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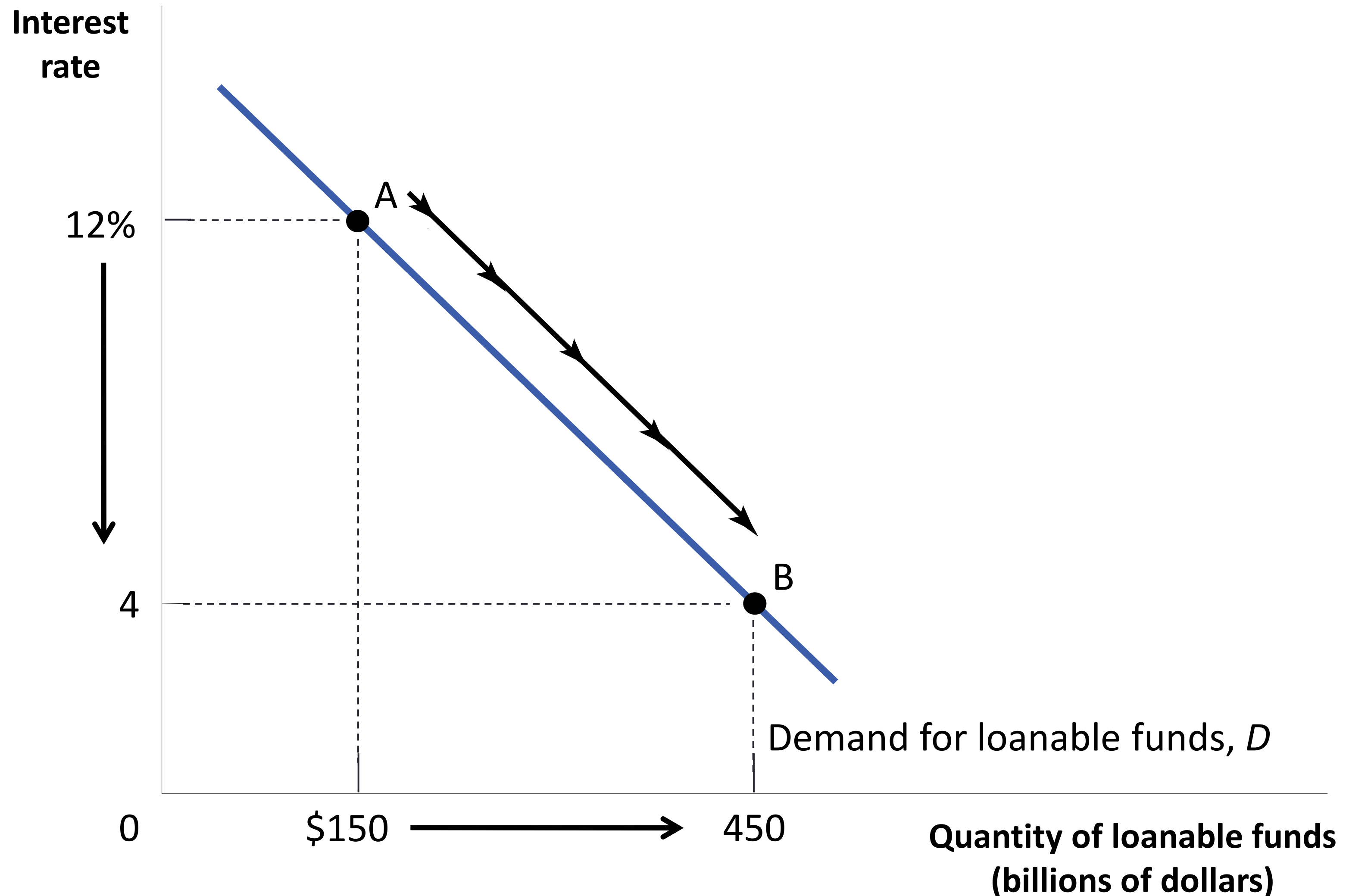
SECTION 6 SAVINGS, INVESTMENT SPENDING, AND THE FINANCIAL SYSTEM

