Money Market Equilibrium

Excess supply of money. People buy bonds and interest rate falls.

Excess demand for money. People sell bonds and interest rate rises.
Interest Rate Determination

- Changing the Interest Rate
  - Suppose the Fed begins to fear inflation.
  - It decides to raise interest rates to discourage borrowing and the purchase of goods and services.
Interest Rate Determination

• Changing the Interest Rate
  • To do so, the Fed sells securities in the open market.
  • Bank reserves decline.
  • Less new loans are made.
  • The money supply decreases.
Real Money (trillions of 1992 dollars)

Interest Rate Changes

Interest rate (percent per year)
Monetary Policy

- Profiting by Predicting the Fed
  - People try to anticipate what the Fed is about to do buy and sell bonds in the hope of incurring a profit.
  - People who anticipate that the Fed is about to increase the money supply buy bonds right away, pushing their prices upward and pushing interest rates downward before the Fed acts.
Question:

\[ \frac{\Delta \hat{P}_{Bond}}{\Delta \hat{i}} \]

- What happens to the expected price of bonds (stocks) if the expected rate of interest increases?

- Assume \[ \frac{\Delta \hat{P}_{Bond}}{\Delta \hat{i}} < 0 \]
  
- if \[ \Delta \hat{i} > 0 \]
  
- then \[ \Delta \hat{P}_{Bond} < 0 \]
  
- sell bonds
  
- buy cash balances
Stocks + Bonds

- sell (move into cash balances)
  - if $\Delta \hat{i} > 0$
  - if there is no uncertainty about $\Delta \hat{i} \geq 0$
- buy (move out of cash balances)
  - if $\Delta \hat{i} < 0$
  - if there is no uncertainty about $\Delta \hat{i} \geq 0$