MODULE 28
THE MONEY MARKET
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AP Macroeconomics

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The Money Market

- The market where the Fed and the users of money interact thus determining the nominal interest rate (i%).
- Money Demand (MD) comes from households, firms, government and the foreign sector.
- The Money Supply (MS) is determined only by the Federal Reserve.

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Money Demand

- Transaction Demand – demand for money as a medium of exchange (independent of the interest rate).
- Asset Demand – demand for money as a store of value (dependent on the interest rate).
- Total Money Demand – (MD) is downward sloping because at high interest rates people are less inclined to hold money and more inclined to hold stocks & bonds. At lower interest rates people sacrifice less when they hold money.

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Money Supply

- The money supply is determined by the Federal Reserve because the Fed has monopoly control over the supply of money.
- Only the Central Bank (Federal Reserve) can control the money supply.

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AP Tips & Tricks

- If you see a question and it talks about buying or selling bonds or it mentions anything about OMOs, the Discount rate, or TAF the question is dealing with the Money Market and is an action taken by the Central Bank.
- Although Fiscal and Monetary policies may have a similar effect (expansionary & contractionary) make sure you pay attention to who is taking the action, and what type of action is being taken!
  - Even if you get the same end result in terms of the changes in the economy, if you misstate the policies you will not receive credit on the FRQ question! Be careful!

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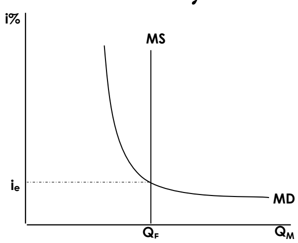
The Money Market



The equilibrium of MS & MD determines the nominal interest rate (i%). MD is downward sloping because the nominal interest rate is the opportunity cost of holding money. MS is vertical because it is independent of the interest rate.

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AP Tips & Tricks

- Remember that the Money Market graph uses nominal interest rate, i%, and not real interest rate, r%, like the Loanable Funds graph does.
- One of the most common mistakes I see AP students make is confusing the two graphs and mixing labels.
- <u>You always get credit on the Free Response Questions for having a properly labeled base graph. If you are struggling PLEASE come in for tutoring!</u>

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Changes in Money Demand

- Money Demand is dependent on both the Price Level and Real GDP which together comprise the Nominal GDP
  - Nominal GDP ↑ .: MD→ .: i% ↑
  - Nominal GDP ↓ .: MD← .: i% ↓

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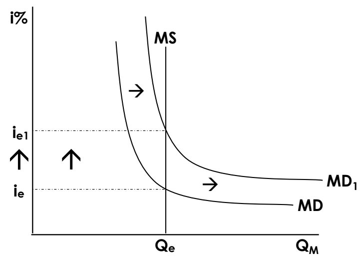
Increase in Money Demand



MD→ .: i%↑

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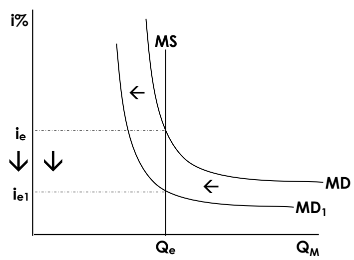
Decrease in Money Demand



MD← .: i%↓

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Changes in Money Supply

- Only the Federal Reserve determines the money supply
- Expansionary Monetary Policy
  – MS→ .: i% ↓
- Contractionary Monetary Policy
  – MS← .: i% ↑

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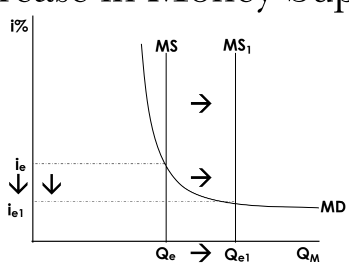
Increase in Money Supply



MS→ .: i%↓

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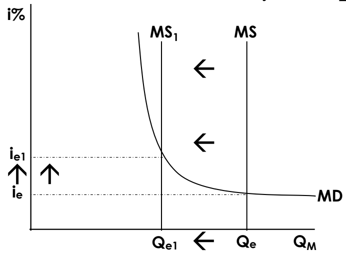
Decrease in Money Supply



MS← .: i%↑

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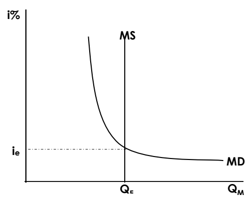
Summary

- The Money Market is where the Central Bank and the users of money interact thus determining the nominal interest rate (i%).
  - MD→ .: i%↑
  - MD← .: i%↓
  - MS→ .: i%↓
  - MS← .: i%↑



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