

# **MONEY AND BANKING**

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# Chapter 1

## Why Study Money, Banking, and Financial Markets?



# Chapter 1 outline

- 1. Why Study Financial Markets?**
- 2. Why Study Financial Institutions and Banking?**
- 3. Why Study Money and Monetary Policy?**
- 4. Why Study International Finance?**



# 1. Why Study Financial Markets?

**If the central bank has raised the interest rate:**

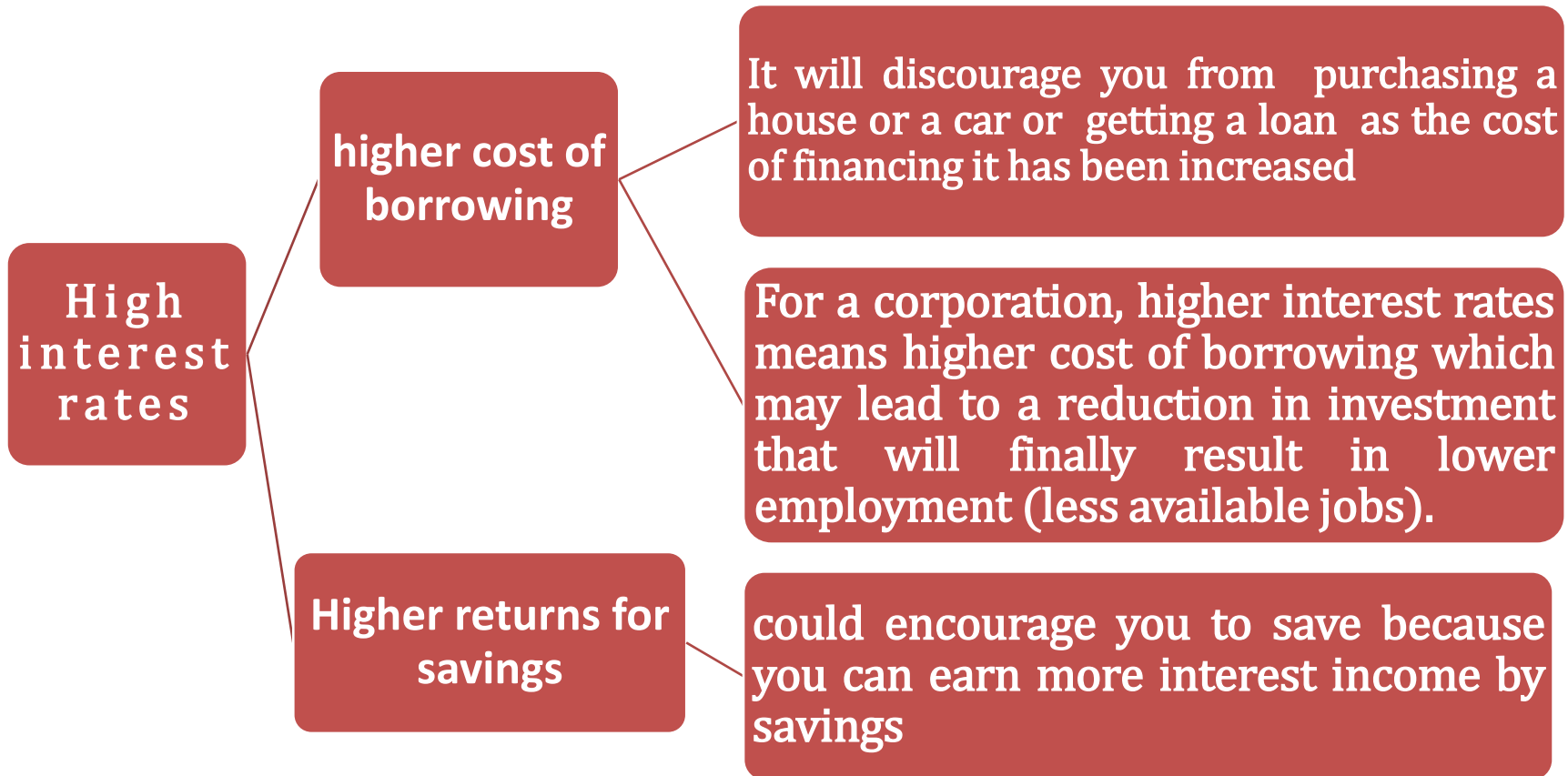
1. What effect might this have on the interest rate of a loan you plan to get?
2. Does it mean that a house will be more or less affordable in the future?
3. Will it make it easier or harder for you to get a job next year?
4. How this will affect your savings?

