

The Money Market and the Loanable Funds Market

Introduction and Description

This lesson presents the money market and the loanable funds market. These two markets are used later to explain the effects of monetary and fiscal policy on the economy through the aggregate supply/aggregate demand (AS/AD) model.

In Activity 4-4, students create and manipulate money market graphs. In Activity 4-5, students are introduced to the loanable funds market, as distinguished from the money market, and they create and manipulate loanable funds market graphs.

Objectives

1. Define *transactions demand for money*, *precautionary (liquidity) demand for money*, and *the speculative demand for money*, and discuss the motives for holding assets as money.
2. Identify the slope of the money demand curve and the factors that cause the demand for money to change.
3. Identify the slope of the money supply curve and what will cause the money supply curve to shift.
4. Explain how interest rates are determined in the money market.
5. Explain the differences and similarities between the money market and the loanable funds market.
6. Identify and explain the slope of the demand and supply curves for loanable funds and the factors that cause the curves to shift.
7. Explain how interest rates are determined in the loanable funds market.

Time Required

Two class periods or 90 minutes

Materials

1. Activities 4-4 and 4-5
2. Visuals 4-1 and 4-2

Bell Ringer

Ask students if they have ever seen a Federal Reserve Note and, if so, where.



Procedure

1. Explain that individuals are faced with the decision to hold their wealth as money or interest-bearing assets. Holding money means forgoing the interest that could have been earned from an interest-bearing asset. That is, the opportunity cost of holding money is forgone interest. Define and explain the three types of money demand: transactions, precautionary, and speculative.
2. Ask students who determines the supply of money (tie this discussion back to the bell ringer). Explain that the supply of money is determined by the Fed and does not depend on the interest rate.
3. Draw a graph of the money market, as shown in Visual 4-1.
4. Explain that the demand for money also depends on the price level and on the level of real GDP. For example, if prices double, the demand for money will increase because a person will need twice as much money to buy goods and services and as real GDP increases, the demand for money increases.
5. Identify the equilibrium interest rate on your money market graph. Remind students about how changes in demand and supply affected equilibrium in product markets. Changes in

money demand (MD) or money supply (MS) will cause changes in the equilibrium interest rate. Show what happens to the interest rate as

- prices rise (MD increases and the interest rate rises)
- income increases (MD increases and the interest rate rises)
- the Fed increases the money supply (interest rate decreases).

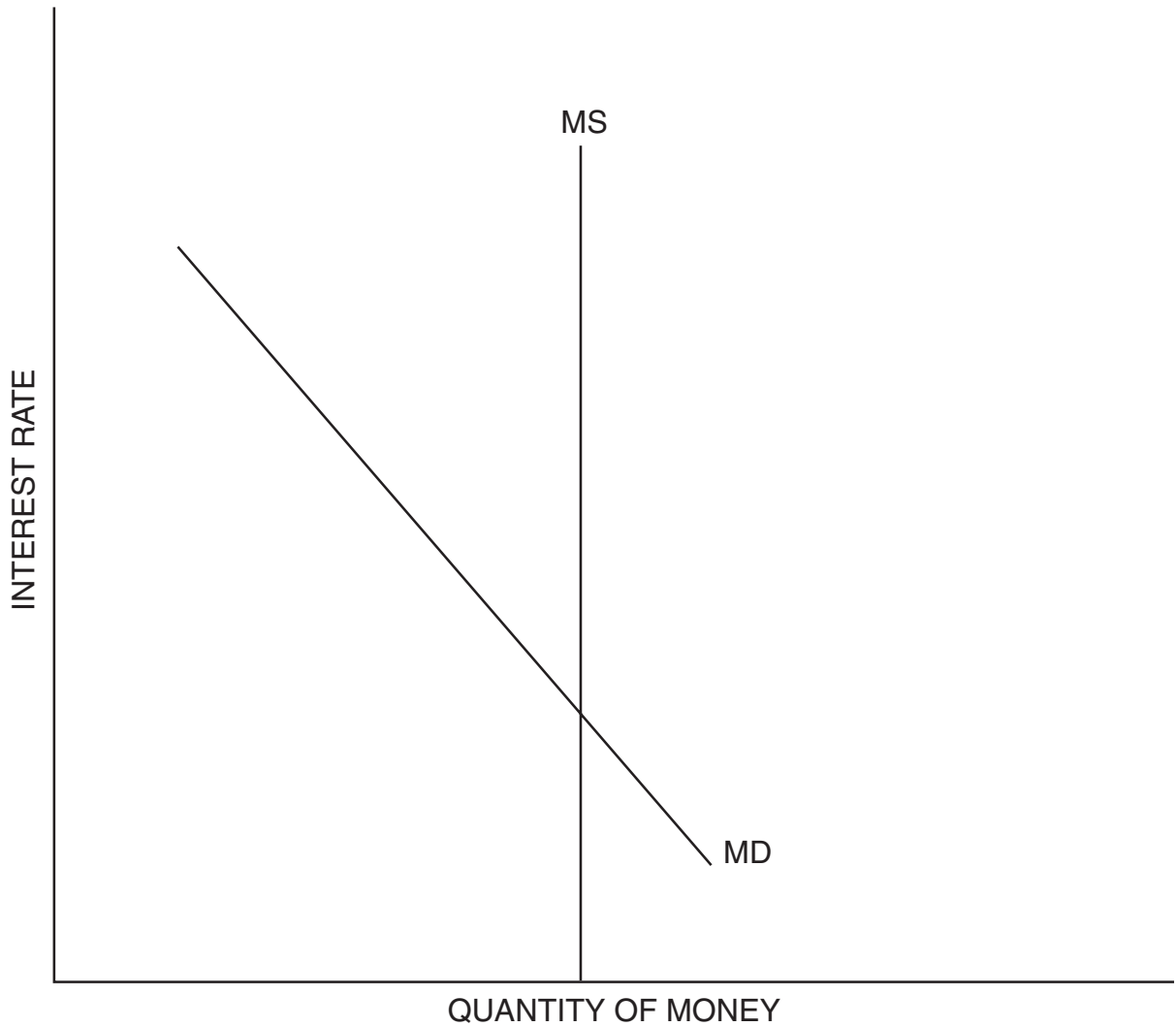
6. Have students complete Activity 4-4.



