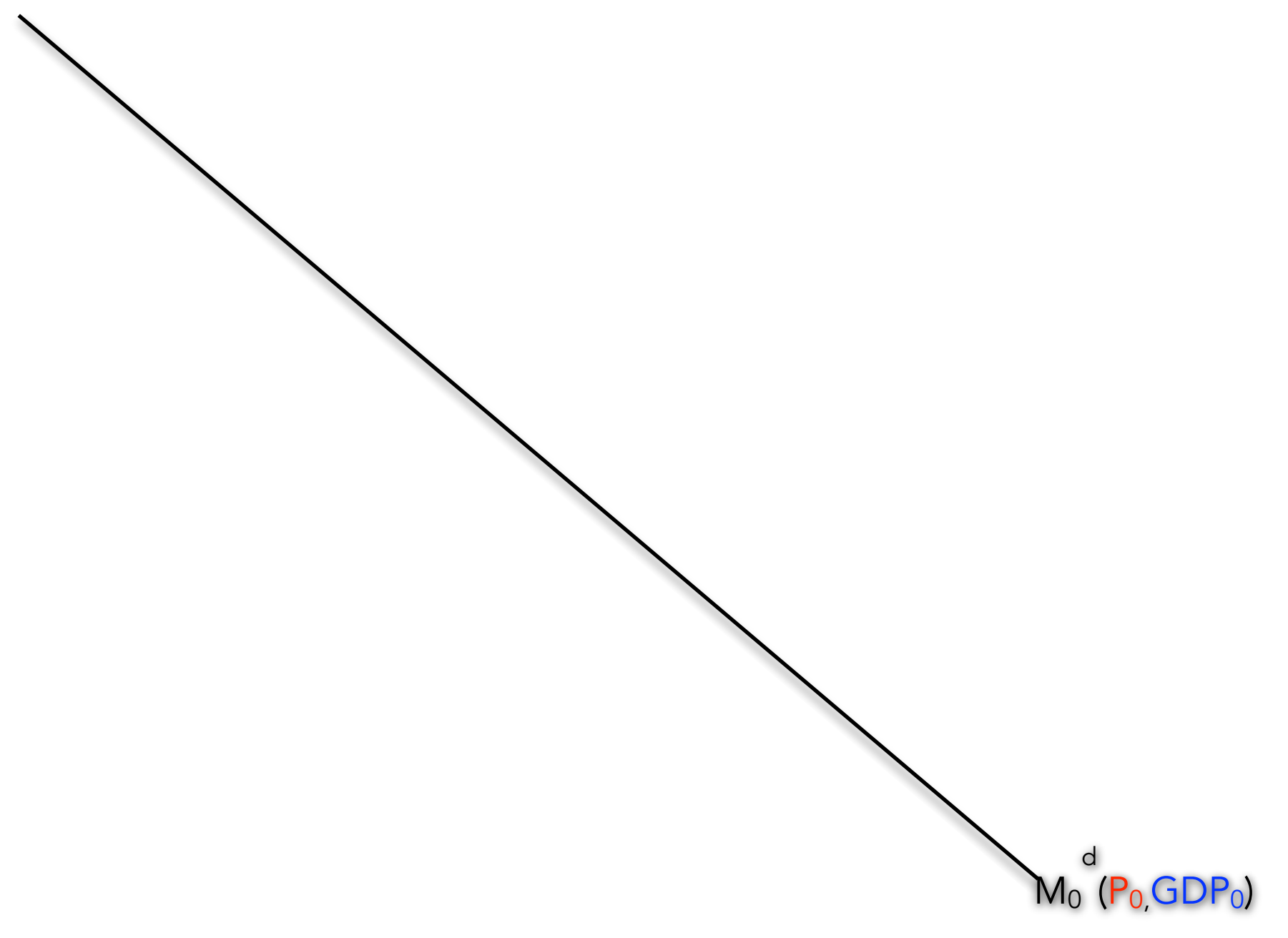




i





$$i_0 = 5\%$$

$$M^d = 300b$$

$$i_1 = 3\%$$



$$M^d = 900b$$

$$i_2 = 1\%$$



$$M^d = 1,200b$$

T





















a











a

S













P





















Assume the Money Market
starts at equilibrium at 3%

M_0^s



$M_0^s = 900b$





P







e











e

a

S

e











6















e

p

u

b







W









e

e





a



g

e









u





b

2



a



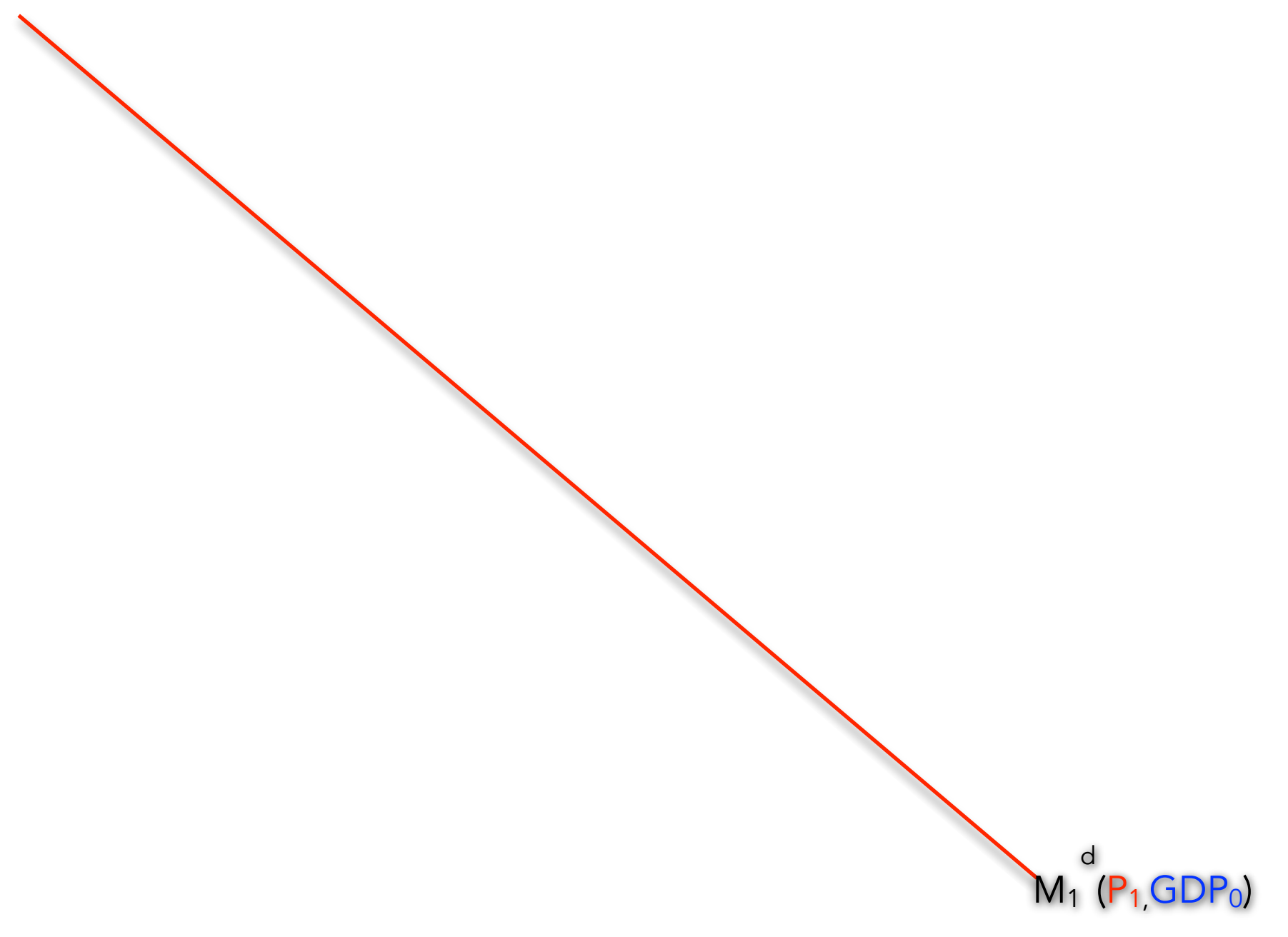
C

e

S



A rightward shift in the Demand for
Money



Short of liquid
balances at 3%



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

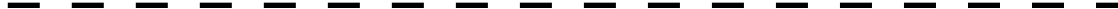


The interest rate will rise to



a new equilibrium at 5%

$$\dot{i}_0 = 5\%$$





New
equilibrium

I leave the effect of
a **Decrease** in the
Price level for you to
work as an exercise

The effect of an increase in the Price Level

If **prices increase** (inflation) the public will need **larger** liquid balances

The effect of an increase in the Price Level

