ECONOMICS OF MONEY, BANKING AND FINANCIAL MARKETS

Prepared by

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THE TEXT BOOK

Economics of Money, Banking and Financial Markets

Written by

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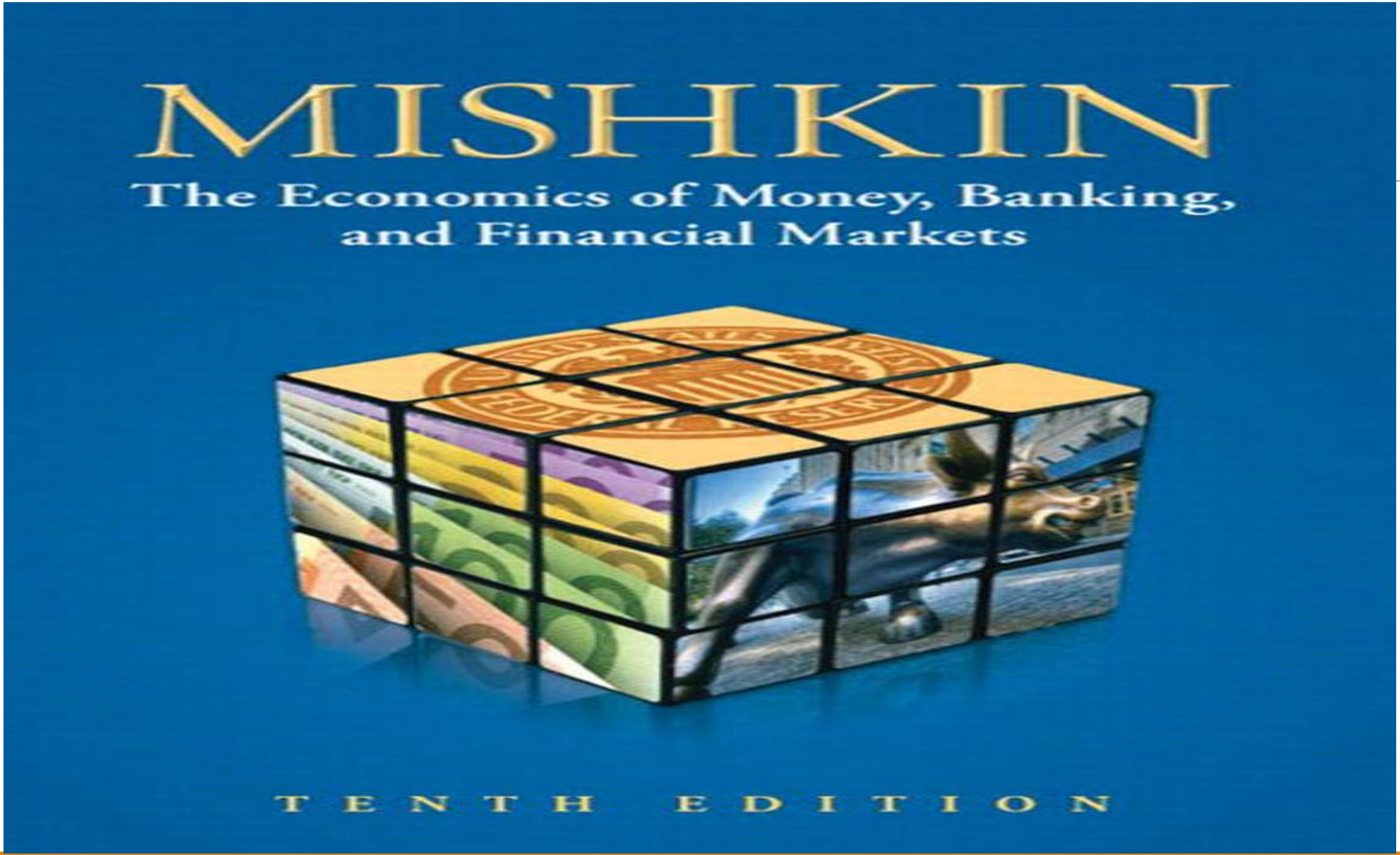

MISHKIN
The Economics of Money, Banking, and Financial Markets
TENTH EDITION

Chapter 1: Why Study Money, Banking, and Financial Markets?

