Money Supply and Interest Rates

FIN 204 Lecture 4.2.

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2 Mar. 2009

Outline

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The Central Bank controls money supply

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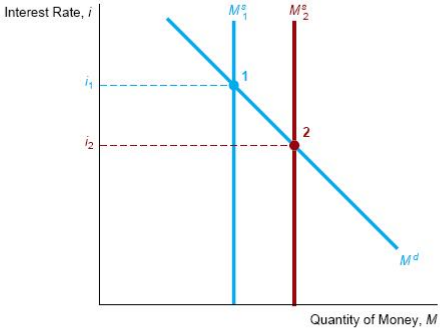
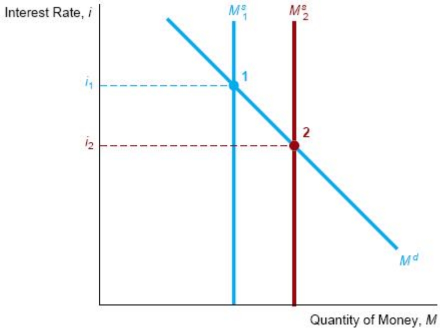


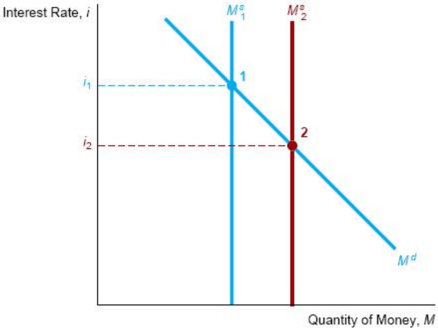
The Central Bank controls money supply



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

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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 $\uparrow$

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The Price-Level Effect of M_s on M_d

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

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The Price-Level Effect of M_s on M_d

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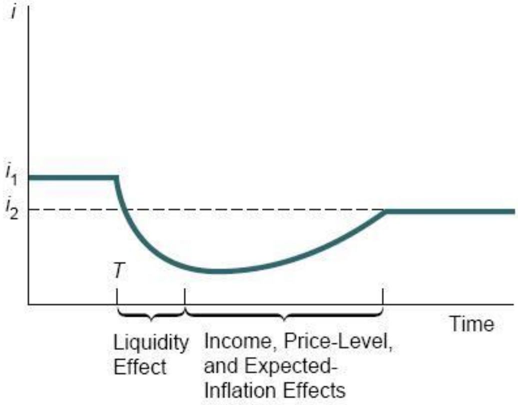
The Expected Inflation Effect of M_s on M_d

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

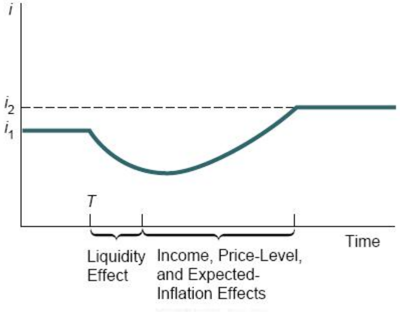
The Effect of Money Demand on Interest Rates

The benchmark case: Liquidity Effect Dominating



The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominat*ED*



The Effect of Money Demand on Interest Rates

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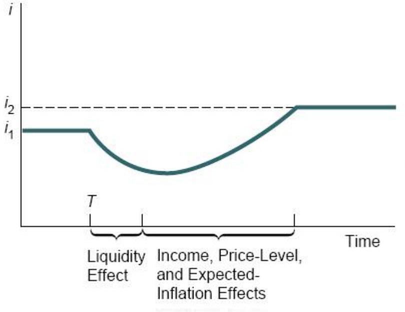
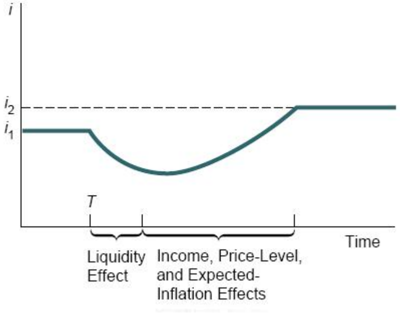


The three effects dominate in the long-run



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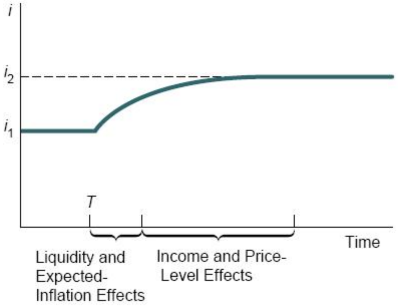
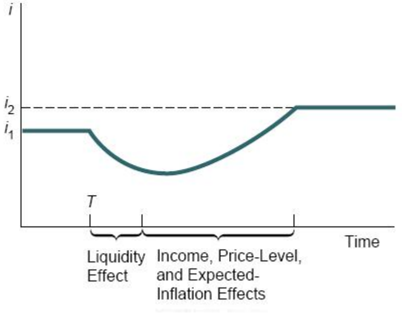


Expected inflation effect kicks in immediately

The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominat*ED*



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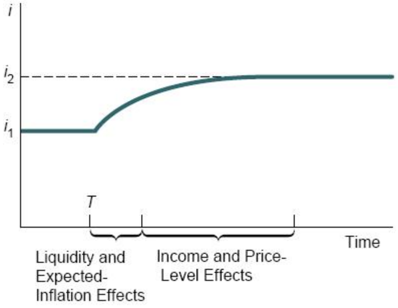

Expected inflation effect kicks in immediately

Let's play policymaking...

Liquidity Effect Dominat*ED*
Evidence