LECTURE FOUR - PART FOUR

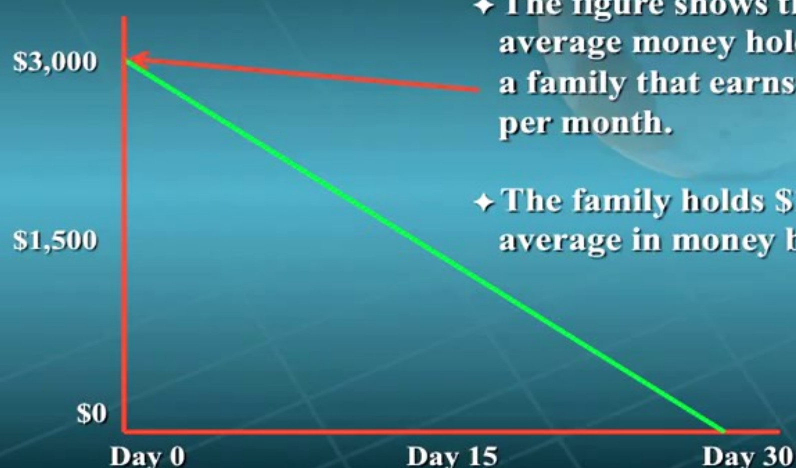
Determinants of Money Demand

- We have talked about:
  - The functions of money
  - The price of money
- The two major determinants of money demand:
  - Transactions Demand
  - Asset Demand

Transactions Demand for Money

- Both consumers and businesses need money as a medium of exchange.
- Households use it to buy products like groceries.
- Firms need it to pay their workers and buy materials.

Mechanics of Transactions Demand



- The figure shows the average money holdings of a family that earns $3000 per month.
- The family holds $1500 on average in money balances.

Nominal GDP Determines Transactions Demand

- The basic determinant of the amount of money demanded for transactions is the level of nominal GDP.
- The larger the total money value of all goods and services that are exchanged in the economy, the larger the amount of money needed to negotiate these transactions.

A Question:

What do you think will happen to the transactions demand for money if prices and nominal GDP double?

The Answer:

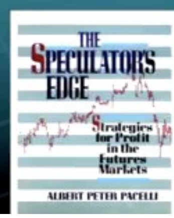
- If prices and nominal GDP double, the transactions demand for money will also double!!

The Asset Demand for Money

- The asset demand for money is also called the "speculative motive"
- People hold money because they use it as a store of value.

Understanding the Speculative Nature of Asset Demand

- Suppose you want to buy some stocks or bonds but you think that the prices are too high.
- So you hold on to your money until the prices fall.
- Essentially, you are <u>speculating</u> that a better investment opportunity will appear.



Inflation Erodes the Value of Money

- Money provides no rate of return like other assets like stocks, bonds, and savings accounts.
- If inflation occurs, your money will lose value!

The "Opportunity Cost" of Holding Money

- The "opportunity cost" of holding money includes:

1. The interest that could have been earned by lending the money.
2. The rate of return that could have been earned by investing the money in stocks.
3. The loss in value from holding money during inflation.

Question

What do you think will happen to the asset demand for money if interest rates rise or the expectation of inflation increases?

How Inflation and Interest Rates Affect the Asset Demand for Money

Answer

If the interest rate or inflationary expectations rise, the opportunity cost of holding money increases.

Therefore, the asset demand for money must decrease.