Why Study Financial Markets?

- Financial markets are places for the transfer of funds from individuals or entities with surplus funds to those with a deficit.
- Financial markets such as bond and stock markets are crucial to promoting greater economic efficiency by channeling funds from people who do not have a productive use for them to those who do.

Chapter 1: Why Study Money, Banking, and Financial Markets?

- **Financial markets are markets in which funds are transferred from individuals or firms with surplus funds to those with a deficit. (stock markets and bond markets)**
- **Financial markets such as stock markets and bond markets are crucial to promoting greater economic efficiency by channeling funds from people who do not have a productive use for them to those who do.**

Chapter 1: Why Study Money, Banking, and Financial Markets?

Well-functioning financial markets are a key factor in producing high economic growth, and poorly performing financial markets are one reason that many countries in the world remain desperately poor.

Activities in financial markets also have direct effects on personal wealth, the behavior of businesses and consumers, and the cyclical performance of the economy.

Summary:

- **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. (stock markets and bond markets).**
- **By allocating financial resources more efficiently, financial markets contributes to promote economic efficiency.**

Chapter 1: Why Study Money, Banking, and Financial Markets?

- **A well-functioning financial markets are key for high economic growth.**
- **Activities in financial markets have direct effects on personal wealth, business and consumer behavior, and the cyclical behavior of the economy.**

Chapter 1: Why Study Money, Banking, and Financial Markets?

- **The stock market is a market for buying and selling stocks and bonds. When persons own stocks(called Stockholders), they receive a return called profit. Also, when persons own bonds (called bondholders), they receive a return called interest.**

The Bond Market and Interest Rates:

- **An assets is a financial claim or piece of property that is subject to ownership.**
- A **security (or financial instrument) is a claim on the issuer's future income or assets (it includes bonds and stocks). Because the maturity date of the bond is in the future.**

- **A bond is a debt security that promised to make payments for a specified period.**
- **An interest rate is the cost of borrowing, or the price paid for the rental of funds.**
- **A stock (or common stock) represents a share of ownership in a corporation. It is a claim on the earnings (profit) and the assets of the corporation.**

❑ Why Study Financial Institutions and Banking?

- Banks and other financial institutions are what make financial markets work. Without them, financial markets would not be able to move funds from people who save to people who have productive investment. Thus, they play a crucial role in the economy.

- **Financial Intermediaries**: institutions that borrow funds from people who have saved and make loans to other people:

- **Banks**: accept deposits and make loans.

- Banks are intermediaries because they accept deposits and make loans.

- Other Financial Institutions: **insurance companies**, finance companies, **pension funds** and investment companies.

- **Financial Innovation: the development of new financial products and services.**

- **Can be an important force for good by making the financial system more efficient.**

- **Financial Crisis: major disruptions in financial markets that are characterized by sharp declines in asset prices and the failures of many financial and nonfinancial firms.**

Chapter 1: Why Study Money, Banking, and Financial Markets?

❑ Why Study Money and Monetary policy?

Money, also referred to as the money supply, is defined as <u>anything that is generally accepted in payment for goods or services or in the repayment of debts</u>. Money is linked to changes in economic variables that affect all of us and are important to the health of the economy.

Money and Business Cycles:

- **Evidence suggests that money plays an important role in generating business cycles.**

- **Monetary Theory ties changes in the money supply to changes in aggregate economic activity and the price level.**