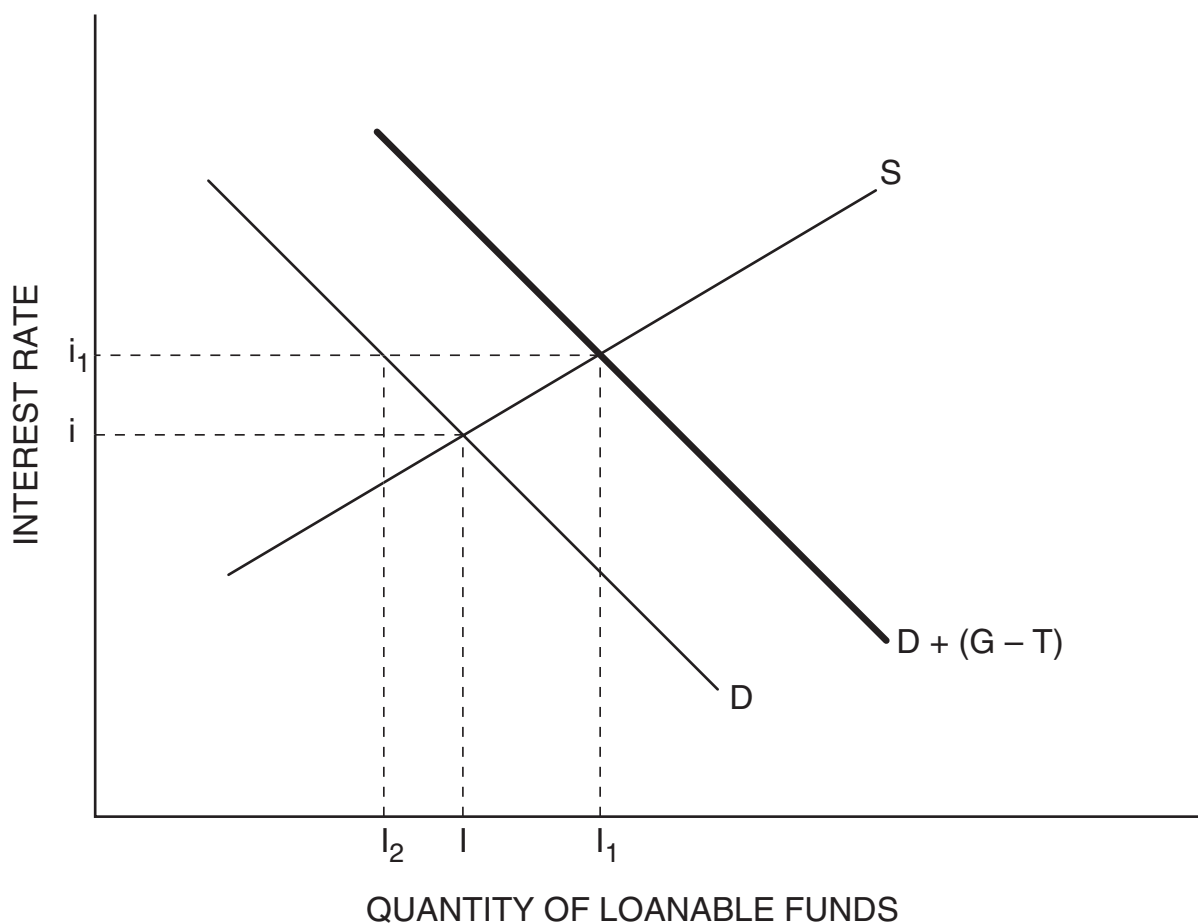
Teacher Alert: Make sure students understand the differences (and similarities) between the money market and the loanable funds market, and use the appropriate one! The slope of the supply curve is a key distinction!

7. Draw a graph of the loanable funds market as shown in Visual 4-2. Point out the similarities between money and loanable funds and the graphs of the money and loanable funds market. Point out that the vertical axis is the *real* interest rate in the loanable funds market and that the supply of loanable funds *does* depend on the interest rate.
8. Explain who supplies loanable funds and who demands loanable funds and why. Provide examples of why people would demand or supply more or less loanable funds, and illustrate the corresponding shift of the curve and the effect on equilibrium in the loanable funds market.
9. Have students complete Activity 4-5.

The Money Market



Loanable Funds Market



I and i are the initial equilibrium values.

D = private sector demand for funds (investment).

$D + (G - T)$ = private + government demand for funds.

I_1 and i_1 are the new equilibrium values.

I_2 = new level of private investment.

$I_1 - I_2$ = government demand for funds ($G - T$).