LECTURE 2:

WHERE THE MONEY GOES

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1. What is GDP?

GDP (Gross Domestic Product) is the total monetary value of all final goods and services produced within an economy during one year.

- **Final goods and services** = products sold for final use (not intermediate goods used to make other products).
- **Why it matters:** GDP measures the size of an economy and its annual production — a key flow variable.

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2. Double-Counting Phenomenon

When money moves through many intermediaries (banks, brokers, firms), the financial system can *appear* much larger than the real economy.

- **Double counting** happens when the same economic value is recorded multiple times as it passes through the system (e.g., a deposit becomes a loan becomes a deposit again).
- **Result:** multiple financial claims (debts and assets) can be created from the same original value, inflating measures of financial activity even though underlying real value has not increased.
- **Important note:** Ultimately, money finances **real assets** (property, factories, ideas) — financial claims derive value from those real assets.

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3. Stock vs Flow Variables

- **Stock variables** measure how much of something exists at a specific point in time.
  - *Example:* Wealth = the value of all assets you own *now*.
- **Flow variables** measure quantities over a period of time (per month, per year).

    - *Example:* Income = money you earn per month or year; GDP is a flow for the economy.

How they interact:

1. **Flows add to stocks.** Saving (a flow) increases wealth (a stock).
2. **Stocks generate flows.** Owning a factory (stock) produces output and revenue (flow).

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4. Retained Profits and Internal Financing

- **Retained profits (retained earnings):** profits a company keeps instead of distributing as dividends.
- **Internal financing:** using retained profits to pay for new investments (buy equipment, expand production) rather than borrowing or issuing equity.
    - **Benefit:** reduces reliance on external financing and interest payments.
    - **Limit:** limited by how much profit the firm actually earns.

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5. Two Main Types of Businesses

1. **Financial businesses**
    - Their core activities are borrowing, lending, trading, and managing money (banks, credit-card firms, broker-dealers, asset managers).
    - They hold many financial assets, but much of those assets are funded by liabilities (deposits, borrowing). The net value (after repaying obligations) and earned interest margins become their profits.
2. **Non-financial businesses**
    - Produce and sell goods or provide non-financial services (manufacturers, retailers, law firms).
    - They use finance mainly to fund production and growth (loans, retained earnings).

Key idea about financial firms:

- Financial firms operate largely on *intermediated* money — they borrow from some parties (deposits, wholesale funding) and lend or invest to others. The assets they hold are often not accumulated savings but instruments created or borrowed from elsewhere; their profit comes from the spread between what they pay and what they earn. After covering liabilities, remaining value (and retained profits) is a real/financial claim they keep.

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6. Short clarifications & examples

- **GDP** is a *flow* (annual production). **Wealth** is a *stock* (snapshot at a moment).
- **Double counting example:** a manufacturer sells to a wholesaler, who sells to a retailer — if we mistakenly sum every sale as final output we will overstate GDP; GDP counts only final sales. In finance, the same dollar redeposited and reloaned can create multiple claims.
- **Internal financing example:** a small firm reinvests profits to buy a new machine rather than taking a bank loan.

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7. Key takeaways

- GDP measures the economy's production over time (flow); wealth measures accumulated assets (stock).
- Money can appear to multiply inside the financial system because financial claims are created as money passes through intermediaries — but real economy value is tied to real assets.
- Stocks and flows interact: flows build stocks, and stocks produce flows.
- Firms can fund growth internally (retained earnings) or externally (debt, equity); financial firms primarily intermediate others' funds and generate profits from financial spreads.

8. Additional Notes