**ABC (AP) Questions:**

1. **Who is Alan Greenspan?**

   Al is the chairman of the Federal Reserves. He's a good friend of William at least in William's dreams.

2. **What is the relationship between the federal funds rate, investment spending, and consumption spending?**

   The federal funds rate is the interest rate for loans among banks. The Fed targets the federal funds rate through open market transactions (the selling and buying of government bonds). The federal funds rate is also the short-term interest rate.

   There is a negative relationship between the federal funds rate and investment spending. When the federal funds rate increases, then the opportunity cost of investing increases. Investment spending falls.

   There is a negative relationship between the federal funds rate and consumption spending. When the federal funds rate increases, then the opportunity cost of consuming increases. Consumption falls.

   ![Graph showing the relationship between Federal funds rate and Investment](image1)
   ![Graph showing the relationship between Federal funds rate and Consumption](image2)

   The Fed's effect on the federal funds rate does *not* shift the curves in the long-run Investment-Savings model because the federal funds rate is in the short-run.

3. **How does a low federal funds rate increase investment spending?**

   When the federal funds rate is low, then the opportunity cost of investment is also low. Investment rises.
The Economist Questions:

1. Why are economists so concerned about oil prices?

Oil is a major input for most industries. The 1973 OPEC oil-price shocks caused high inflation and unemployment in the United States.

An increase in oil prices raises the cost of production for all firms. Firms increase output prices which pushes-up inflation. AS shifts up.

The Fed combats inflation by increasing the interest rate. An increase in the interest rate increases the opportunity cost of investment. Investment spending drops which reduces output. Unemployment rises.

2. What are the externalities of oil consumption? Positive or negative externalities?

The negative externalities are:

Loss of national security because the U.S. is dependent on other countries for a major input.

Environmental destruction and global warming.

3. What is the affect of an oil tax, proposed by the article, on long-run and short-run inflation and unemployment?

In the short-run, an oil tax raises the price of oil. An increase in the price of oil raises the cost of production for all firms, which raises the price of output. Inflation rises. In other words, the AS curve shifts up.

In the short-run, the Fed raises interest rates to combat inflation. An increase in the interest rate increases the opportunity cost of investment and the opportunity cost of consumption. Investment and consumption falls. Y falls which raises unemployment.

In the short-run, the oil tax raises inflation and raises unemployment. The article mentions raising oil taxes and lowering other taxes. However, this assumes that the lowering of other taxes reduces the cost of production for most or all firms. There are very few taxes that the government can lower in order to affect the AS curve. Oil prices affect all firms.
In the short-run, the oil tax will create technological innovations in energy resources. This reduces the negative externalities of oil consumption and decreases the price of energy and oil. Prices of output decrease, which reduces inflation.

The technological innovation increases our long-run potential output ($Y^*$).

In the long-run, the oil tax decreases inflation and decreases unemployment.

In the long-run, the oil tax will create technological innovations in energy resources. This reduces the negative externalities of oil consumption and decreases the price of energy and oil. Prices of output decrease, which reduces inflation.