The Loanable Funds Market

Coach Burnett
AP Macroeconomics

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The Loanable Funds Market

- The market where savers and borrowers exchange funds (Q_{LF}) at the real rate of interest (r%).
- The demand for loanable funds, or borrowing, comes from the households, firms, government and the foreign sector.
- The supply for loanable funds, or savings, comes from households, firms, government, and the foreign sector.

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The Loanable Funds Market

- People/businesses/government WITH money supply it to others. In return they receive interest of the money loaned to others.
- People/businesses/government WITHOUT money borrow it to others at an interest rate that is to be paid back at a later time.

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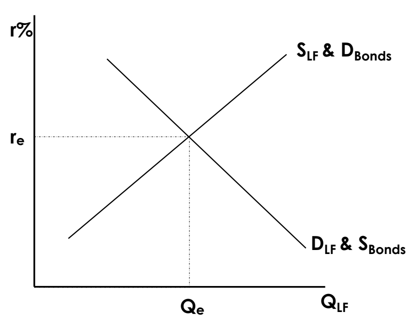
Loanable Funds Market In Equilibirium



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What is a Bond?

- A bond is a certificate of debt issued by a government or corporation guaranteeing payment of the original investment <u>plus</u> interest by a specified future date.
- The demand for loanable funds is in fact the supply of bonds.
- The supply of loanable funds is also the demand for bonds.

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Changes in the Demand for Loanable Funds

- Remember that demand for loanable funds = borrowing (i.e. Supplying bonds)
- More borrowing = more demand for loanable funds
  - (D_{LF} →)
- Less borrowing = less demand for loanable funds
  - (D_{LF} ←)
- Examples:
  - Government deficit spending = more borrowing = more demand for loanable funds .: D_{LF} → .: r%↑
  - Less investment demand = less borrowing = less demand for loanable funds .: D_{LF} ←.: r%↓

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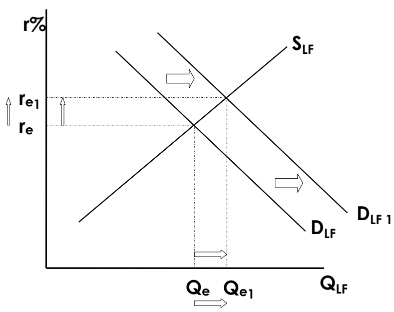
Increase in the Demand for Loanable Funds



D_{LF} → .: r% ↑ & Q_{LF} ↑

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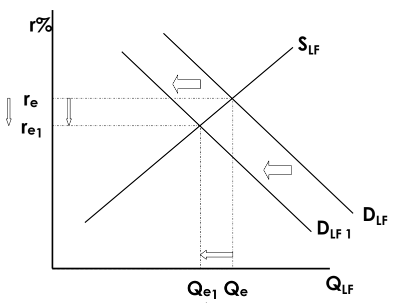
Decrease in the Demand for Loanable Funds



D_{LF} ← .: r% ↓ & Q_{LF} ↓

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Changes in the Supply for Loanable Funds

- Remember that supply for loanable funds = savings (i.e. Demand for bonds)
- More savings = more supply of loanable funds
  - (S_{LF} →)
- Less borrowing = less supply of loanable funds
  - (S_{LF} ←)
- Examples:
  - Government budget surplus = more saving = more supply of loanable funds .: S_{LF} → .: r% ↓
  - Decrease in consumers' MPS = less saving = less supply of loanable funds .: S_{LF} ← .: r% ↑

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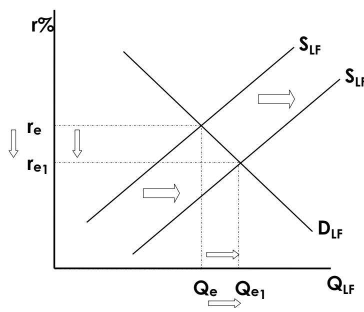
Increase in the Supply for Loanable Funds



S_{LF} → .: r% ↓ & Q_{LF} ↑

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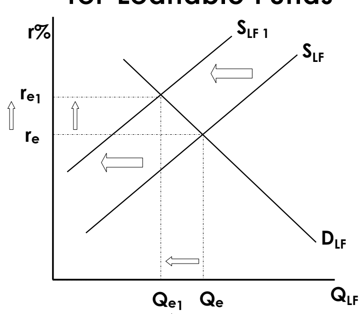
Decrease in the Supply for Loanable Funds



S_{LF} ← .: r% ↑ & Q_{LF} ↓

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Final Thoughts

- The loanable funds market determines the real interest rate (r%).
- The loanable funds market relates saving and borrowing.
- Changes in saving and borrowing will create changes in loanable funds and therefore the r% changes.
- When the government enacts fiscal policy it will affect the loanable funds market.
- Any changes in the real interest rate (r%) will in turn affect levels of Gross Private Investment (I_G)

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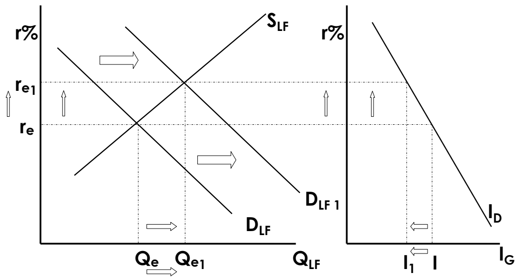
What this will tie into…



G↑ and/or T↓ .: Government deficit spends .: D_{LF} → .: r%↑ .: I_G↓

(Crowding-Out Effect)

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