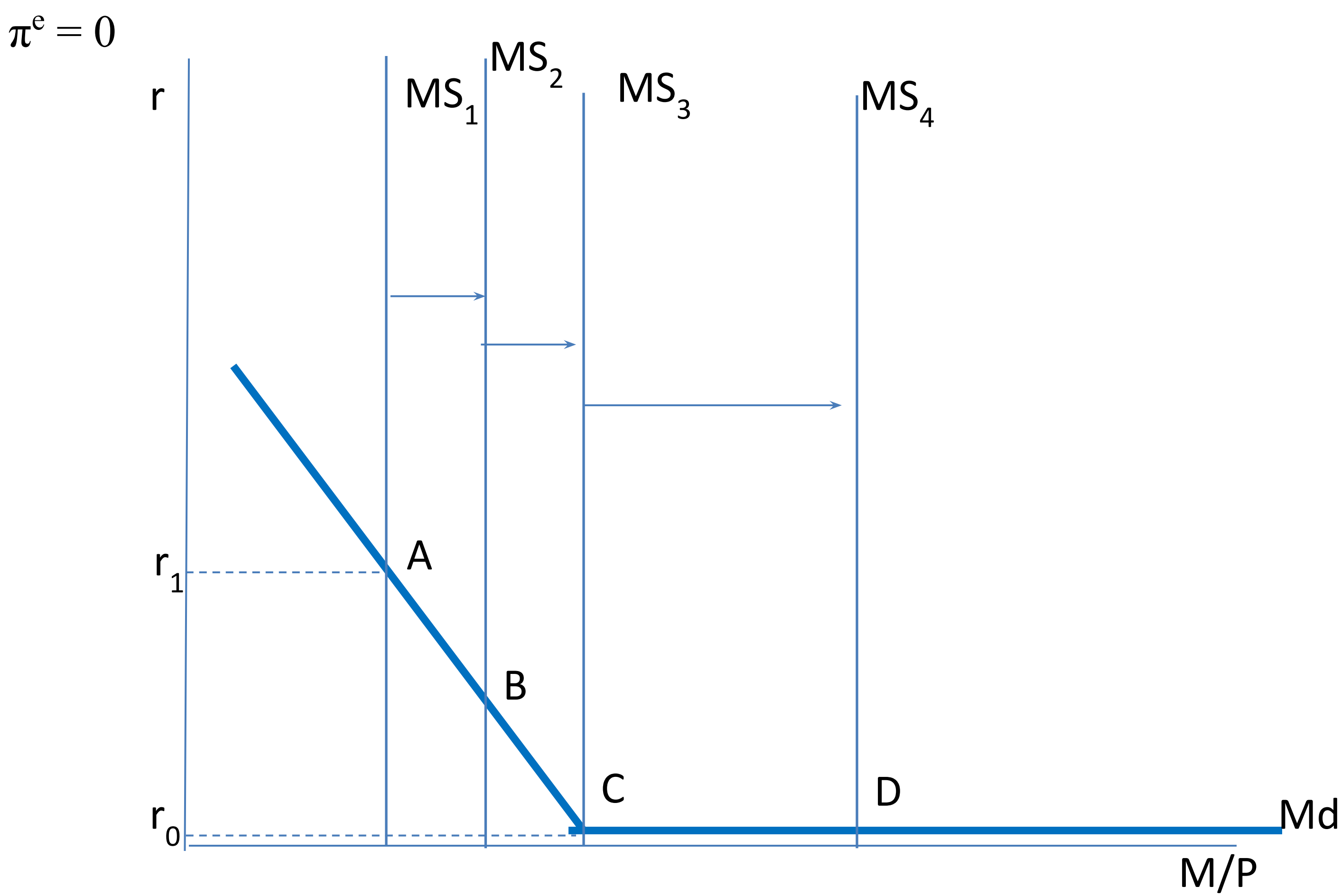
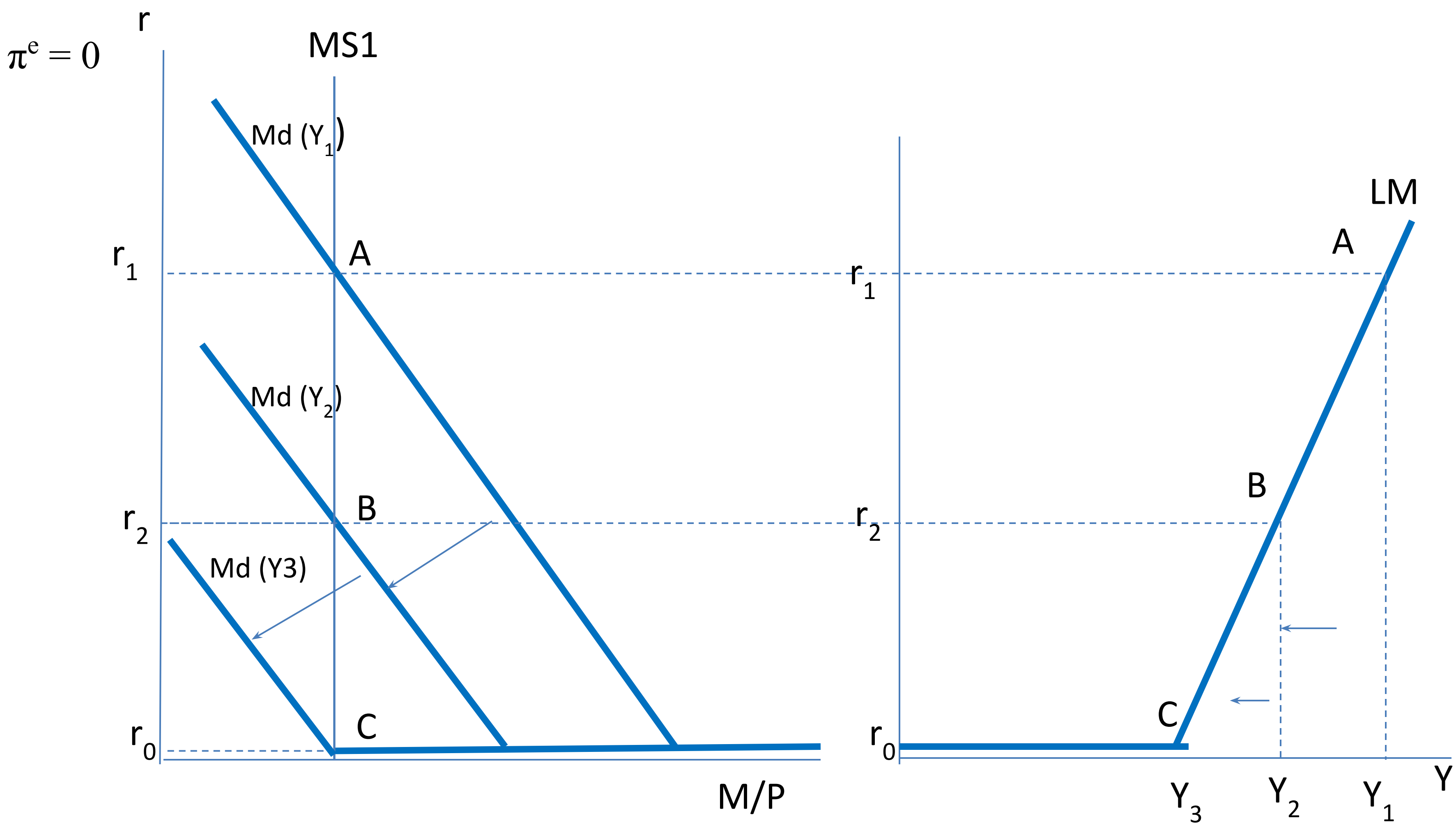
Money Demand, Money Supply, Liquidity Trap



