

LOS.25.a, (Part 1)

SS 5

Discuss the factors determining the demand for money.

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LOS.25.a, (Part 2)

SS 5

Define the demand for money curve and the effects of changes in real GDP and financial innovation on the demand for money curve.

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LOS.25.a (Part 1)

The **demand for money** is largely determined by interest rates. Think of the interest that could be earned on money deposited in a savings account or money market fund as the opportunity cost of holding money. At higher interest rates, the opportunity cost of holding money increases, and people will desire to hold less money and more assets that are sensitive to changes in the price level.

The **supply of money** is determined by the central bank (the Fed in the U.S.) and is independent of the interest rate. This causes a vertical (perfectly inelastic) supply curve.

LOS.25.a, (Part 2)

If real GDP rises, more goods and services are bought and sold, and more money is needed to conduct these transactions. Increases in real GDP shift the money demand curve up. Decreases in real GDP shift it down so that less money is demanded at each level of interest rates.

The increased use of credit cards and debit cards, the availability of interest bearing checking accounts, easier transfer of funds from savings to checking, the proliferation of ATMs, and internet banking and bill paying are all financial innovations that have affected the demand for money curve. Overall, financial innovation has reduced the demand for money below what it would have been if only the increase in real GDP was at work. The increased use of credit cards and ATMs have likely been the most important innovations with respect to the demand for money.