	Prefa Ackno	oce owledgments	xxv xxviii
	RT I rodu	ction and heritage	1
1.	Intro	duction	3
	1.1	What is money and what does it do? 5 1.1.1 Functions of money 5 1.1.2 Definitions of money 5 Money supply and money stock 6	
	1.3	Nominal versus the real value of money 7	
	1.3	Money and bond markets in monetary macroeconomics 7	
	1.5	A brief history of the definition of money 7	
	1.6	Practical definitions of money and related concepts 12	
	1.0	1.6.1 Monetary base and the monetary base multiplier 14	
	1.7	Interest rates versus money supply as the operating target of monetary policy 15	
	1.8	Financial intermediaries and the creation of financial assets 15	
	1.9	Different modes of analysis of the economy 18	
	1.10	The classical paradigm: the classical group of	
		macroeconomic models 20	
	1.11	The Keynesian paradigm and the Keynesian set of macroeconomic models 24	
	1.12	Which macro paradigm or model must one believe in? 26	
	1.13	Walras's law 28	
	1.14	Monetary policy 28	
	1.15	Neutrality of money and of bonds 29	
	1.16	Definitions of monetary and fiscal policies 30	
		Conclusions 31	
		Summary of critical conclusions 32	
		Review and discussion questions 32	
		References 33	

_	
7	1
J	4

2.	The h	eritage o	of monetary economics
	2.1	Quantit	y equation 35
			Some variants of the quantity equation 38
	2.2	Quantit	y theory 39
		2.2.1	Transactions approach to the quantity theory 40
		2.2.2	Cash balances (Cambridge) approach to the quantity
			theory 45
	2.3	Wickse	ll's pure credit economy 49
	2.4	Keynes	's contributions 52
			Keynes's transactions demand for money 54
		2.4.2	Keynes's precautionary demand for money 55
		2.4.3	Keynes's speculative money demand for an individual 56
		2.4.4	Keynes's overall speculative demand function 58
		2.4.5	Keynes's overall demand for money 60
		2.4.6	Liquidity trap 61
		2.4.7	Keynes's and the early Keynesians' preference for fiscal
			versus monetary policy 62
	2.5		nan's contributions 63
		2.5.1	Friedman's "restatement" of the quantity theory of money 63
		2.5.2	Friedman on inflation, neutrality of money and monetary
			policy 65
		2.5.3	Friedman versus Keynes on money demand 66
	2.6		t of money supply changes on output and employment 67
			Direct transmission channel 69
			Indirect transmission channel 69
		2.6.3	Imperfections in financial markets and the lending/credit
			channel 70
		2.6.4	· · · · · · · · · · · · · · · · · · ·
			open economy 70
		2.6.5	The state of the s
		<i>C</i> -	less-developed economies 71
			clusions 71
			nary of critical conclusions 73
			ew and discussion questions 73 rences 74
		Kejei	rences 74
	PART I	•	
	Mone	y in the	economy