This course provides answers to these and other questions by examining how financial institutions (banks, insurance companies, and other institutions) work and by exploring the role of money in the economy.



# 1. Why Study Financial Markets?

- **An interest rate** is the cost of borrowing or the price paid for the rental of funds (**i.e., the price of money**)



# 1. Why Study Financial Markets?

**Financial markets (FM):** 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 (shortage).

- They promote greater economic efficiency

- **Financial markets:**

bonds, stocks, and foreign exchange



# 1. Why Study Financial Markets?

## Bonds Market

- **A bond** is a debt security that promises to make payments regularly for a specified (usually long) period of time.
- **Treasury bill** is a debt security that promises to make payments regularly for a specified short period of time

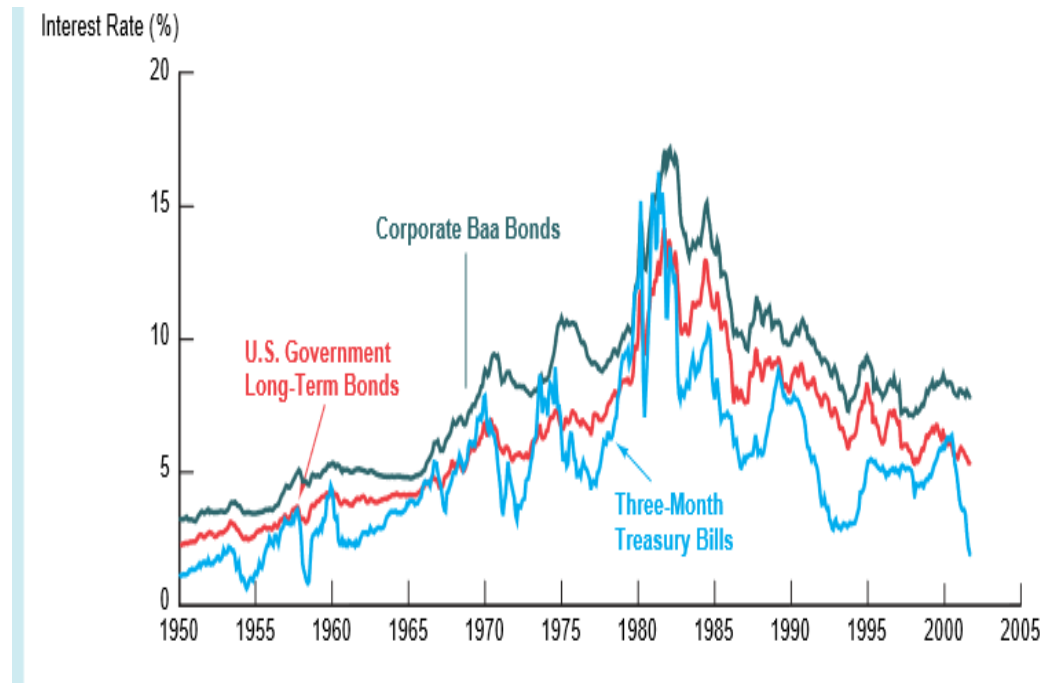


FIGURE 1 Interest Rates on Selected Bonds, 1950-2002



# 1. Why Study Financial Markets?

## Stock Market

- **stock** represents a share of ownership in a corporation.
  - ✓ It is a way for corporations to raise funds to finance their activities.
  - ✓ it has direct effects on personal wealth.
  - ✓ The stock market is a main factor in business investment decisions.
  - ✓ stock prices are very volatile (fluctuating)

