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*The American Economic Review*, Vol. 82, No. 2, Papers and Proceedings of the Hundred and Fourth Annual Meeting of the American Economic Association (May, 1992), 346-353.

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## Liquidity Effects and the Monetary Transmission Mechanism

By LAWRENCE J. CHRISTIANO AND MARTIN EICHENBAUM\*

"Experience and common sense tell us that...ordering materials and hiring workers...will look like a better deal if the prime rate is 6% instead of 8%..." (James Tobin, 1991 p. A14)

Conventional wisdom holds that an expansionary-monetary-policy shock generates a persistent decrease in nominal interest rates and a persistent increase in the levels of employment and output. However, the traditional literature contains very little econometric evidence to support this view (William Reichenstein, 1987). A hallmark of this literature is its use of the identifying assumption that monetary policy disturbances correspond to the statistical innovation in measures of money like the monetary base or M1. Recently, several researchers have argued that this assumption is grossly counterfactual in light of the actual operating procedures of the Federal Reserve Board (Ben Bernanke and Alan Blinder, 1990; Christiano and Eichenbaum, 1991, 1992b; Steven Strongin, 1991; Eichenbaum, 1992; Christopher A. Sims, 1992). Each of these researchers argues that inno-

vations to broad monetary aggregates primarily reflect shocks to money demand rather than shocks to money supply, or policy. Pursuing alternative assumptions for identifying money-supply shocks, each provides strong empirical evidence in support of the conventional view.

These findings pose an important challenge to macroeconomists. This is because existing quantitative, general-equilibrium business-cycle models, which allow for capital accumulation, are inconsistent with the conventional view. Certainly, this is true for real-business-cycle models in which money is introduced simply by imposing cash-in-advance constraints on agents or by incorporating a transaction demand for money. A generic implication of these models is that, if money growth displays positive persistence, then unanticipated shocks to the growth rate of money drive interest rates up, not down (Christiano, 1991; Christiano and Eichenbaum, 1991). This is because, in these models, money shocks affect interest rates exclusively through an anticipated inflation effect. More surprisingly, Robert G. King (1991) and King and Mark Watson (1991) show that the mere existence of "sticky" wages or prices per se also does not rationalize the conventional view.

In our opinion, any convincing rationalization of the conventional view will involve business-cycle models in which monetary-policy shocks generate significant, persistent liquidity effects. Recently, some researchers have studied general-equilibrium models in which purely *transitory* liquidity effects arise (e.g., Robert E. Lucas, Jr., 1990; Christiano and Eichenbaum, 1991; Timothy S. Fuerst, 1992). Because of the strong liquidity effect in these models, a positive money shock drives the nominal interest rate down. Out-

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put then expands, in part because of the reasons suggested in the quote from Tobin (1991) at the start of this paper.

While these models cannot rationalize *persistent* liquidity effects, we view them as interesting starting points for a broader research program. This paper discusses the basic frictions and mechanisms underlying the liquidity effects in these models and investigates one way to generate persistence. We argue that once a simplified version of the model in Christiano and Eichenbaum (1991) is modified to allow for extremely small costs of adjusting sectoral flows of funds, positive monetary-policy shocks generate long-lasting, quantitatively significant liquidity effects as well as persistent increases in aggregate economic activity.

### I. The Economic Environment

We begin by considering a simplified version of the model in Christiano and Eichenbaum (1991) in which the only source of uncertainty in the agents' environment pertains to monetary policy. The model has three types of agents: households, goods-producing firms, and financial intermediaries. At the start of period  $t$ , the representative household possesses the economy's entire beginning-of-period money stock  $M_t$ . The household allocates  $Q_t$  dollars to purchases of the consumption good,  $C_t$ , and lends the rest,  $M_t - Q_t$ , to financial intermediaries. Consumption purchases must be fully financed with cash that comes from two sources:  $Q_t$  and current-period wage earnings. The household chooses  $Q_t$ ,  $C_t$ , and the fraction of period  $t$  devoted to work ( $L_t$ ) to maximize the expected value of the criterion  $\sum_{t=0}^{\infty} \beta^t U(C_t, 1 - L_t)$ . Here  $U(C_t, 1 - L_t)$  denotes the household's utility function, given by  $(1 - \gamma)\ln(C_t) + \gamma\ln(1 - L_t)$ . Also,  $\beta$  and  $\gamma$  are scalars between 0 and 1.

