

Interaction between money side and goods side

Antony P. Mueller

UFS

March 2013

antonymueller@gmail.com

Determinants of profit

Profit

$$\Pi = (p \times q) - (wL + iK)$$

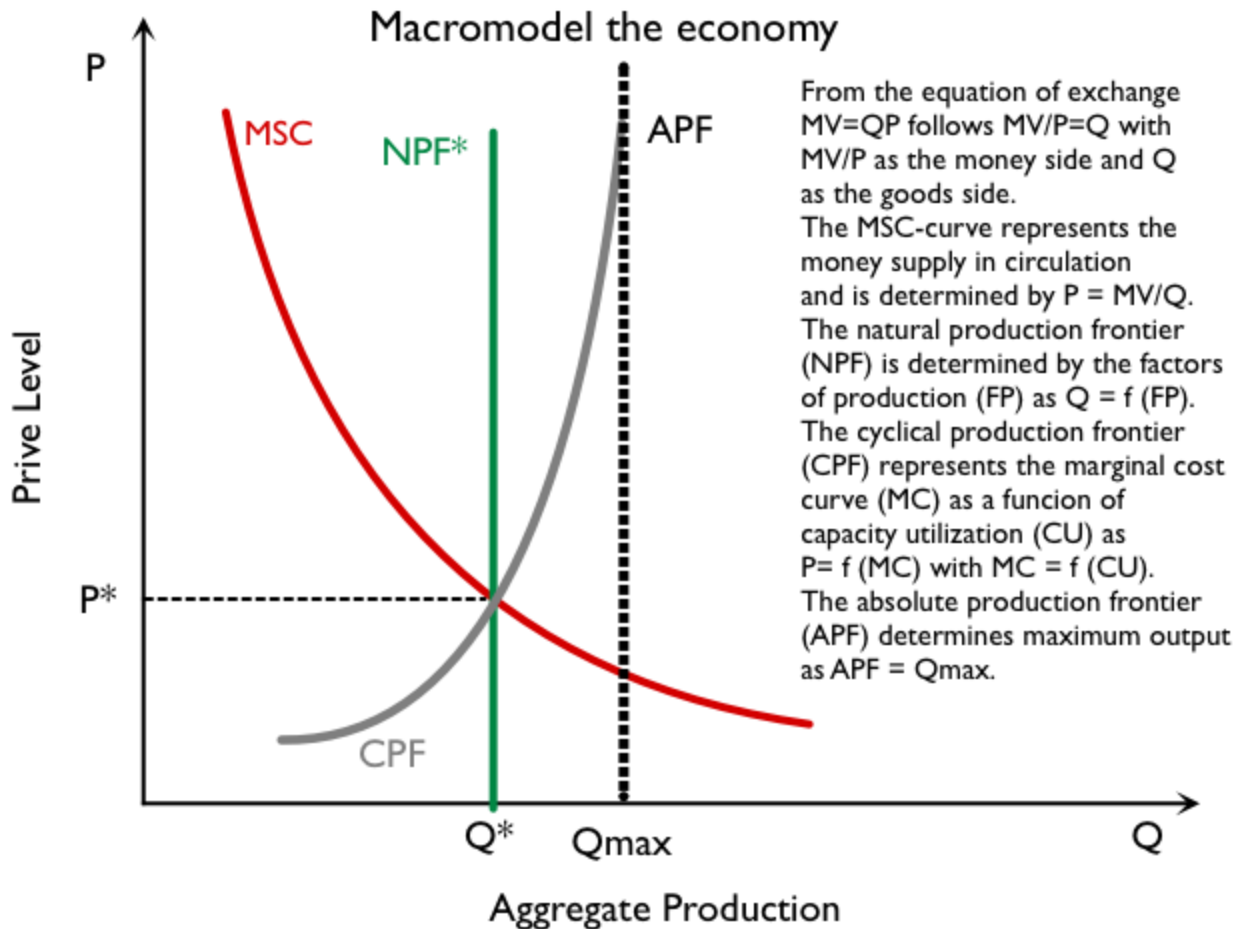
Interest rate

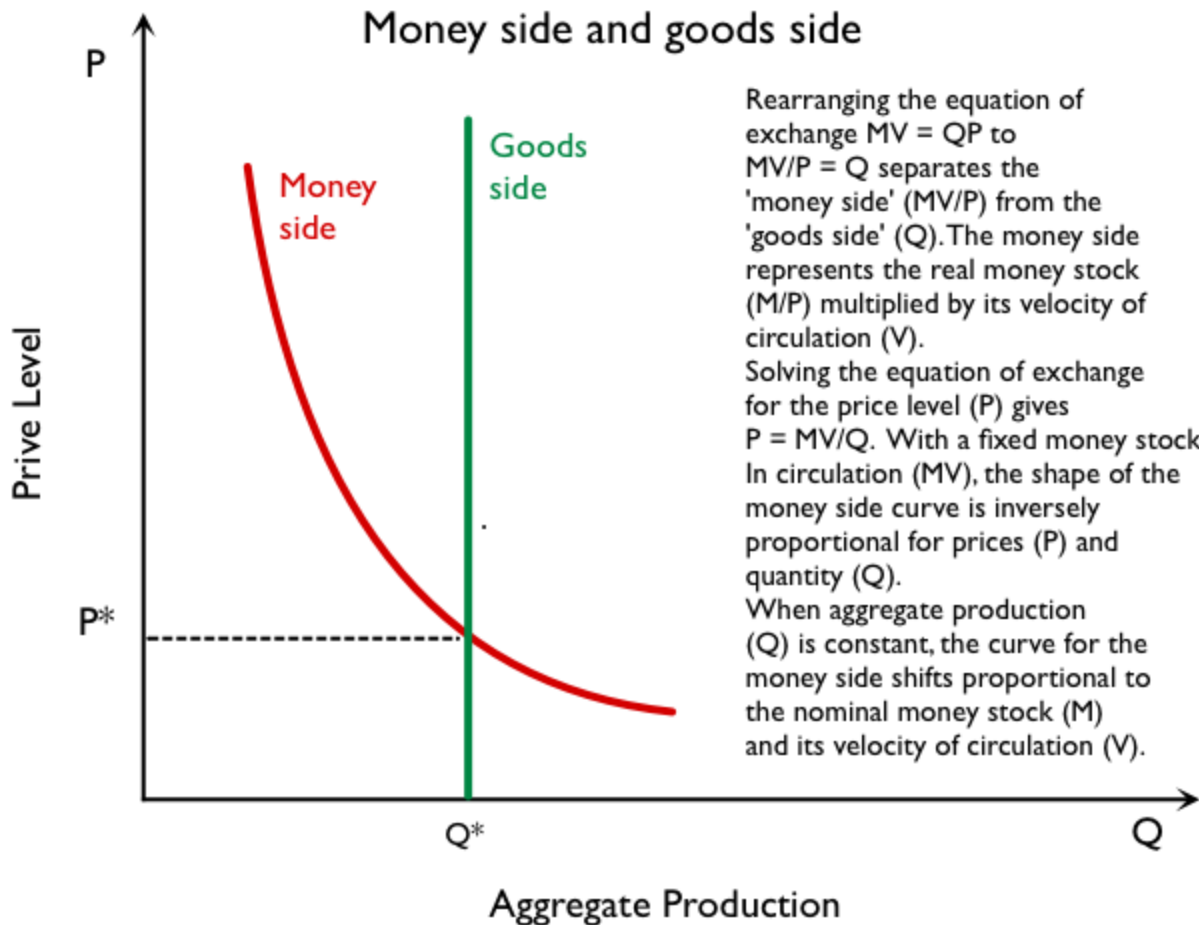