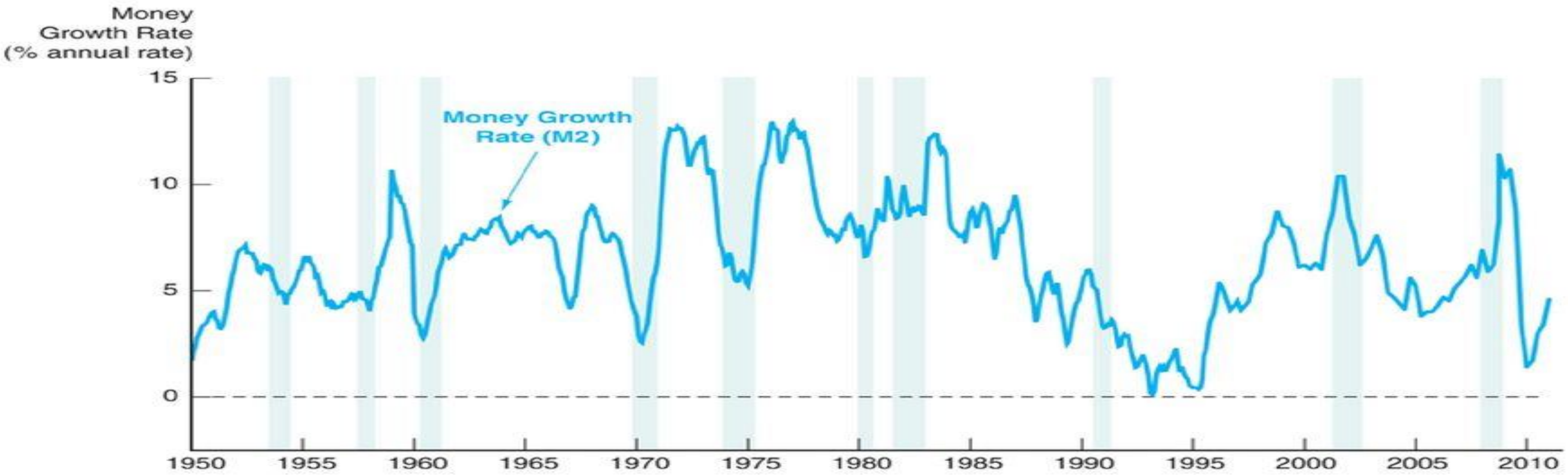
Chapter 1: Why Study Money, Banking, and Financial Markets?

- **Business cycles are the upward and downward movements of aggregate output produced in the economy.**

- **Business cycles affect all of us in important ways. When output is rising, for example, it is easier to find a good job; when output is falling, finding a good job might be difficult.**

Figure 3 shows the movements of the rate of money growth over the 1950–2011 period, with the shaded areas representing recessions, periods of declining aggregate output. What we see is that the rate of money growth has declined before every recession, indicating that changes in money might be a driving force behind business cycle fluctuations. However, not every decline in the rate of money growth is followed by a recession.

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



Source: Based on Federal Reserve Bulletin, p. A4, Table 1.10; www.federalreserve.gov/releases/h6/hist/h6hist1.txt.

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figure 3: Money Growth (M2 Annual Rate) and the Business Cycle in the United States, 1950–2011 Although money growth has declined before every recession, not every decline in the rate of money growth is followed by a recession. Shaded areas represent recessions. There are several other factors that can contribute to recessions, such as asset price bubbles, financial crises, and shocks to the economy from outside events (e.g., wars, pandemics).

Chapter 1: Why Study Money, Banking, and Financial Markets?

- **We explore how money and monetary policy might affect aggregate output in Chapters 19 through 25 in Part 6 of this book, where we study monetary theory, the theory that relates the quantity of money and monetary policy to changes in aggregate economic activity and inflation.**

Money and Inflation

Money and inflation are closely linked concepts in economics. Inflation refers to the general increase in prices of goods and services over time, resulting in a decrease in the purchasing power of money. In other words, as inflation occurs, each unit of currency buys fewer goods and services. Central banks monitor and adjust monetary policy to control inflation and maintain price stability, as moderate inflation is often considered healthier for economic growth than deflation or hyperinflation.

- **As shown in Figure 4, which illustrates the movement of average prices in the U.S. economy from 1950 to 2011. The average price of goods and services in an economy is called the aggregate price level, or, more simply, the price level. Inflation, a continual increase in the price level, affects individuals, businesses, and the government. It is generally regarded as an important problem to be solved. To solve the inflation problem, we need to know something about its causes.**

- **What explains inflation?** **One evidence to answering this question is found in Figure 4. which plots the money supply and the price level. As we can see, the price level and the money supply generally rise together. These data seem to indicate that a continuing increase in the money supply might be an important factor in causing the continuing increase in the price level that we call inflation.**

As you can see, a positive association exists between inflation and the growth rate of the money supply.