This maximization occurs by choice of contingency plans for  $L_t$  and  $C_t$ , which are functions of model variables dated period  $t$  and earlier. In the *basic liquidity model*, the household's contingency plan for  $Q_t$  is not a function of the period- $t$  realization of monetary policy. This assumption is intended to

capture, in an analytically convenient way, the institutional and other factors which constrain households' choice of  $Q_t$ , at least in the short run. Institutional considerations include the fact that, in the real world, a fraction of  $M_t$  is held by firms and financial intermediaries in the form of retained earnings or pension funds and cannot readily be allocated by households to change  $Q_t$ . In addition, a variety of fixed costs, such as those stressed by George A. Akerlof (1979), render it suboptimal for households continually to readjust their nominal consumption/saving plan.

To illustrate the impact of the assumed rigidity in  $Q_t$ , we also analyze the *basic cash-in-advance (CIA) model*, which allows  $Q_t$  to be a function of the period- $t$  innovation in monetary policy. In both models, the maximization occurs subject to the cash constraint that nominal consumption expenditures,  $P_t C_t$ , cannot exceed  $Q_t$  plus  $W_t L_t$ . Here  $P_t$  and  $W_t$  denote the period- $t$  dollar price of goods and labor, respectively. In addition, the household must obey its budget constraint,

$$(1) \quad M_{t+1} = R_t(M_t - Q_t) + D_t + F_t \\ + (Q_t + W_t L_t - P_t C_t)$$

where  $R_t$  is the gross interest rate in period  $t$  and  $F_t$  and  $D_t$  denote period- $t$  dividends received from firms and financial intermediaries, respectively. This budget constraint does not reflect households' ownership of firms and financial intermediaries, since we assume—without loss of generality—that shares in these entities are not traded.

The financial intermediary has two sources of funds:  $M_t - Q_t$  and lump-sum injections  $X_t$  of cash by the monetary authority. These funds are lent over the period in perfectly competitive markets to firms at the gross interest rate  $R_t$ . The financial intermediary's net cash position at the end of the period is distributed, in the form of dividends, to the financial intermediary's owner, the household, after the consumption-good market has closed.

The period- $t$  technology for producing new goods is given by

$$(2) \quad f(K_t, z_t, L_t) = K_t^\alpha (z_t, L_t)^{1-\alpha} \\ + (1-\delta)K_t$$

for  $0 < \alpha < 1$  and  $0 < \delta < 1$ . Here  $K_t$  is the beginning-of-period- $t$  stock of capital,  $\delta$  is the rate of depreciation on capital, and the function  $f(\cdot, \cdot)$  denotes new period- $t$  output plus the undepreciated part of capital. Also,  $z_t$  is the state of technology at period  $t$ , which grows at the constant geometric rate  $\mu > 0$ . Firms must borrow working capital  $W_t L_t$  from financial intermediaries to cover their labor costs. Loans must be repaid to the financial intermediaries at the end of period  $t$ . Consequently, the total period- $t$  cost associated with hiring labor equals  $R_t W_t L_t$ .

Firms own the stock of capital, which evolves according to

$$(3) \quad I_t = K_{t+1} - (1-\delta)K_t$$

where  $I_t$  denotes period- $t$  gross investment. Unlike labor, capital is assumed to be a credit good, so that the firm need not borrow funds from the financial intermediary to finance investment activities. At the end of the period, after the consumption-good market closes, the firm's net cash position is distributed to its owner, the household. The perfectly competitive firm maximizes the expected present discounted value of dividends by choice of contingency plans which specify  $I_t$  and  $L_t$  as functions of model variables dated period  $t$  and earlier.

## II. Generating a Liquidity Effect

The key feature of the basic liquidity model which lets it generate a substantial liquidity effect is that the assumed rigidity in  $Q_t$  prevents an increase in the money supply from being distributed proportionally among all agents. To see this, first consider the basic CIA model. To keep things simple, suppose that the growth rate of money,  $X_t/M_t$ , is an independently and identically distributed random variable. Under these

circumstances, a money shock is neutral: it simply results in a proportional jump in current and future prices and wages, leaving all other variables unaffected. The key feature of the basic CIA model which underlies this result is that the nominal expenditures of all agents respond to the money shock in an equiproportionate manner. Among other things, this requires that the percentage of the money stock available to financial intermediaries,  $(M_t - Q_t + X_t)/(M_t + X_t)$ , be invariant to  $X_t$ . It is easily confirmed that this requires  $Q_t$  to be a positive function of  $X_t$ .