3. Money in the economy: General equilibrium analysis

3.1 Money and other goods in the economy 80

3.2 Stylized facts of a monetary economy 83

3.3 Optimization without money in the utility function 84

77

(MIUF) 88 3.4.1 Money in the utility function (MIUF) 89 3.4.2 Money in the indirect utility function (MIUF) 90 3.4.3 Empirical evidence on money in the utility function 93 3.5 Different concepts of prices 93 3.6 User cost of money 94 3.7 The individual's demand for and supply of money and other goods 95 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97 3.8 The firm's demand and supply functions for money and other goods 97
 3.4.2 Money in the indirect utility function (MIIUF) 90 3.4.3 Empirical evidence on money in the utility function 93 3.5 Different concepts of prices 93 3.6 User cost of money 94 3.7 The individual's demand for and supply of money and other goods 95 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.4.3 Empirical evidence on money in the utility function 93 3.5 Different concepts of prices 93 3.6 User cost of money 94 3.7 The individual's demand for and supply of money and other goods 95 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.5 Different concepts of prices 93 3.6 User cost of money 94 3.7 The individual's demand for and supply of money and other goods 95 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.6 User cost of money 94 3.7 The individual's demand for and supply of money and other goods 95 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.7 The individual's demand for and supply of money and other goods 95 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.7.1 Derivation of the demand and supply functions 95 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.7.2 Price level 95 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
 3.7.3 Homogeneity of degree zero of the demand and supply functions 96 3.7.4 Relative prices and the numeraire 97
functions 96 3.7.4 Relative prices and the numeraire 97
-
3.8 The firm's demand and supply functions for money and other goods 07
5.6 The juin 3 demand and supply functions for money and other goods 97
3.8.1 Money in the production function (MIPF) 98
3.8.2 Money in the indirect production function 98
3.8.3 Maximization of profits by the firm 100
3.8.4 The firm's demand and supply functions for money and
other goods 101
3.9 Aggregate demand and supply functions for money and other goods in
the economy 101
3.10 Supply of nominal and real balances 102
3.11 General equilibrium in the economy 103
3.12 Neutrality and super-neutrality of money 105
3.12.1 Neutrality of money 105
3.12.2 Super-neutrality of money 105
3.12.3 Reasons for deviations from neutrality and
super-neutrality 107
3.13 Dichotomy between the real and the monetary sectors 109
3.14 Welfare cost of inflation 112
Conclusions 115
Summary of critical conclusions 116
Review and discussion questions 117
References 118
Rejerences 110
PARTIII
The demand for money
The uchianu for money
4. The transactions demand for money
4.1 The basic inventory analysis of the transactions demand

for money 122
4.2 Some special cases: the profitability of holding money and bonds for transactions 125

4.3	Demand for currency versus demand deposits 127			
4.4	Impact of economies of scale and income distribution 128			
<i>4.5</i>	Efficient funds management by firms 129			
4.6	The demand for money and the payment of interest on demand			
7.0	deposits 130			
4.7	Demand deposits versus savings deposits 131			
4.8	Technical innovations and the demand for monetary assets 132			
4.9	Estimating money demand 133			
7.7	Conclusions 135			
	Summary of critical conclusions 136			
	Review and discussion questions 136			
	References 137			
	Rejerences 137			
Portf	Tolio selection and the speculative demand for money			
5.1	Probabilities, means and variances 140			
5.2	Wealth maximization versus expected utility maximization 142			
5.3	Risk preference, indifference and aversion 144			
5.5	5.3.1 Indifference loci for a risk averter 145			
5.4	The expected utility hypothesis of portfolio selection 145			
5.5	The efficient opportunity locus 147			
3.3	5.5.1 Expected value and standard deviation of the portfolio 147			
	5.5.2 Opportunity locus for a riskless asset and a risky asset 148			
	5.5.3 Opportunity locus for risky asset and a risky asset 148			
	5.5.4 Efficient opportunity locus 151			
	5.5.5 Optimal choice 151			
5.6	Tobin's analysis of the demand for a riskless asset versus			
5.0	a risky one 154			
5.7				
5.7	5.7.1 EUH and measures of risk aversion 158			
	5.7.2 Constant absolute risk aversion (CARA) 159			
	5.7.3 Constant relative risk aversion (CRRA) 162			
	5.7.4 Quadratic utility function 164			
5.8				
5.9				
	Is there a positive portfolio demand for money balances in the modern economy? 165			
	Conclusions 167			
	Appendix 1 167			
	Axioms and theorem of the expected utility hypothesis 167			
	Appendix 2 169			
	Opportunity locus for two risky assets 169			
	Summary of critical conclusions 172			
	Review and discussion questions 172			
	References 174			
	Negoronices 1/4			

