37 The Money Market

MODULE 37

The Demand (Opportunity Cost) for Money

- The decision process to hold money: is the benefit of holding money greater than the cost?

- The interest rate reflects the opportunity cost of holding money.

  - **Short-term interest rates** are the interest rates on financial assets that mature within six months or less.
  - **Long-term interest rates** are interest rates on financial assets that mature a number of years in the future.

The Demand for Money and Interest Rates

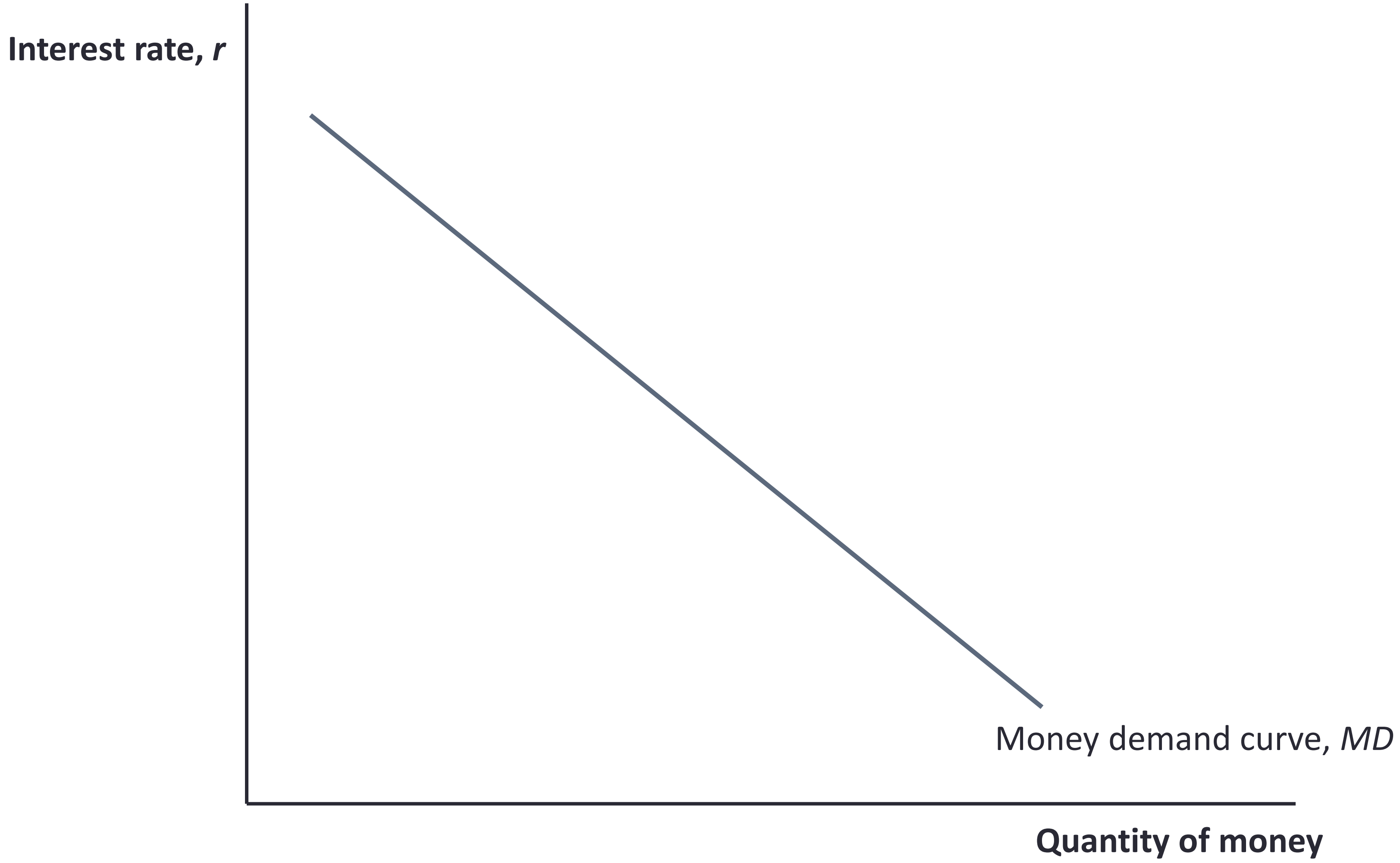
TABLE 37-2

Interest Rates and the Opportunity Cost of Holding Money

	June 2007	June 2008
Federal funds rate	5.25%	2.00%
One-month certificates of deposit (CDs)	5.30%	2.50%
Interest-bearing demand deposits	2.30%	1.24%
Currency	0	0
CDs minus interest-bearing demand deposits (percentage points)	**3.00**	**1.26**
CDs minus currency (percentage points)	**5.30**	**2.50**

Source: Federal Reserve Bank of St. Louis.