If  $Q_t$  does not respond to  $X_t$ , a positive money shock increases the total percentage of the money supply available to financial intermediaries. As long as  $R_t$  exceeds 1, financial intermediaries lend all of the cash at their disposal to firms. However, this requires that firms absorb a disproportionately large share of new cash injections. For firms to do so voluntarily, interest rates must fall. Of course, if the growth rate of money displays positive persistence, then the expected inflation effects of a change in the growth rate of money exert countervailing pressure on interest rates. Under these circumstances, whether interest rates fall or rise depends on which effect is stronger.

Suppose for the moment that the liquidity effect dominates, so that  $R_t$  falls in response to a positive money shock. To understand the resulting impact on aggregate employment and output, it is useful to think in terms of the demand and supply curves for labor in  $(W_t/P_t, L_t)$  space. The firm's Euler equation for  $L_t$  equates the marginal cost of an extra unit of labor to the marginal product of that labor. Since the firm must borrow working capital at the gross interest rate  $R_t$ , this requires that  $R_t W_t/P_t$  equal the marginal product of labor. It follows that an increase in the interest rate shifts the labor demand curve toward the origin.

The household's Euler equation for labor equates the marginal utility of leisure to the marginal benefit of working,  $W_t/P_t$ , times the marginal utility of consumption. Conditional on a fixed value of the marginal utility of consumption, this Euler equation generates a static upward-sloped labor supply

curve that does not directly involve  $R_t$ . Therefore, if the monetary authority reduces  $R_t$ , it shifts the labor demand curve to the right without inducing a directly offsetting shift in the labor supply curve. If the general-equilibrium effects on the marginal utility of consumption are small, this logic suggests that unanticipated expansionary-monetary-policy disturbances generate increases in aggregate hours worked and output as well as in the real wage rate.

### III. Some Quantitative Properties of the Basic Liquidity Model

To investigate the quantitative properties of the basic liquidity model, we calculated the impulse-response functions of the system to a shock in the growth rate of money. As in Christiano and Eichenbaum (1991), here we suppose that  $M_{t+1} = M_t + X_t$  and

$$(4) \quad x_t = (1 - \rho_x)x + \rho_x x_{t-1} + \varepsilon_{xt}$$

where  $x_t$  is the growth rate of money,  $X_t/M_t$ ;  $\varepsilon_{xt}$  is an independently and identically distributed shock with standard deviation  $\sigma_{\varepsilon_x}$ ;  $0 < \rho_x < 1$ ; and  $x$  denotes the unconditional mean of  $x_t$ . In calculating our impulse-response functions, we assumed values for the parameters equal to those used in Christiano and Eichenbaum (1991). The parameters  $\beta$ ,  $\mu$ ,  $\alpha$ ,  $\gamma$ ,  $\delta$ ,  $\chi$ ,  $\sigma_{\varepsilon_x}$ , and  $\rho_x$  were set equal to  $(1.03)^{-0.25}$ , 0.004, 0.36, 0.797, 0.012, 0.012, 0.014, and 0.30, respectively.

Figures 1-7 display the response of the system to a one-standard-deviation (1.4 percent) shock in  $x_t$  that occurs in period 5. Consider first the basic CIA model. Notice that in the impact period of the shock, the interest rate  $R_t$  rises. At the same time, investment  $I_t$  rises while consumption  $C_t$  falls. This is because the rise in  $R_t$  acts like a tax on the cash good (consumption) and a subsidy on the credit good (investment). Notice also that the fraction of time worked ( $L_t$ ) falls. This effect can be viewed as reflecting a leftward shift in the labor demand curve and a rightward shift in the labor supply curve. The former is induced by the rise in  $R_t$ , while the latter is induced by the