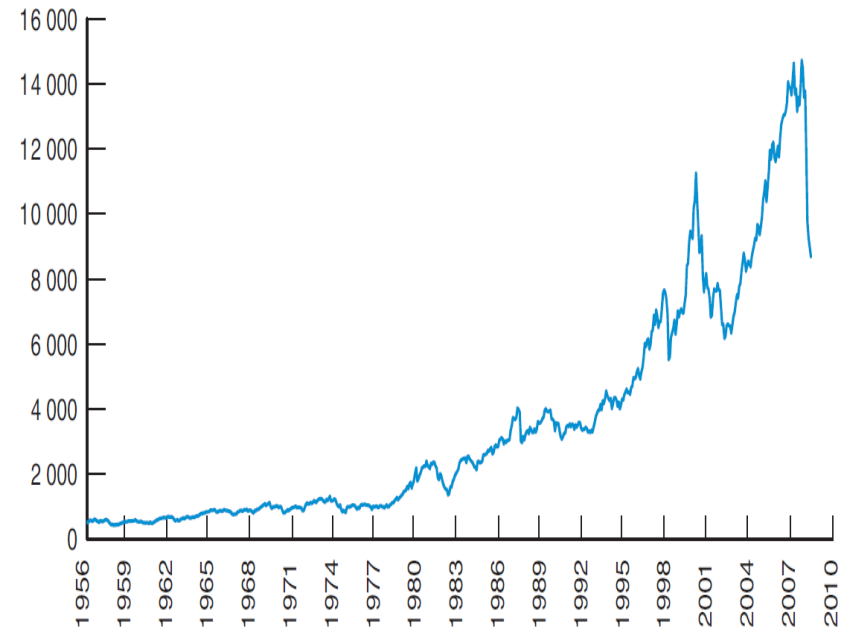


FIGURE 1-2 Stock Prices as Measured by the S&P/TSX Composite Index, 1956–2009

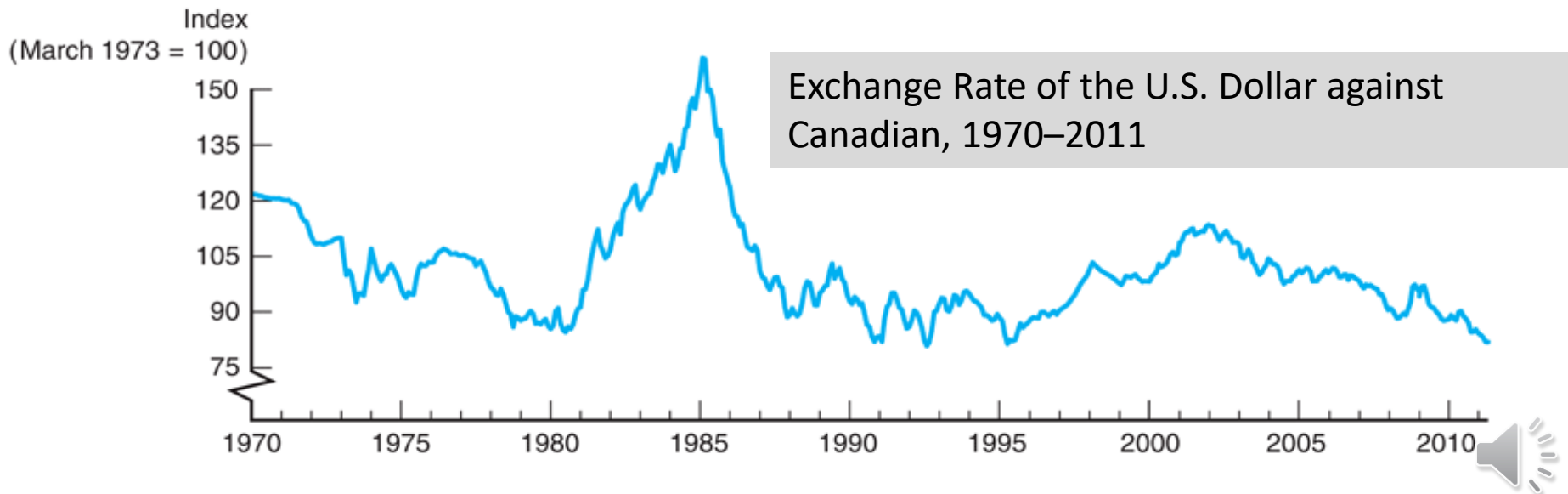




# 1. Why Study Financial Markets?

## Foreign Exchange Market

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



## 2. Why Study Financial Institutions and Banking?

- ❑ Banks and other financial institutions are what make financial markets work.
- **Financial Intermediaries:** institutions that borrow funds from people who have saved and make loans to other people or corporations:
