1. Draw a loanable funds diagram depicting equilibrium in the loanable funds market:

2. Now suppose there is an increase in the government deficit. Show what this will do to the demand and/or supply in the above diagram. (Indicate the appropriate shifts). What has happened to equilibrium interest rates?

3. Now suppose that for every dollar of new deficit spending, the public decides to save an additional dollar of income (this is consistent with a controversial theory called Ricardian Equivalence). Illustrate this on the above diagram. What has happened to equilibrium interest rates?

4. Now illustrate this example of Ricardian equivalence in terms of the bond market. Show the appropriate shifts in bond demand and/or supply. What has happened to bond prices?

5. Now draw the bond market in equilibrium. Now suppose that the Federal Reserve decides to
purchase $100 million in bonds. Illustrate what this will do in the bond market. What has happened to bond prices and interest rates? What has this action by the Federal Reserve done to the deficit?

6. Now suppose that there is an increase in deficit spending of $100 million dollars (financed by issuing new Treasury bonds) and at the same time the Federal Reserve decides to purchase $100 million in bonds. Draw a diagram illustrating what has happened in the bond market. What has happened to equilibrium bond prices and interest rates? (This is a situation often referred to as “monetizing” the deficit.)