6.	Preca	nutionary and buffer stock demand for money	175
	6.1	An extension of the transactions demand model to precautionary demand 177	
	6.2	Precautionary demand for money with overdrafts 181	
	6.3	Precautionary demand for money without overdrafts 183	
	6.4	Buffer stock models 184	
	6.5	Buffer stock rule models 186	
		6.5.1 The rule model of Akerlof and Milbourne 186	
		6.5.2 The rule model of Miller and Orr 188	
	6.6	Buffer stock smoothing or objective models 191	
		6.6.1 The smoothing model of Cuthbertson and Taylor 191	
		6.6.2 The Kanniainen and Tarkka (1986) smoothing model 193	
	6.7	Empirical studies on the precautionary and buffer stock models 196	
		Conclusions 201	
		Summary of critical conclusions 202	
		Review and discussion questions 203	
		References 203	
7.	Mone	etary aggregation	205
	7.1	The appropriate definition of money: theoretical considerations 206	
	7.2	Money as the explanatory variable for nominal national income 207	
	7.3	Weak separability 208	
	7.4	Simple sum monetary aggregates 210	
	7.5	The variable elasticity of substitution and near-monies 212	
	7.6	User cost of assets 216	
	7.7	Index number theory and Divisia aggregates 217	
	7.8	The certainty equivalence monetary aggregate 219	
	7.9	Judging among the monetary aggregates 220	
		7.9.1 Stability of the money demand function 221	
		7.9.2 Controllability of the monetary aggregate and policy	
		instruments and targets 221	
		7.9.3 Causality from the monetary aggregate to income 221	
		7.9.4 Information content of economic indicators 223	
		7.9.5 The St Louis monetarist equation 224	
		7.9.6 Comparing the evidence of Divisia versus simple-sum	
		aggregation 225	
	7.10	Current research and policy perspectives on monetary	
		aggregation 228	
		Conclusions 228	
		Appendix: Divisia aggregation 230	
		Measuring prices by the user costs of liquidity services 232	
		Adjustments for taxes on rates of return 233	
		Summary of critical conclusions 234	

8.	The	demand	function	for	money
----	-----	--------	----------	-----	-------

- 8.1 Basic functional forms of the closed-economy money demand function 238
 - 8.1.1 Scale variable in the money demand function 240
- 8.2 Rational expectations 241
 - 8.2.1 Theory of rational expectations 241
 - 8.2.2 Information requirements of rational expectations:
 - 8.2.3 Using the REH and the Lucas supply rule for predicting expected income 245
 - 8.2.4 Using the REH and a Keynesian supply function for predicting expected income 247
 - 8.2.5 Rational expectations problems and approximations 248
- 8.3 Adaptive expectations for the derivation of permanent income and estimation of money demand 249
- 8.4 Regressive and extrapolative expectations 251
- 8.5 Lags in adjustment and the costs of changing money balances 252
- 8.6 Money demand with the first-order PAM 254
- 8.7 Money demand with the first-order PAM and adaptive expectations of permanent income 255
- 8.8 Autoregressive distributed lag model: an introduction 256
- 8.9 Demand for money in the open economy 257
 - 8.9.1 Theories of currency substitution 258
 - 8.9.2 Estimation procedures and problems 261
 - 8.9.3 The special relation between M and M^* in the medium-of-payments function 264
 - 8.9.4 Other studies on CS 266

Conclusions 267

Summary of critical conclusions 268

Review and discussion questions 268

References 269

9. The demand function for money: Estimation problems, techniques and findings

9.1 Historical review of the estimation of money demand 271

9.2 Common problems in estimation: an introduction 275

- 9.2.1 Single equation versus simultaneous equations estimation 276
- 9.2.2 Estimation restrictions on the portfolio demand functions for money and bonds 276
- 9.2.3 The potential volatility of the money demand function 277

		9.2.4 Multiconnearity 278	
		9.2.5 Serial correlation and cointegration 278	
	9.3	The relationship between economic theory and cointegration analysis:	
		a primer 279	
		9.3.1 Economic theory: equilibrium and the adjustment to equilibrium 279	
	9.4	Stationarity of variables: an introduction 280	
		9.4.1 Order of integration 282	
		9.4.2 Testing for non-stationarity 283	
	9.5	Cointegration and error correction: an introduction 284	
		9.5.1 Cointegration techniques 286	
	9.6	Cointegration, ECM and macroeconomic theory 288	
	9.7	Application of the cointegration—ECM technique to money demand estimation 288	
	9.8	Some cointegration studies of the money-demand function 289	
	9.9	Causality 292	
	9.10	An illustration: money demand elasicities in a period of innovation 292	
	9.11	Innovations and the search for a stable money-demand function 293	
		Conclusions 294	
		Summary of critical conclusions 296	
		Appendix 297	
		The ARDL model and its cointegration and ECM forms 297	
		Review and discussion questions 298	
		References 300	
PA	RTIV		
		ry policy and central banking	303
10.		ey supply, interest rates and the operating targets of monetary	
	polic	y: Money supply and interest rates	305
	10.1	Goals, targets and instruments of monetary policy 306	
	10.2	Relationship between goals, targets and instruments, and difficulties	
		in the pursuit of monetary policy 308	
	10.3	Targets of monetary policy 309	
	10.4	Monetary aggregates versus interest rates as operating targets 309	
		10.4.1 Diagrammatic analysis of the choice of the operating target of monetary policy 310	
		10.4.2 Analysis of operating targets under a supply shock 313	
	10.5	The price level and inflation rate as targets 316	
	10.6	Determination of the money supply 319	
		10.6.1 Demand for currency by the public 319	
		10.6.2 Commercial banks: the demand for reserves 322	

