1. Draw an AD/AS diagram showing the economy in both short and long term equilibrium at the natural rate of unemployment (full employment).

a) Suppose that the Federal Reserve purchases bonds on the open market. Show what impact this will have on output and prices in the short run on the above diagram.

Prices will ________________________________.

Output will ________________________________.

b) What will be the long run impact on prices and output? Explain.
2. Suppose we start again at a long and short run equilibrium at full employment which there is an increase in money demand (decrease in the velocity of money). What impact would this have on aggregate supply/demand/and prices in the short run? In the long run?

Illustrate using AD/AS diagrams.

3. Suppose the economy is at full employment when the government enters into a war, requiring a big increase in defense expenditures. Why might this cause a problem (look at it in terms of an AD/AS diagram)? How could the Federal Reserve respond so as to mitigate this problem?