  - Banks: accept deposits and make loans
  - Other Financial Institutions
  - insurance companies, finance companies, pension funds, mutual funds and investment companies
- **Financial Innovation:** the development of new financial products and services (e.g., holding debit cards instead of cash, using internet banking to transfer money (**e-finance**)).



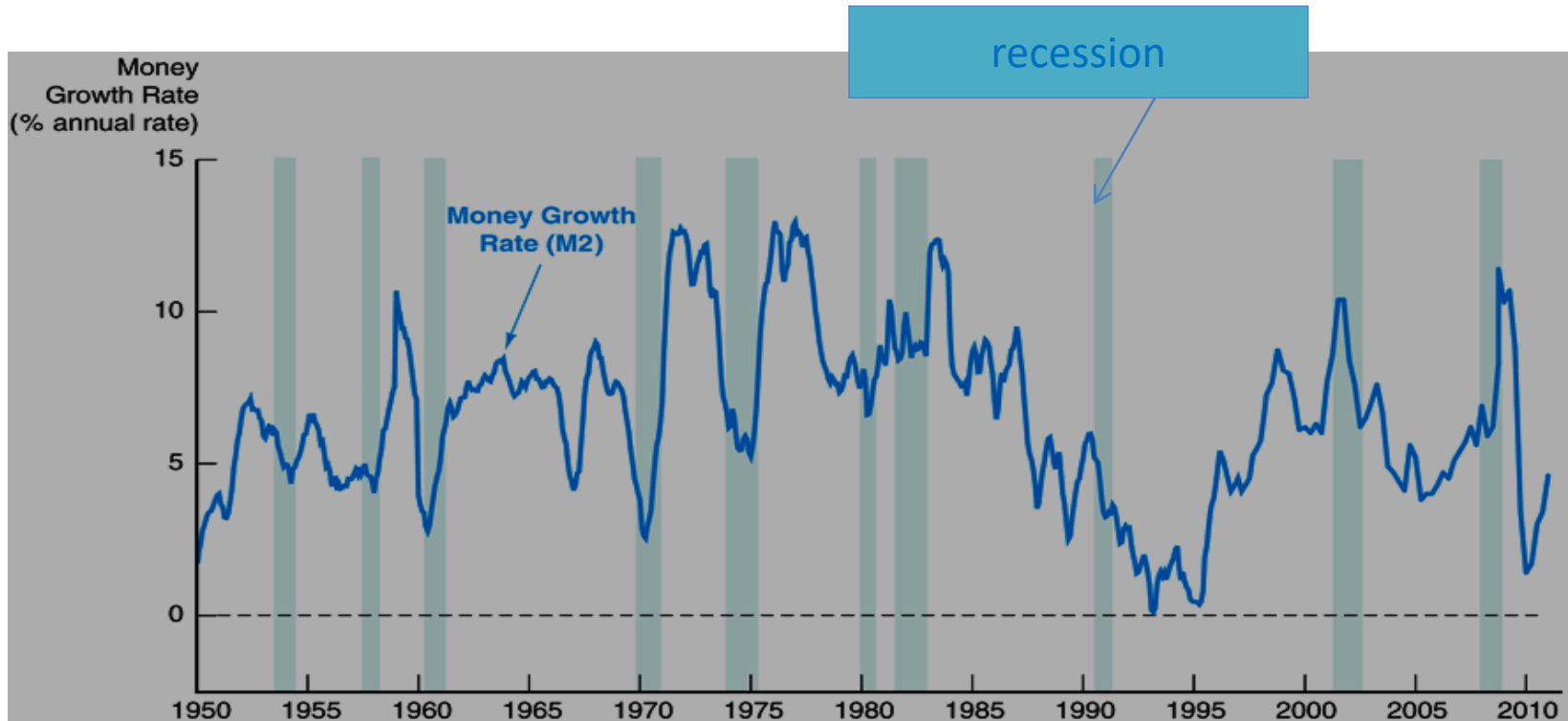
## 2. Why Study Financial Institutions and Banking?

