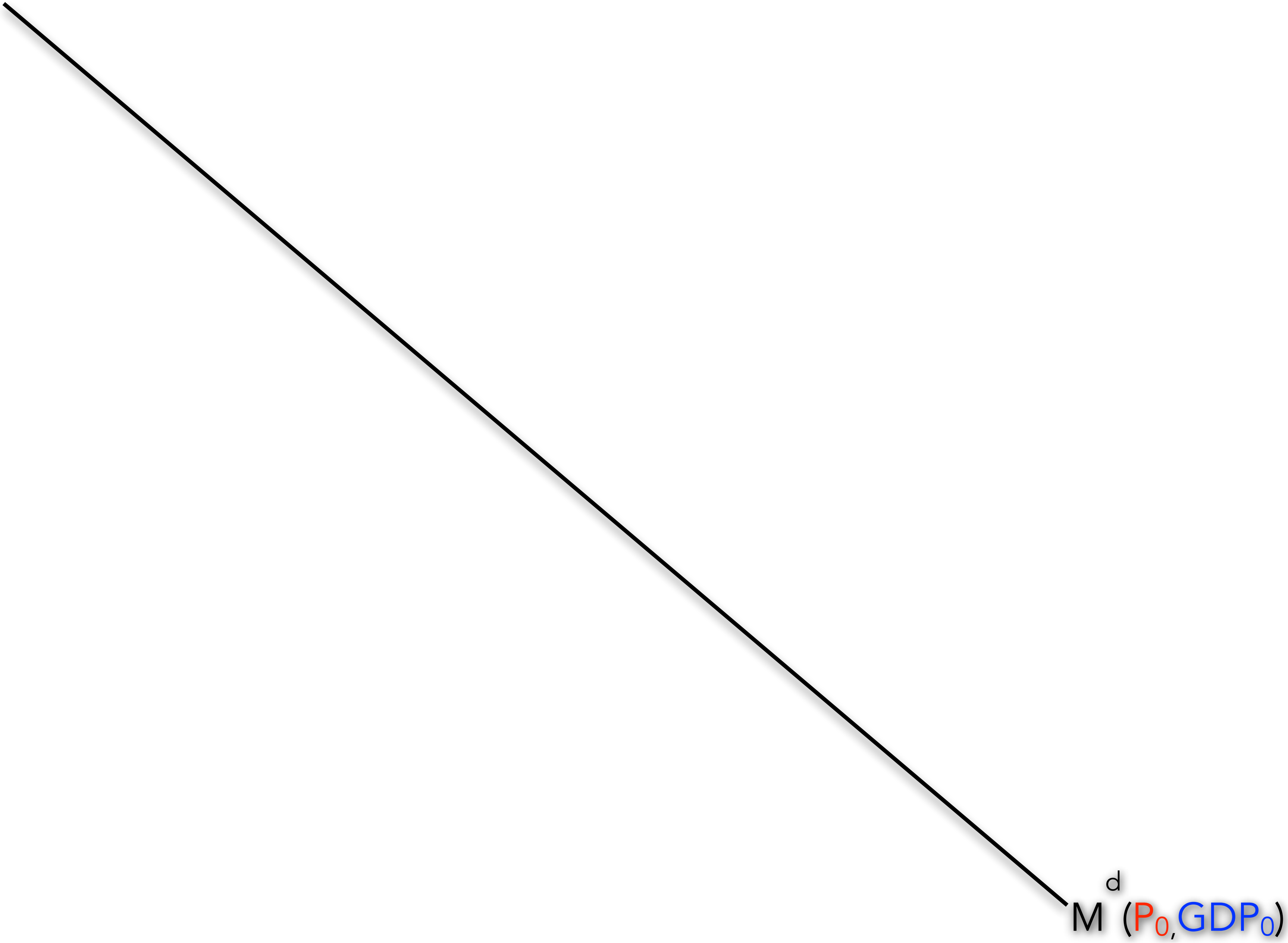
If the interest rate is above equilibrium, there are excess liquid balances, money is plentiful and there is pressure for the interest rate to fall

