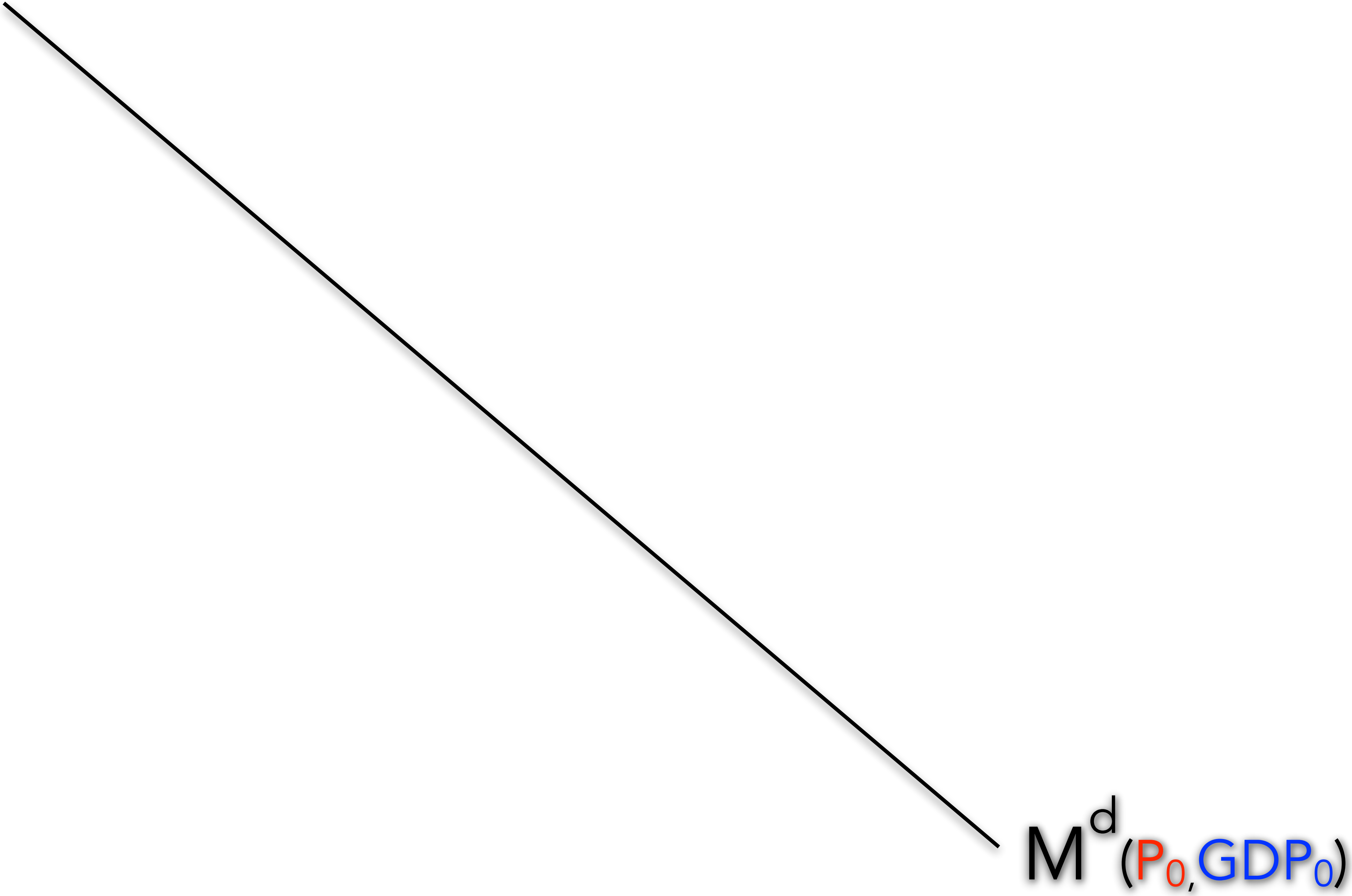
Equilibrium in the Money Market

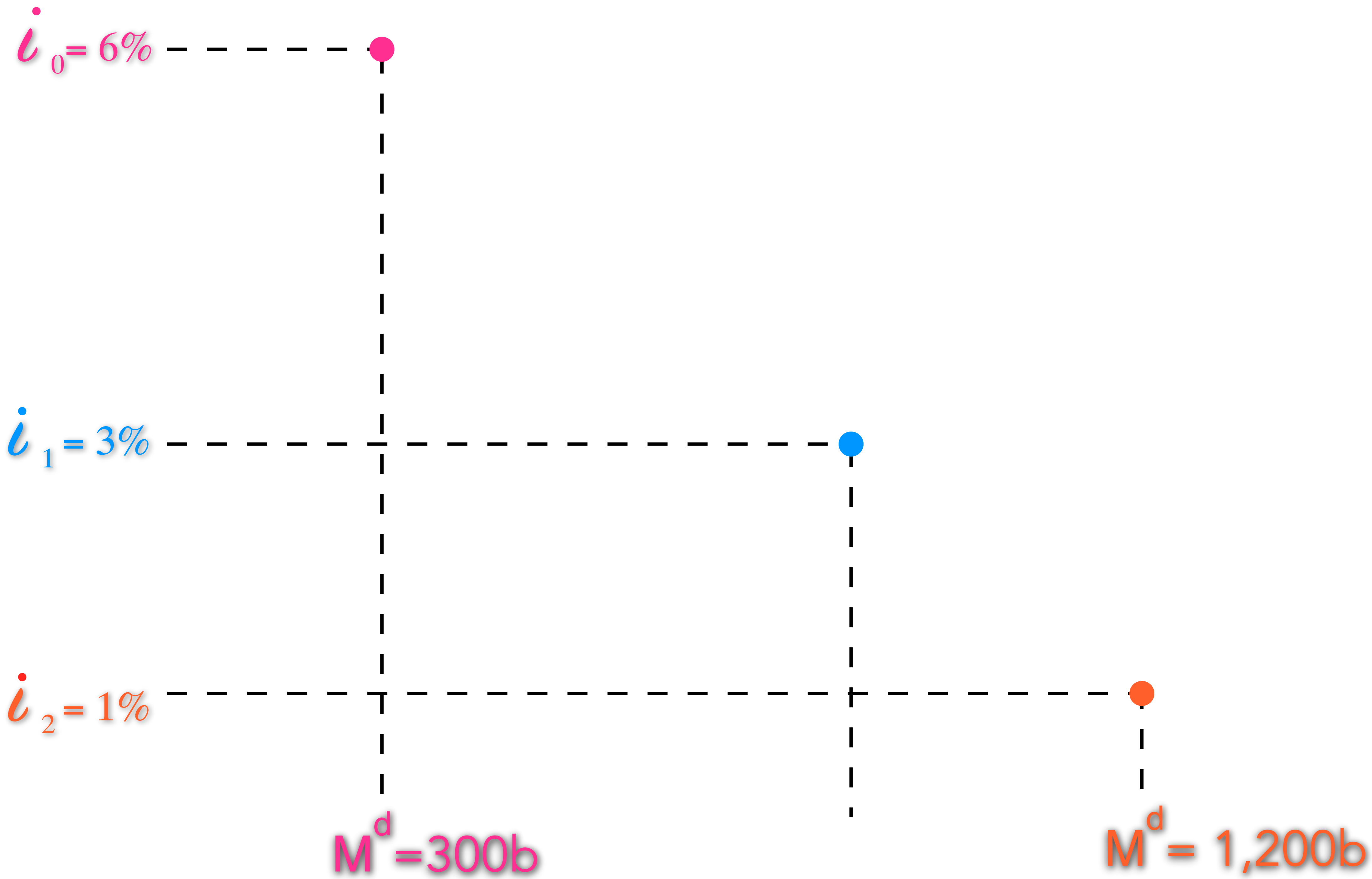
Currency+
Deposits

i


$M^d(P_0, GDP_0)$

M^s

$M^s = 900b$



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

If the interest rate is 6%, the amount of currency + deposits the public **wants** to hold for transactions is 300b

But the public is actually holding

$M^s = 900b$

excess liquid balances

The public has excess liquid balances which they do not need for transactions, sitting idle (not earning interest) in cash and checking accounts

The public will look for a way to earn interest on these excess idle balances

The public will look for borrowers willing to pay interest on these funds

It will be difficult to find willing borrowers at 6% interest, because at 6%, everyone wants to lend (excess liquid balances) money is plentiful

