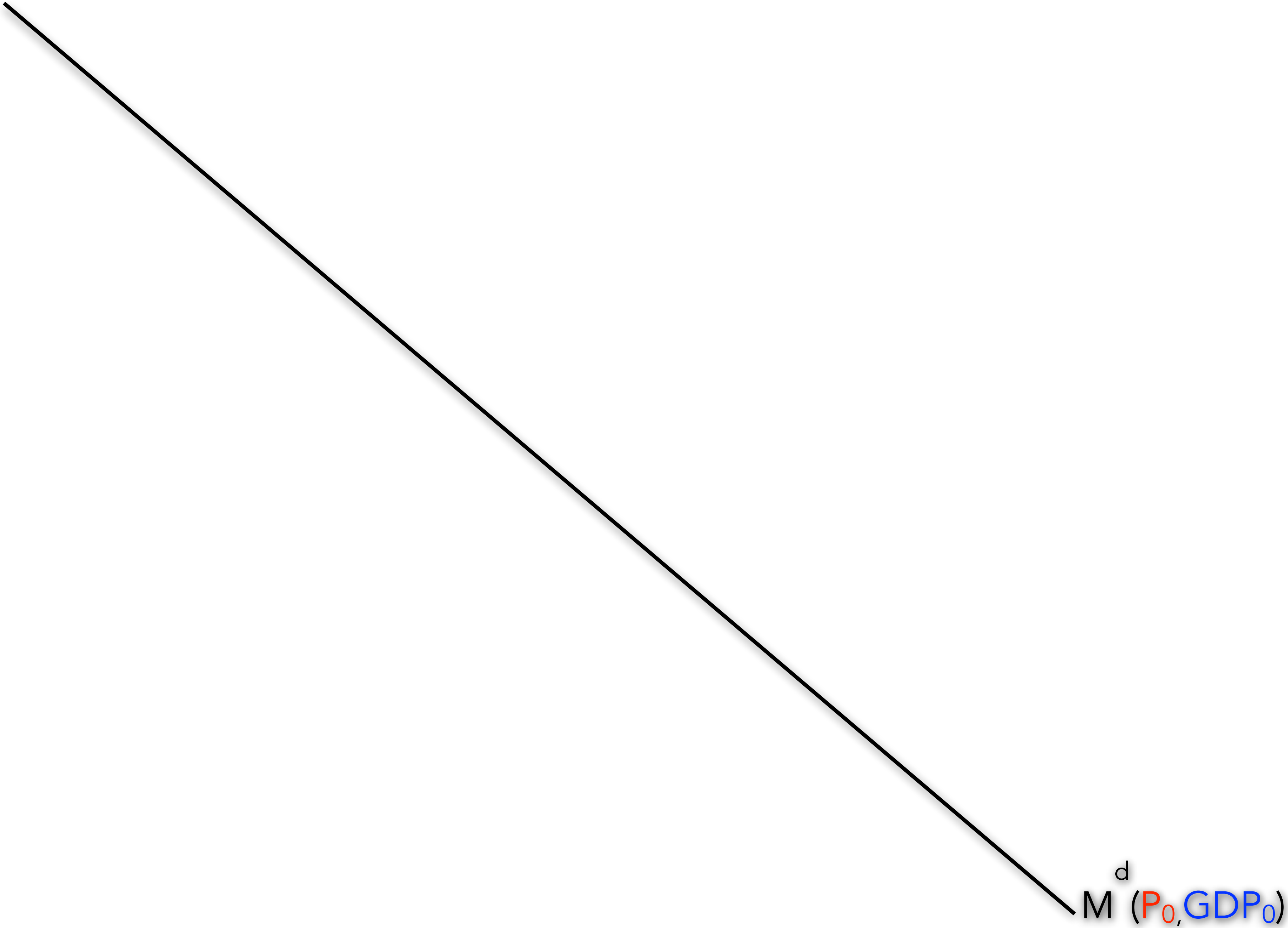
Equilibrium in the Money Market

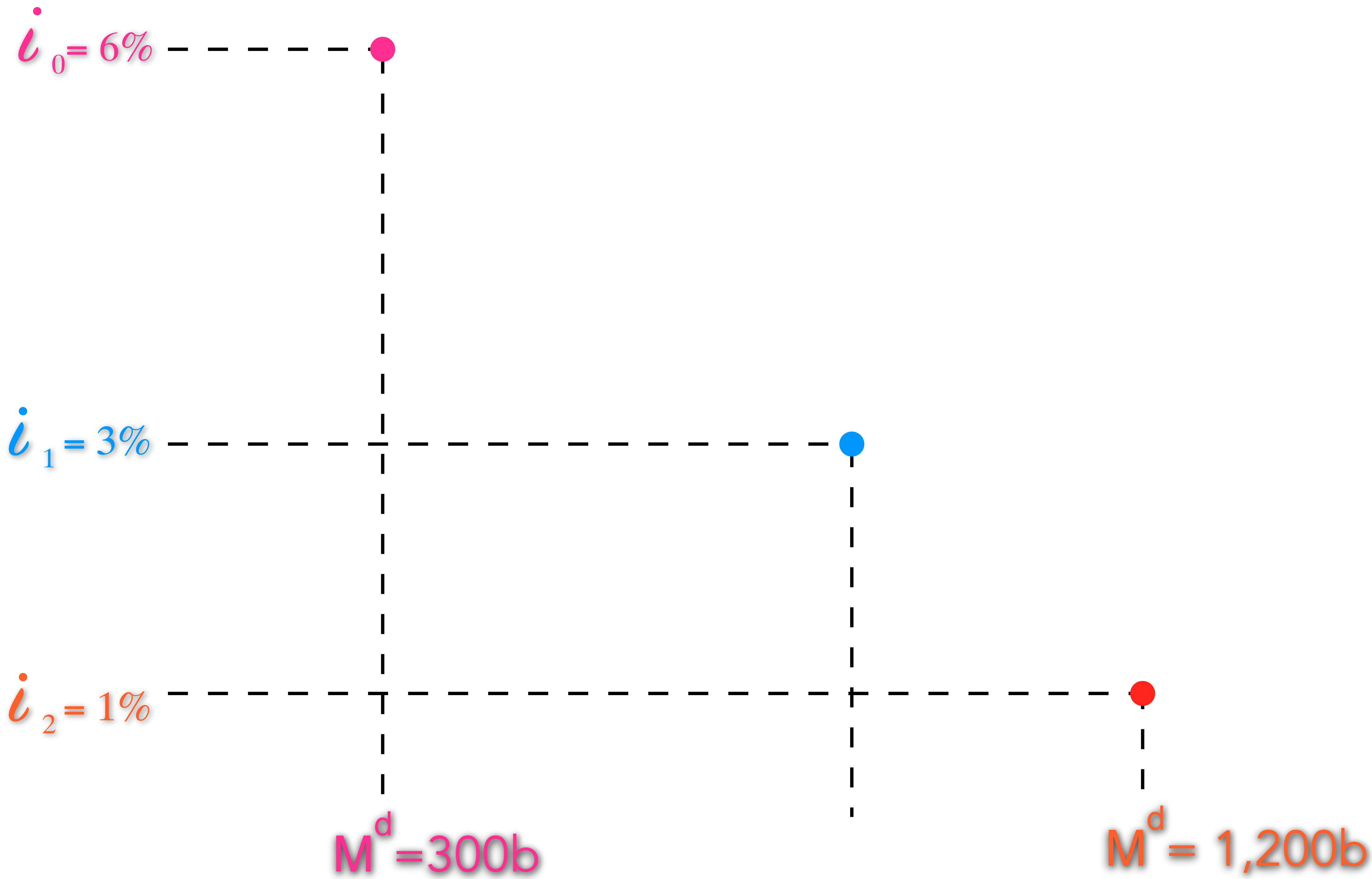
Currency+
Deposits

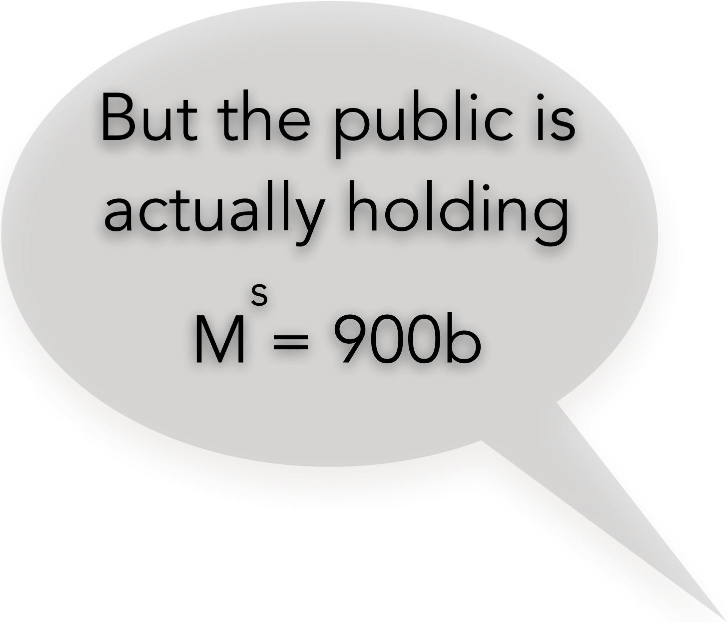
i


$M^d(P_0, GDP_0)$

M^s

$M^s = 900b$


$i_0 = 6\%$
$i_1 = 3\%$
$i_2 = 1\%$
M^d=300b
M^d= 1,200b


But the public is actually holding
$M^s = 900b$

Short of liquid balances

The public will look for a way to get liquid balances (cash and deposits)

The public will look for willing lenders
to get the necessary funds

To find willing lenders, borrowers must offer a higher interest rate

If the interest rate is 1%, the amount of currency + deposits the public **needs** to hold for transactions is 1,200b

The public does not have enough liquid balances (cash and deposits) to pay for transactions