As very low interest rates, investors are indifferent between bonds and money – money demand becomes perfectly elastic.
Increase in the money supply is held as cash.

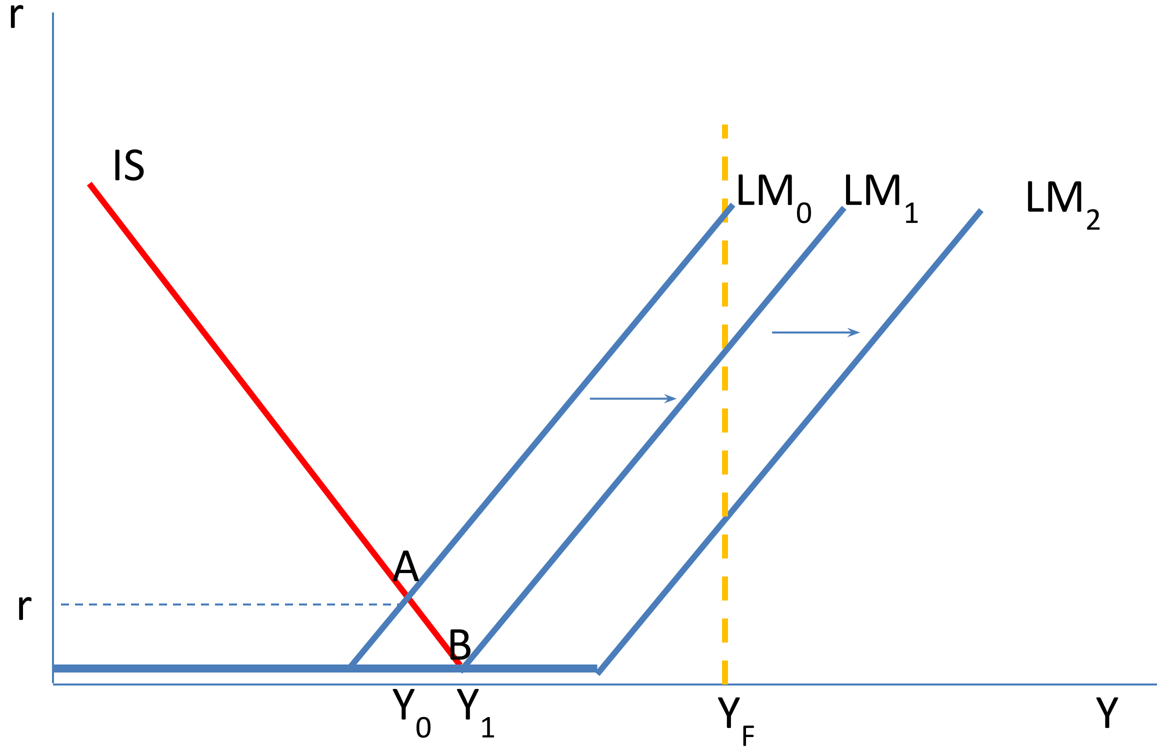
Derivation of the LM-Curve With Liquidity Trap



As income falls below Y_3 , no effect on the interest rate. The LM-curve is horizontal.