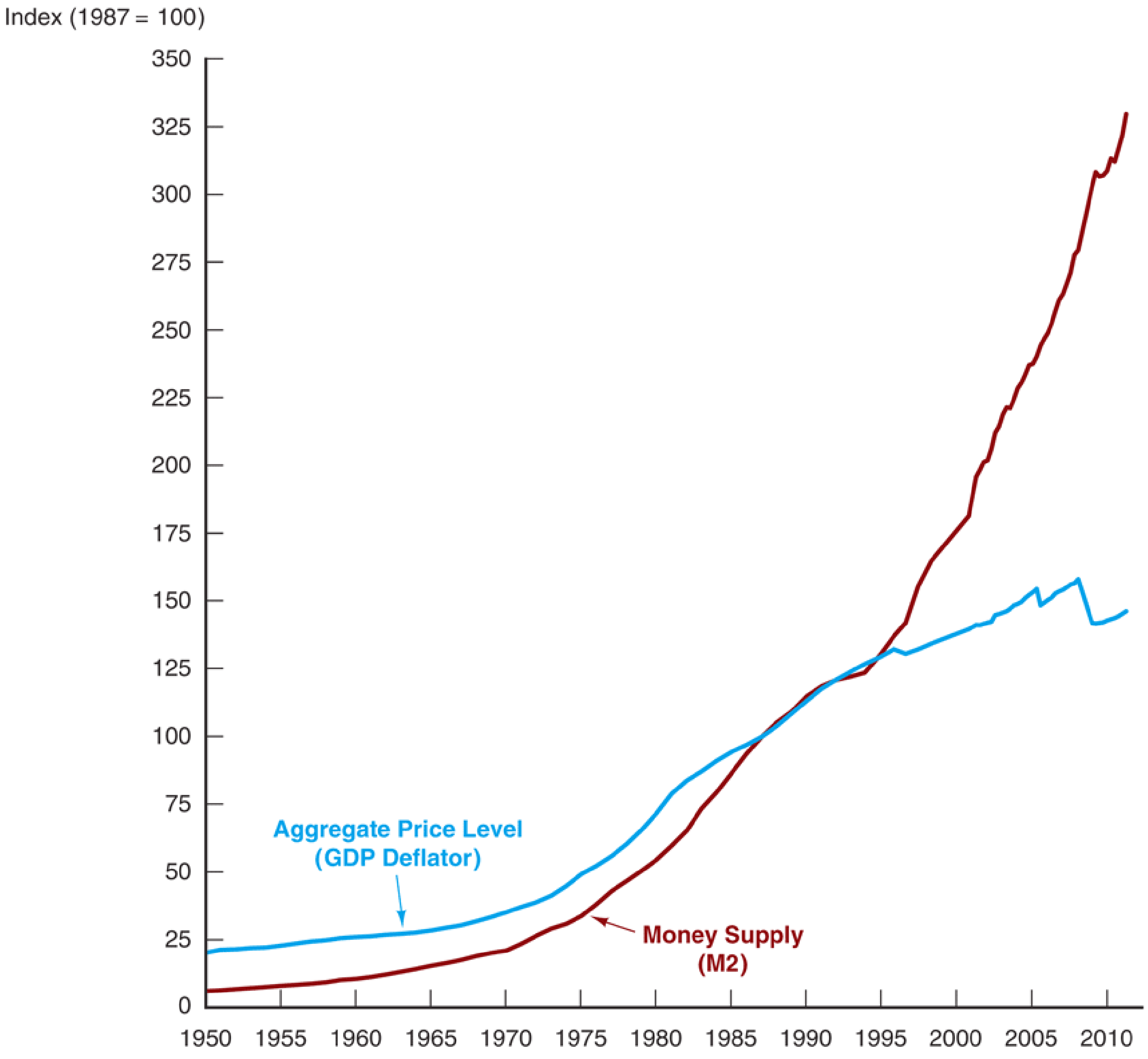


Figure 4 Aggregate Price Level and the Money Supply in the United States, 1950–2011.