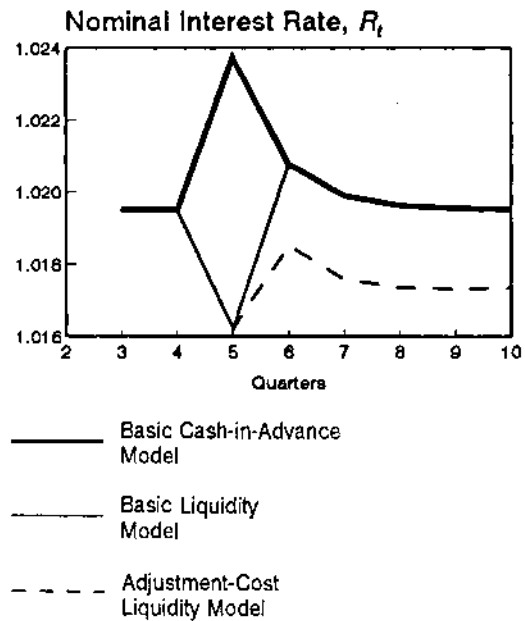


FIGURE 1. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: NOMINAL INTEREST RATE,  $R_t$

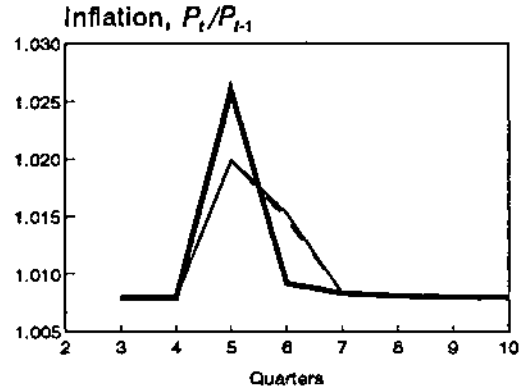


FIGURE 2. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: INFLATION,  $P_t/P_{t-1}$  (SEE FIG. 1 FOR KEY)

fall in  $C_t$ . Both shifts contribute to a fall in the real wage rate  $W_t/P_t$ . That  $L_t$  falls reflects that the shift in the labor demand curve dominates the shift in the labor supply curve. Given our assumption of diminishing marginal labor productivity, the

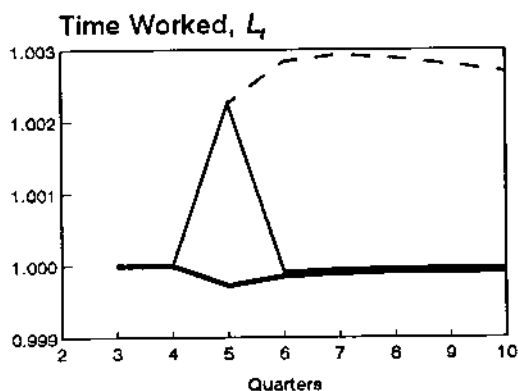


FIGURE 3. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: TIME WORKED,  $L_t$  (SEE FIG. 1 FOR KEY)

Note: The graph plots the variable after scaling by  $\exp(-0.004t)$ .

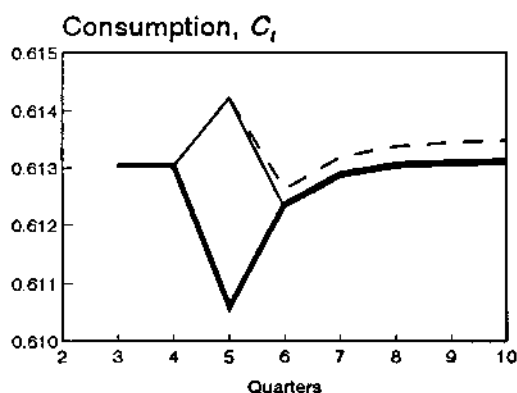


FIGURE 5. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: CONSUMPTION,  $C_t$  (SEE FIG. 1 FOR KEY)

Note: The graph plots the variable after scaling by  $\exp(-0.004t)$ .

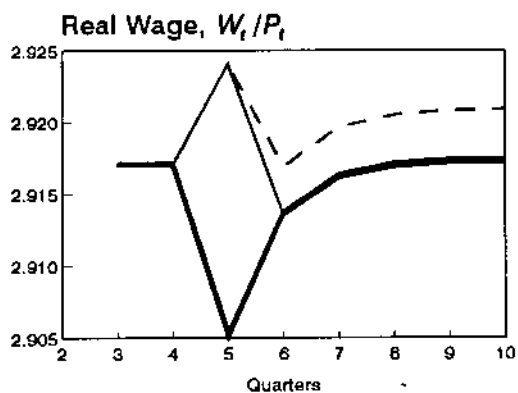


FIGURE 4. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: REAL WAGE,  $W_t / P_t$  (SEE FIG. 1 FOR KEY)

Note: The graph plots the variable after scaling by  $\exp(-0.004t)$ .

