CONCEPT: THE MARKET FOR LOANABLE FUNDS

● We can simplify the financial system to one market called the ***market for loanable funds***

□ ***Loanable Funds*** – income that households have chosen to save rather than spend on consumption

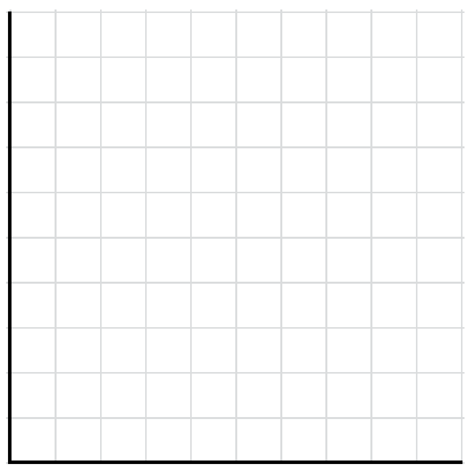
□ Just like any market, there are suppliers and demanders:

> Supply → ____________________

> Demand → ____________________

> "Price" → ____________________

Market for Loanable Funds



□ Firms compare the rate of return of new projects with the available interest rate on the market

> Firms will fund projects that have a rate of return higher than the equilibrium interest rate

> At lower interest rates, the demand for funds naturally increases (more projects are worth funding)

□ Households will save based on the "reward" they can receive for lowering their consumption today

> At lower interest rates, the supply of funds naturally decreases (less "rewarding" to save)

□ Recall the difference between ***nominal interest*** and ***real interest***:

> ***Nominal Interest Rate*** – The stated rate of interest on a loan

> ***Real Interest Rate*** – The nominal interest rate ___________________________

> Since both savers and investors are concerned with inflation, the equilibrium rate is the _____________