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Financial Changes and Interest Elasticity of Money Demand: Further Tests of the Gurley and Shaw Thesis

by Ali F. Darrat and Michael A. Webb *

I. INTRODUCTION

Several empirical studies[1] have recently suggested that significant financial innovations have caused instability in the money demand relationship in the United States. A similar line of thought was earlier advanced by Gurley and Shaw [*1955, 1960*] who argue that the proliferation of money substitutes and other changes in the financial market would significantly increase the interest elasticity of money demand. Gurley and Shaw contend that money and other non-monetary financial assets are competitive for the variety of services that they provide. It may thus be expected that the increased availability of interest-bearing money substitutes can raise the sensitivity of money holdings to changes in interest rates. The implications of the growth of money substitutes are important to monetary policy since with high interest elasticity of money demand, monetary policy becomes less effective (for a lucid review article of the Gurley and Shaw thesis, see Marty [*1961*]).

Clearly, a reliable testing of the Gurley and Shaw thesis (hereafter, G-S thesis) requires sufficiently long-time series of data in order to detect the hypothesised gradual shift in the interest elasticity of money demand over time. Thus, Cagan and Schwartz [*1975*] and Hafer and Hein [*1984*] use US data for the 1921–71 and 1915–79 periods respectively to test the validity of the above hypothesis for the US, with empirical results that are at odds with the G-S thesis.

No empirical work has been done, however, to investigate the G-S thesis for countries other than the US, resulting in a specific lack of evidence for a developing country, which would begin the study period with a particularly

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