Money and Interest rate:

- **Interest rates are the price of money.**

(Suppose you deposited $1,000 and the interest rate was 10%, the return would be 100)

- **Money and interest rates are closely interconnected in the world of finance and economics. The relationship between money and interest rates is related to the supply and demand for money in the financial system.**

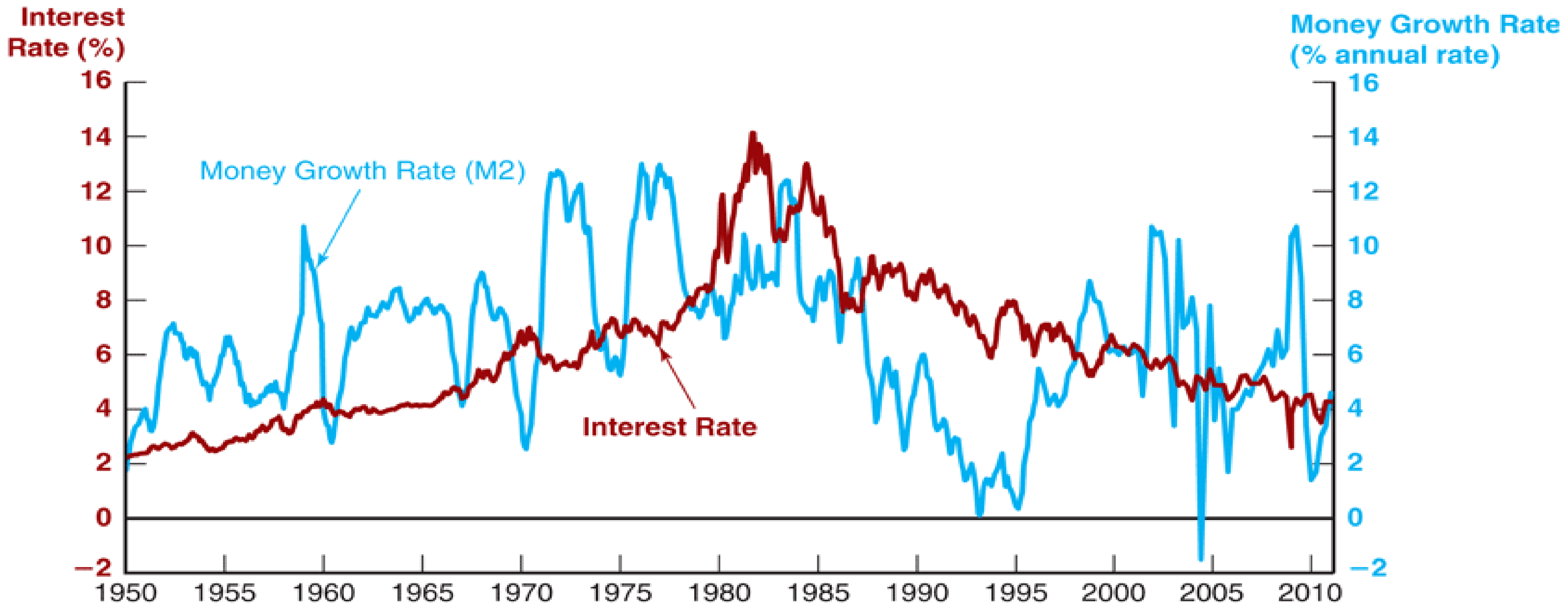
- **An increase in the money supply leads to more money being available in the financial system. As a result, banks have excess reserves, which they can lend out to individuals and businesses.**

Chapter 1: Why Study Money, Banking, and Financial Markets?

- **When the money supply increases, and banks have more funds to lend, the competition among borrowers for loans leads to a decrease in interest rates. Lower interest rates make borrowing more attractive and stimulate spending and investment.**

$\uparrow$ money supply $\longrightarrow$ $\downarrow$ interest rates $\longrightarrow$ $\uparrow$ Lending and borrowing $\longrightarrow$ $\uparrow$ spending and investment.

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



Conduct of Monetary Policy:

Monetary policy is the management of the money supply and interest rates. Monetary policy is conducted by the central bank.

- **we study how central banks like the Federal Reserve System can affect the quantity of money and interest rates in the economy.**

Fiscal Policy and Monetary Policy:

- **Fiscal policy** involves decisions about **government spending** and **taxation**. A **budget deficit** is the excess of government expenditures over tax revenues for a particular time period, typically a year, while a **budget surplus** arises when tax revenues exceed government expenditures. The government must finance any deficit by borrowing, while a budget surplus leads to a lower government debt burden.

