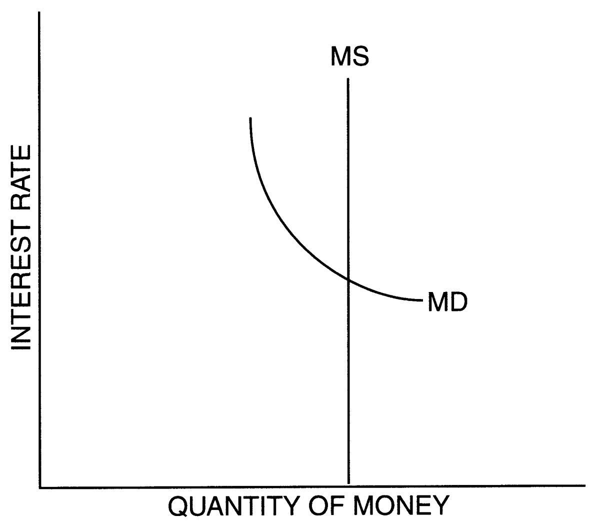
The Money Market

The money market consists of the demand for money and the supply of money. We generally assume that the Federal Reserve determines the supply of money. Thus, the supply of money is a vertical line. The demand for money is based on a decision of whether to hold your wealth in the form of interest bearing assets (savings accounts, stocks, etc.) or as money (noninterest bearing). The demand for money is a function of interest rates and income, and is determined by three motives:

- Transactions demand — the demand for money to make purchases of goods and services
- Precautionary demand — the demand for money to serve as protection against an unexpected need
- Speculative demand — the demand for money because it serves as a store of wealth

The interest rate represents the opportunity cost of holding money; that is, the interest rate represents the forgone income you might have made had you held an interest-bearing asset rather than money, a noninterest-bearing asset. Thus the demand for money has an inverse relationship with the interest rate. The demand curve represents the demand for money at various levels of the interest rate for the given income level (GDP). The graph of the money market looks like this:

Figure 39.1
The Money Market



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1. Suppose the Federal Reserve increases the money supply by buying Treasury securities.

   (A) What happens to the interest rate?

   (B) What happens to the quantity of money demanded?

   (C) Explain what happens to loans and interest rates as the Fed increases the money supply.

2. Suppose the demand for money increases.

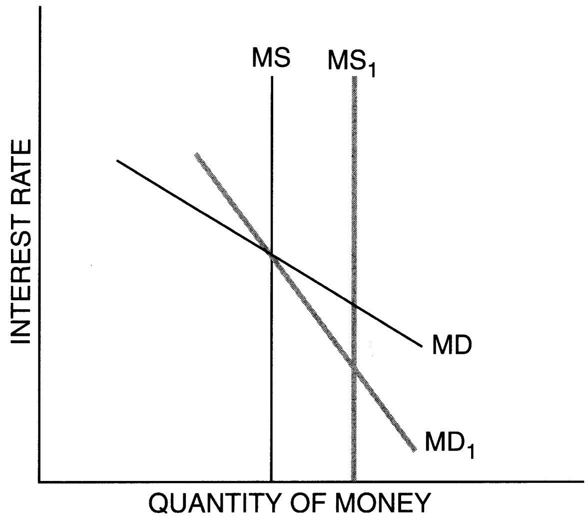
   (A) What happens to the interest rate?

   (B) What happens to the quantity of money supplied?

   (C) If the Fed wants to maintain a constant interest rate when the demand for money increases, explain what policy the Fed needs to follow and why.

   (D) Why might the Fed want to maintain a constant interest rate?

Figure 39.2
Alternative Money Demand Curves



3. Suppose there are two money demand curves — MD and MD_1 — and the Fed increases the money supply from MS to MS_1 as shown in Figure 39.2.

   (A) Compare what happens to the interest rate with each MD curve.

   (B) Explain the effect of the change in the money supply on consumption, investment, real output and prices. Would there be a difference in the effects under the two different money demand curves? If so, explain.

   (C) How would you describe, in economic terms, the difference between the two money demand curves?

   (D) If the Federal Reserve is trying to get the economy out of a recession, which money demand curve would it want to represent the economy? Explain.