10.7	Mechanical theories of the money supply: money supply identities 325
10.8	Behavioral theories of the money supply 327
10.9	Cointegration and error-correction models of the money supply 331
10.10	Monetary base and interest rates as alternative policy
	instruments 331
	Conclusions 333
	Summary of critical conclusions 334
	Review and discussion questions 334
	References 336
11. The	central bank: Goals, targets and instruments
11.1	· ·
11.2	Evolution of the goals of central banks 342
11.3	
	11.3.1 Open market operations 345
	11.3.2 Reserve requirements 346
	11.3.3 Discount/bank rate 348
	11.3.4 Moral suasion 351
	11.3.5 Selective controls 351
	11.3.6 Borrowed reserves 352
	11.3.7 Regulation and reform of commercial banks 352
11.4	of money 353
	11.4.1 Arguments for the competitive supplies of private monies 353
	11.4.2 Arguments for the regulation of the money supply 354
	11.4.3 Regulation of banks in the interests of monetary policy 354
	5 Administered interest rates and economic performance 356
	Monetary conditions index 357
	7 Inflation targeting and the Taylor rule 358
11.	
	Conclusions 360
	Summary of critical conclusions 361
	Review and discussion questions 361
	References 362
12. Th	e central bank: Independence, time consistency and credibility
12	a management goding 505
12	.2 Conflicts among policy makers: theoretical analysis 368
. 12	.3 Independence of the central bank 370
12	.4 Time consistency of policies 373

12.4.1 Time-consistent policy path 37412.4.2 Reoptimization policy path 376

		12.4.3 Limitations on the superiority of time-consistent policies over reoptimization policies 377	
		12.4.4 Inflationary bias of myopic optimization versus intertemporal	
		optimization 381	
		12.4.5 Time consistency debate: modern classical versus Keynesian	
		approaches 381	
		12.4.6 Objective functions for the central bank and the economy's	
		constraints 382	
	12.5	Commitment and credibility of monetary policy 387	
		12.5.1 Expectations, credibility and the loss from discretion versus	
		commitment 387	
		12.5.2 Credibility and the costs of disinflation under the EAPC 391	
		12.5.3 Gains from credibility with a target output rate greater than y^f 393	
		12.5.4 Analyses of credibility and commitment under supply shocks	
		and rational expectations 395	
	12.6	•	
	12,7	Empirical relevance of the preceding analyses 398	
		Conclusions 399	
		Appendix 401	
		Myopic optimal monetary policy without commitment in a	
		new Keynesian framework 401	
		Intertemporal optimization with commitment in a new	
		Keynesian framework 403	
		Summary of critical conclusions 403	
		Review and discussion questions 404	
		References 405	
PA	RTV		
Mo	onetai	ry policy and the macroeconomy	407
13.	The c	determination of aggregate demand	409
	13.1	Boundaries of the short-run macroeconomic models 410	
		13.1.1 Definitions of the short-run and long-run in	
		macroeconomics 410	
	13.2	The foreign exchange sector of the open economy and the	
	123	determination of the exchange rate under floating exchange rates 411	
	13.3	The commodity sector 413	
	13.4	13.3.1 Behavioral functions of the commodity market 415	
	13.7	The monetary sector: determining the appropriate operating target of monetary policy 418	
	13.5	Derivation of the LM equation 419	
		13.5.1 The link between the IS and LM equations: the Fisher equation	
		on interest rates 421	

