**Economics 470/570** **Name: ________________________________**
**Fall 2007** **(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. Equation of Exchange
3. Investment
4. Expenditure Multiplier
5. IS Curve
6. Crowding out

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

1. Use the supply and demand model for bank reserves to explain and illustrate the effects of (a) an open market operation to buy bonds, (b) a decrease in the discount rate, and (c) an increase in required reserves.

2. Explain the speculative motive for holding money in Keynes' liquidity preference theory.

3. Explain why investment is less sensitive to interest rate changes in recessions as compared to when the economy is operating closer to full employment. Explain why the IS curve is vertical when investment is completely insensitive to changes in the interest rate.

4. Do changes in the money supply and government spending affect output in the long-run? Explain using the IS-LM model.

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

1. What is meant by the phrase lender of last resort? Why is this important? Explain and show graphically how the Fed uses discount rate policy to limit the amount the federal funds rate can increase.

2. According to Baumol, the transactions demand for money depends upon the interest rate as well as nominal income. Explain why the transactions demand for money depends upon the interest rate. Why is this important?

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. Which case represents a liquidity trap?

4. Explain Poole's rules.