

Part 1 - Introduction

Who are these guys?



Can you define these terms?

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| <ul style="list-style-type: none">• Federal Reserve System• FOMC• Federal Funds• Federal Funds Rate• Discount Loan• Discount Rate• Open Market Operation• Quantitative Easing• Large Scale Asset Purchases | <ul style="list-style-type: none">• MBS• Money Market• Capital Market• Sub-prime Mortgage• Shadow Banking System• Operation Twist• ZLB• LIBOR rates |
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Chapter 1 - Why study Money, Banking and Financial Markets?

1. To understand how financial markets work and why they are important

Financial markets are markets in which funds are transferred from people and firms who have an excess of available funds to people and firms who have a need of funds

Obviously, there are many financial markets

Financial markets are crucial towards:

- Promoting greater economic efficiency by channeling funds from people whom do not have a productive use for them to those who do.
- Well-functioning financial markets are a key factor in producing high economic growth and poorly performing financial markets are one reason that many countries around the world remain poor.
- Activities in the financial markets also have direct effects on personal wealth, the behavior of businesses and consumers, and the overall economy

Example: the Bond Market

A bond is a debt security that promises to make payments periodically for a specified period of time

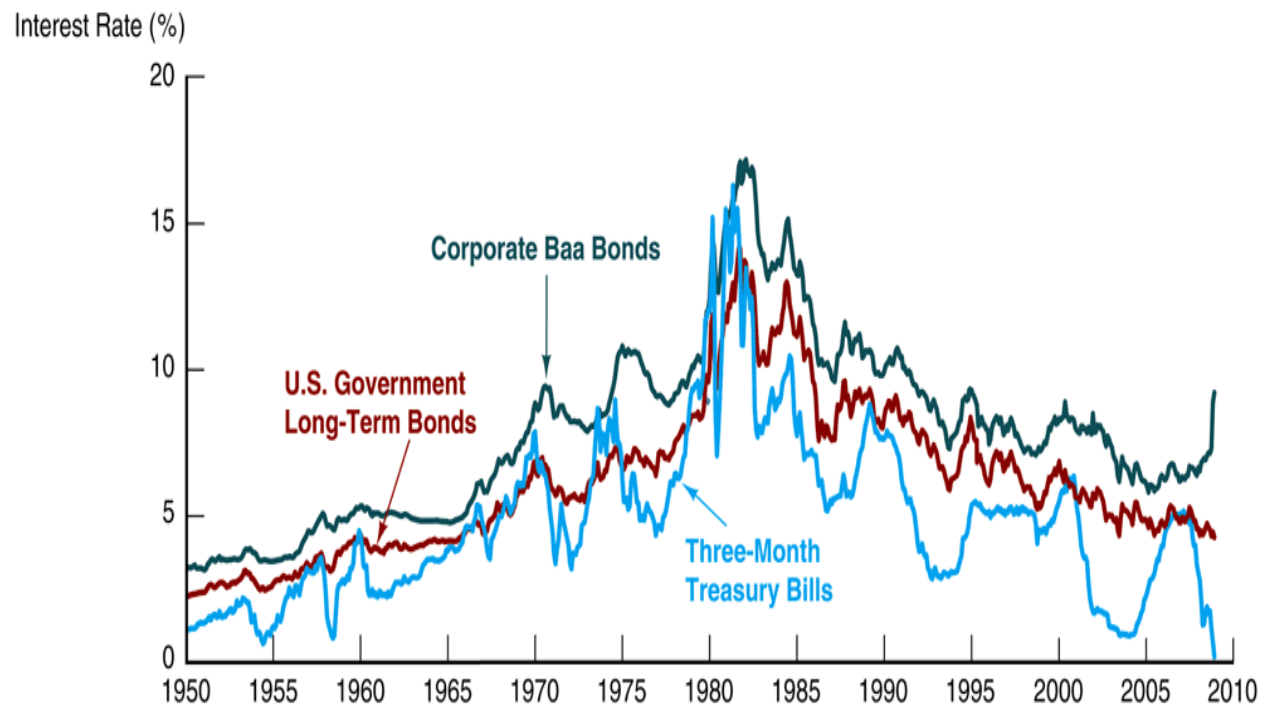
A security is a claim on the issuer's future income or assets

The bond market is especially important to economic activity because it enables corporations and governments to borrow to finance their activities.

The bond market is also where interest rates are determined.