13.6	Aggregate demand for commodities in the IS-LM model 421			
	13.6.1 Keynesian-neoclassical synthesis on aggregate demand in the			
	IS-LM model 424			
13.7	Ricardian equivalence and the impact of fiscal policy on aggregate			
demand in the IS-LM model 424				
13.8	IS-LM model under a Taylor-type rule for the money supply 429			
13.9	Short-run macro model under an interest rate operating			
	target 429			
	13.9.1 Determination of aggregate demand under simple interest rate			
	targeting 434			
	13.9.2 Aggregate demand under the Taylor rule 435			
	13.9.3 Aggregate demand under the simple interest rate target and			
	Ricardian equivalence 436			
	13.9.4 The potential for disequilibrium in the financial markets under			
	an interest rate target 436			
13.10	Does interest rate targeting make the money supply			
	redundant? 439			
13.11 Weaknesses of the IS-LM and IS-IRT analyses of aggregate				
	demand 440			
13.12	Optimal choice of the operating target of monetary policy 441			
	Conclusions 444			
	Appendix 444			
	The propositions of Ricardian equivalence and the evolution of			
	the public debt 444			
	Summary of critical conclusions 446			
	Review and discussion questions 446			
	References 449			
14. The	classical paradigm in macroeconomics			
14.1	Definitions of the short run and the long run 453			
14.2				
14.3				
14.4				
	14.4.1 The rate of unemployment and the natural rate of			
	unemployment 463			
	14.4.2 IS-LM version of the neoclassical model in a diagrammatic			
	form 465			

14.5 Fundamental assumptions of the Walrasian equilibrium analysis 467 Disequilibrium in the neoclassical model and the non-neutrality

14.6.2 Causes of deviations from long-run equilibrium 470 The relationship between the money supply and the price level: the

14.6.1 Pigou and real balance effects 468

14.6

14.7

of money 468

heritage of ideas 471

14.8	The classical and neoclassical tradition, economic liberalism and						
	laissez fa	ire 472					
	14.8.1	Some major misconceptions about traditional classical and neoclassical approaches 474					
14.9	Uncertai	nty and expectations in the classical paradigm 475					
		ions and the labor market: the expectations-augmented					
	-	curve 476					
	•	Output and employment in the context of nominal wage contracts 476					
	14.10.2	The Friedman supply rule 481					
	14.10.3						
	14.10.4	The short-run equilibrium unemployment rate and Friedman's expectations-augmented Phillips curve 483					
14.11	Price ext	pectations and commodity markets: the Lucas supply					
	function						
14.12		is model with supply and demand functions 488					
		and demarcating the models of the classical paradigm 492					
		iness cycle theory and monetary policy 495					
		riedman and monetarism 497					
14.16	6 Empirical evidence 501						
	Conclusions 503						
	Summary of critical conclusions 504						
	Review and discussion questions 505						
	Referenc						
The K	Keynesian	paradigm	510				
15.1	Keynesia	n model I: models without efficient labor markets 514					
	15.1.1	Keynesian deficient-demand model: quantity-constrained analysis 517					
15.2	Keynesia	n model II: Phillips curve analysis 522					
15.3	Compone	ents of neoKeynesian economics 525					
	15.3.1	Efficiency wage theory 525					
	15.3.2	Costs of adjusting employment: implicit contracts and labor hoarding 527					
	15.3.3	Price stickiness 528					
15.4	New Key	nesian (NK) macroeconomics 532					
	15.4.1	NK commodity market analysis 533					
	15.4.2	NK price adjustment analysis 534					
	15.4.3	Other reasons for sticky prices, output and employment 537					
	15.4.4	Interest rate determination 539					
	15.4.5	Variations of the overall NK model 543					
	15.4.6	Money supply in the NK model 544					
	15.4.7	NK business cycle theory 548					

	Reduced-form equations for output and employment in the Keynesian and neoclassical approaches 549
	Empirical validity of the new Keynesian ideas 551 Conclusions 552
	Summary of critical conclusions 556
	Review and discussion questions 557
	References 561
Mone	y, bonds and credit in macro modeling
16.1	Distinctiveness of credit from bonds 570
	16.1.1 Information imperfections in financial markets 570
16.2	Supply of commodities and the demand for credit 575
16.3	Aggregate demand analysis incorporating credit as a
	distinctive asset 577
	16.3.1 Commodity market analysis 577
	16.3.2 Money market analysis 577
	16.3.3 Credit market analysis 579
	16.3.4 Determination of aggregate demand 581
16.4	Determination of output 582
16.5	Impact of monetary and fiscal policies 583
16.6	Instability in the money and credit markets and monetary
	policy 585
16.7	Credit channel when the bond interest rate is the exogenous monetary
	policy instrument 587
16.8	The informal financial sector and financial underdevelopment 588
16.9	Bank runs and credit crises 588
16.1	10 Empirical findings 589
	Conclusions 591
	Appendix A 592
	Demand for working capital for a given production level in a simple stylized model 592
	Appendix B 593
	Indirect production function including working capital 593
	Summary of critical conclusions 595
	Review and discussion questions 595
	References 596
17. M	acro models and perspectives on the neutrality of money
17.	
17	
17	3 The Lucas critique of estimated equations as a policy tool 606

