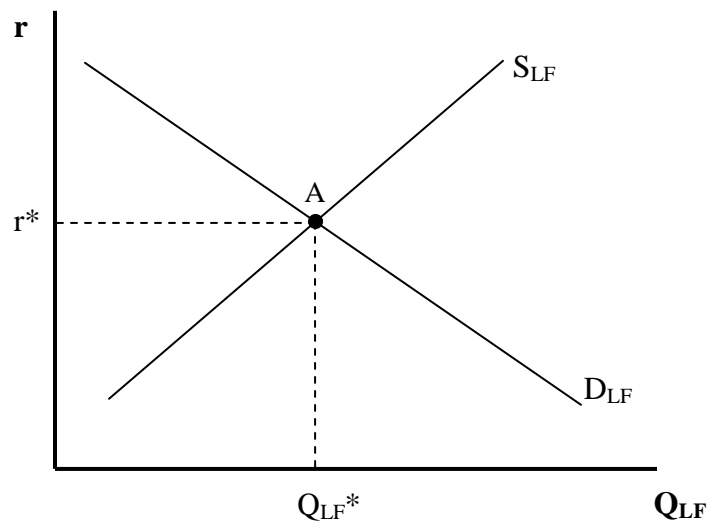


4 Macro Markets – Loanable Funds

There are two ways to look at the market for loanable funds. If we simply define this as the private sector market for loanable funds, then we are looking at a market that links savings with investment. Using this definition, firms and households are the demanders of loanable funds, which they ultimately use to buy capital, homes and durable goods. Banks, and more generally financial institutions are the suppliers of loanable funds, but of course where do financial institutions get the money they loan out? In most cases, that money comes from savings. The other perspective is the one we will take, which is to define this market as including all borrowers. On the demand side of the loanable funds market, this definition will now not only include firms and households, but also a very large borrower of money, government. When firms, households or government needs to borrow more money in order to finance expenditure, the demand for loanable funds will shift outward.

The market for loanable funds will includes all borrowers on the demand side and financial institutions, the providers of loanable funds, on the supply side. The price of loanable funds would be the interest rate, and equilibrium would be where that interest rate allows the quantity of loanable funds demanded to be equal to the quantity of loanable funds that are supplied. That equilibrium is illustrated in the graph below as r^* and Q_{LF}^* .

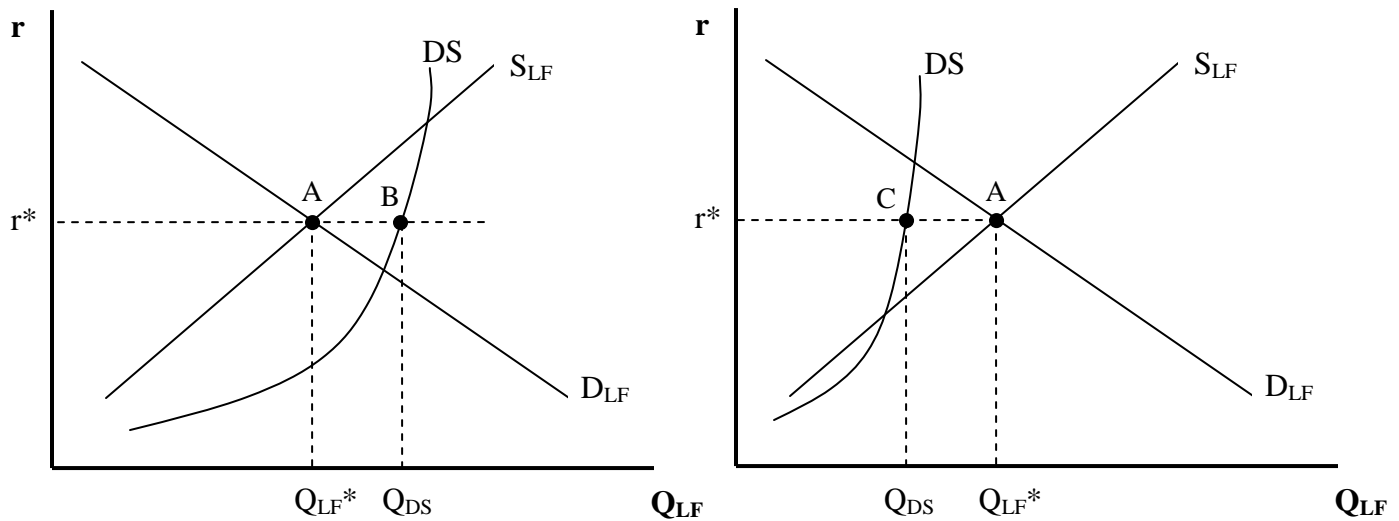


The demanders of loanable funds (government, households and firms) will borrow Q_{LF}^* in this setting, as the suppliers of loanable funds (financial institutions) provide Q_{LF}^* at r^* .

Now, let's examine what we have here. Given that we never made it a point to mention that foreign citizens can also supply loanable funds, it's possible to interpret this graph as depicting the domestic market for loanable funds. Suppose we extend the model by assuming that loanable funds can flow both into this country and out of the country. Let's add to that by considering where domestic loanable funds come from, i.e. domestic savings. We can make this explicit by including another curve on the graph, a curve we'll call the domestic savings curve.

What would the domestic savings curve look like? The curve would show us the quantity of domestic savings that would exist at each equilibrium interest rate. The higher the interest rate, the more domestic citizens would save, and so we assume that this curve will have a positive slope if we include it on the graph above. The position of the domestic savings curve provides us with important information about the flow of loanable funds into the country and out of it.

Consider the two graphs below. In both graphs, we have an identical demand and supply for loanable funds. On the left, we have a domestic savings curve that is much further to the right of the graph than the domestic savings curve on the righthand graph. In other words, we have two situations. One where domestic citizens save more (left side graph), no matter what the interest rate, and one where domestic citizens save much less (right side graph).



In both graphs, we observe the quantity of loanable funds that demanders need in order to finance their spending (Q_{LF}^*), but we also observe the quantity of domestic savings that's available for domestic suppliers to loan out (Q_{DS}).

On the left side graph, we notice that $Q_{DS} > Q_{LF}^*$. This means that because citizens save a lot, domestic suppliers have plenty of money available to loan out, more than what is needed by domestic borrowers. What happens to the excess domestic savings (represented on the leftside graph as the horizontal distance between pts A and B)? Loanable funds will flow out of the country to be invested elsewhere, something we refer to as capital outflow. When $Q_{LF}^* > Q_{DS}$, we see just the opposite. I.e., there are not enough domestic savings available for domestic borrowers (where this deficit is represented on the rightside graph as the horizontal distance between pts A and C), and so borrowers must turn to foreign suppliers of loanable funds to get to Q_{LF}^* . I.e., loanable funds would be flowing into the country, which is what we call capital inflow.

Note that this implies that countries with low savings rates are likely destined to rely on foreign lenders when it comes to financing investment projects and government spending. This also suggests one results of increased government borrowing, something we'd represent as an increase in demand on our graphs above, which is that an increase in demand for loanable funds by government would be accompanied by an increase in capital inflow (or, at the very least, a decrease in capital outflow).