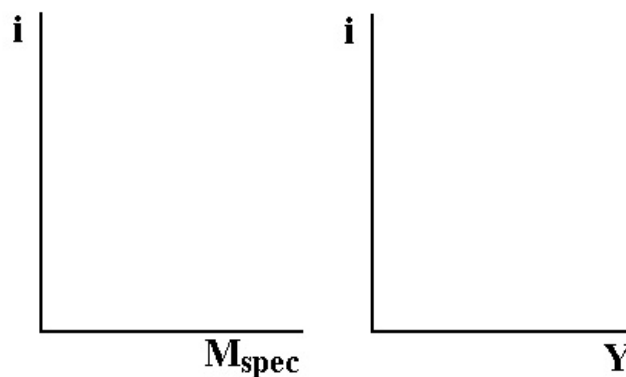


## Study Problem: Liquidity-Preference Theory in the IS-LM Framework

### An Exercise in Keynesian Liquidity-Preference Theory and Policy

According to Keynes, the speculative demand for money  $M_{\text{spec}}$  is sensitive to changes in the interest rate. In other words, it is interest-elastic—and extremely so at very low rates of interest. (The speculative demand for money is contrasted with the transactions demand  $M_{\text{trans}}$ , the latter being a stable function of income.) In ISLaMic Art, the speculative demand for money gives rise to an LM curve that consists of three distinct “regions.” On the axes provided, show how these regions relate to the demand for speculative balances. Label the three regions Extreme Keynesian, Intermediate, and Classical.



Now, read the passage below and circle the appropriate word or phrase in parentheses.

#### Theory:

In the Keynesian model, the accumulation of large speculative balances implies that people expect the rate of interest to **(rise, fall)**. They **(want, do not want)** to hold bonds because the interest rate and bond prices are **(directly, inversely)** related to one another. If the supply of money remains constant, the high speculative demand implies a **(high, low)** level of transactions balances, which corresponds to a **(high, low)** level of income. If, with a given money supply and an equilibrium rate of interest, people are suddenly overcome by the fetish of liquidity, the demand for speculative balances would shift **(rightward, leftward)**, putting **(upward, downward)** pressure on the rate of interest.

#### Policy:

If people are suddenly overcome by the fetish of liquidity, the Federal Reserve should **(increase, decrease)** the money supply. Once full-employment income has been achieved, the Fed’s policy rule of “Print money to **(hold, spend)**, but not money to **(hold, spend)**” may not be a viable policy rule because the speculative demand for money is too **(stable, unstable)**. Besides, the Fed may not have an unambiguous indicator of the needed policy: its timely information includes **(the interest rate, income)** but not **(the interest rate, income)**.