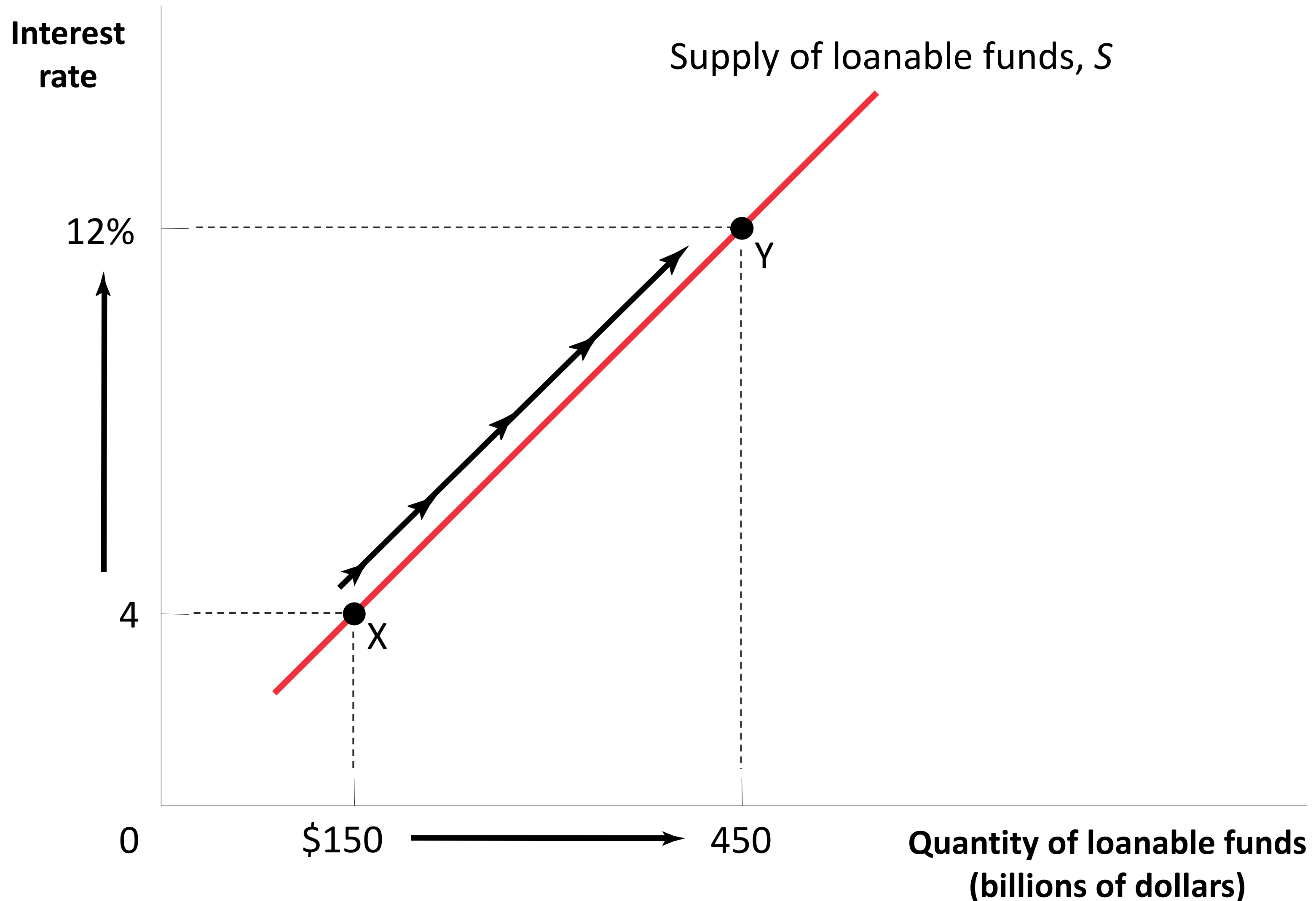
The Market for Loanable Funds

- The **loanable funds market** is a hypothetical market that examines market outcomes generated by borrowers and lenders.
- The **interest rate** is the price charged by the lender to a borrower for the use of their savings for one year.

