**Explanation**

In this classroom activity students work in groups (pairs) that include a borrower (consumer or firm) and a lender (bank). There are three rounds of activity that the pairs engage in. In Round 1, students work with nominal and real interest rates to think more deeply about how inflation can transfer purchasing power from borrowers to lenders, or vice-versa. In Round 2, students consider the impact of changes in the Federal Funds rate on borrowing/lending and overall economic activity. In Round 3, students are asked to think critically about inflation expectations, the impact of prediction errors, and the roll of forward guidance by the Federal Reserve Bank in forming expectations.

By the end of this activity students should:

1. Be comfortable with and be able to use nominal interest rates and inflation rates to compute a real interest rate (or real interest rates and inflation rates to compute a nominal interest rate);
2. Understand how inflation impacts purchasing power and identify who gains/loses with inflation.
3. Be able to explain how changes in the Fed Funds rate impacts overall borrowing and lending;
4. Recognize the limits of conventional monetary policy, and the need for unconventional policy, at near zero interest rates;
5. Understand the importance of inflation expectations as well as errors in expectations and identify who gains/loses when errors are present;
6. Understand the importance of and interpret Federal Reserve language related to guiding inflation expectations (forward guidance).

**Materials needed**

* Black playing cards, numbers 2-9. Have enough cards for 1 per team.
* Red playing cards, numbers 2-9. Have enough cards for 1 per team.
* 1 Student Worksheet for each pair of students.
* 1 Student Instructions for each pair of students
* 1 die (to be used by the instructor)
* Representative market basket of goods (can have a physical basket or draw on the board)

**Timing**

This activity can be completed in a 50 minute classroom period. Conceivably, it could be used for any size class, but larger classes would need TA help to distribute and collect materials and worksheets.

**Extensions/Assessment**

This activity can be extended by having students analyze Federal Reserve Open Market Committee statements (<http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm#18545>) for language that gives clear guidelines about future Federal Reserve policy. It might be helpful to include a representative statement under different Fed Chairs and have students note differences in openness.