- **Financial crises**: are major disturbances in financial markets that are characterized by sharp declines in asset prices and failures of many financial and nonfinancial firms.
- The **most recent financial crises** in the USA started in August of 2007, which is the **worst financial disruption since the Great Depression** when defaults in subprime residential mortgages led to major losses in financial institutions, producing a numerous bank failures.

# 3. Why Study Money and Monetary Policy?

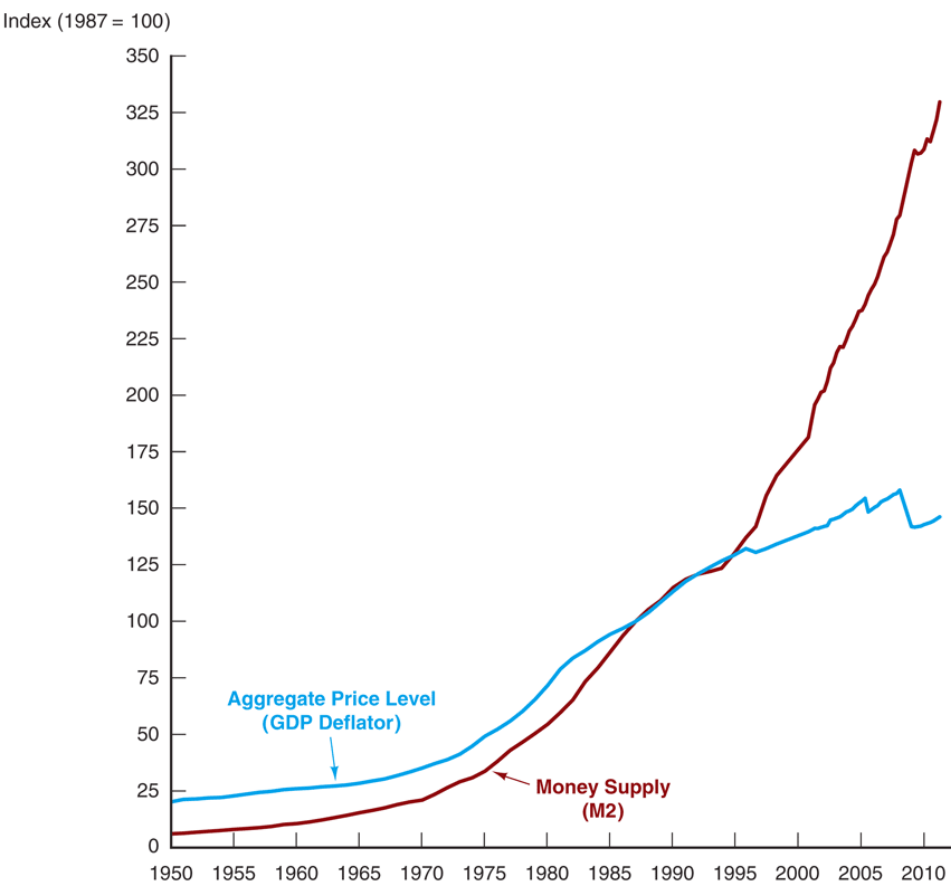
- **Money** is anything that is generally accepted for payments of goods and services or in the repayment of debts.
- Evidence suggests that money plays an important role in generating **business cycles**
- **Business cycles:** the upward and downward movement of aggregate output produced in the economy.
- Business cycle affects us in immediate and important ways. When output is rising (expansions), it is easier to find a good job; when output is falling (Recessions) , finding a good job might be difficult
- **Monetary Theory** ties changes in the money supply to changes in aggregate economic activity and the price level

