Money Demand and Risks of Financial Markets of Pakistan

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Abstract

Irrespective of national boundaries, central banks have three key objectives. These include control of inflation, reduction in unemployment and boosting economic growth. All the three objectives are achieved by controlling monetary aggregates i.e. setting appropriate monetary policy. Although many explanations of behavior of financial markets assume that money balance is explicitly controlled by central bank (e.g money market explanation of relationship between interest rate and exchange rate[1]) but historical behavior of monetary aggregates challenges the control of central banks over this phenomenon

In this paper, we document that money demand does not move in reaction to income and interest rates only. By employing Johansen's cointegration and ordinary least squares on financial risk model of money demand, we report that liquidity risk significant affects the demand for money, therefore, central bank should target risk adjusted money supply in setting monetary policy.

[1] This explanation argues that when interest rate increases, demand for money decreases as money demand is negatively related to interest rate. This results in disequilibrium of money market. To bring money market back to equilibrium, either money demand needs to achieve original level or money supply needs to be reduced. This explanation assumes that money supply is under control of central bank and thus argues that money demand increases due to increase in income. This increase in income is supposed to be due to depreciation of local currency against foreign currency or basket of foreign currencies.