

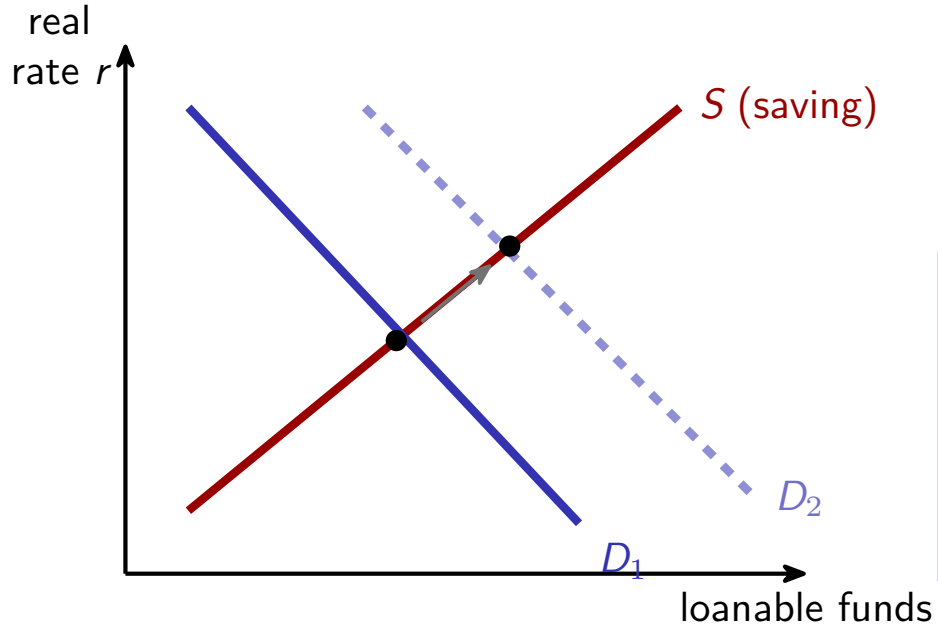
Exercise walk-through

4.7

The Loanable Funds Market

AP Macroeconomics

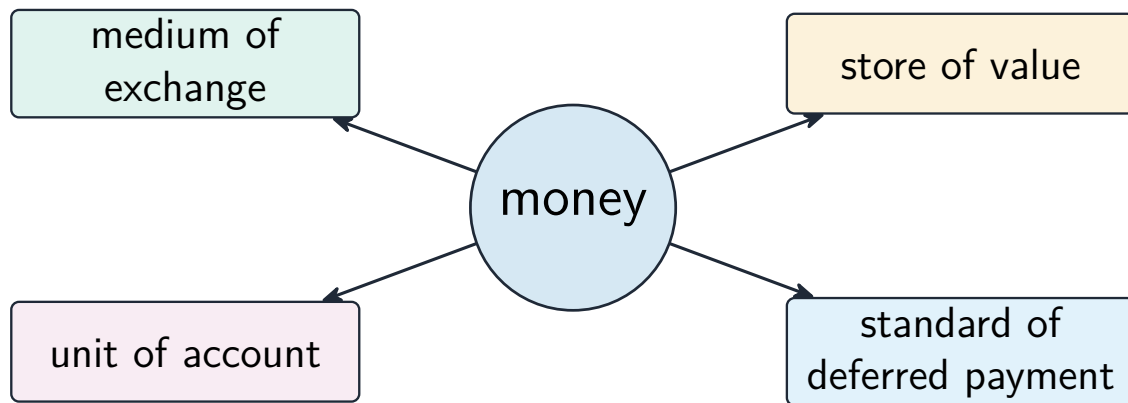
The loanable funds market



Sets the **real interest rate** :
saving supplies funds (up), investment
borrows them (down).

Government borrowing shifts demand right ($D_1 \rightarrow D_2$): the real rate rises and private investment is squeezed – **crowding out**.

