AP Macroeconomics
Dr. Funk

Loanable Funds Market and Crowding-Out Effect

1. What are loanable funds?

- *all income that people have chosen to save and lent out*
- *there are public and private savings*

2. Who supplies loanable funds?

- directly: *people who save from their income and therefore lent out directly to a firm – buying bonds from a corporation*
- indirectly: *HH make deposits in a bank – increases the bank's excess reserves*

3. Who demands loanable funds?

- *HH and firms who wish to borrow to make investments or purchases which they otherwise could not afford (ex.: mortgages, business loans)*

Case Scenario	*Graph*
4. Policy 1: Saving Incentive 4.1. Describe the Proposal - *expand eligibility for special accounts such as retirement accounts (401k, 403b, IRA), thus people can shelter their savings from taxation* - *reform the tax code to encourage greater savings* - *remember: Keynes warned for savings, but while they might be less desirable in the SR they are beneficial in the LR* 4.2. Which curve of the Lonanable Funds Market will be affected by the proposal? - *Supply of Loanable Funds* 4.3. How will this curve be affected? - *Supply of Loanable Funds will increase* 4.4. Which changes regarding the equilibrium have taken place? Why? - *Increase in Supply of Loanable Funds – Supply curve in lonanable funds market shifts right – real interest rates (r) decrease – thus lower cost for borrowing money in the loanable funds market* - *HH and business firms are more motivated to borrow for investments in capital goods and / or goods that appreciate in value over time*	

5. Policy 2: Investment Incentive

5.1. Describe the Proposal

- *tax code / tax law that makes business investment and/or private investment more attractive (ex.: investment tax credit for building a new factory, business complex, or buying new machines and equipment)*

5.2. Which curve of the Lonanable Funds Market will be affected by the proposal?

- *Demand of Loanable Funds*

5.3. How will this curve be affected?

- *Demand of Loanable Funds will increase*

5.4. Which changes regarding the equilibrium have taken place? Why?

- *Increase in Demand of Loanable Funds – Demand curve in lonanable funds market shifts right – real interest rates (r) increase – thus higher cost for borrowing money in the loanable funds market BUT*
- *HH , business firms and the public sector are more motivated to save at higher interest rates, which can lead to an increase in supply of loanable funds*
- *Thus, at the end there might only be a movement along the demand curve for loanable funds.*

6. Policy 3: Government Budget Deficit and Surplus 6.1. Describe the Proposal - *Gov. runs a deficit and needs to borrow money in the bond market (money market), thus Demand for Money increases ☹ ☹ ☹* 6.2. Which curve of the Lonanable Funds Market will be affected by the proposal? - *Supply of Loanable Funds can be affected if the government has previously contributed as a saver* - *Demand of Loanable Funds can be affected if the government has previously not borrowed or not borrowed as heavily as it does now* 6.3. How will this curve be affected? - *Supply Curve in Loanable Funds Market would shift left* - *Demand Curve in Loanable Funds Market would shift right* 6.4. Which changes regarding the equilibrium have taken place? Why? - *either case scenario will lead to an increase of real interest rates (r)* - *this will lead to less borrowing by business firms and HH, thus I and C will be decreasing* - *government spending has partially crowded out possible expansion of the private sector*	