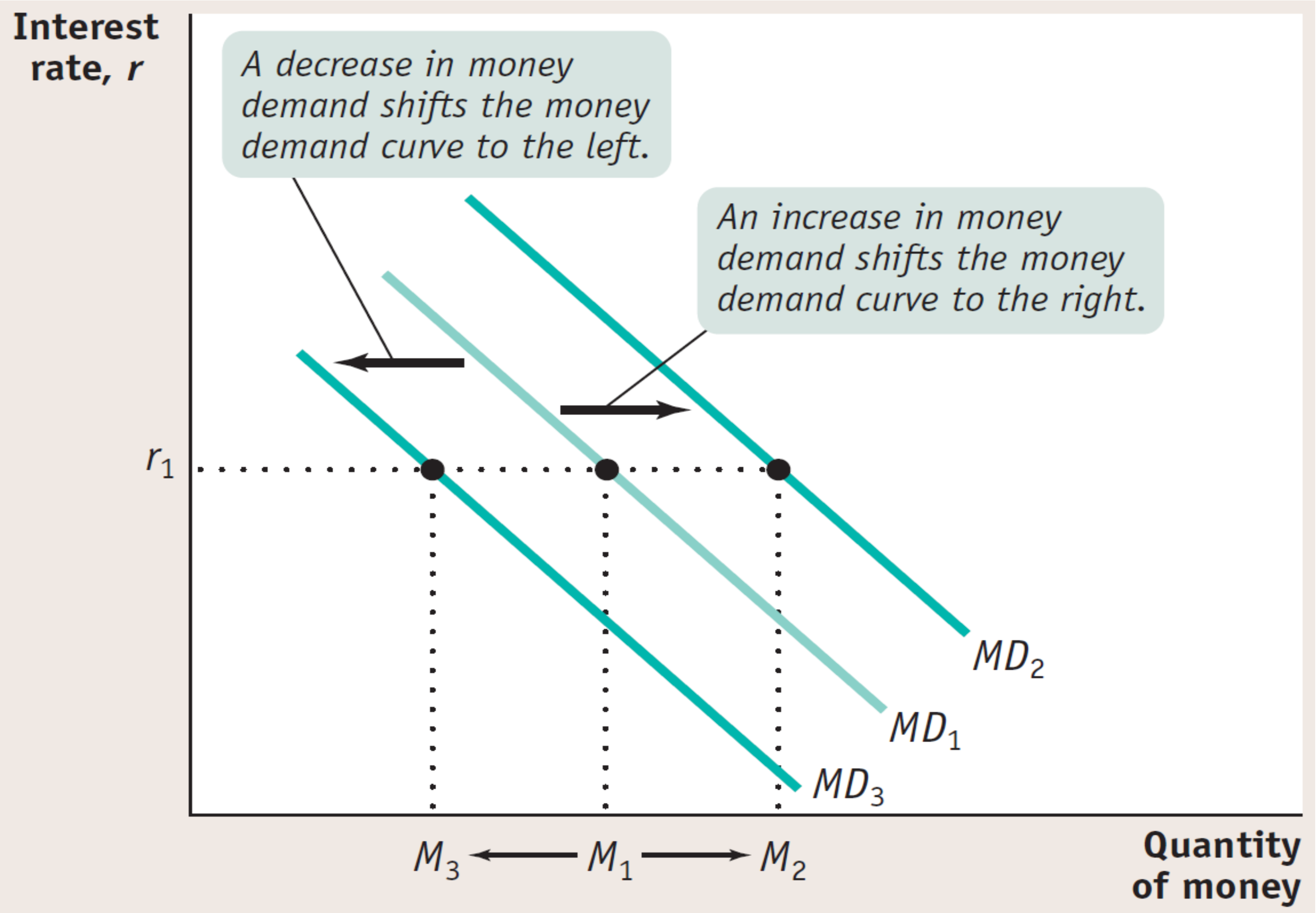
The Demand Curve for Money



Shifts of the Real Money Demand Curve

- Changes in aggregate price level
- Changes in real GDP
- Changes in banking technology

Shifts in the Demand for Money



Money and Interest Rates

- According to the **liquidity preference model of the interest rate**, the interest rate is determined by the supply and demand for money.

- We also have the **loanable funds model of interest rates**.

- Either model, together with the **money supply curve**, shows how the nominal quantity of money supplied and the equilibrium interest rate.

The Equilibrium Interest Rate