Answer on Question #89413, Economics / Macroeconomics

**QUESTION**: The rate of interest is a price:

a. Of what is it the price? (1 mark)

b. What determines this price? (Sketch a relevant graph of the money market). (2 marks)

c. What factors influence the demand for money? (2 marks)

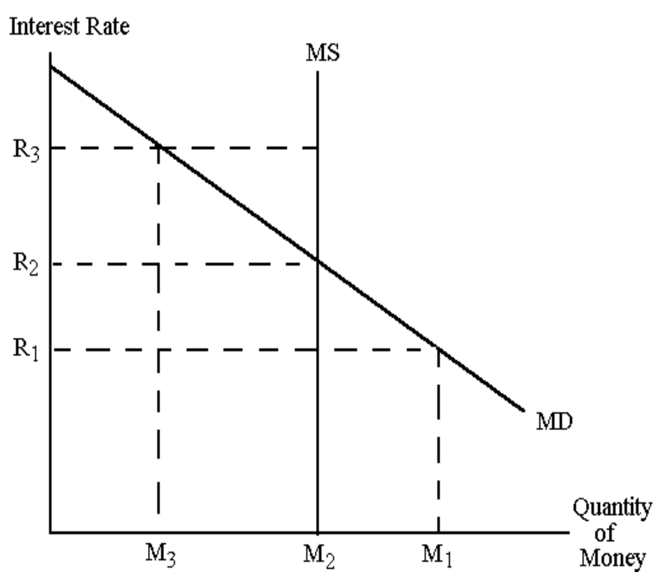
d. What factors influence the supply of money? (2 marks)

e. If the money market is in short-run equilibrium, explain the adjustments that will take place for: i) an increase the in the money supply (2 marks)

**ANSWER:**

**A.** Rate of interest is the price of capital and is determined quantity of money in the economy.

**B.** The rate of interest is determined by supply of money and demand for money in an economy. The equilibrium rate of interest is determined at the point where money supply equates the demand for money in the money market as shown in the diagram below.

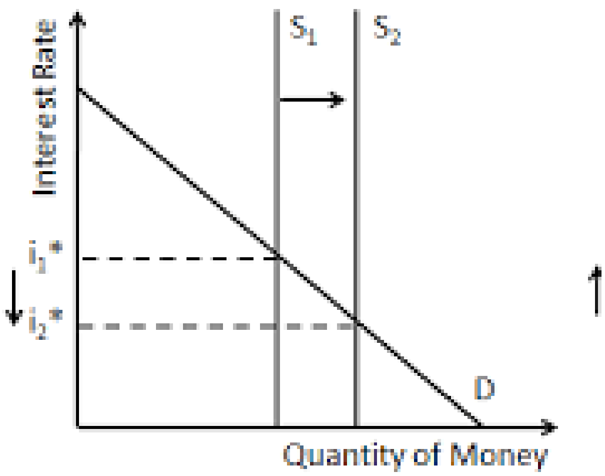



here the equilibrium rate of interest is determined at R2.

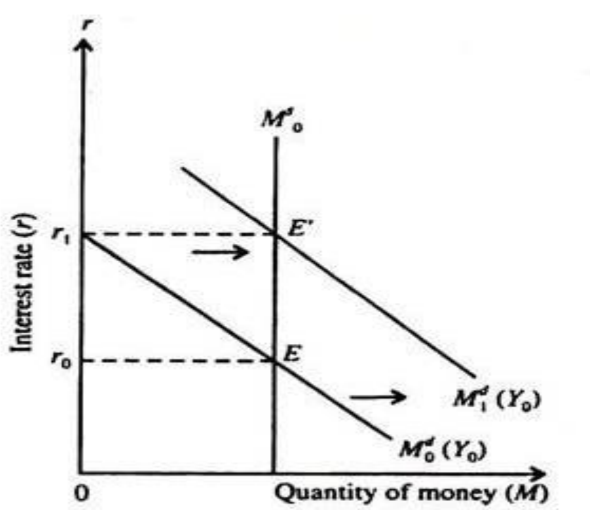
**C.** Interest Rates, consumption spending, precautionary demand, transaction Costs of stocks and onds, change in the general level of prices and international aspects are some of the factors which influence money supply in an economy.

**D.** Supply of money is exogenously determined by a central bank of an economy. The central bank can bring changes in this suppply through its policy measures like open market operations, changes in reserve requirements and changes in policy interest rates.

**E.** (I) Increase in money supply ***causes equilibrium rate of interest to fall*** as shown in figure below.




E (ii) Given the money supply ***an increase in demand for money will cause a rise in equilibrium rate of interest*** as shown in figure below.

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