Figure 3 Money Growth (M2 Annual Rate) and the Business Cycle in the United States 1950–2011



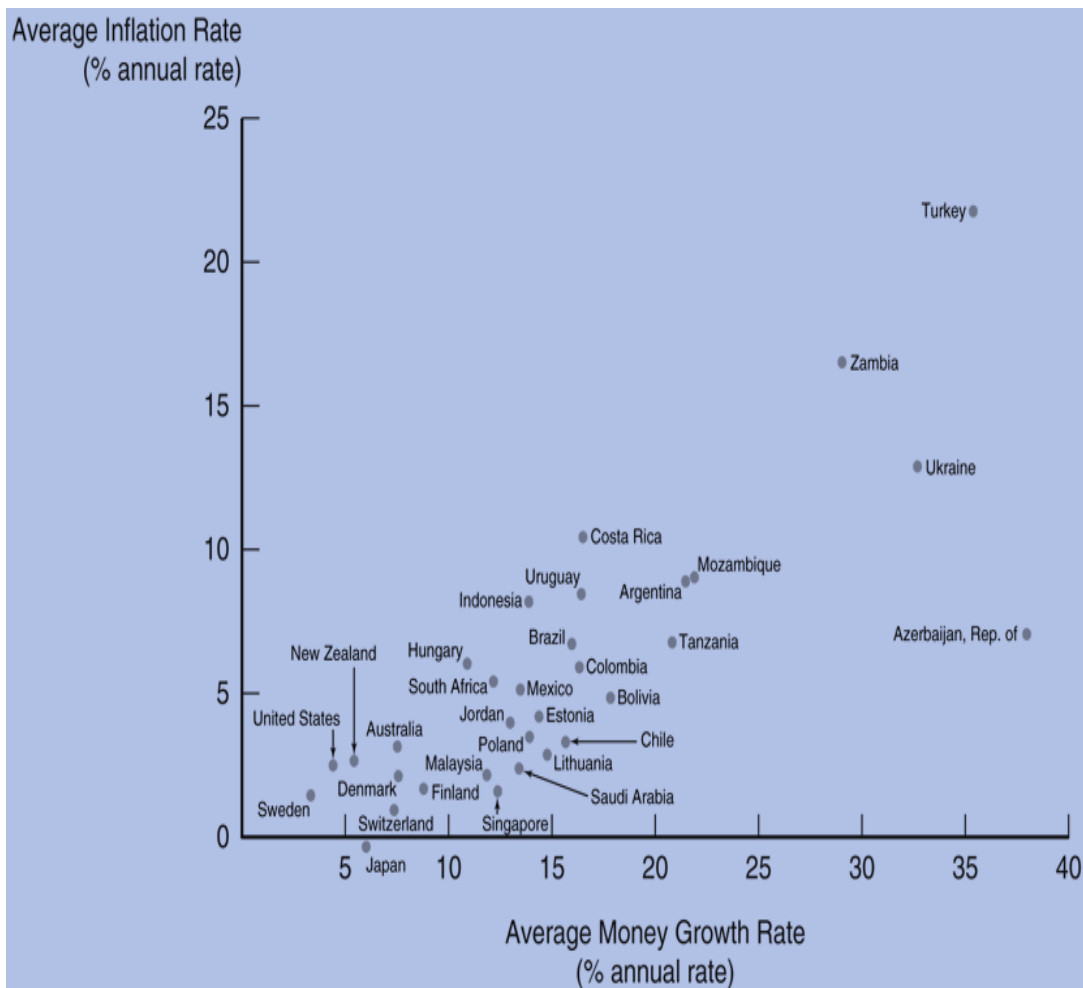
- **Recessions:** are periods of declining aggregate output.
- Every recession follows a decline in the rate of money growth, indicating that changes in money might be a driving force behind business cycle fluctuations

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



- **Aggregate price level (or price level)**: is the average price of goods and services in an economy
- **Inflation**: a continual increase in the price level that affects individuals, businesses, and the government.
- Inflation is generally regarded as an important problem to be solved and is often at the top of political and policymaking agendas.