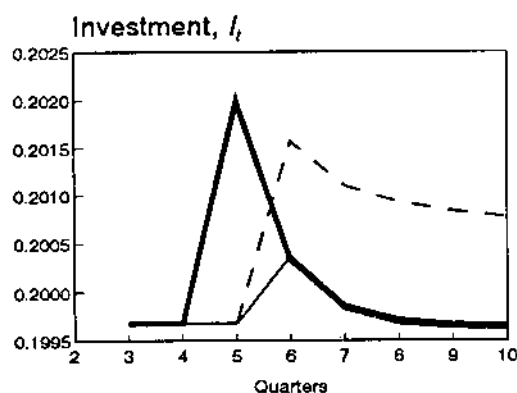


FIGURE 6. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: INVESTMENT,  $I_t$  (SEE FIG. 1 FOR KEY)

Note: The graph plots the variable after scaling by  $\exp(-0.004t)$ .

marginal cost of hiring labor,  $R_t W_t / P_t$ , must rise since  $L_t$  falls. Finally, since  $L_t$  has fallen and the stock of capital is unchanged, current output must also fall. With output down and the stock of money up, prices rise by more than the percentage change in the money supply.

Since  $0 < \rho_x < 1$ , monetary growth continues to be high relative to its steady-state

level after the shock. With the growth rate of money declining over time, the inflation rate also declines toward its steady-state value. Consequently,  $R_t$  is also high relative to its steady-state value but declining over time. Since  $R_t$  is declining, consumption slowly rises to its steady-state level, while investment declines to its steady-state level. Since a high value of  $R_t$  depresses labor

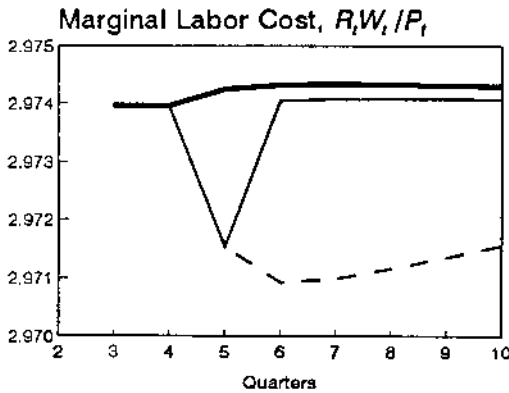


FIGURE 7. RESPONSE TO A 1.4-PERCENT MONEY-GROWTH SHOCK IN PERIOD 5 IN THREE BUSINESS-CYCLE MODELS: MARGINAL LABOR COST,  $R_t W_t / P_t$ . (SEE FIG. 1 FOR KEY)

Note: The graph plots the variable after scaling by  $\exp(-0.004t)$ .

demand, as long as  $R_t$  is high, hours worked and the real wage stay low, and the marginal cost of hiring labor stays high.

To summarize, according to the basic CIA model, a positive money shock drives interest rates up and drives employment, consumption, and output down—just the opposite of the conventional view.

In sharp contrast to the basic CIA model, the basic liquidity model implies that the contemporaneous values of  $R_t$  and  $I_t$  fall while  $C_t$  and  $L_t$  rise in response to a positive money shock. The rise in  $L_t$  can be thought of as occurring because the fall in  $R_t$  induces a rightward shift in the labor demand curve, while the rise in consumption induces a leftward shift in the labor supply curve. Both shifts contribute to a rise in the real wage rate. That  $L_t$  initially rises reflects the fact that the shift in the labor demand curve dominates the shift in the labor supply curve. With  $L_t$  up and with diminishing marginal labor productivity, the marginal cost of hiring labor,  $R_t W_t / P_t$ , falls. The contemporaneous increase in the price level is muted by the increase in aggregate output. As a result, the initial rise in the inflation rate is less than proportional to the initial percentage increase in the money supply. The intuition regarding the dynamic

response of the system thereafter is similar to that for the basic CIA model.

While these results are encouraging, the basic liquidity model clearly fails on one key dimension: it cannot generate persistent liquidity effects. Because households face zero costs of adjusting sectoral flows of funds over different periods of time, all flows are instantly adjusted in the period after a monetary disturbance, so that the liquidity effects generated by the model are purely transitory.

