FACULTY OF JURIDICAL SCIENCES

Lecture-11

EFFECTS OF MONEY ON OUTPUT AND PRICES

Having examined the building blocks of monetary theory, we now describe the monetary transmission mechanism, the route by which changes in the sup: ply of money are translated into changes in output, employment, prices, and inflation, For concreteness, assume that the Federal Reserve is concerned about inflation and has decided to slow down the economy. There are three steps in the process:

1. To start the process, the Fed takes steps to reduce bank reserves. As we saw in Section A of this chapter, the Fed reduces bank reserves primarily by selling government securities in the open market; this open-market operation changes the balance sheet of the banking system by reducing total bank reserves.
2. Each dollar reduction in bank reserves produces a multiple contraction in checking deposits, thereby reducing the Rooney supply, changes in reserves lead to a multiplied change in deposits. Since the money supply equals currency plus checking deposits, the reduction in checking deposits reduces the money supply.
3. The reduction in the money supply increases interest rates and lightens credit conditions, with an unchanged demand for money; a reduced supply of money will raise interest rates. ‘In addition, the amount of credit (loans and borrowing) available to people will decline, Interest rates will rise for mortgage borrowers and for businesses that want to build factories, buy new equipment, or add to inventories. Higher interest rates tend to reduce asset-prices (such as those of stocks, bonds, and houses) and therefore depress the values of people’s assets.”