What happens to the real interest rate in the short run and in the long run?
  
- 2) Let's examine how the goals of the Fed influence its response to shocks. Suppose Fed A cares only about keeping the price level stable, and Fed B cares only about keeping output and employment at their natural levels. Explain how each Fed would respond to
  - a) An exogenous decrease in the velocity of money.
  - b) An exogenous increase in the price of oil.
  
- 3) Almost all economists agree that wages and prices are flexible in the long run and that real GDP moves toward its natural level. The speed with which this occurs, however, is a subject of considerable debate. Some economists believe that sticky wages and prices make the movement back to the natural level a long, protracted process, while others believe that wages and prices are sufficiently flexible to move the economy rapidly to its natural level.

What do you suppose economists who believe that the natural level is achieved very slowly think about the importance of stabilization policies? Why? What do you suppose economists who believe that the natural level is achieved rapidly think about stabilization policies? Why?

- 4) Suppose velocity is stable. What specific things would the Federal Reserve need to know in order to keep output at its natural level following a supply shock?

Suppose instead that velocity is unstable and unpredictable. How would this complicate the Federal Reserve's ability to stabilize the economy following a supply shock?