
1) a) The **term structure of interest rates** shows the relation between interest rates and “time to maturity.” How are these typically related? What happens to the relationship when people expect inflation to rise in the future?  
b) Suppose the interest rate on a risk-less bond maturing in 1 year is 9% and on a risk-less bond maturing in 2 years is 11%. What would the **expectations theory of the term structure** predict would be the interest on a one year bond selling one year from today and maturing in two years?  
c) Provide a reason why long-term and short-term interest rates tend to move together.  
d) What might cause long-term interest rates to fall, and short-term interest rates tend to rise?  
e) The term structure can be summarized by a “yield curve” with time to maturity on the horizontal axis, and interest on the vertical axis. Draw three points on such a curve where interest on 1, 2 and 5 year bonds are 4%, 6% and 7% respectively.  

2) a) Briefly describe the following: Federal Funds Rate; Commercial Paper Rate; and Prime Rate.  
b) What does it mean to “downgrade” the debt of a borrower? How would this affect the interest rate this borrower pays?  
c) How does the interest rate on home loans compare with that on credit card debt? Why might there be a difference?  

3) a) Theory in Ch 11 implies the quantity of money demanded will change as interest rate falls. How will it change and why? Is this depicted by a shift in the money demand curve?  
b) Theory presented in Ch 12 implies planned investment will change as interest rate falls. How will it change and why? How is this depicted by a shift in the Aggregate Expenditures Function?  

4) a) Suppose aggregate planned expenditures = actual GDP (= National Income); i.e., AE=Y; when Y = 100 (billion $) and “the” interest rate, r = 5%. All else constant, if r increases to 10%, will AE be larger or smaller than 100? How will a change in r affect AE?  
b) In Chapters 12 and 13, how do we assume money demand changes with changes in interest, income and price level?  
c) In a simple Keynesian model, what must be true in order for monetary policy to increase equilibrium Y = Y_e?  

5) a) What do economists mean when they refer to “crowding out” effect of an increase in government spending, G?  
b) List three reasons for “crowding out.”  
c) By what chain of events might an increase in G reduce I?  
d) How does the “interest sensitivity of planned investment” relate to the extent of crowding out?  

6) How would each of the following affect planned investment, I: i) interest rate; ii) expected future sales; iii) capacity utilization rate, and iv) relative productivity of labor (L) and capital (K).  

7) a) Explain the two reasons given in Chapter 13 for the AD curves slope. What is the third reason presented in class?  
b) What change independently (or exogenously) as we move along an AD curve?  
c) What happens to the AD curve when the money supply increases?, G increases? Tax is reduced?  

8) a) In figure 13.6, AS is drawn with a slope that increases as Y increases. What does this depict?  
b) If an economy were in a depression, the AS would be flatter. Why?  
c) If an economy were in an expansion, the AS curve would be steeper. Why?  
d) List two things that would shift AS left.  
e) Contrast a long run with short run AS curve.  

9) “Potential output” can be called “full employment” level of output. Actual output approximately equals potential (or full employment level of) output when the unemployment rate approximately equals the “natural rate of unemployment.” In this situation, what are the effects of expansionary fiscal policy and expansionary monetary policy?  

10) It is sometimes convenient to depict the AS curve as having a horizontal, and a vertical segment. (see page 272). Which segment better corresponds to classical theory and which to Keynesian theory?  

11) “Adverse supply shocks” are called “cost shocks” in our text. Give an example of such a shock and explain the effect on national income and the price level. Can such a shock cause “sustained inflation”?
12) a) In the classical view of unemployment, what is the basic cause of unemployment? How does a market reduce unemployment? How would a binding minimum wage law affect the rate of unemployment? 
b) In a Keynesian model, unemployment can be the result of sticky wages - explain how. Why might wages be “sticky?”
c) The aggregate labor supply is conventionally drawn upward sloping – why? Individual labor supply curves can also be drawn. Why would an individual labor supply curve be upward sloping. How could an individual labor supply curve be “backward bending” with negative slope?

13) a) What is assumed constant along a short-run Phillips curve? 
b) What happens to the Phillips Curve if the future inflation rate expected by workers increases? 
c) Points on a short-run Phillips Curve can be derived by equilibria of AD and AS. Shifts in which, AS or AD, will give points on a Phillips Curve? 
d) Figure 14.10 shows Y₁ > Y₀ (= full employment level of output) 
Realize “full employment level of output” = “potential output” can be written: Yₚₒᵗ (for potential) or Yᵢ (or full employment). 
e) If output is above “potential output,” how does the actual unemployment rate compare to the natural rate (or NAIRU)? What will happen to the price level and inflation? 
f) What government policy can cause a sustained inflation?