1/.7	resung i	he effectiveness of monetary policy, estimates based on the	
	Lucas ar	nd Friedman supply models 607	
	17.4.1	A procedure for segmenting the money supply changes into	
		their anticipated and unanticipated components 608	
	17.4.2	Separating neutrality from rational expectations: Mishkin's	
		test of the Lucas model 610	
17.5	Distingu	ishing between the impact of positive and negative money	
	supply sh	hocks 611	
17.6	LSW mod	del with a Taylor rule for the interest rate 612	
17.7	Testing t	the effectiveness of monetary policy: estimates from	
	Keynesia	an models 615	
	17.7.1	Using the LSW model with a Keynesian supply equation 615	
	17.7.2	Gali's version of the Keynesian model with an exogenous money supply 616	
17.8	A compa	act form of the closed-economy new Keynesian model 618	
	17.8.1	Empirical findings on the new Keynesian model 619	
	17.8.2	Ball's Keynesian small open-economy model with a	
		Taylor rule 621	
17.9	Results of	of other testing procedures 622	
17.10	Summing	g up the empirical evidence on monetary neutrality and	
	rational	expectations 622	
17.11	Getting a	away from dogma 623	
	17.11.1	The output equation revisited 624	
	17.11.2	The Phillips curve revisited 625	
<i>17.12</i>	Hysteres	is in long-run output and employment functions 626	
	Conclusi	ions 626	
	Summary	y of critical conclusions 630	
	Review a	and discussion questions 630	
	Referenc	res 634	
Walra	as's law a	and the interaction among markets	636
18.1	Walras's	s law 637	
	18.1.1	Walras's law in a macroeconomic model with four goods 640	
	18.1.2	The implication of Walras's law for a specific market 641	
18.2	Walras's	s law and selection among the markets for a model 641	
18.3	Walras's	s law and the assumption of continuous full employment 643	
18.4	Say's lav	w 643	
18.5	Walras's	s law, Say's law and the dichotomy between the real and	
	monetary	y sectors 646	
18.6	The wear	lth effect 646	
18.7	The real	balance effect 647	

