The Demand (Opportunity Cost) for Money

- The decision process to hold money: is the benefit of holding money greater than the cost?

- The interest rate reflects the opportunity cost of holding money.

  - **Short-term interest rates** are the interest rates on financial assets that mature within six months or less.
  - **Long-term interest rates** are interest rates on financial assets that mature a number of years in the future.
## The Demand for Money and Interest Rates

### Table 37-2

**Interest Rates and the Opportunity Cost of Holding Money**

<table>
<thead>
<tr>
<th></th>
<th>June 2007</th>
<th>June 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal funds rate</td>
<td>5.25%</td>
<td>2.00%</td>
</tr>
<tr>
<td>One-month certificates of deposit (CDs)</td>
<td>5.30%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Interest-bearing demand deposits</td>
<td>2.30%</td>
<td>1.24%</td>
</tr>
<tr>
<td>Currency</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>CDs minus interest-bearing demand deposits (percentage points)</td>
<td>3.00</td>
<td>1.26</td>
</tr>
<tr>
<td>CDs minus currency (percentage points)</td>
<td>5.30</td>
<td>2.50</td>
</tr>
</tbody>
</table>

*Source: Federal Reserve Bank of St. Louis.*
The Demand Curve for Money

Interest rate, $r$

Money demand curve, $MD$

Quantity of money
Shifts of the Real Money Demand Curve

- Changes in aggregate price level
- Changes in real GDP
- Changes in banking technology
Shifts in the Demand for Money

A decrease in money demand shifts the money demand curve to the left.

An increase in money demand shifts the money demand curve to the right.

Interest rate, $r$

$MD_1$ $MD_2$ $MD_3$

$M_3$ $M_1$ $M_2$

Quantity of money
Money and Interest Rates

- According to the liquidity preference model of the interest rate, the interest rate is determined by the supply and demand for money.

- We also have the loanable funds model of interest rates.

- Either model, together with the money supply curve, shows how the nominal quantity of money supplied and the equilibrium interest rate.
The Equilibrium Interest Rate

![Equilibrium Interest Rate Diagram](Image)

- **Equilibrium interest rate**
- **Equilibrium**
- **Money supply curve, MS**
- **Money supply chosen by the Fed**

Interest rate, $r$

- $r_H$
- $r_E$
- $r_L$

Quantity of money

- $M_H$
- $M$
- $M_L$