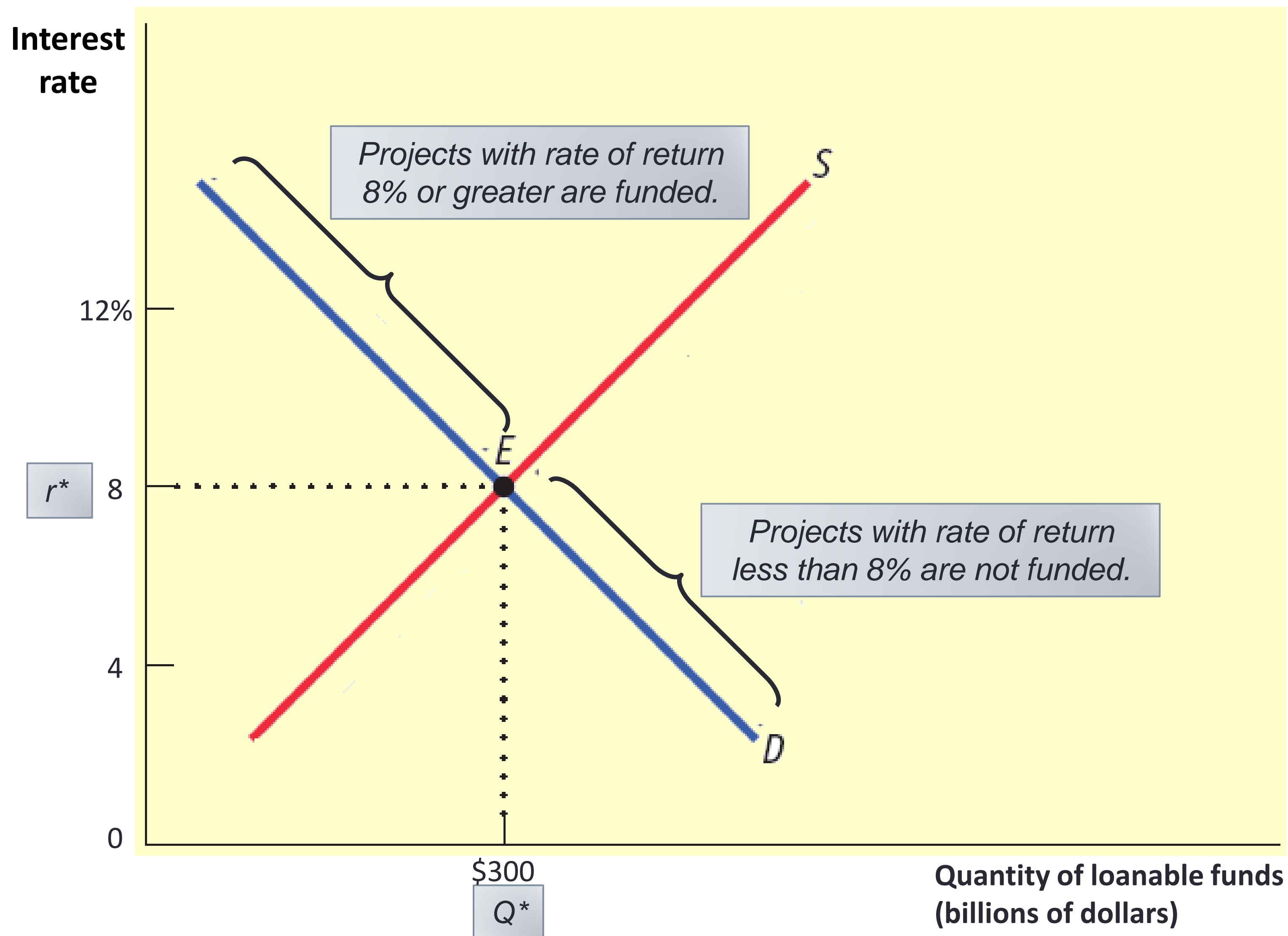
The Demand for Loanable Funds



The Supply for Loanable Funds



Equilibrium in the Loanable Funds Market



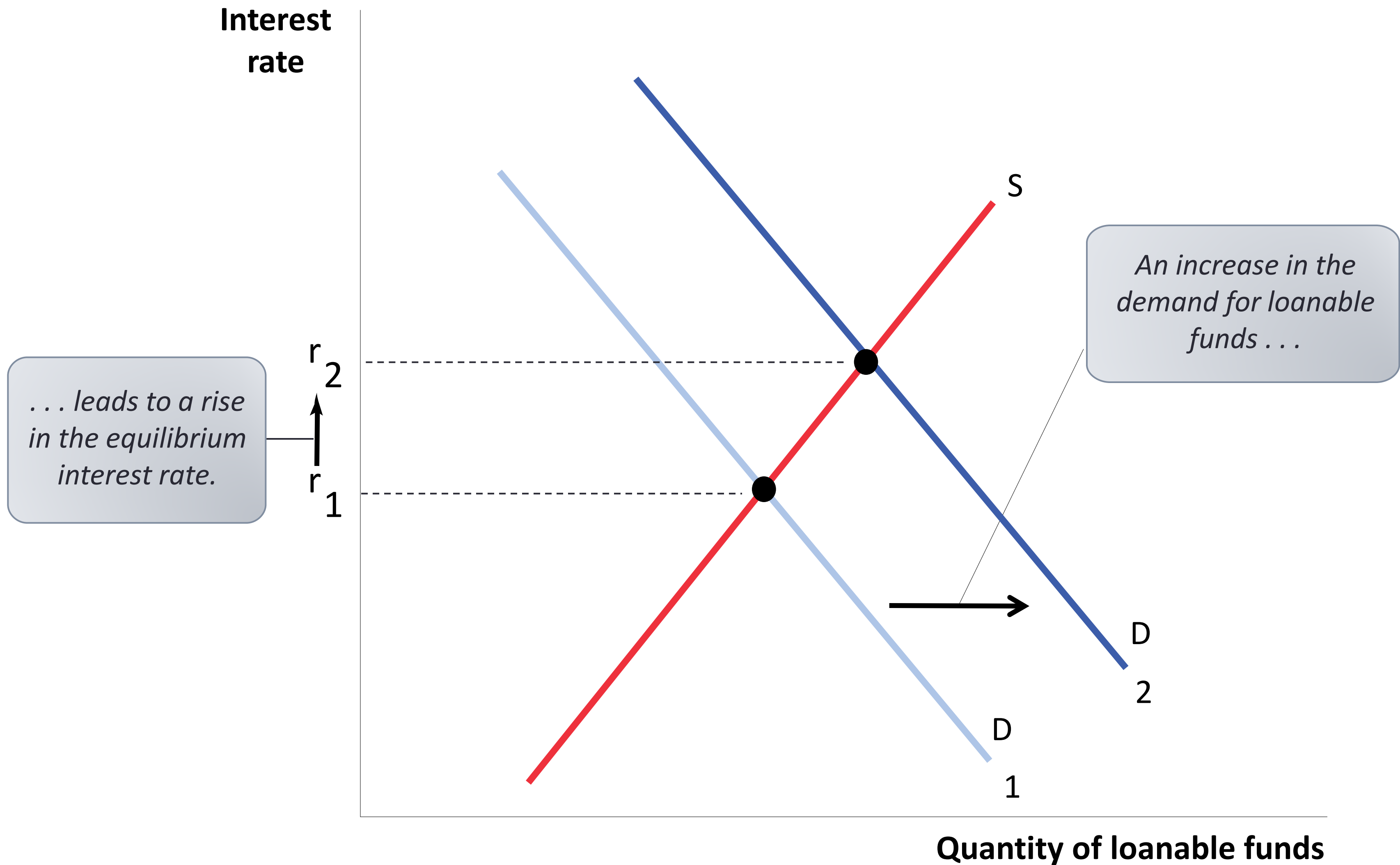
Shifts of the Demand for Loanable Funds

- Factors that can cause the demand curve for loanable funds to shift include:

  - ***Changes in perceived business opportunities***
  - ***Changes in the government's borrowing***

- **Crowding out** occurs when a government deficit drives up the interest rate and leads to reduced investment spending.