1	
-	Walras's law really a law? When might it not hold? 648 8.8.1 Intuition: violation of Walras's law in recessions 648
1	8.8.2 Walras's law under excess demand for commodities 651
1	8.8.3 Correction of Walras's law 651
18.9 N	otional demand and supply functions in the classical paradigm 652
	e-evaluating Walras's law 652
	8.10.1 Fundamental causes of the failure of Walras's law 652
	8.10.2 Irrationality of the behavioral assumptions behind Walras's
•	law 653
18 11 1	Reformulating Walras's law: the Clower and Drèze effective demand
	and supply functions 653
	8.11.1 Clower effective functions 653
	8.11.2 Modification of Walras's law for Clower effective
	functions 654
	18,11.3 Drèze effective functions and Walras's law 654
18 12	Implications of the invalidity of Walras's law for monetary policy 655
	Conclusions 655
	Summary of critical conclusions 656
	Review and discussion questions 656
	References 658
PART VI	
	s of interest in the economy
	s of interest in the economy
The rate	s of interest in the economy nacroeconomic theory of the rate of interest
The rate	nacroeconomic theory of the rate of interest
The rate 19. The 1 19.1	nacroeconomic theory of the rate of interest Nominal and real rates of interest 662
The rate	nacroeconomic theory of the rate of interest Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand
The rate 19. The 1 19.1	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663
The rate 19. The r 19.1 19.2	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663
The rate 19. The i 19.1 19.2	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665
The rate 19. The r 19.1 19.2	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate
The rate 19. The r 19.1 19.2 19.3 19.4	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667
19. The rate 19. 1 19.1 19.2 19.3 19.4	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669
The rate 19. The r 19.1 19.2 19.3 19.4	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670
19. The rate 19. 1 19.1 19.2 19.3 19.4	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate
19. The rate 19. 1 19.1 19.2 19.3 19.4 19.5	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673
19. The rate 19. 1 19.1 19.2 19.3 19.4	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate
19. The rate 19. 1 19.1 19.2 19.3 19.4 19.5	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate of interest 673
19. The rate 19. 1 19.1 19.2 19.3 19.4 19.5	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate of interest 673 19.7.1 Loanable funds theory in the modern classical approach 675
The rate 19. The r 19.1 19.2 19.3 19.4 19.5 19.6	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate of interest 673 19.7.1 Loanable funds theory in the modern classical approach 675 19.7.2 David Hume on the rate of interest 676
19. The rate 19. 1 19.1 19.2 19.3 19.4 19.5	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate of interest 673 19.7.1 Loanable funds theory in the modern classical approach 675 19.7.2 David Hume on the rate of interest 676 Keynesian heritage: the liquidity preference theory of the
The rate 19. The r 19.1 19.2 19.3 19.4 19.5 19.6	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate of interest 673 19.7.1 Loanable funds theory in the modern classical approach 675 19.7.2 David Hume on the rate of interest 676 Keynesian heritage: the liquidity preference theory of the interest rate 678
The rate 19. The r 19.1 19.2 19.3 19.4 19.5 19.6	Nominal and real rates of interest 662 Application of Walras's law in the IS-LM models: the excess demand for bonds 663 19.2.1 Walras's law 663 Derivation of the general excess demand function for bonds 665 Intuition: the demand and supply of bonds and interest rate determination 667 Intuition: dynamic determination of the interest rate 669 The bond market in the IS LM diagram 670 19.6.1 Diagrammatic analysis of dynamic changes in the rate of interest 673 Classical heritage: the loanable funds theory of the rate of interest 673 19.7.1 Loanable funds theory in the modern classical approach 675 19.7.2 David Hume on the rate of interest 676 Keynesian heritage: the liquidity preference theory of the interest rate 678

	19.10	Neutrali of intere	ty versus non-neutrality of the money supply for the real rate	
	19.11	Determi	nants of the long-run ("natural") real rate of interest and the	
	10.12		trality of fiscal policy 681	
		-	al evidence: testing the Fisher equation 683	
	19.13	_	the liquidity preference and loanable funds theories 683 ions 686	
		Summar	y of critical conclusions 687	
		Review d	and discussion questions 687	
		Referenc	res 689	
20.	The s	tructure	of interest rates	690
	20.1	Some of	the concepts of the rate of interest 691	
	20.2	Term str	nucture of interest rates 692	
		20.2.1	Yield curve 692	
		20.2.2	Expectations hypothesis 694	
		20.2.3	Liquidity preference version of the expectations	
			hypothesis 697	
		20.2.4	Segmented markets hypothesis 698	
		20.2.5	Preferred habitat hypothesis 698	
		20.2.6	Implications of the term structure hypotheses for monetary policy 699	
	20.3	Financia	al asset prices 699	
	20.4		al estimation and tests 701	
		20.4.1	Reduced-form approaches to the estimation of the term structure of yields 701	
	20.5	Tests of	the expectations hypothesis with a constant premium and	
			expectations 702	
		20.5.1	Slope sensitivity test 703	
		20.5.2	Efficient and rational information usage test 704	
	20.6	Random	walk hypothesis of the long rates of interest 705	
	20.7	Informa	tion content of the term structure for the expected rates of	
		inflation	708	
		Conclus	ions 710	
		Summar	y of critical conclusions 711	
		Review o	and discussion questions 711	
		Referenc	ces 712	
PAI	RTVII			
		oing gen	erations models of money	715
21.	The b	enchmai	k overlapping generations model of fiat money	717
	21.1	Stulinad	empirical facts about money in the modern economy 718	
	21.2	-	themes about money in OLG models 719	