The Definition, Measurement, and Functions of Money



The functions of money – the AP exam tests the first three (medium of exchange, unit of account, store of value); standard of deferred payment is beyond the CED

Real rates, money measures, and the modern policy tool

the real interest rate

what you actually earn in purchasing power: nominal rate minus inflation

M1

currency plus checkable deposits – **the most liquid** tier

M2

M1 plus savings deposits and other near-money – broader and less liquid

excess reserves

what a bank holds beyond its requirement – the basis of money creation

the modern system

central banks run an **ample-reserves** system: rather than nudging the money supply, the Fed sets **interest on reserves**

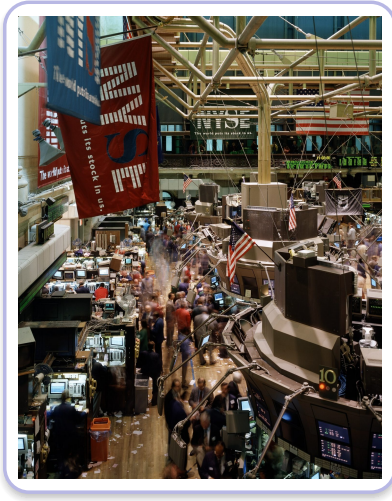
the two directions

expansionary (easy) money lowers rates; **contractionary** (tight) money raises them

National savings

= private savings + public savings, and it is the supply side of the loanable funds market.

Financial Assets



A stock exchange is where financial assets are bought and sold, setting prices from supply and demand

Exam tips

- Know money's three functions and the M1/M2 measures.
- The **money market** sets the nominal interest rate (vertical money supply); more money supply lowers the rate.
- Compute the **money multiplier** $\frac{1}{rr}$ and the maximum change in the money supply from a new deposit.
- Trace monetary policy: money supply $\rightarrow$ interest rate $\rightarrow$ investment $\rightarrow$ AD $\rightarrow$ output.
- Distinguish the money market (nominal rate) from the loanable-funds market (real rate); use the real rate = nominal – inflation.

Exercises 2.1-2.3

2.1 State who supplies and who demands loanable funds. [2]

2.2 State what is determined in the loanable funds market. [1]

2.3 State the effect of increased government borrowing on the real interest rate. [1]

Exercises 2.1-2.3

2.1 State who supplies and who demands loanable funds. [2]

2.1

- savers supply funds; borrowers (firms and government) demand them
-

2.2 State what is determined in the loanable funds market. [1]

2.2

- the equilibrium real interest rate
-

2.3 State the effect of increased government borrowing on the real interest rate. [1]

2.3

- it rises

Exercises 3.1-3.2

3.1 In the loanable funds market, the “price” is the

[1]

☐

A nominal interest rate

B real interest rate

C exchange rate

D price level

3.2 An increase in saving shifts the supply of loanable funds

[1]

☐

A to the left

B to the right

C not at all

D vertically

Exercises 3.1-3.2

3.1 In the loanable funds market, the “price” is the

[1]

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A nominal interest rate

B real interest rate

C exchange rate

D price level

3.1 B

- real interest rate.

3.2 An increase in saving shifts the supply of loanable funds

[1]

☐

A to the left

B to the right

C not at all

D vertically

3.2 B

- to the right.

Exercise 3.3 (a)

3.3 The government runs a large budget deficit and borrows heavily.

(a) State the effect on the demand for loanable funds.

[1]

Exercise 3.3 (a)

3.3 The government runs a large budget deficit and borrows heavily.

(a) State the effect on the demand for loanable funds.

[1]

(a)

- it increases (shifts right)

Exercise 3.3 (b)

3.3 The government runs a large budget deficit and borrows heavily.

(b) State the effect on the real interest rate.

[1]

Exercise 3.3 (b)

3.3 The government runs a large budget deficit and borrows heavily.

(b) State the effect on the real interest rate.

[1]

(b)

- it rises

Exercise 3.3 (c)

3.3 The government runs a large budget deficit and borrows heavily.

(c) Name the effect this has on private investment.

[1]

Exercise 3.3 (c)

3.3 The government runs a large budget deficit and borrows heavily.

(c) Name the effect this has on private investment.

[1]

(c)

- crowding out of private investment