Module 2. Money Market, Goods Markets and Asset Market Equilibrium

Lecture session 5

4. Money Market and Interest Rate Determination

- 4.1. Money supply (MS)
  - 4.1.1 M1 and the functions of money, medium of exchange, unit of account, sort of value
  - 4.1.2 Rate of growth in MS determined by central bank (CB)
  - 4.1.3 Nominal versus real MS
- 4.2. Money demand, MD = f(i, P, Y)
  - 4.2.1 Define demand for cash balances (for a given market basket)
  - 4.2.2 Opportunity cost of holding cash, risks associated with i, P and liquidity preferences
  - 4.2.3 Relationship with income and number of transactions
  - 4.2.4 Relationship of P and MD: nominal versus real MD; MD/P = L(i,Y)
- 4.3. Modeling money market: MS, MD and i-rate
  - 4.3.1 Equilibrium MS and MD: i*, interest rate determination
  - 4.3.2 Changes in equilibrium

5. Interest Rates, Capital Flows, Exchange Rates and Capital Markets

- 5.1. Interest parity and investor behavior
  - 5.1.1 Investor behavior with regard to assets valued in foreign or local currency
  - 5.1.2 Interest parity, law of one price for asset rates, and equilibrium interest, E
  - 5.1.3 Assumptions or conditions for interest parity to hold
  - 5.1.4 Example and intuition: covered interest arbitrage
  - 5.1.5 Risk premiums
- 5.2. International capital markets
  - 5.2.1 Brief history of exchange regimes and trends in international capital flows
  - 5.2.2 Trends in capital flows
  - 5.2.3 Theory of capital markets and critics of global capital
  - 5.2.4 Indicators of a global capital markets: does a global capital market exist?
  - 5.2.5 Questioning of benefits of financial integration: problems, bubbles
  - 5.2.6 What is debt and what is the role of debt in bubbles?
  - 5.2.7 Capital controls: case for controls, types of controls and effectiveness

Study questions: What is the supply of money and the demand for money? What are the factors that determine supply and demand for money? How does a change in the rate of growth in the supply of money occur? What are the implications of a change in the rate of growth in the money supply? What causes a change in money demand? What does it mean for there to be equilibrium in the money market? Which factors cause changes in equilibrium in the money market? What is interest-rate parity? What are the assumptions regarding investment behavior such that interest parity holds? Does interest parity hold in reality? What factors might explain why interest parity does not hold? What is covered interest parity and how does it relate to arbitrage? Does an international capital market exist in the real world? What are the trends in international capital flows? What types of capital are a concern for policymakers? What does the theory say about capital markets and what do the critics of liberalization of capital markets (or capital market integration) argue? What is the purpose of finance? What are the indicators of a global capital market? What is the role of debt in asset price bubbles? What is the case for capital controls? What types of capital flow should be controlled and what might be an effective means of doing so?