Economics 470/570
Fall 2011
Midterm Exam 2

Name: ______________________________

Part I - Definitions. Define each of the following (4 points each, 20 points total).

1. Velocity of Money
2. MP Curve
3. Crowding Out
4. AE curve
5. Policy Effectiveness

Part II. Answer FIVE of the following six questions (16 points each, 80 points total).

1. (a) Explain why the demand curve for reserves slopes downward. (b) Explain the shape of the supply curve for reserves. (c) Use the supply and demand model for bank reserves to explain and illustrate the effects of an open market operation to buy bonds. (d) Explain how the discount rate and the rate the Fed pays on bank reserves limit the variability of the federal funds rate.

2. Explain the quantity theory of money. What assumptions are imposed to arrive at a theoretical statement? Explain the Cambridge approach and illustrate that it leads to the same result as the quantity theory. What is the money demand function in the classical model?

3. 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. What did Tobin add to this theory?

4. 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?

5. (a) Using the MP curve from class, derive the dynamic AD curve and explain why it is negatively sloped. (b) Show graphically how the AD curve shifts when there is a change in government spending or taxes. In general, what causes the AD curve to shift?

6. (a) Can budget deficits lead to inflation? Explain using the government budget constraint. (b) Explain debt monetization.

Note: Only answer 5 questions. Do NOT answer all six.