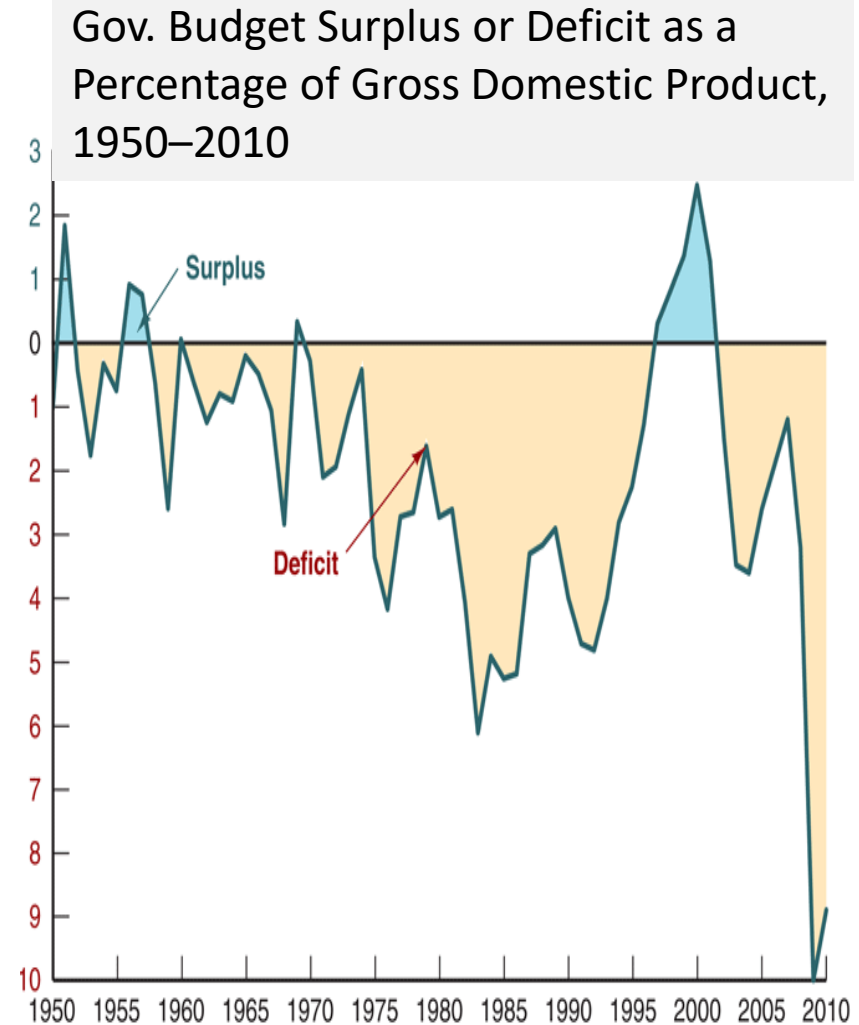
Figure 5 Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 2000-2010



- There is a positive association between inflation and the growth rate of the money supply.
- The countries with the highest inflation rates are also the ones with the highest money growth rates (e.g., Turkey, Zambia and Ukraine).
- Sweden and the USA had low inflation rates over the same period, and their rates of money growth have been low.

# Fiscal Policy and Monetary Policy

- **Monetary policy** is the management of the money supply and interest rates
  - Conducted in the U.S. by the Federal Reserve System (Fed) and in other countries by central banks.
- **Fiscal policy** deals with 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





## 4. Why Study International Finance?

- The globalization of financial markets has accelerated at a rapid pace in recent years.
- Financial markets have become increasingly integrated throughout the world.
- Local companies often borrowing in foreign financial markets and foreign companies borrowing in the local financial market.
- Banks and other financial institutions have become increasingly international and often have operations in many countries throughout the world