Economics 470/570
Winter 2014
Midterm Exam 2

Answer each of the following questions (20 points each)

1. 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?

2. (a) Derive the AD curve graphically and mathematically (use the MP curve that depends only on inflation). (b) Show graphically how the AD curve shifts when there is a change in government spending or taxes.

3. Do monetary and fiscal policy become more or less effective when investment or net exports become more responsive to changes in the interest rate? Explain. (Use the MP curve that depends upon both inflation and output.)

4. (a) Use IS-MP and AD-AS diagrams to show that an increase in consumer confidence has no long-run effect on output when prices and wages are allowed to vary. (b) Use IS-MP and AD-AS diagrams to show how inflation, output, and interest rates adjust in the short-run and long-run in response to an improvement in technology. (For both parts, use the MP curve that depends only on inflation.)

5. Why does the Federal Reserve put so much emphasis on its credibility?