Economics 470/570
Fall 2008
Midterm 2

Part I – Definitions. Define each of the following (5 points each, 20 points total).

1. Velocity of money
2. Expenditure multiplier
3. IS curve
4. Crowding out

Part II – Essays and problems. Answer FOUR of the following questions (20 points each, 80 points total)

1. (a) Explain why the demand curve for reserves slopes downward. (b) Use the reserve demand, reserve supply model to show graphically how an increase in financial market risk impacts the federal funds rate. Then show how the Fed would respond in order to return the federal funds rate to its target value. [Assume that the Fed pays interest on reserves at a rate below the target federal funds rate, and that the discount rate is above the federal funds rate.]

2. (a) Derive the LM curve for the case where the economy contains a liquidity trap. (b) Show graphically and explain intuitively why monetary policy is ineffective in a liquidity trap, but fiscal policy is fully effective.

3. Explain intuitively how and why the money multiplier changes when (a) the required reserve ratio increases, (b) the currency to demand deposit ratio increases, and (c) the excess reserve to demand deposit ratio increases. Who determines each of these quantities?

4. Discuss and explain the speculative motive for holding money in Keynes' liquidity preference theory. Also explain why, in aggregate, money demand is negatively related to the interest rate.

5. (a) What is the money demand function in the classical model? (b) What does the LM curve look like in the classical model? Explain. (c) Is fiscal policy effective in the classical model? Why or why not? What about monetary policy?