

Money Supply and Interest Rates

ECO 420 Lecture 4.2.

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

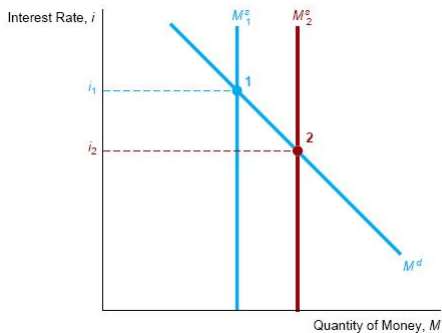
Money Supply and Interest Rates

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The Central Bank controls money supply

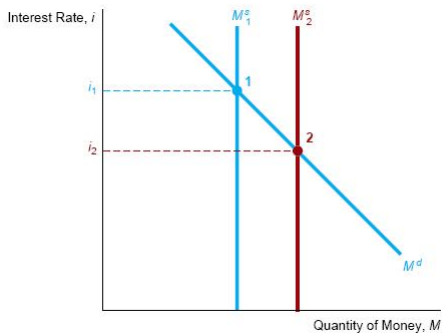
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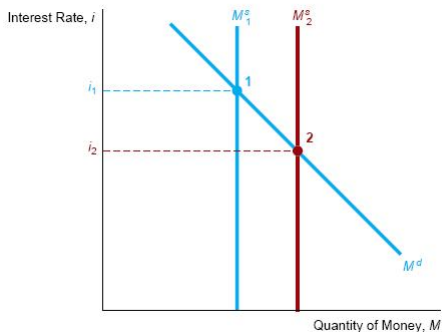
The Central Bank controls money supply



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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- 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

The Three Effects of Money Supply on Money Demand

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- 1 Increase inflation (price-level effect)
- 2 Increase expected inflation (expected inflation 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 Expected Inflation Effect of M_s on M_d

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

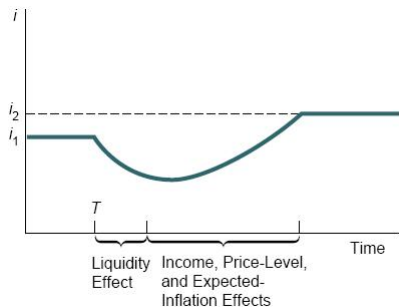
The Effect of Money Demand on Interest Rates

The benchmark case: Liquidity Effect Dominating



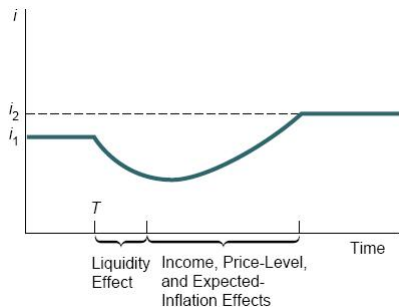
The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominant



The Effect of Money Demand on Interest Rates

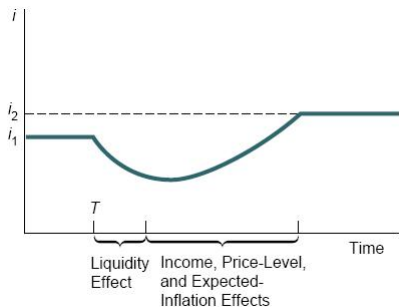
The other two cases: Liquidity Effect Dominant



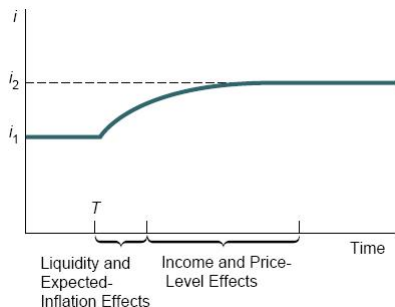
The three effects dominate in the long-run

The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominant



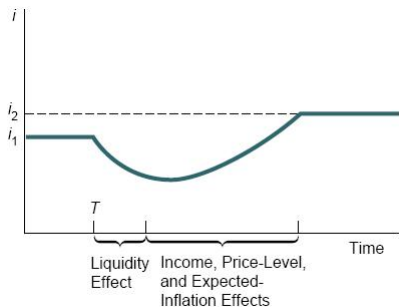
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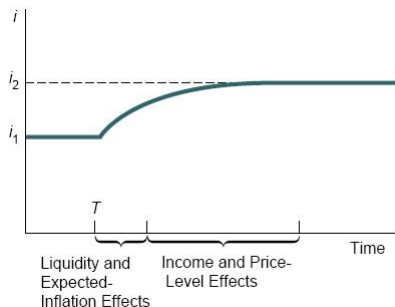
Expected inflation effect kicks in immediately

The Effect of Money Demand on Interest Rates

The other two cases: Liquidity Effect Dominant



The three effects dominate in the long-run



Expected inflation effect kicks in immediately

Let's play policymaking...

Liquidity Effect Dominant *ED*

Evidence