$$i = r + \pi^e$$

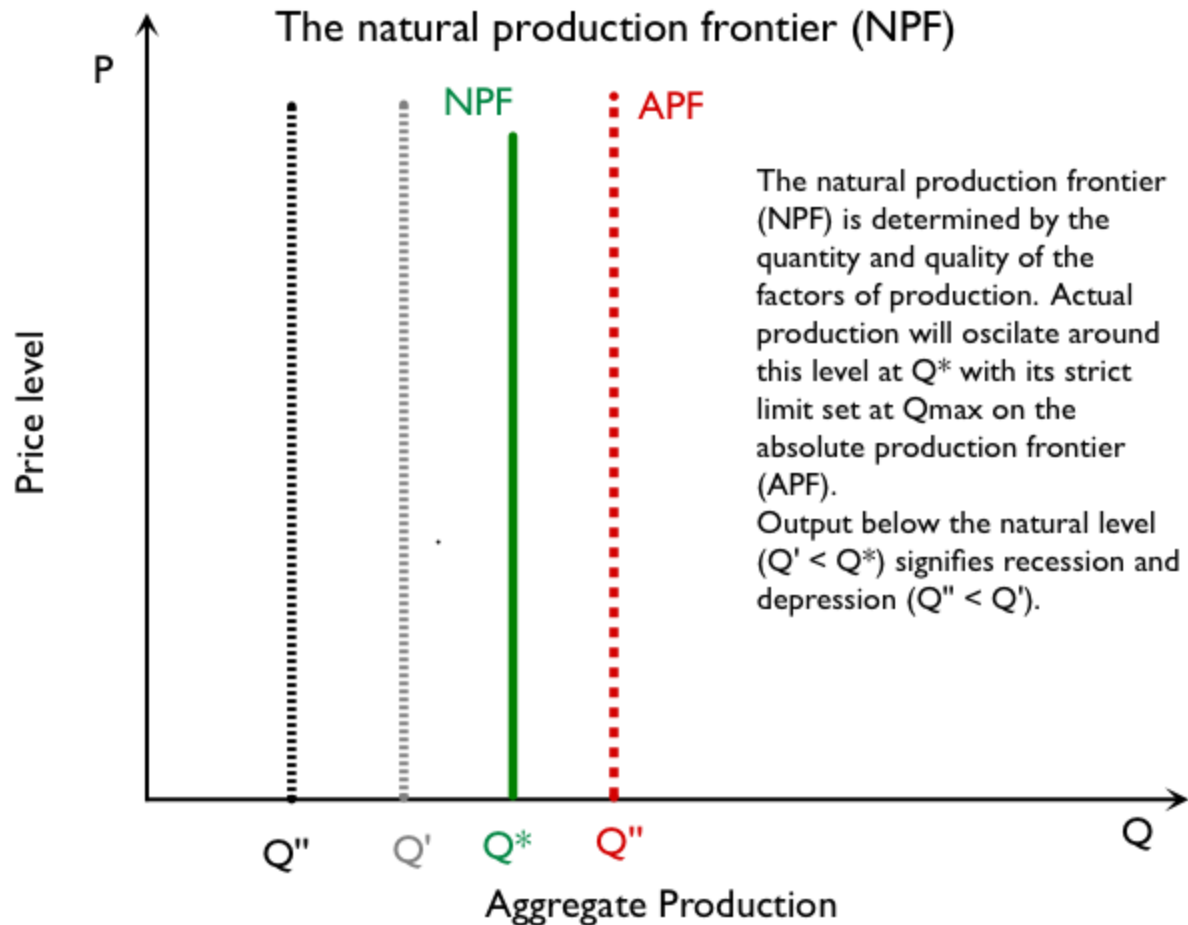
$$r = i - \pi^e$$

Real wage rate