To find willing borrowers, lenders must drop the interest rate

W

h

e

n

t

h

e

r

e

a

r

e

e

X

C

e

S

S

I

i

q

u

i

d

b

a

I

a

n

C

e

/

m

O

n

e

y

i

S

p

e

n

t

i

f

u

a

n

d

t

h

e

r

e

i

S

p

r

e

S

S

u

r

e

f

O

r

t

h

e

i

n

t

e

r

e

S

t

r

a

t

e

t

O

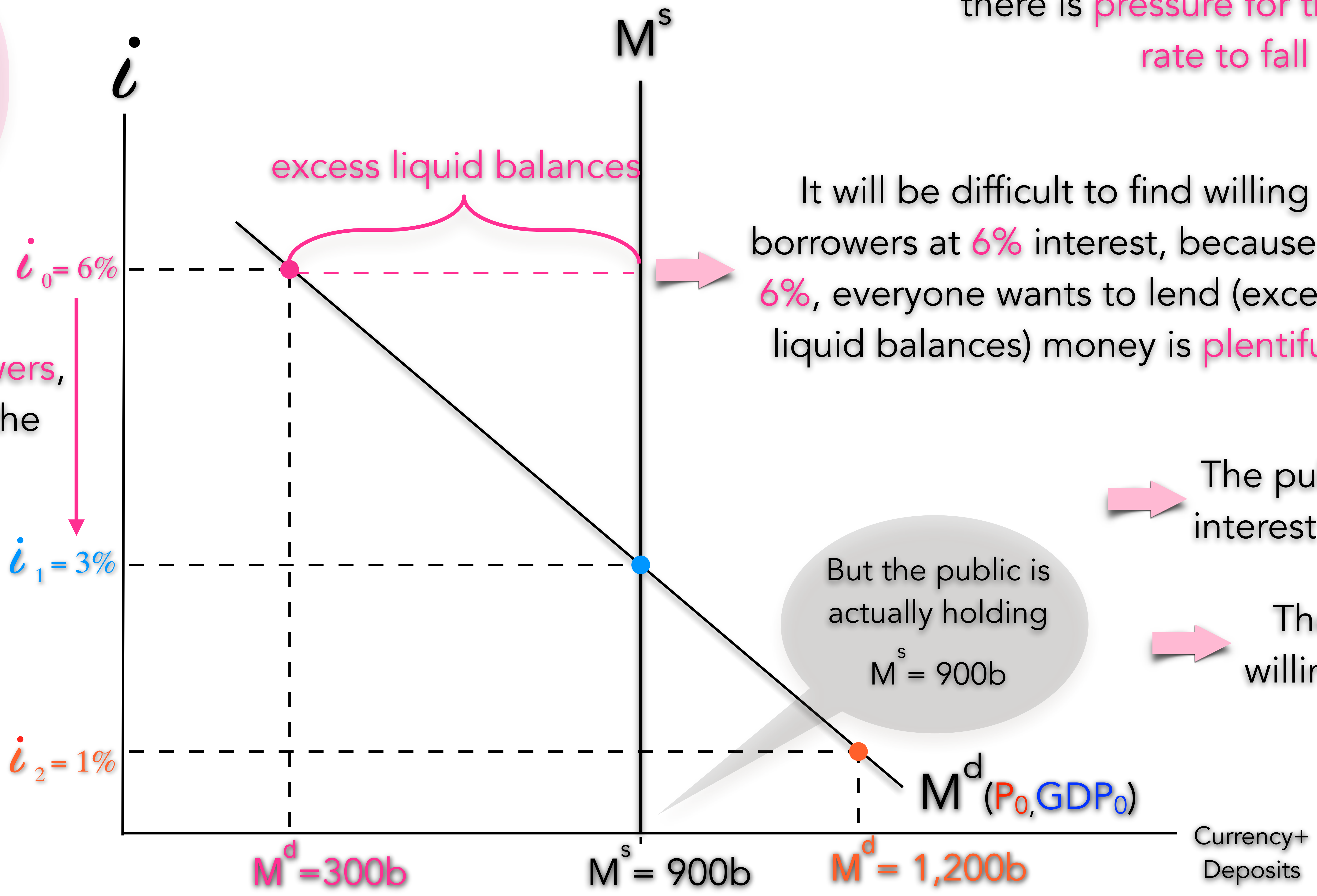
f

a

Equilibrium in the Money Market

If the interest rate is 6%, the amount of currency + deposits the public **wants** to hold for transactions is 300b

When there are excess liquid balances, money is plentiful and there is pressure for the interest rate to fall



To find willing borrowers, lenders must drop the interest rate

It will be difficult to find willing borrowers at 6% interest, because at 6%, everyone wants to lend (excess liquid balances) money is plentiful

The public will look for a way to earn interest on these excess idle balances

The public will look for borrowers willing to pay interest on these funds