	21.3.1	Microeconomic behavior: the individual's saving and
		money demand 723
	21.3.2	Macroeconomic analysis: the price level and the value of money 725
	21.3.3	The stationary state 727
	21.3.4	Indeterminacy of the price level and of the value of fiat money 728
	21.2.6	· · · · · · · · · · · · · · · · · · ·
27.4	21.3.5	c OLG model with a growing population 729
21.4		
21.5		in the basic OLG model 731 c OLG model with money supply growth and a growing
21.6		
21.7	population	
21.7		ncy of monetary expansion in the money transfer case 734
21.8		ncy of price stability with monetary expansion and population
21.0	growth	
21.9	•	lemand in the OLG model with a positive rate of time
21.10	preferen	
	-	fiat monies 740
21.11	•	s, bubbles and market fundamentals in OLG analysis 741
		ions 742
		ry of critical conclusions 743
		and discussion questions 743
	Kejeren	ces 744
22. The	OLG mo	del: Seigniorage, bonds and the neutrality of fiat money
22.1	Seignio	rage from fiat money and its uses 747
	22.1.1	Value of money under seigniorage with destruction of
		government-purchased commodities 748
	22.1.2	Inefficiency of monetary expansion with seigniorage as a
		taxation device 749
	22.1.3	Change in seigniorage with the rate of monetary expansion 751
	22.1.4	Change in the lifetime consumption pattern with the rate of
		monetary expansion 751
	22.1.5	Seigniorage from monetary expansion versus lump-sum
		taxation 752
	22.1.6	and the second concentration device 132
22.2	? Fiat m	oney and bonds in the OLG framework 753
22	3 Wallac	ce-Modigliani-Miller (W-M-M) theorem on open market
	operat	ions 755
	22.3.1	W-M-M theorem on open market operations with
		commodity storage 755
	22.3.2	on open market operations in the
		money-bonds OLG model 758

21.3 The basic OLG model 722

	22.4	Getting	veyona ine simplistic OLG analysis of money 700	
		22.4.1	Model I: an OLG model with money, capital and	
			production 760	
		22.4.2	Model II: the preceding OLG model with a linear	
			production function 764	
	22.5	Model I	II: the Lucas OLG model with non-neutrality of money 764	
	22.6		OLG models explain the major facets of a monetary	
		economy		
		-	ions 770	
			y of critical conclusions 771	
			and discussion questions 771	
		Reference	•	
		Rejerent	CCS //2	
23.	The C	OLG mod	lel of money: Making it more realistic	773
	23.1	A T-peri	iod cash-in-advance money-bonds model 775	
		23.1.1	Cash-in-advance models with money and one-period	
			bonds 777	
		23.1.2	Analysis of the extended multi-period OLG cash-in-advance	
			money-bonds model 777	
		23.1.3	W-M-M theorem in the extended OLG cash-in-advance	
			money-bonds model 781	
	23.2	An exten	aded OLG model with payments time for purchases and the	
			MIUF 784	
		23.2.1	OLG model extended to incorporate money indirectly in the	
		20.2.1	utility function (MIIUF) 785	
	23.3	An ortor	aded OLG model for firms with money indirectly in the	
	20.0		ion function (MIIPF) 790	
		23.3.1	Rationale for putting real balances in the production	
		23.3.1	function 790	
		23.3.2		
			• •	
	22.4		Intuitive empirical evidence 793	
	23.4		LG model with MIIUF and MIIPF 795	
			ions 796	
			y of critical conclusions 797	
			and discussion questions 798	
		Referenc	ces 799	
PA	RT VII	I		
Mo	oney a	nd finan	icial institutions in growth theory	801
24.	Mone	etary gro	wth theory	803
	24.1		dity money, real balances and growth theory 806	
	24.2		ances in disposable income and growth 808	
	47.4	r iai vali	unces in disposable income una growin ovo	

24.3 Real fiat balances in the static production function 8

- 24.4 Reformulation of the neoclassical model with money in the static production and utility functions 812
- 24.5 Why and how does money contribute to per capita output and its growth rate? 815
- 24.6 How does the use of money change the labor supplied for production? 816
- 24.7 Distinction between inside and outside money 817
- 24.8 Financial intermediation (FI) in the growth and development processes 817
- 24.9 The financial system 818
- 24.10 Empirical evidence on the importance of money and the financial sector to growth 822
- 24.11 A simplified growth model of endogenous technical change involving the financial sector 827
- 24.12 Investment, financial intermediation and economic development 828
 Conclusions 829
 Summary of critical conclusions 831
 Review and discussion questions 831
 References 832

Index