Monetary Policy in a Liquidity Trap

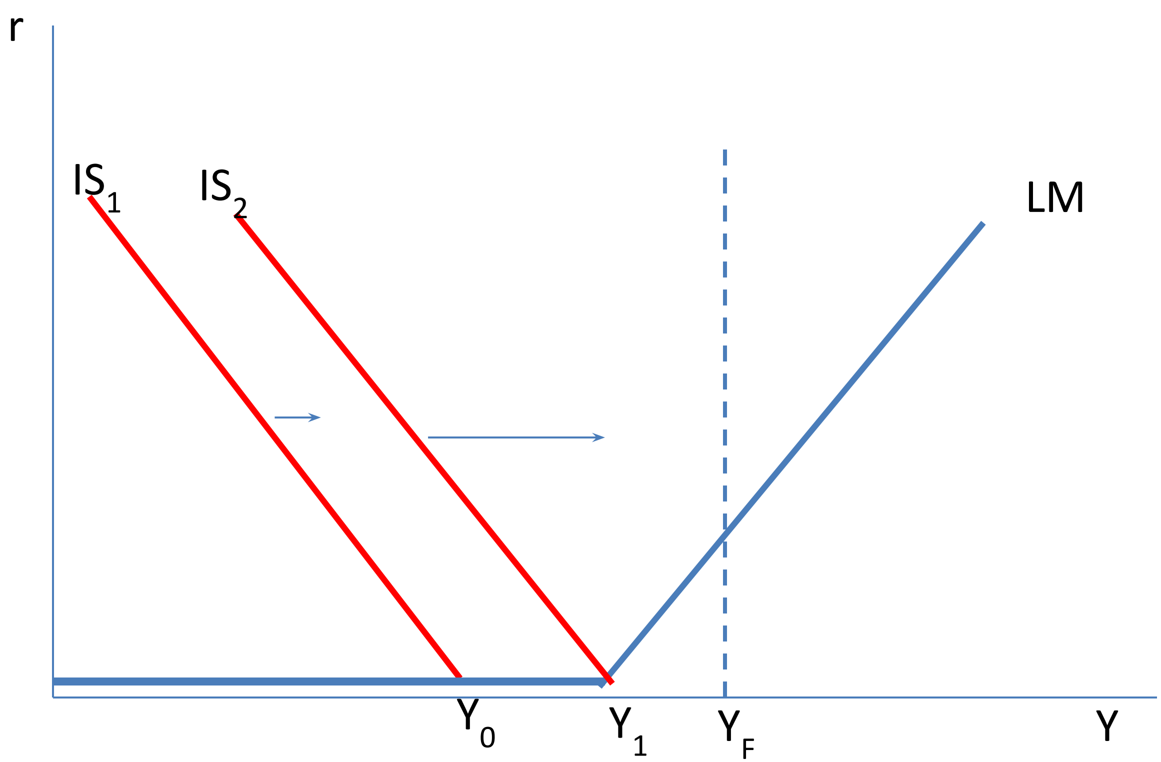
$\pi^e = 0$



The economy is at Y_0 below full employment potential. Monetary policy is ineffective in pushing the economy beyond Y_1.

Fiscal Policy in a Liquidity Trap

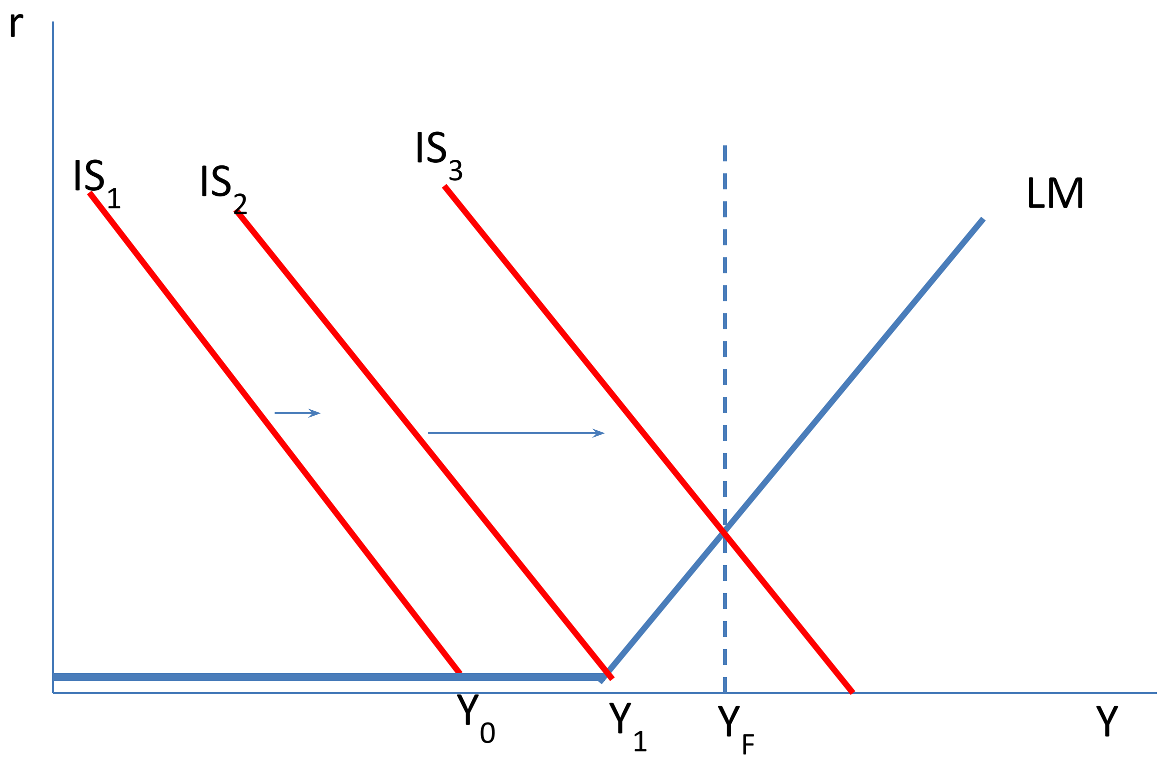
$\pi^e = 0$



But, fiscal policy seems to work and you get the full multiplier effect as you move from Y_0 to Y_1. Why do you get the full multiplier effect?