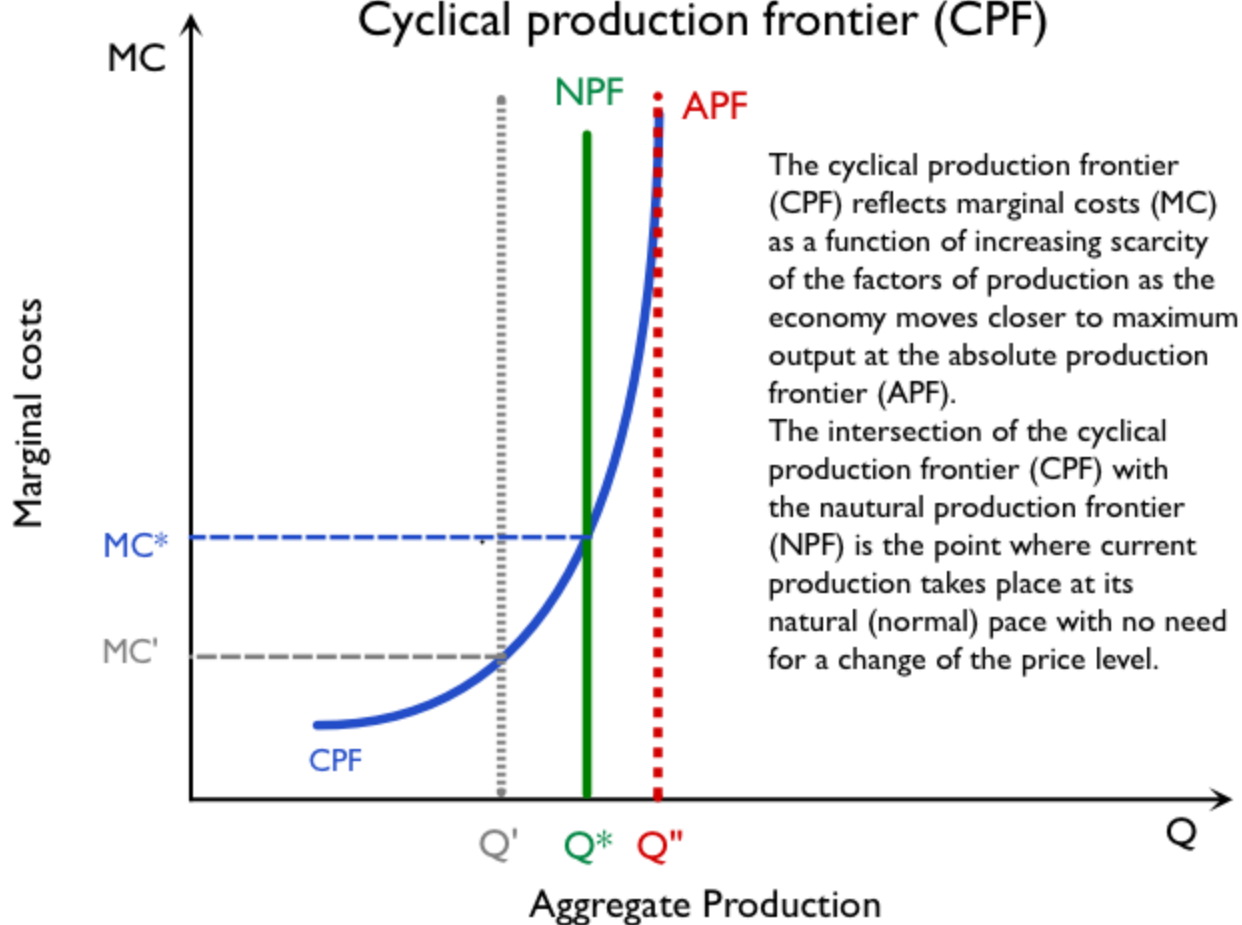
$$\frac{W}{P}$$



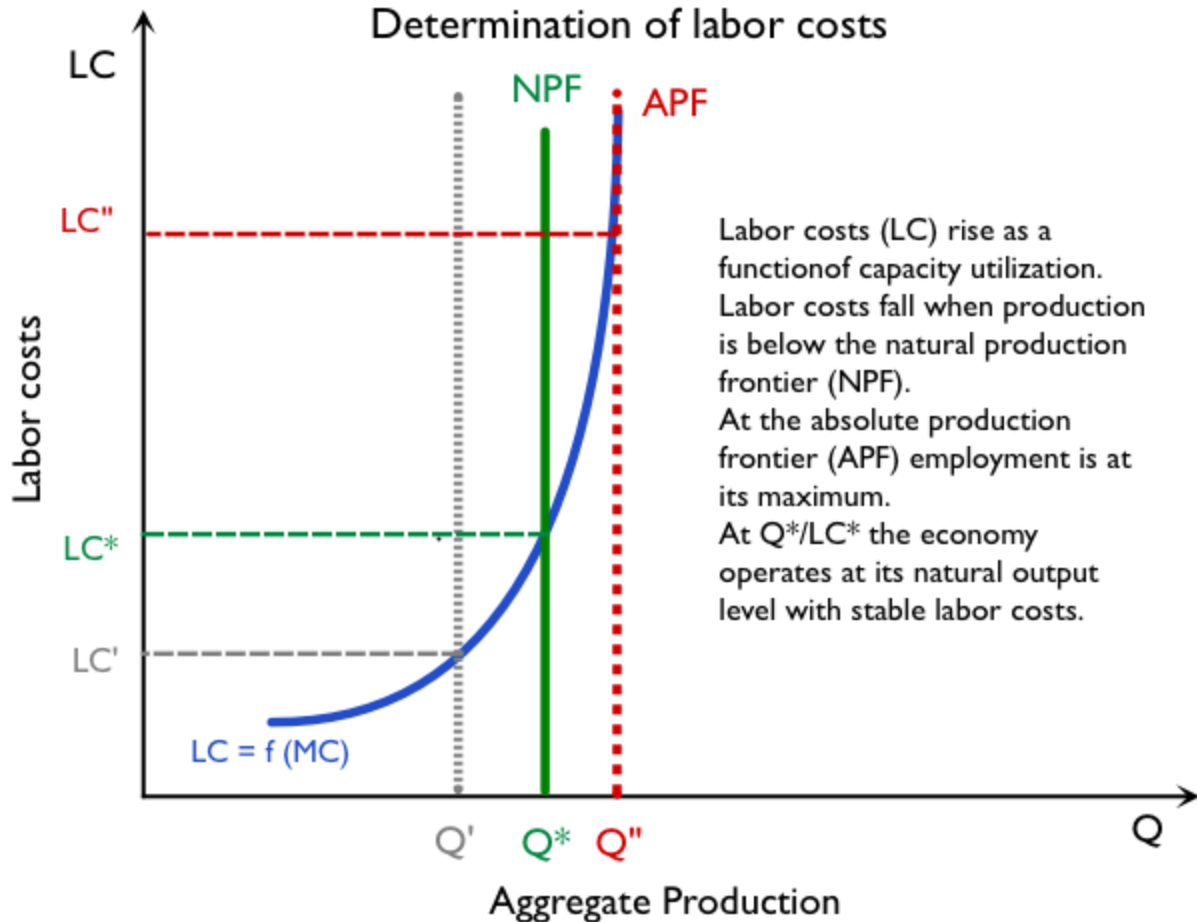




Cyclical production frontier (CPF)

