Economics 470/570 **Name: ______________________________**
Fall 2006 **(1 point if name is on *all* exam pages)**
Midterm #2

Part I - Definitions. Define each of the following (3 points each, 18 points total).

1. Velocity of money
2. Disposable income and the MPC
3. Policy effectiveness
4. Expenditures
5. IS curve
6. Crowding out

Part II - Short Answer. Answer each of the following questions (9 points each, 36 points total).

1. Is velocity a constant in Keynes' liquidity preference theory? When actual data is examined, does velocity appear to be a constant? Briefly, why is this important?

2. Derive the LM curve graphically. Explain intuitively why it slopes upward.

3. Show graphically and explain intuitively how an increase in taxes affects income and the interest rate in the IS-LM model.

4. What did Tobin add to Keynes' theory of the speculative demand for money? Why was this development important?

Part III – Essays and problems. Answer THREE of the following questions (15 points each, 45 points total)

1. Explain the quantity theory of money. Explain the Cambridge approach and illustrate that it leads to the same identity as the quantity theory. What assumptions are imposed to arrive at a theoretical statement?

2. Discuss the transactions, precautionary, and speculative motives for holding money in Keynes liquidity preference theory. When all three motives are put together, what theory of money demand emerges?

3. Use the IS-LM model to show that monetary policy becomes more effective relative to fiscal policy as money demand becomes less sensitive to the interest rate. Explain the result intuitively.

4. The Fed currently uses an interest rule for its monetary policy decisions. Use Poole's rules to explain why the Fed might prefer an interest rate rule over a money rule.