The interest rate is the cost of borrowing, expressed as a percentage

Graph 1: Interest Rates on Selected US. Bonds, 1950-2008



Interest rates are important, even on a personal level:

- They can deter you from making certain purchases
- They can encourage savings
- They influence business's investment decisions.

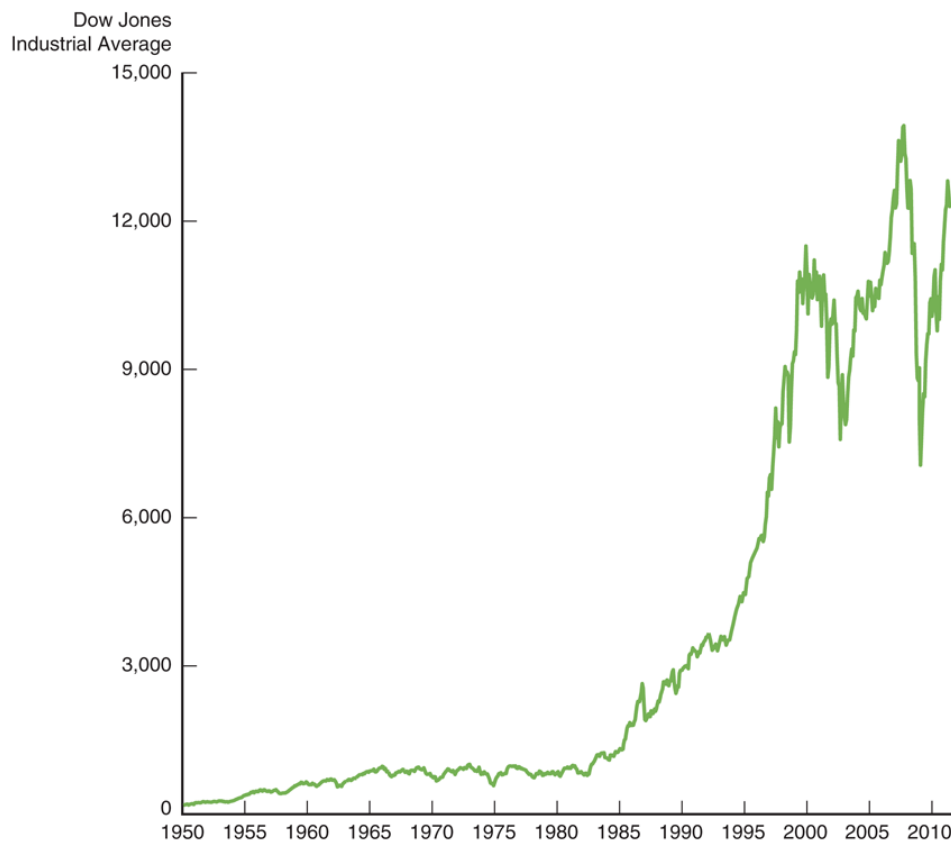
Example: the Stock Market

A common stock represents a share of ownership in a corporation

It is an equity security that is a claim on the earnings and assets of the corporation after debt obligations have been satisfied (residual claim)

Firms can issue new shares to finance investment spending

Figure 2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2011



2. To understand how financial institutions work

Financial institutions are institutions that provide financial services for its clients or members

One of the most important financial services provided by financial institutions is acting as financial intermediaries

Financial intermediaries: institutions that borrow funds from (issue liabilities to) people who save and make loans to other people

Why should we care about financial markets and institutions?

- They affect our everyday lives and determine the economic well-being of countries

- A well-functioning financial system promotes economic efficiency
 - ◆ Facilitate Payments
 - ◆ Channel Funds from Savers to Borrowers
 - ◆ Enable Risk Sharing