Summary:

- **Fiscal policy deals with government spending and taxation**

- **Budget deficit is the excess of expenditures over revenues for a particular year.**

  (Government spending > Government revenues)

- **Budget surplus is the excess of revenues over expenditures for a particular year.**

  (Government spending < Government revenues)

-Any deficit must be financed by borrowing (treasury bonds, national loans).

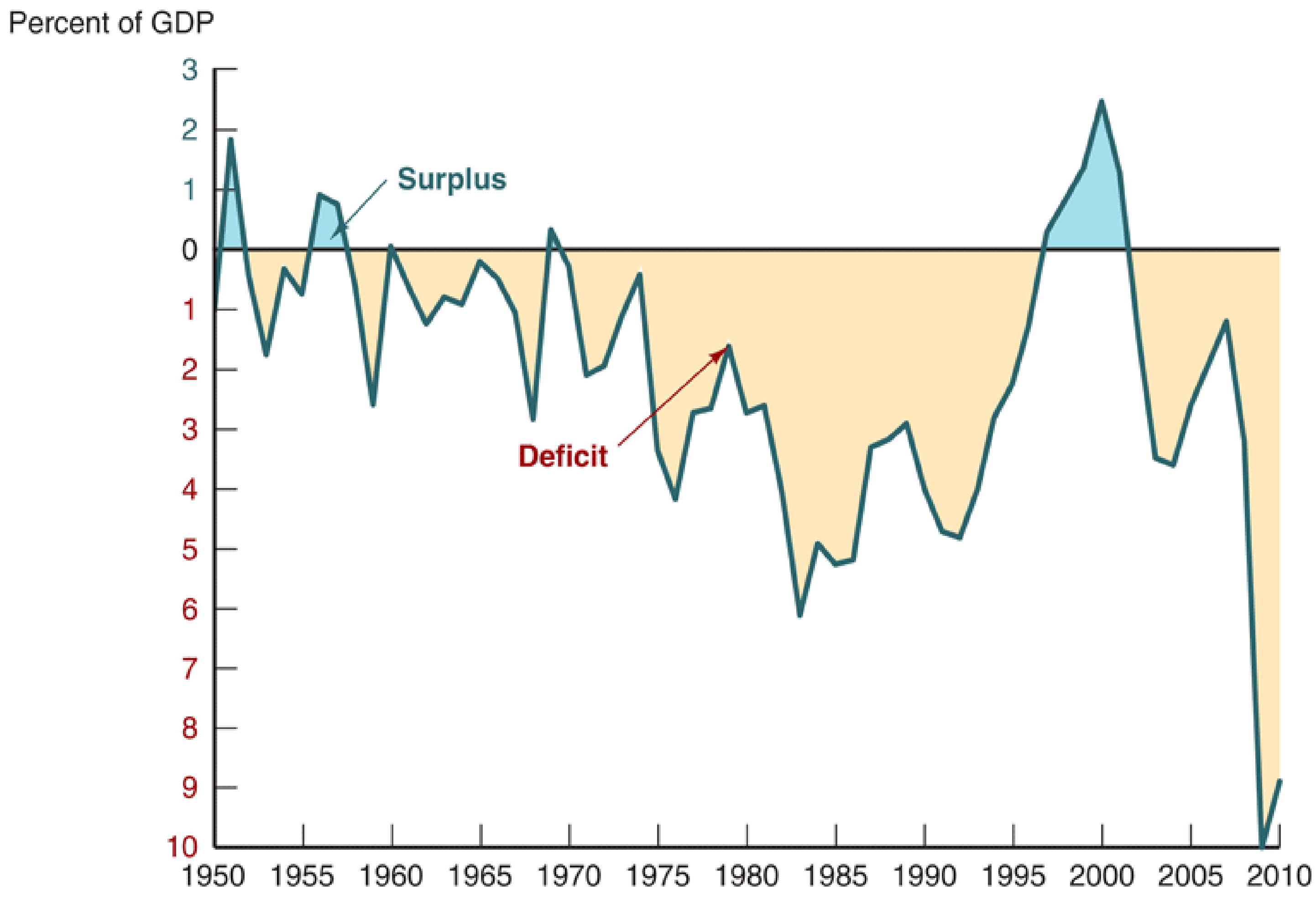


Figure 7 Government Budget Surplus or Deficit as a Percentage of Gross Domestic Product, 1950–2010

❑ 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**

THANKS