Keynes argued that when interest rates were high relative to some normal value, people would expect bond prices to increase, so the quantity of money demanded would decrease.

The Keynesian demand for real balances can be expressed as Md/P = f(i,Y).

Short Essay Type Questions

Explain the Keynesian theory of money demand. What motives did Keynes think determined money demand? What are the two reasons why Keynes thought velocity could NOT be treated as a constant?
A. Keynes believed the demand for money depended on **income** and **interest rates.**
Money was held to facilitate normal transactions and as a precaution for unexpected transactions. For both of these motives, money demand depended on income.
People also held money as an assed, for speculative purposes. The speculative motive depends on income and interest rates. People hold more money for speculation purposes when they expect bond prices to fall, generating a negative return on bonds. Since money demand varies with interest rates, velocity changes when interest rates change. Also, since money demand depends upon expectations about future interest rates, unstable expectations can make money demand, and thus velocity, unstable.

If velocity and aggregate output are reasonably constant (as the classical economists believed), what will happen to the price level when the money supply increases from $1 trillion to $4 trillion?
A. The price level will quadruple.

According to the portfolio theories of money demand, what are the four factors that determine money demand? What changes in these factors can increase the demand for money?
A. The 4 factors:
-interest rates (decreases in interest rates increase money demand)
-wealth (higher wealth leads to higher money demand)
-risk of alternative assets (a higher risk of alternative assets increases money demand)
-liquidity of other assets (a decrease in liquidity of alternative assets increases the demand for money)

Calculate what happens to nominal GDP if velocity remains constant at 4 and the money supply increases from $250 billion to $375 billion.
Originally, nominal GDP is $1 trillion. After the money supply increases, nominal GDP is $1.5 trillion.

What happens to nominal GDP if the money supply grows by 20% but velocity declines by 30%?
Nominal GDP declines by approximately 10%.

Why does the Keynesian view of the demand for money suggest that velocity is unpredictable?
A. Velocity is unpredictable because interest rates, which have large fluctuations affect the demand for money and hence velocity.
If people's expectations of the normal level of interest rates change, the demand for money changes. Keynes thought that these expectations moved unpredictably, meaning that money demand and velocity are also unpredictable.