Equilibrium in the Money Market

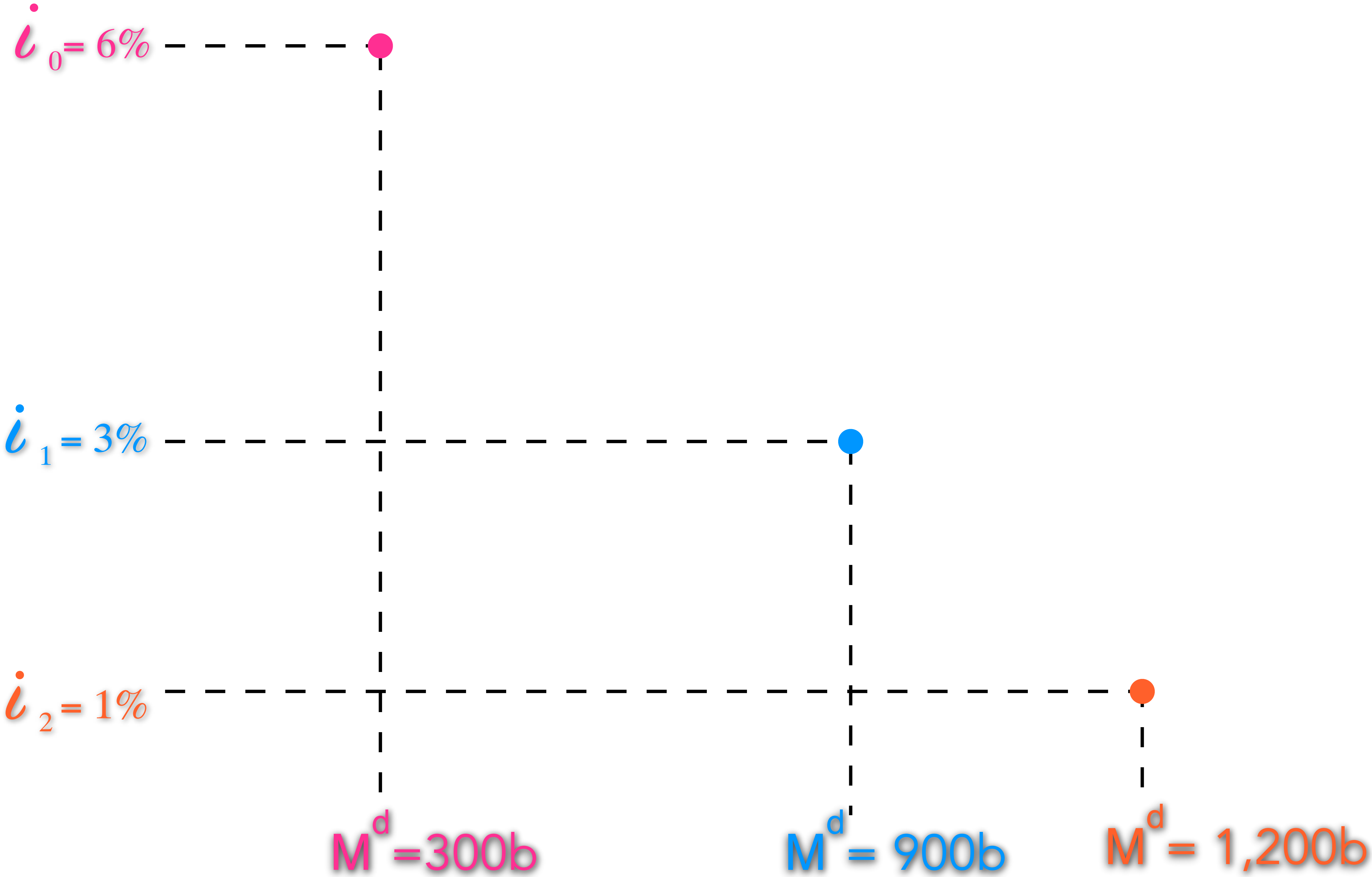
Currency+
Deposits

i


$M^d(P_0, GDP_0)$

M^s

$M^s = 900b$


$i_0 = 6\%$
$i_1 = 3\%$
$i_2 = 1\%$
$M^d = 300b$
$M^d = 900b$
$M^d = 1{,}200b$

If the interest rate is 3%, the amount of currency + deposits the public is actually holding is exactly what the public **wants** to hold for transactions

The public will not need to look for lenders or borrowers and thus there will be no reason for the interest rate to change

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We can safely assume that the Money Market will eventually settle at equilibrium