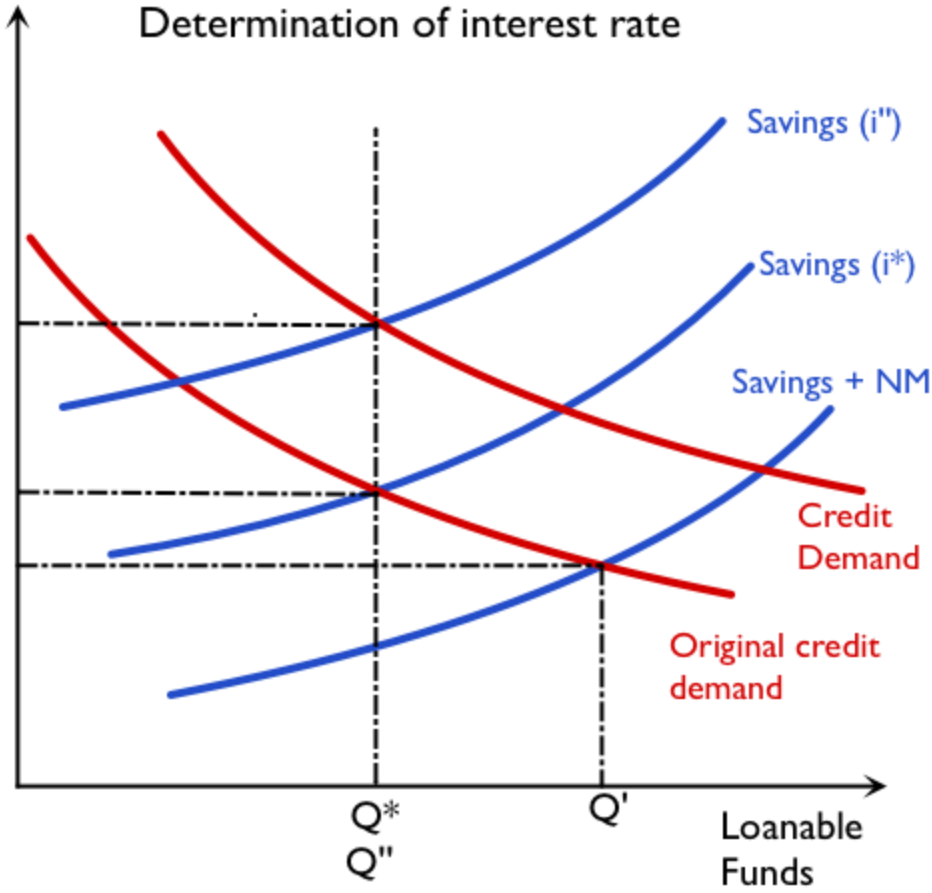


Determination of labor costs

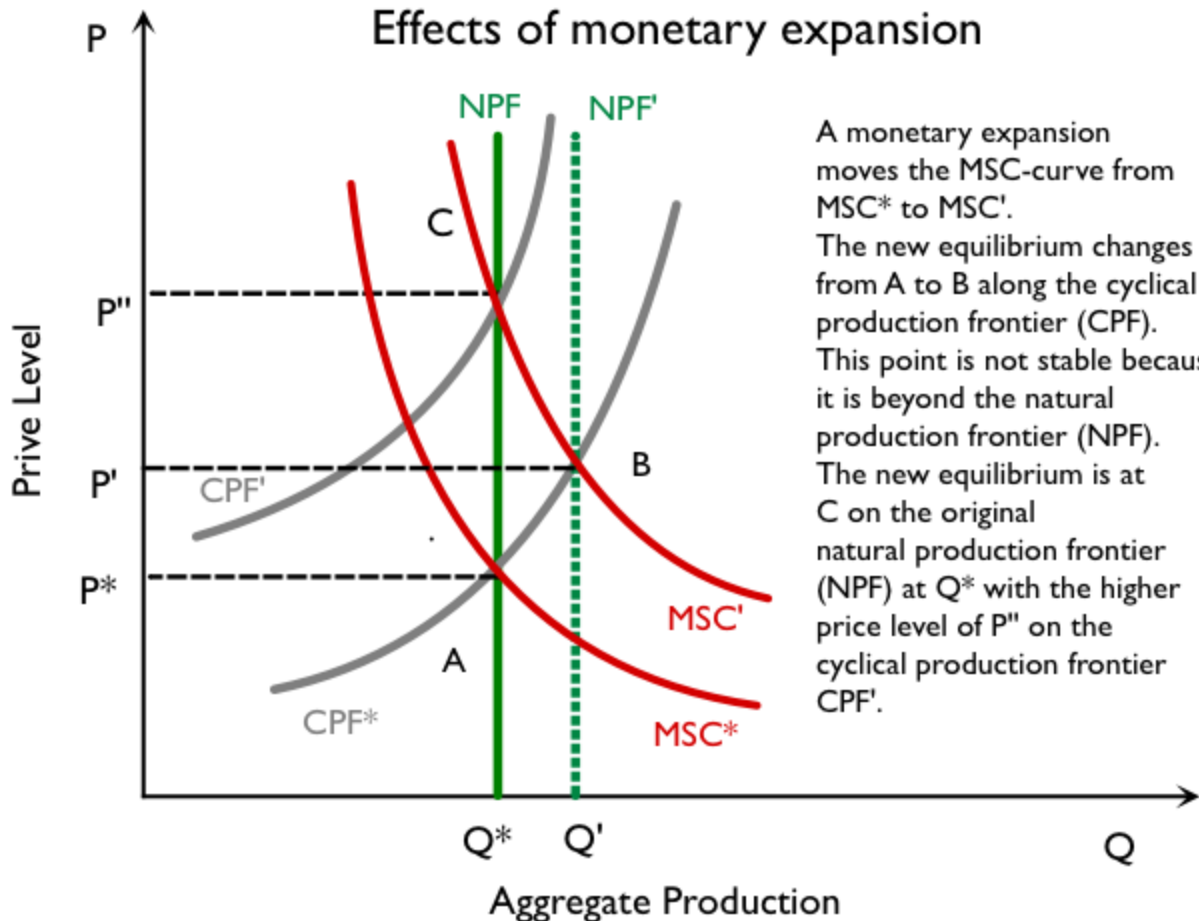


Determination of interest rate

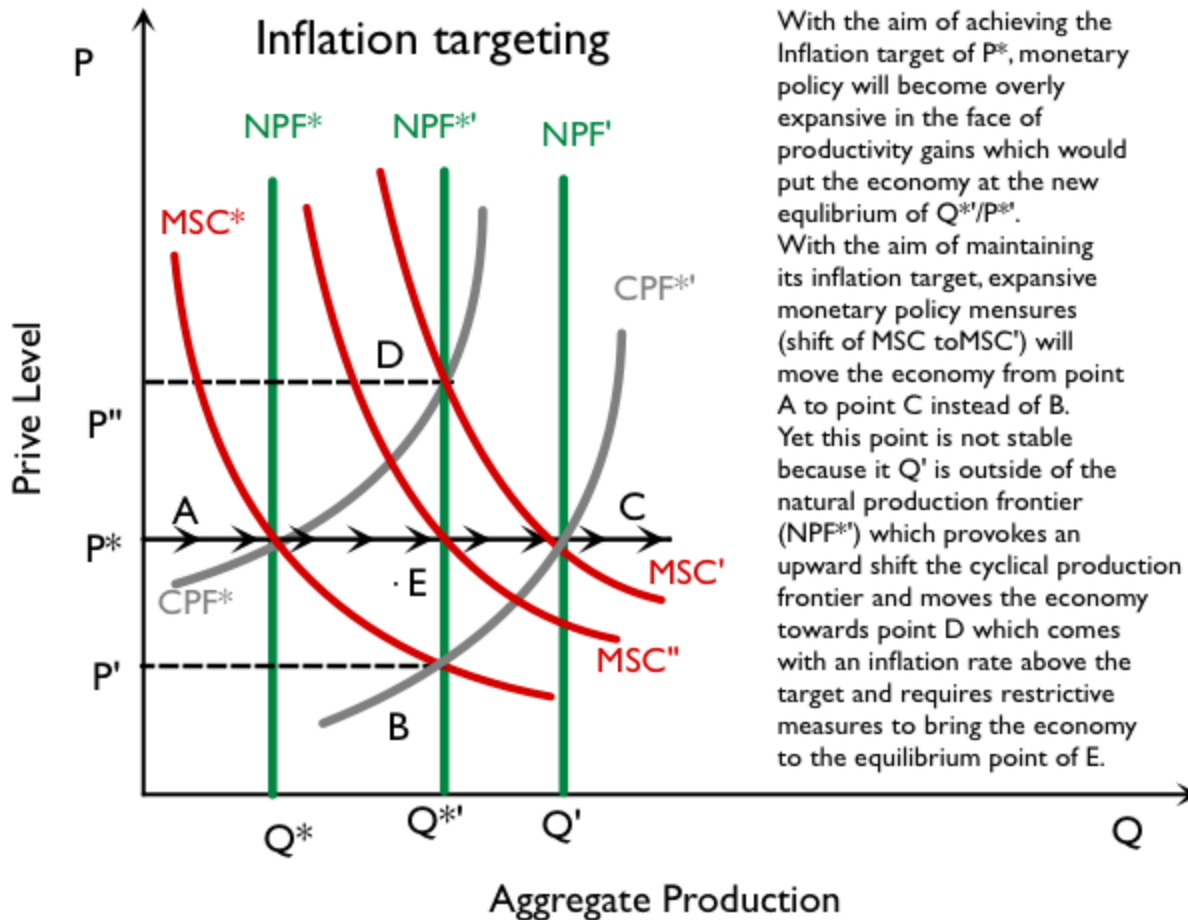
A monetary expansion shifts the original supply curve of loanable funds from i^*/Q^* to i'/Q' and leads to a credit expansion along the original credit demand curve. As consequence of a higher price level that comes with the economic expansion to Q' , both the demand and supply curves for loanable funds move up to the new equilibrium of a higher interest rate (i'') and back to the natural output at Q^* .



Effects of monetary expansion



A monetary expansion moves the MSC-curve from MSC^* to MSC' . The new equilibrium changes from A to B along the cyclical production frontier (CPF). This point is not stable because it is beyond the natural production frontier (NPF). The new equilibrium is at C on the original natural production frontier (NPF) at Q^* with the higher price level of P'' on the cyclical production frontier CPF' .



With the aim of achieving the Inflation target of P^* , monetary policy will become overly expansive in the face of productivity gains which would put the economy at the new equilibrium of $Q^{*'}/P^{*'}$. With the aim of maintaining its inflation target, expansive monetary policy measures (shift of MSC to MSC') will move the economy from point A to point C instead of B. Yet this point is not stable because it Q' is outside of the natural production frontier ($NPF^{*'}$) which provokes an upward shift the cyclical production frontier and moves the economy towards point D which comes with an inflation rate above the target and requires restrictive measures to bring the economy to the equilibrium point of E.

© Antony P. Mueller 2013

- Reference
- www.continentaleconomics.com
- Contact
- antonymueller@gmail.com