It will be difficult to find willing lenders at 1% interest, because at 1%, everyone wants to borrow (short of liquid balances) money is scarce

W

h

e

n

t

h

e

r

e

a

r

e

S

h

O

r

t

a

g

e

S

O

f

I

i

q

u

i

d

b

a

|

a

n

C

e

S

/

m

n

e

y

i

S

S

C

a

r

C

e

a

n

d

t

h

e

r

e

i

S

p

r

e

S

S

u

r

e

f

r

t

h

e

i

n

t

e

r

e

S

t

r

a

t

e

t

O

r

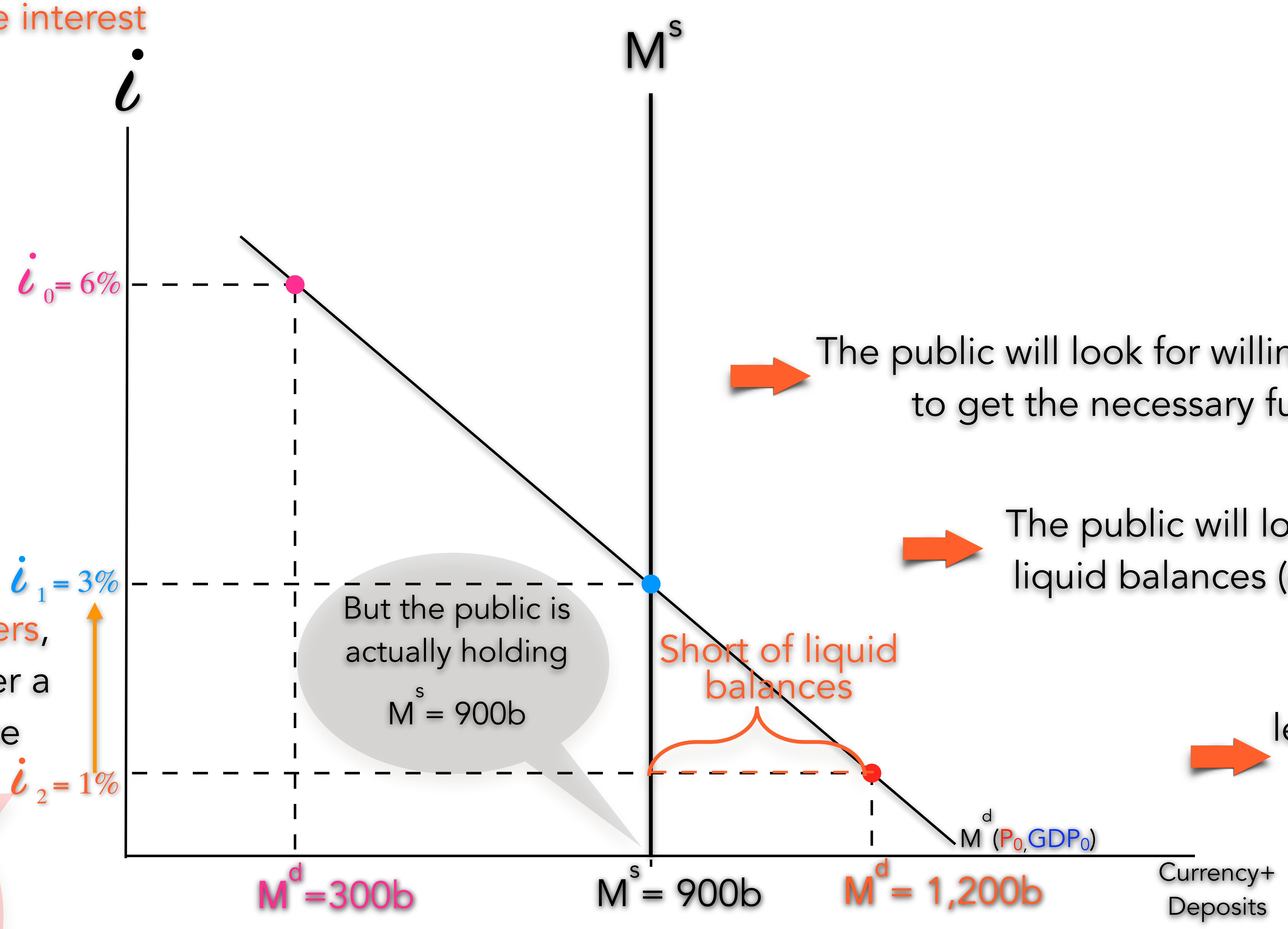
i

S

e

Equilibrium in the Money Market

When there are shortages of liquid balances, money is scarce and there is pressure for the interest rate to rise



The public will look for willing lenders to get the necessary funds

The public will look for a way to get liquid balances (cash and deposits)

It will be difficult to find willing lenders at 1% interest, because at 1%, everyone wants to borrow (short of liquid balances) money is scarce

To find willing lenders, borrowers must offer a higher interest rate

If the interest rate is 1%, the amount of currency + deposits the public **needs** to hold for transactions is 1,200b

Equilibrium in the Money Market