The Money Market is in equilibrium at a 3% interest rate

$$i_e = 3\%$$

If the interest rate is below equilibrium, there are shortages of liquid balances, money is scarce and there is pressure for the interest rate to rise

All the Fed needs to do to cause a decrease in interest rates is to make money plentiful: inject reserves

All the Fed needs to do to cause an increase in interest rates is to make money scarce: decrease reserves

Whether money is scarce or plentiful, the public will engage in transactions which will move the interest rate to equilibrium

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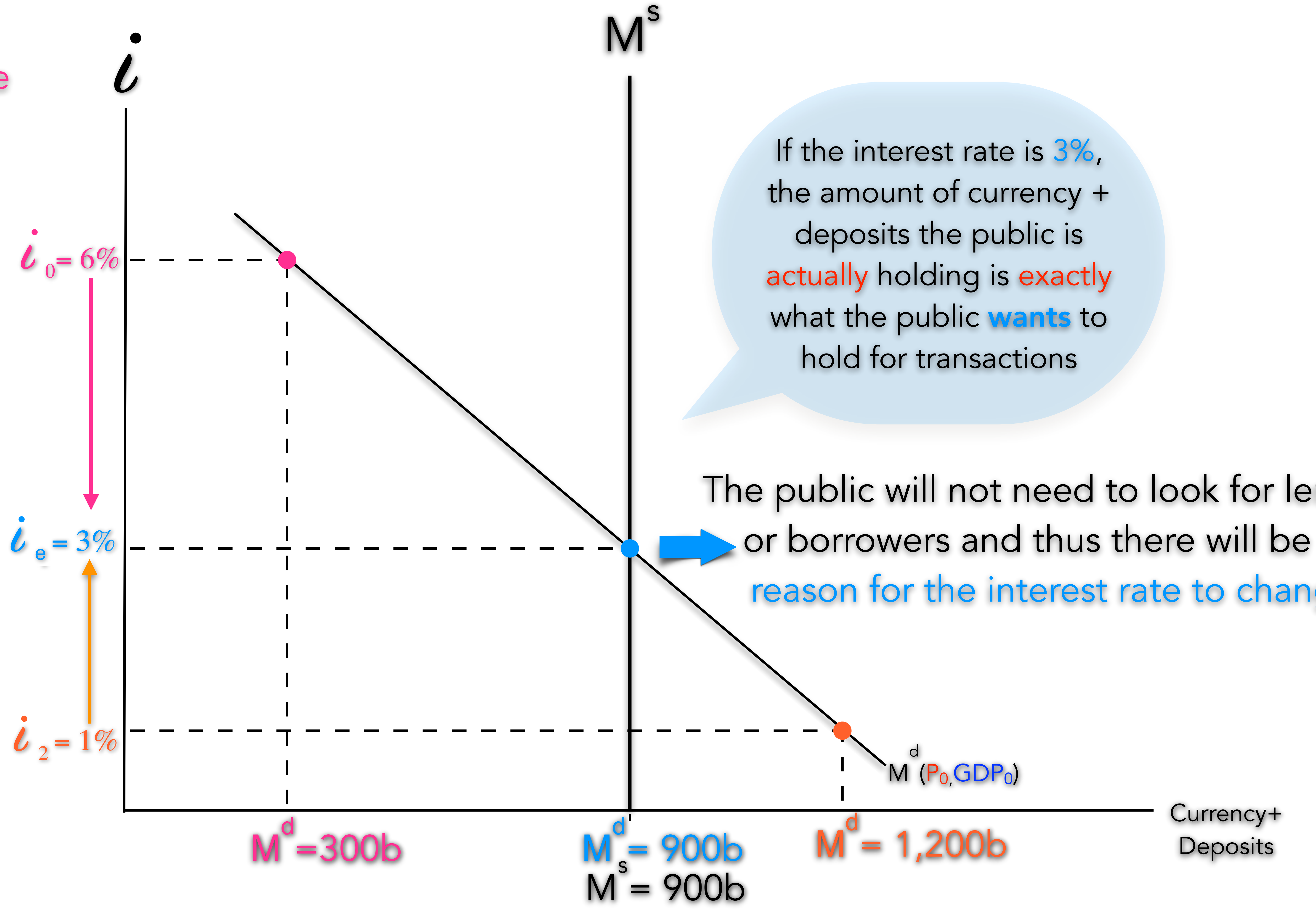

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