Demand for Money

The Price of Money

- Foregone interest is the opportunity cost (price) of money people choose to hold.

The Demand for Money

- The ***demand for money*** is the quantities of money people are willing and able to hold at alternative interest rates, *ceteris paribus*.
- A ***portfolio decision*** is the choice of how (where) to hold idle funds.

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The Demand for Money

- Although holding money provides little or no interest, there are reasons for doing so:
  - Transactions demand.
  - Precautionary demand.
  - Speculative demand.

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The Demand for Money

- ***Transactions demand for money*** – Money held for the purpose of making everyday market purchases.
- ***Precautionary demand for money*** – Money held for unexpected market transactions or for emergencies.

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The Demand for Money

- ***Speculative demand for money*** – Money held for speculative purposes, for later financial opportunities.

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Why Hold Money

- **John Maynard Keynes noted that people had three reasons for holding money**
  - **People hold money to make transactions**
  - **People hold money for precautionary reasons**
  - **People hold money to speculate**

Why Hold money

- **Economists have since identified four factors that influence the three Keynesian motives for holding money**
  - **The price level**
  - **Income**
  - **The interest rate**
  - **Credit availability**

The Keynesian Motives for Holding Money

- **The transaction motive**
  - **Individuals have day-to-day purchases for which they pay in cash or by check**
  - **Individuals take care of their rent or mortgage payment, car payment, monthly bills and major purchases by check**
  - **Businesses need substantial checking accounts to pay their bills and meet their payrolls**

The Keynesian Motives for Holding Money

- **The precautionary motive**
  - **People will keep money on hand just in case some unforeseen emergency arises**
    - **They do not actually expect to spend this money, but they want to be ready if the need arises**

The Keynesian Motives for Holding Money

- **The speculative motive**
  - **When interest rates are very low you don’t stand to lose much holding your assets in the form of money**
  - **Alternatively, by tying up your assets in the form of bonds, you actually stand to lose money should interest rates rise**
    - **You would be locked into very low rates**
  - **This motive is based on the belief that better opportunities for investment will come along and that, in particular, interest rates will rise**

Four Influences on the Demand for Money

- **The price level**
  - **As the price level rises, people need to hold higher money balances to carry out day-to-day transactions**
  - **As the price level rises, the purchasing power of the dollar declines, so the longer you hold money, the less that money is worth**
  - **Even though people tend to cut down on their money balances during periods of inflation, as the price level rises people will hold larger money balances**

Four Influences on the Demand for Money

- Income
  - The more you make, the more you spend
  - The more you spend, the more money you need to hold as cash or in your checking account
  - Therefore as income rises, so does the demand for money balances

Four Influences on the Demand for Money

- Interest rates
  - The quantity of money demanded (held) goes down as interest rates rise
    - The alternative to holding your assets in the form of money is to hold them in some type of interest bearing paper
    - As interest rates rise, these assets become more attractive than money balances

Four Influences on the Demand for Money

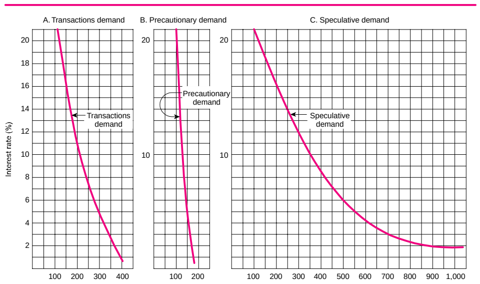
- Credit availability
  - If you can get credit, you don't need to hold so much money
    - The last three decades have seen a veritable explosion in consumer credit in the form of credit cards and bank loans
    - Over this period, increasing credit availability has been exerting a downward pressure on the demand for money

Four Influences on the Demand for Money

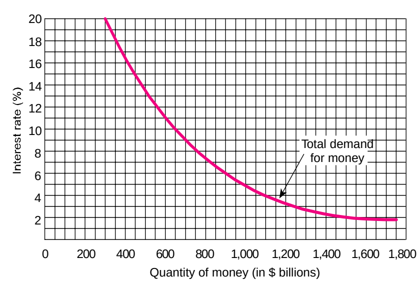
- Four generalizations
  - As interest rates rise, people tend to hold less money
  - As the rate of inflation rises, people tend to hold more money
  - As the level of income rises, people tend to hold more money
  - As credit availability increases, people tend to hold less money

The Demand Schedule for Money

The Three Demands for Money



Total Demand for Money

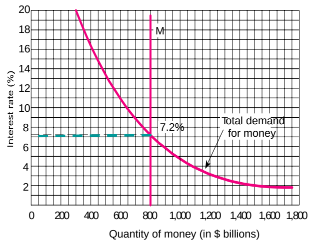


This is the sum of the transaction demand, precautionary demand, and speculative demand for money shown in the previous slide

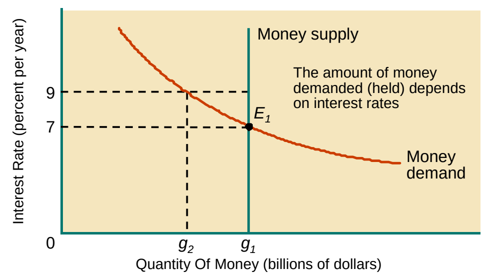
Total Demand for Money and the Supply of Money

The interest rate of 7.2 percent is found at the intersection of the total demand for money and the supply of money (M)

Since at any given time the supply of money (M) is fixed it can be represented as a vertical line



Money Market Equilibrium



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Liquidity Trap

- The ***liquidity trap*** is the portion of the money-demand curve that is horizontal.
- People are willing to hold unlimited amounts of money at some (low) interest rate.

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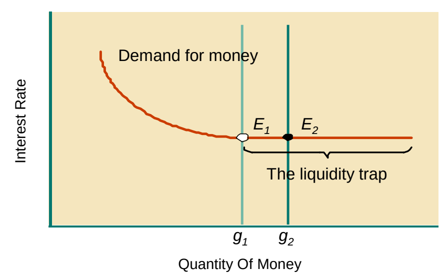
Constraints on Monetary Stimulus

A liquidity trap can stop interest rates from falling



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