Answer on Question #89439, Economics / Macroeconomics

QUESTION: If the money market is in short-run equilibrium, explain the adjustments that will take place for: i) an increase the in the money supply ii) increase in the demand for money

ANSWER: (i) Suppose the money market is in short run equilibrium at E. Now, when the quantity of money supplied increases from OM_1 to OM_2, the new money supply curve is MS2 which equates the demand for money curve, MD at new equilibrium point E' causing the rate of interest fall from i to i'. ***Hence, keeping the money demand same, an increase in the supply of money brings down the rate of interest***.

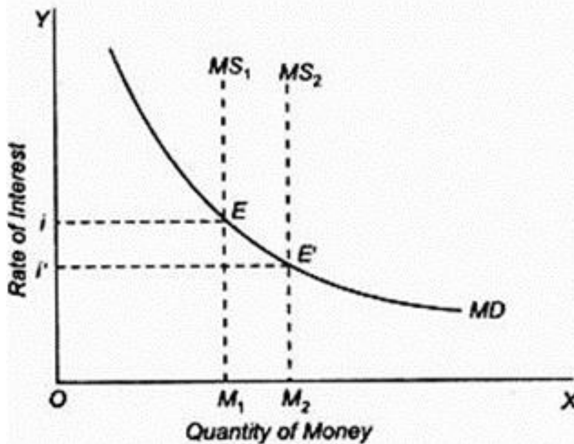

Fig a- INCREASE IN MONEY SUPPLY

(ii) Assuming that the supply of money remains unchanged at M and the money demand curve shifts from MD_1 to MD_2 due to increase in demand for money. the rate of interest rises from i_1 to i_2 as the new equilibrium is now determined at point F as shown in fig b. ***Thus, an increase in money demand with the given quantity of money OM will cause a rise in the rate of interest.***

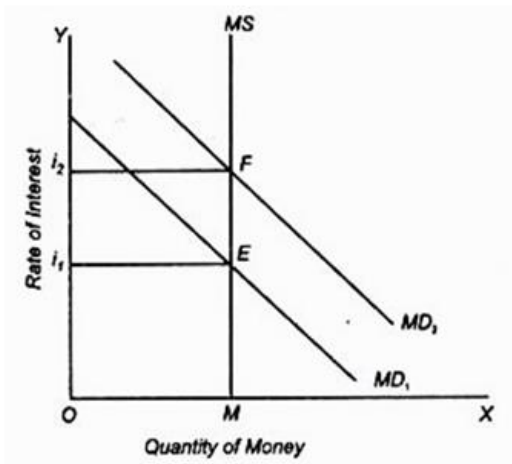

Fig b- INCREASE IN DEMAND FOR MONEY

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