ECO 301: Money and Banking **Your Name:** ____________________

In-class Exercise: Aggregate Supply / Aggregate Demand

Directions: Work in groups of up to four people and answer the following questions. All papers will be collected, but only one member's paper will be randomly selected and graded and all members of the group will receive the same grade. Failure to complete the worksheet with a group will result in a 15 percentage point penalty.

By signing below, you agree that the following work represents the efforts of everyone in the group, and you are willing to accept as your own grade for the group project the grade earned from this representation of your group's work.

Signature Group Member 1	Print Name	Date
Signature Group Member 2	Print Name	Date
Signature Group Member 3	Print Name	Date
Signature Group Member 4	Print Name	Date

1. Suppose real GDP is equal to potential GDP when the Fed conducts an open market purchase of bonds.

   (a) Describe and illustrate the short-run effect on real GDP and the price level. How does real GDP in the short run compare to its initial level?

   (b) Describe and illustrate the long-run effect on real GDP and the price level (redraw your previous answer to start answering this question). If there is a change in price level, what impact does this have on *real* money supply in the long-run? Describe and illustrate the impact on the market for money. What does this imply about the limitations of monetary policy?

2. Suppose real GDP is equal to potential GDP when there is an improvement in financial technology that causes people to want to hold more of their income and wealth in interest-bearing financial assets, and less in money.

   (a) Describe and illustrate the short-run effect on real GDP and the price level. How does real GDP in the short run compare to its initial level?

   (b) Describe and illustrate the long-run effect (again, redraw your previous answer to start answering this equation) on real GDP and the price level. If there is a change in price level, what impact does this have on *real* money supply in the long-run?

   (c) Beginning with the situation that you describe in part (a), describe and illustrate a monetary policy that can achieve price stability and bring GDP back to potential GDP.

3. Suppose a crisis in residential mortgage loans leads to a financial crisis affecting the liquidity and solvency of financial firms across the country. In response, banks keep large amounts of liquidity on hand to avoid liquidity problems, and banks severely restrict the amount of lending they do.

   (a) Describe the impact on excess reserves. Describe and illustrate the impact this has on the market for money.

   (b) Describe and illustrate the impact on real GDP and price level in the short-run.

   (c) Describe and illustrate a monetary policy that can achieve price stability and bring GDP back to potential GDP.

4. Suppose real GDP is equal to potential GDP when an increase in violence in the Middle East causes a temporary decrease in the global supply of oil.

   (a) Describe and illustrate the short-run and long-run effects on real GDP and price level. Please show to separate graphs: One with the short-run equilibrium, one with the short-run and long-run equilibrium combined.

   (b) Describe and illustrate a monetary policy that can achieve price stability and bring GDP back to potential GDP, without waiting for the long-run recovery that you describe in part (a).