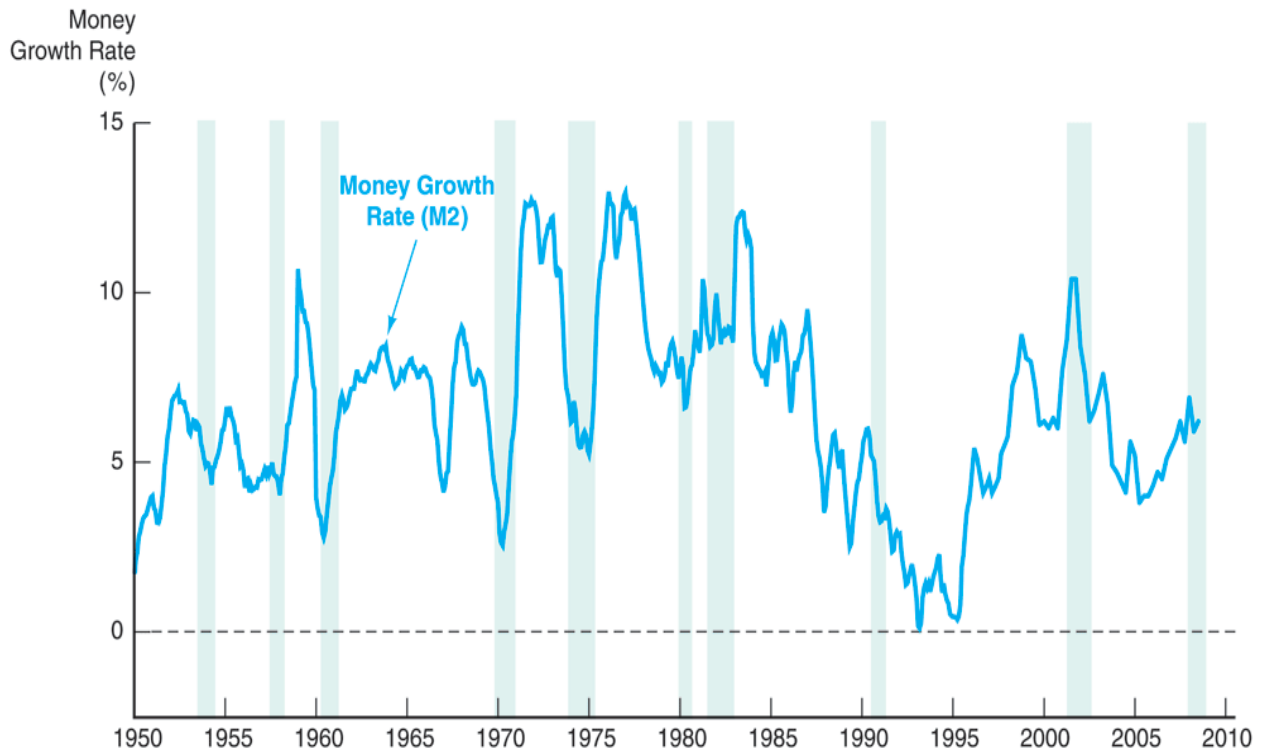
What can make a financial system more efficient?

3. To examine the role of money in the economy

Money (money supply) is an asset used to pay for goods and services, for repayment of debt, and payment of taxes. It is used as a store of wealth and a medium of exchange.

Money and Business Cycles

Figure 3 Money Growth and the Business Cycle in the United States 1950–2011



Money and Inflation

Inflation is the continual rise in the price level, where the price level is the average price of goods and services in an economy.

“Inflation is always and everywhere a monetary phenomenon” – Milton Friedman

Figure 4 Aggregate Price Level and the Money Supply in the United States, 1950–2011