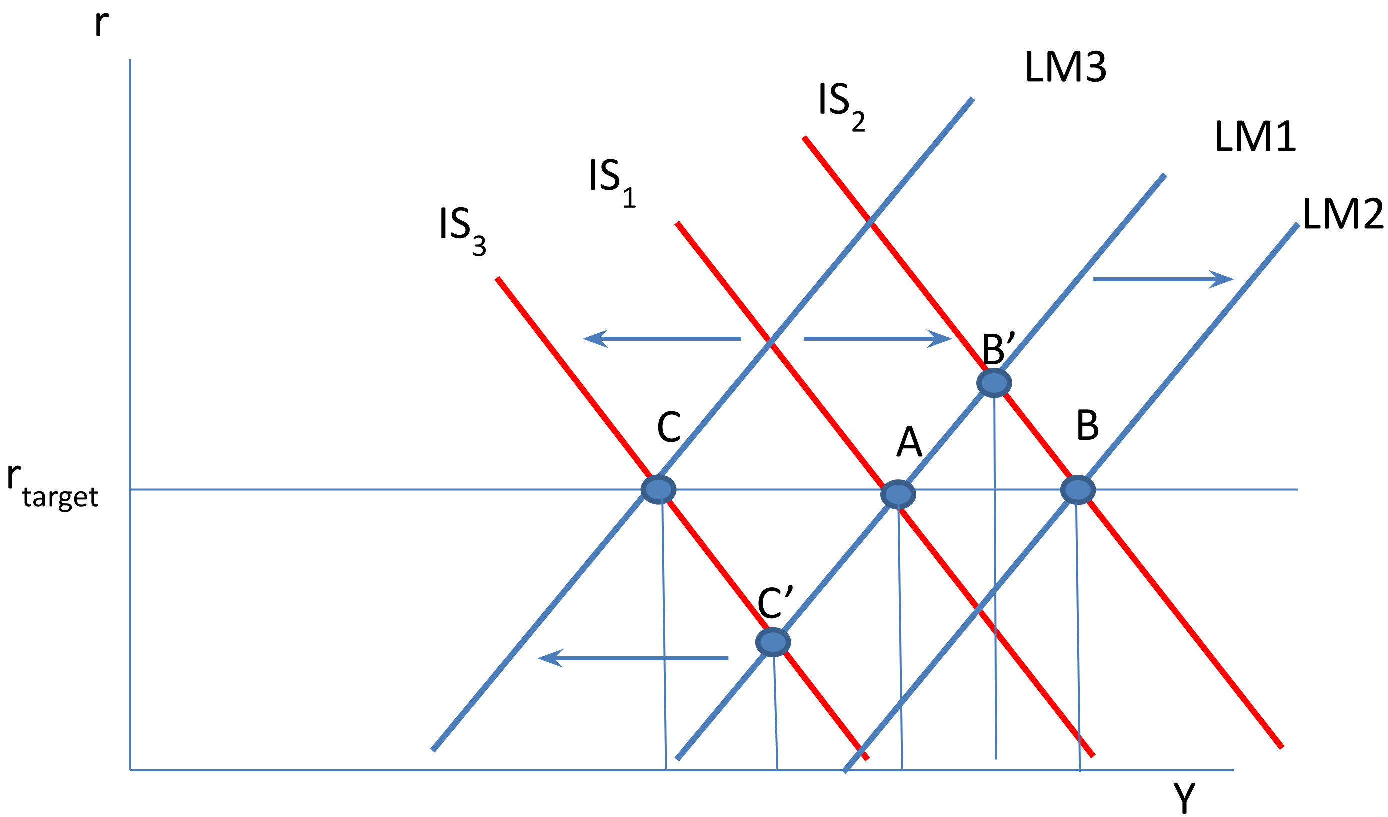
Fiscal Policy in a Liquidity Trap

$\pi^e = 0$



The Fed Targets the Interest Rate – Not the Money Supply

$\pi^e = 0$



Case where real sector of the economy experiences shocks causing shifts in the IS-curve. If the Fed targeted the money supply, go to points B' and C'.