Monetary Policy I

Outline Notes

THE SUPPLY OF MONEY

We have just witnessed how the Fed can increase or decrease the money supply. Let's take a closer look at the supply and demand for money.

1) Definition of the Money Supply

A)

B)

2) Money Market Graph

A)

B)

3) The Money Supply Curve

A)

B)

THE DEMAND FOR MONEY

People hold wealth either as money or as less liquid assets. The demand for money refers to how much M1 money people hold based on the interest rate.

1) Money and Opportunity Cost

A)

B)

2) Nominal Money Demand

A)

B)

C)

3) Real Money Demand

A)

B)

CHANGES IN REAL MONEY DEMAND

When prices increase due to inflation, only the nominal demand for money rises. The following factors cause the real demand for money to change.

1) Consumer Spending

2) Technology

3) Financial Innovation

4) Precautionary Motives

5) International Factors

THE VELOCITY OF MONEY

The **velocity of money** refers to how many times a unit of money is spent during a year. It is another way of illustrating the concept of money demand.

1) The Velocity of Money Equation

A)

B)

Variable	Description
V	Velocity of Money
M	Nominal Quantity of Money (M1 Money)
P	Aggregate Price Level
Y	Aggregate Output (measured by real GDP)
P x Y	Nominal GDP

2) Velocity and Interest Rates

A)

B)

C)

3) Velocity and the Business Cycle

A)

B)

EQUILIBRIUM IN THE MONEY MARKET

The money market is formally known as the **liquidity preference model**. It shows how the Fed affects a very important interest rate: the federal funds rate.

1) The Liquidity Preference Model

A)

B)

C)

2) Setting the Federal Funds Rate

A)

B)

C)

THE DIFFERENT INTEREST RATES

The Fed has a lot of power because it determines the federal funds rate. This interest rate influences all other short-term interest rates in the economy.

1) Federal Funds Rate

A)

B)

2) Discount Rate

3) Prime Rate

4) Short-Term Interest Rates

5) Long-Term Interest Rates