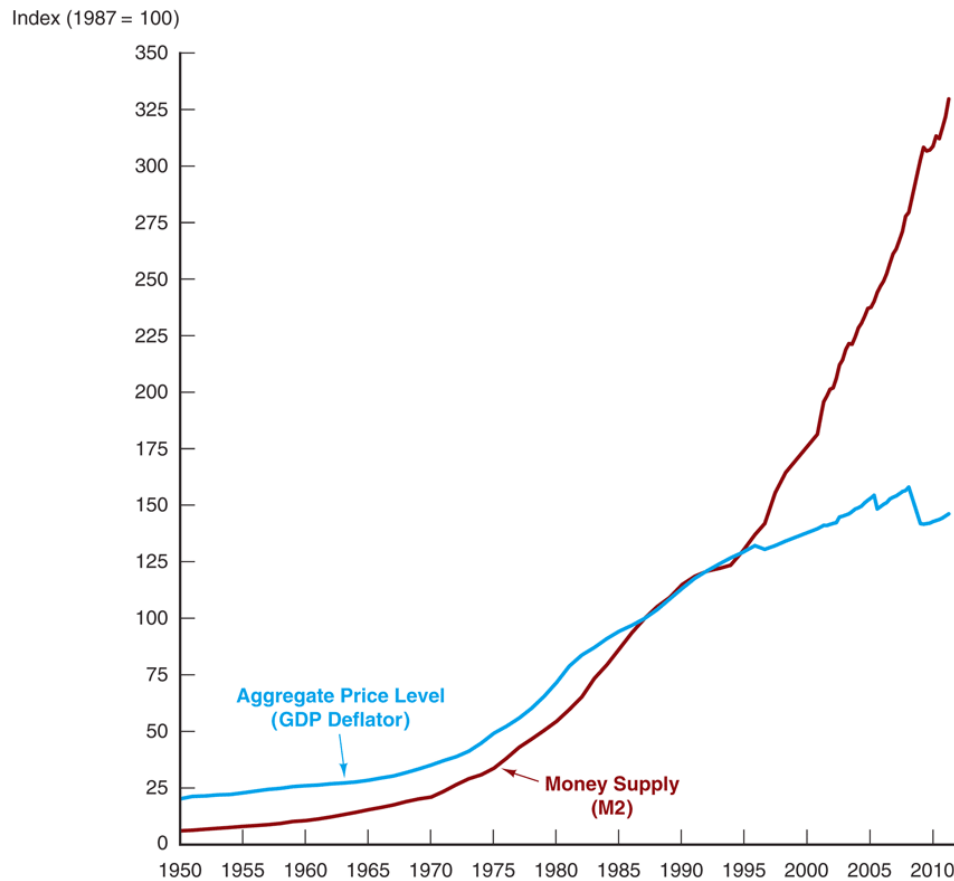
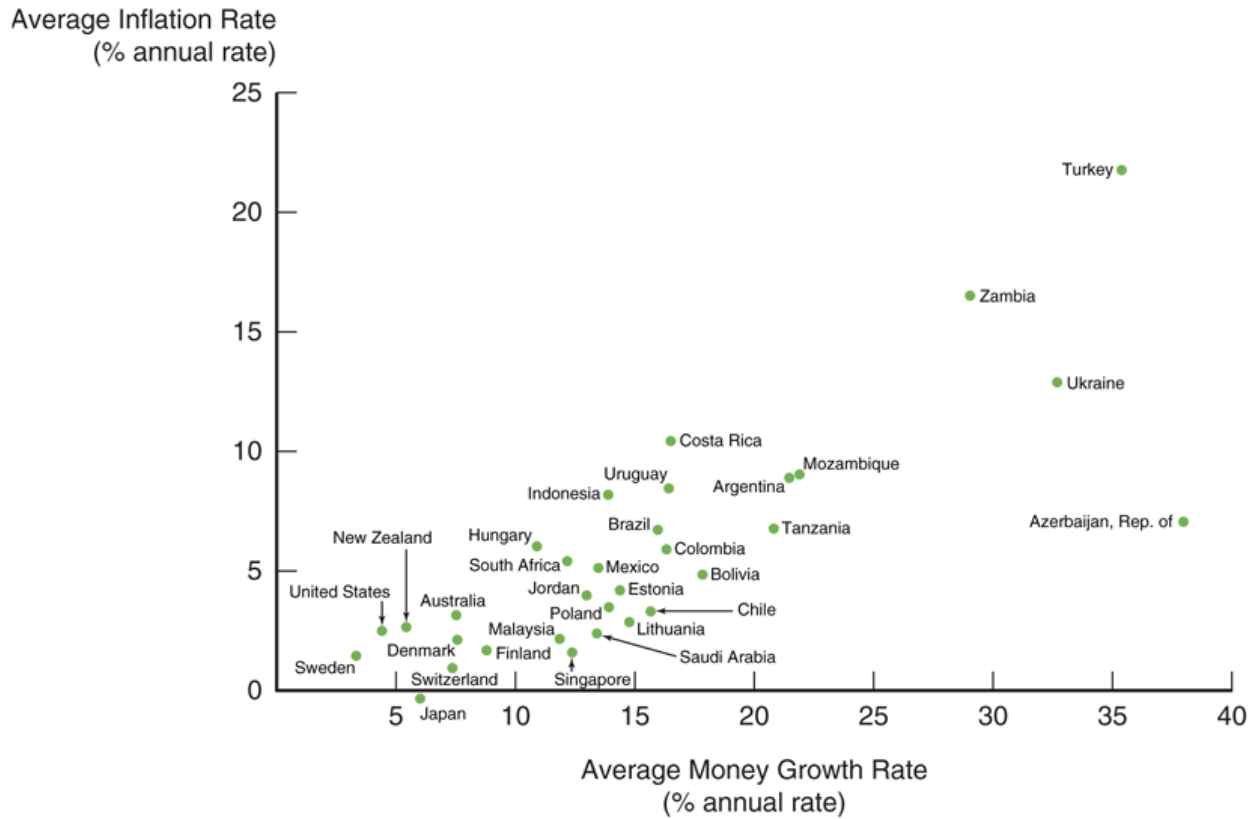
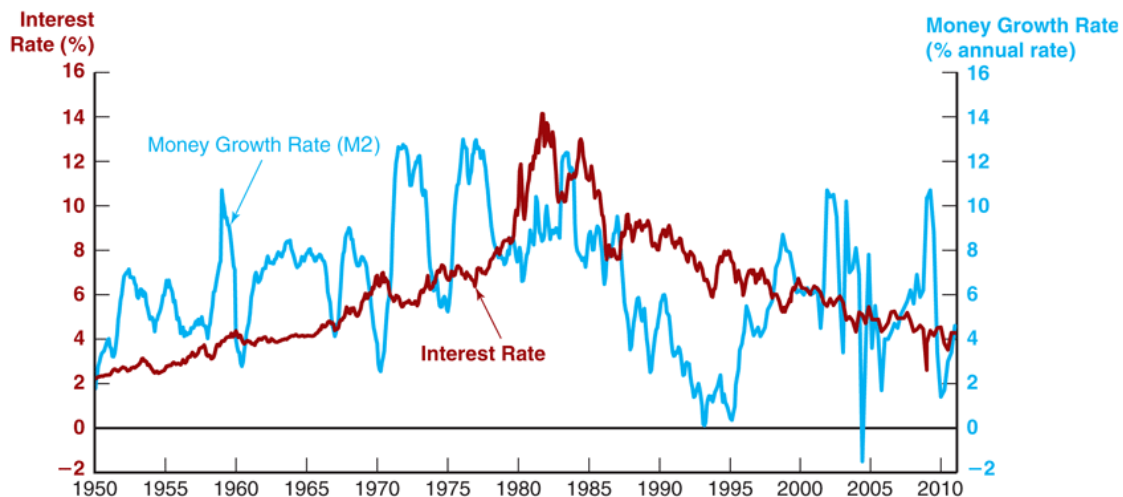


