Introduction to Financial and Money Markets

Economics 301: Money and Banking

Goals and Learning Outcomes

- Goals:
  - Get an overview of money and financial markets.
  - Understand why it is important to study these markets.
- Learning Outcomes:
  - Just touch on LO1: Describe how financial markets affect the overall functioning of the economy.

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Reading

- Hubbard and O'Brien, Chapter 1.

Financial Markets

Financial Markets: markets in which funds are transferred from people or institutions that save to those who want to borrow.

Banking and financial institutions: These are what make financial markets work. These businesses make a profit by moving funds around the economy.

New York Stock Exchange

Market for Money

Market for Money: supply and demand framework for money.

Money: Something generally accepted as a means of payment, typically earning little to no interest.

Monetary Policy: actions by a country's central bank to control the money supply.

Assets

Asset: Anything of value that can be owned. That is anything that can be converted for a means of payment.

Security: *tradable* asset issued by an institution which is a claim on the institution's assets or future income.

Financial Intermediaries

Financial intermediary: A financial firm such as a bank which borrows money from savers and lends money to borrowers.

Most common source of financing for individuals and small businesses.

Financial Markets

Financial Markets: A market for businesses to obtain funds *directly from savers*.

Common for large, widely recognized businesses that can credibly communicate its profitability.

Primary markets: markets where stocks, bonds, or other securities are sold for the first time.

Secondary markets: markets where stocks, bonds, and other securities are traded.

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Bond Markets

- **Bond:** Debt security that promises to make payments periodically for a specified period of time.
- **Interest rate:** cost of issuing a bond, or income received from owning a bond. Typically expressed as a percentage of the bond price.
- Lots of different interest rates:
  - Consumer interest rates: mortgage rates, car loan rates, credit card rates, savings account rates, certificates of deposit rates etc.
  - Government bond rates: Treasury bill rate (Federal government debt), state and local government bonds.
  - Corporate bond rates.
  - Federal reserve rates: discount rate, federal funds rate.

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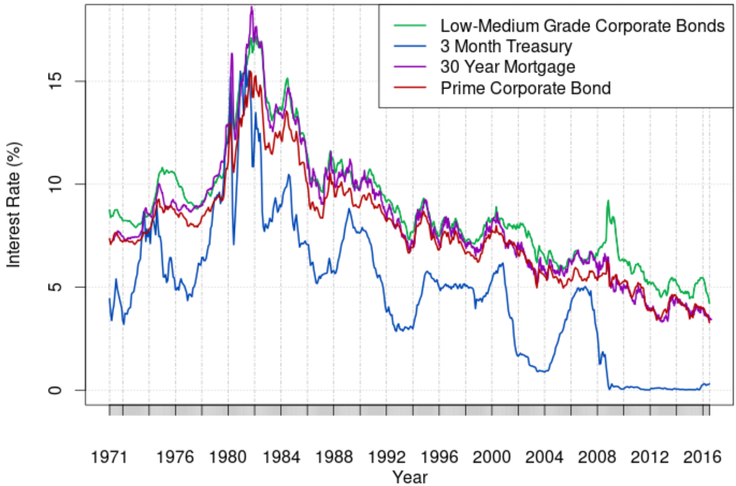
Interest Rates



Importance of Interest Rates

- Interest rates affect the macroeconomy through producers.
  - What do macroeconomists mean by the word, "investment."
  - An increase in interest rates causes firms to _______ their investment spending.
  - An increase in investment spending causes a(n) _______ in future production possibilities.
- Interest rates affect the macroeconomy through consumers.
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Stock Markets

- **Common Stock:** represents a share in ownership of a corporation.
- Security that is a claim on the earnings and assets of the corporation.
- Dividends: distribution of the corporations earnings to the shareholders.
- Capital gain (loss): money earned (lost) by selling a stock for more (less) than you originally purchased it for.
- Why should stock prices change?

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Profits of Firms

What do you expect to happen to profits of a firm if...

- you expect the Federal Reserve is going to soon raise interest rates?
- you expect new government mandated restrictions on the types of lending financial institutions can engage in?
- you expect consumers' incomes to increase in the near future?
- you expect the value of the dollar to decrease against the Euro and the firm sells a large amount of its output to European consumers?

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Foreign Exchange Markets

Foreign Exchange Market: market where funds from one country are exchanged for funds from another country.

Need another country's currency in order to...

- make a financial investment in that country, and
- purchase goods from that country.

Exchange Rate

- Price of one country's currency in terms of another country's currency.
- Many different currencies: dollar/euro, dollar/yen, dollar/pound, etc...
- Two ways to express exchange rate:
  - Exchange rate on 8/26/16: 1.12 USD / EUR
  - Exchange rate on 8/26/16: 0.893 EUR / USD
- If the USD / EUR exchange rate rises, is this a depreciation or appreciation of US Dollar? depreciation or appreciation of Euro?
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Monetary Markets

- The market for money is very closely linked to economic variables that influence the health of the economy.
- **Business Cycles:** upward and downward movement over time of measures of the health of the economy.
- Measures of health of macroeconomy:
  - **Aggregate output**, aka **aggregate production**, aka **real gross domestic product:** measure of the total amount of production of goods and services in an economy.
  - **Unemployment rate:** percentage of the *labor force* that is not employed.
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Origins of a Financial Crisis

- Housing market bubble: ever-rising house prices led banks/borrowers to expect:
  - borrowers to be able to pay off or refinance adjustable rate mortgages.
  - even sub-prime borrowers could sell their house and avoid default.
  - valuable collateral in event of a default.
- Securitization of mortgages.
  - MBS: mortgage-backed securities
  - CDOs: Collateralized debt obligations
  - These are good! They pool risk.
  - These are bad! They *hide* risk!

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Why Study Financial and Monetary Markets?

- Overall interest: Health of the macroeconomy.
- Poorly operating financial markets inhibit productive possibilities.
- Monetary market and financial market, related primarily though interest rates.
- Monetary policy can influence these markets, and may change outcomes production, unemployment, and inflation.

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Homework Assignment

- Due on Monday, September 12, 11:59 PM.
- Short answer questions: End of chapter 1 questions 1.10, 1.11, and 1.12, pages 21-22.
- Type your answers and upload it to the D2L dropbox labeled, "Homework 1: Intro to Financial System."