

Money Supply and Interest Rates

FIN 204 Lecture 4.2.

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- 1 Money Supply and Changes in Money Demand
- 2 The Effect of Money Demand on Interest Rates

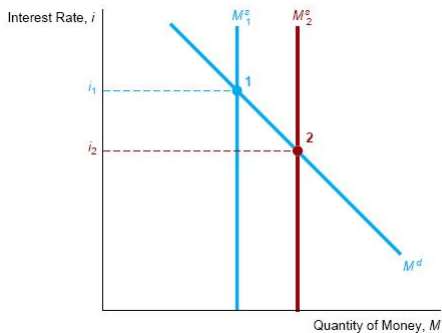
Money Supply and Interest Rates

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The Central Bank controls money supply

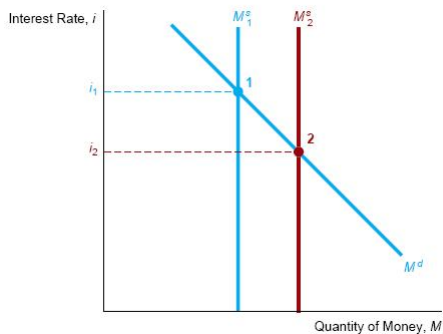
Money Supply and Interest Rates

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Money Supply and Interest Rates

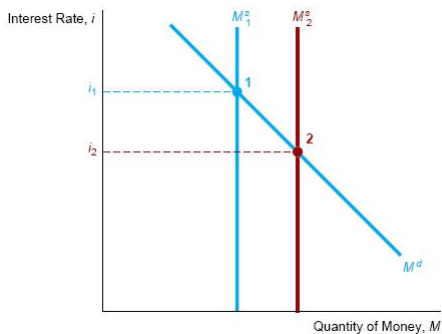
The Central Bank controls money supply



Is that always the case?

Money Supply and Interest Rates

The Central Bank controls money supply



Is that always the case?

No, because M_s has important effects on money demand as well

The Three Effects of Money Supply on Money Demand

What does money supply do?

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- 2 Increase expected inflation (expected inflation effect)

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- 2 Increase expected inflation (expected inflation effect)
- 3 Increase wealth (wealth effect)

The Wealth Effect of Money Supply on Money Demand

Money Supply $\uparrow \Rightarrow$ wealth $\uparrow \Rightarrow$ money demand \uparrow

The Three Effects of Money Supply on Money Demand

What does money supply do?

- 1 Increase inflation (price-level effect)
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The Wealth Effect of Money Supply on Money Demand

Money Supply $\uparrow \Rightarrow$ wealth $\uparrow \Rightarrow$ money demand \uparrow

The Price-Level Effect of M_s on M_d

Money Supply $\uparrow \Rightarrow$ inflation $\uparrow \Rightarrow$ money demand \uparrow

The Three Effects of Money Supply on Money Demand

What does money supply do?

- 1 Increase inflation (price-level effect)
- 2 Increase expected inflation (expected inflation effect)
- 3 Increase wealth (wealth effect)

The Wealth Effect of Money Supply on Money Demand

Money Supply $\uparrow \Rightarrow$ wealth $\uparrow \Rightarrow$ money demand \uparrow

The Price-Level Effect of M_s on M_d

Money Supply $\uparrow \Rightarrow$ inflation $\uparrow \Rightarrow$ money demand \uparrow

The Expected Inflation Effect of M_s on M_d

Money Supply $\uparrow \Rightarrow$ exp. inflation $\uparrow \Rightarrow$ money demand \uparrow

The Effect of Money Demand on Interest Rates

The benchmark case: Liquidity Effect Dominating



The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominant



The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominant ED



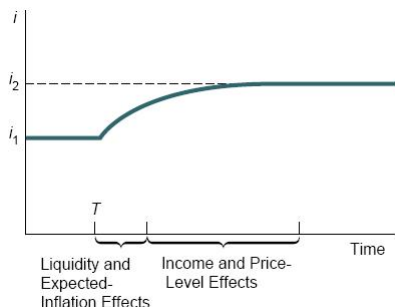
The three effects dominate in the long-run

The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominant ED



The three effects dominate in the long-run



Expected inflation effect kicks in immediately

Liquidity Effect Dominant *ED*

Evidence