Figure 5 Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 2000-2010



Money and Interest Rates

Figure 6 Money Growth (M2 Annual Rate) and Interest Rates (Long-Term U.S. Treasury Bonds), 1950–2011



- Prior to 1980, the rate of money growth and the interest rate on long-term Treasury bonds were closely tied
- Since then, the relationship is less clear but the rate of money growth is still an important determinant of interest rates

Monetary and Fiscal Policy

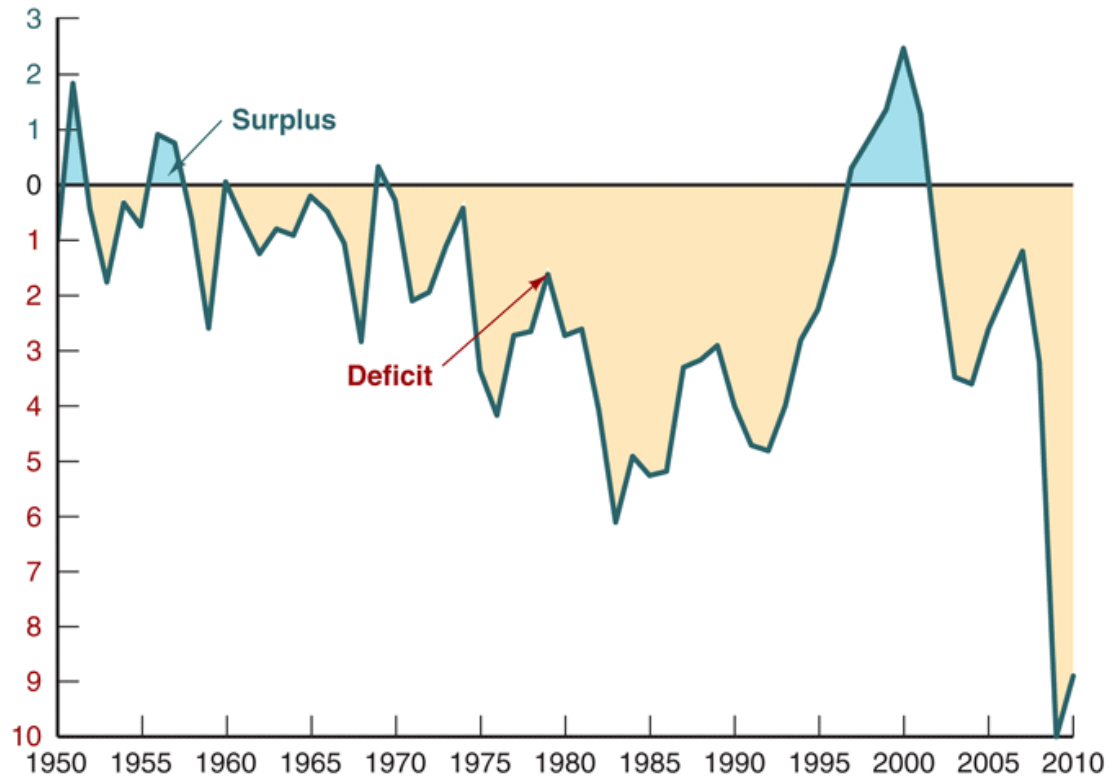
- Monetary policy is the management of the money supply and interest rates
 - The Central bank is responsible for the conduct of a nation's monetary policy
 - Conducted in the U.S. by the Federal Reserve System (Fed)