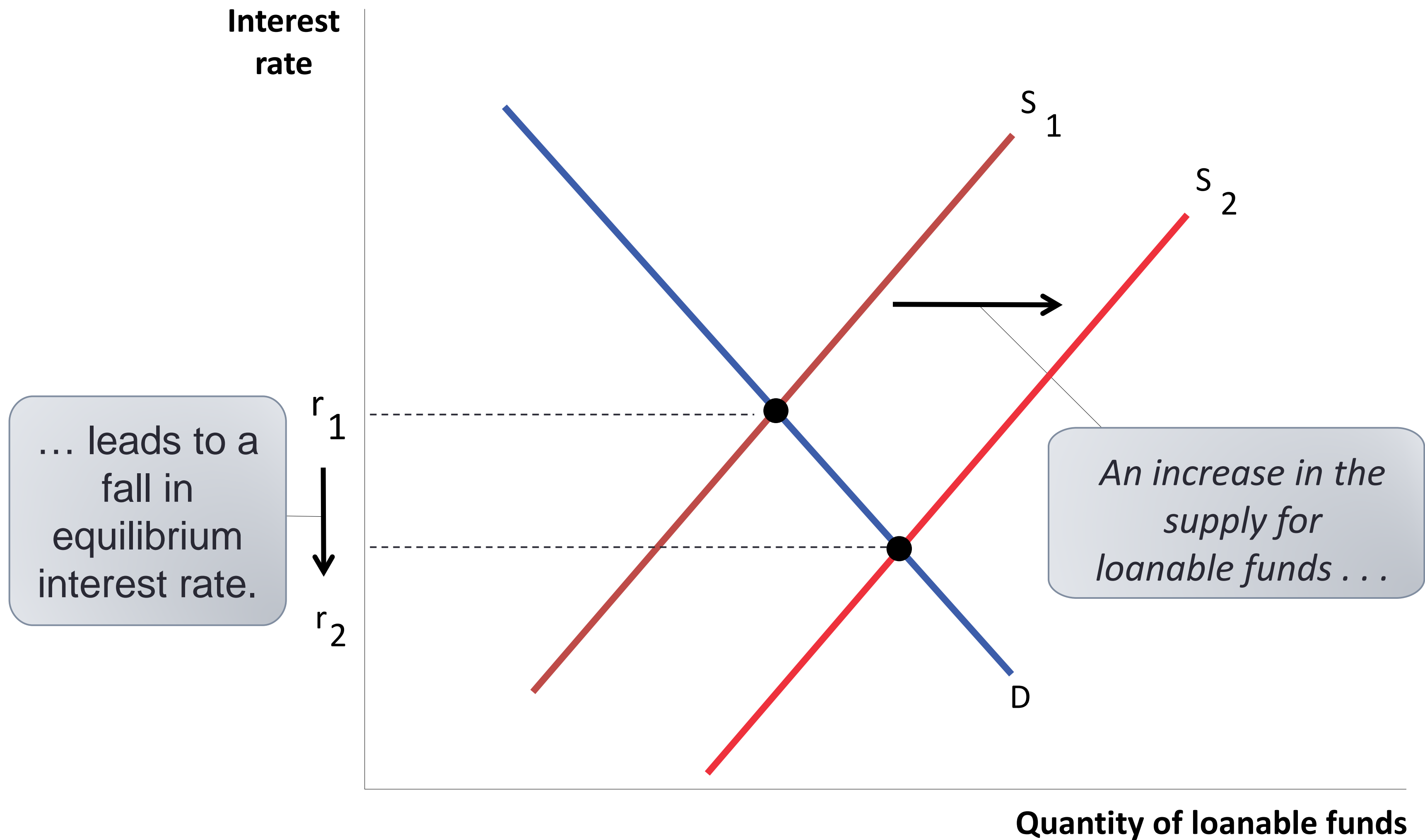
Increase in the Demand for Loanable Funds



Shifts of the Supply of Loanable Funds

- Factors that can cause the supply of loanable funds to shift include:
  - ***Changes in private savings behavior.***
  - ***Changes in government taxes and spending***.
  - ***Changes in capital inflows from foreign countries***.

Increase in the Supply of Loanable Funds



Changes in the Real Interest Rate

- Anything that shifts the supply or demand curve for loanable funds changes the **real interest rate**.
- Historically, major changes in interest rates have been driven by many factors, including:
    - changes in government policy
    - technological innovations that created new investment opportunities

Inflation, Interest Rates and the Fisher Effect

- Interest rates are also affected by inflation expectations.
- The supply and demand of loanable funds shifts when inflation expectations change.
- The **Fisher effect** says that inflation expectations change the nominal interest rate but leave the real rate unchanged.
- Fisher equation: $\boldsymbol{i = r + \pi^{e}}$