#### IV. Generating a Persistent Liquidity Effect

One way to induce persistence is to modify the environment so that the financial sector remains more liquid than the consumption sector for several periods after a money shock. This can be done by assuming that adjusting  $Q_t$  is costly. If households increase  $Q_t$  by a relatively small amount in the period after the money shock because of these adjustment costs, then in that period financial intermediaries and firms will also have to absorb a disproportionately large share of the economy's funds. As long as this is true, liquidity effects will persist. We show that substantial persistence effects can be generated with only very small adjustment costs.

Explicitly modeling the costs involved in adjusting  $Q_t$  is obviously not easy. Here we simply adopt a convenient functional form to investigate the potential of this mechanism for generating persistence effects. Let  $H_t$  denote the fraction of agents' time spent on reorganizing flows of funds. We assume that  $H_t$  is given by

$$(5) \quad H_t = d\{\exp[c(Q_t/Q_{t-1} - [1 + x])] + \exp[-c(Q_t/Q_{t-1} - [1 + x])] - 2\}.$$

In nonstochastic steady state,  $Q_t/Q_{t-1}$  is equal to  $1 + x$ . Therefore, both the level of  $H_t$  and its derivative with respect to  $Q_t/Q_{t-1}$  equal zero in nonstochastic steady state. More generally, (5) implies that changing  $Q_t$  is costly, with the marginal cost being an increasing function of the parameters  $c$  and  $d$ . Our only other change is to define leisure as  $1 - L_t - H_t$ . We refer to

the resulting model as the *adjustment-cost liquidity model*.

To investigate the properties of this model, we calculated the impulse-response function of the system to a one-standard-deviation shock in the growth rate of money assuming that  $d$  equals 0.00005 and  $c$  equals 1,000 (see Figs. 1-7). In the impact period of the shock, the system's response is identical to that of the basic liquidity model. With adjustment costs, however, the liquidity effect persists for many periods. This reflects the fact that the percentage of the money stock absorbed by financial intermediaries and firms remains high for many periods after the money shock. Therefore,  $R_t$  reverts to its steady-state value from below, as households slowly adjust  $Q_t$  to its new steady-state value. Evidently, once costs of adjusting  $Q_t$  are allowed for, the model is capable of generating persistent liquidity effects.

A key question is just how large the adjustment costs must be. As it turns out, the maximal value of  $H_t$  occurs in period 8, at 0.0133 percent of steady-state hours worked. To get a sense of the magnitude of this number, suppose that in nonstochastic steady state households work 320 hours, the sample average of actual hours worked in the postwar U.S. data (Christiano and Eichenbaum, 1992a). Then the maximal value of  $H_t$  translates into a loss of three minutes in the third quarter after the shock. Evidently, only *very* small costs of adjusting sectoral flows of funds are needed to rationalize substantial persistent liquidity effects.

#### V. Directions for Future Research

The liquidity models studied in this paper have a variety of interesting empirical implications. We have begun exploring these by studying the ability of versions of these models to account for aspects of postwar U.S. time-series data (Christiano, 1991; Christiano and Eichenbaum, 1992b). However, these studies do not confront the central prediction of the models, namely, that a disproportionately large share of monetary injections is absorbed by firms to finance variable inputs. In joint work with Charles

Evans, we are testing this prediction by using flow-of-funds data to see where the money actually goes after an open-market operation.

We conclude by noting that the class of models discussed in this paper has a variety of interesting welfare implications which we have not yet fully explored. Consistent with results in Fuerst (1992), optimal monetary policy in our models does not correspond to a  $k$ -percent money rule of the type advocated by Milton Friedman (1968). This is because, in these models, the monetary authority has greater flexibility to direct cash quickly to the financial sector via open-market operations than private agents have via adjustments in their nominal saving decisions. We expect that this friction leads to a type of real-bills doctrine in which it is welfare-improving to increase the money supply in response to an unanticipated change in the real production opportunities facing private agents, such as technology shocks. In a modified version of our models which accommodates this source of uncertainty, positive technology shocks generate increases in the nominal interest rate (Christiano and Eichenbaum, 1991). Consequently, this sort of policy corresponds to an interest-rate-smoothing rule of the type allegedly pursued by the Federal Reserve Board in different subperiods of the postwar era. Similar logic suggests that it may be welfare-improving to accommodate other types of shocks, like increases in the demand for money or the costs of financial intermediation, which would otherwise lead to increases in nominal interest rates. Versions of the models in which money is introduced via a stochastic transactions-based demand for money would let us formally investigate this conjecture.

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