To understand how monetary policy operates, we study monetary theory (the theory that relates the quantity of money and monetary policy to changes in aggregate economic activity and inflation)

- Fiscal policy deals with decisions about government spending and taxation
 - Budget deficit is the excess of expenditures over revenues for a particular year
 - Budget surplus is the excess of revenues over expenditures for a particular year
 - Any deficit must be financed by borrowing

Figure 7 Government Budget Surplus or Deficit as a Percentage of Gross Domestic Product, 1950–2010

Percent of GDP



The Foreign Exchange Market

- The foreign exchange market is where funds are converted from one currency into another
- The foreign exchange rate is the price of one currency in terms of another currency
- The foreign exchange market determines the foreign exchange rate

Why study international finance?

- Financial markets have become increasingly integrated throughout the world.

- The international financial system has tremendous impact on domestic economies:
 - Movements in the exchange rate can affect the cost of living
 - A country's choice of exchange rate policy affects its monetary policy
 - Capital controls impact domestic financial systems and therefore the performance of the economy

Chapter 3 – What is money?

Money - anything that is generally accepted in payment for goods or services or in the repayment of debts.

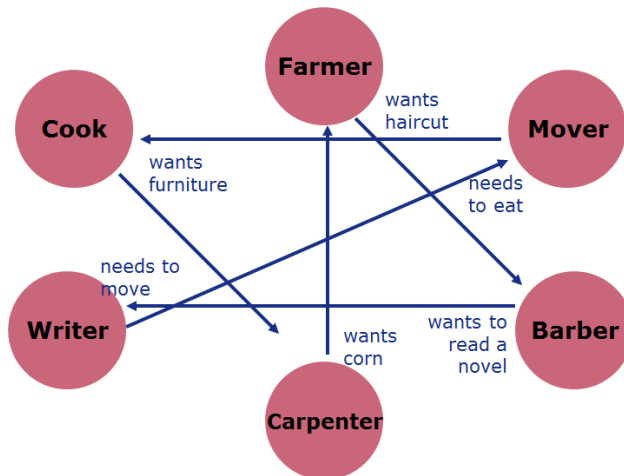
- A stock concept: it is a certain amount at a given point in time.
- Money is different from wealth
- Money is different from income

Functions of money

1. Medium of exchange

- Eliminates the trouble of finding a double coincidence of needs

Coincidence of Wants



- Promotes specialization
- A medium of exchange must
 - be easily standardized
 - be widely accepted
 - be divisible
 - be easy to carry
 - not deteriorate quickly
- 2. **Unit of account** - Used to measure the value of goods and services in terms of money
- 3. **Store of value** - Used to transfer/save purchasing power over time.

Other assets also serve as a store of value.

However, money is the most liquid of all assets, thus people are willing to hold it even though it is not the most attractive store of value.

Liquidity – a measure of the ease an asset can be turned into a means of payment.

Money loses its store of value during inflation.

Measuring money

What assets are to be called money?

- Monetary aggregates (M1 and M2) are constructed using the concept of liquidity:

M1 is the narrowest definition of money and is most liquid.

M1 = currency + traveler's checks + demand deposits + other checkable deposits.

M2 adds to M1 other assets that are not so liquid

M2 = M1 + small denomination time deposits (CDs) + savings deposits and money market deposit accounts + money market mutual fund shares.

Figure 1 Growth Rates of the M1 and M2 Aggregates, 1960–2011

