Introduction to Financial and Money Markets

Economics 301: Money and Banking

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1.1 Goals

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: Understand and appreciate the importance of financial markets for the overall functioning of the economy.

1.2 Reading

Reading

- Read Mishkin, chapter 1.
- For review of macroeconomic measurements, computations, look carefully at appendix to chapter 1.

2 Financial Markets

2.1 Types of Markets

Types of Markets

- **Financial Markets:** markets in which funds are transferred from those who have an excess of available funds (people or institutions that save) to those who have a shortage of funds (borrowers).
  - **Banking and financial institutions:** These are what make financial markets work. These businesses make a profit by moving funds around the economy.

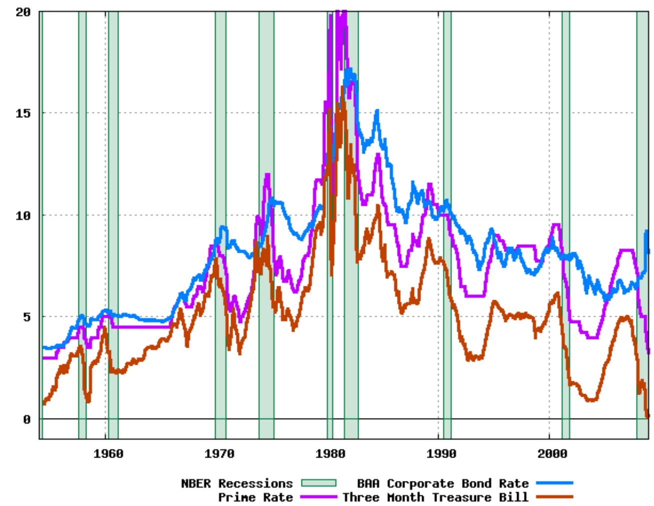
- **Monetary Markets:** market for money.
  - **Money:** anything that can be used as a means of payment.
  - Typically, if something is money, it earns little to no interest.
  - **Monetary Policy:** actions by a country's central bank to control the money supply.
- **Asset:** Anything of value that can be owned. That is anything that can be converted for a means of payment.
- **Security:** issued by an institution; claim on the institutions assets or future income.

2.2 Bond Markets and Interest Rates

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.

Interest Rates



Importance of Interest Rates

- Although there are many interest rates, they often move together.
- Interest rates affect the macroeconomy through producers:
  - Increase in interest rates cause firms to _______ investment (purchases of capital equipment).
  - This causes production possibilities *in the future* to _______.
- Interest rates affect the macroeconomy through consumers:
  - Increase in interest rates causes consumers to _______ consumption (purchases of final goods).
  - Increase in interest rates causes consumers to _______ saving.

2.3 Stock Markets

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?

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?

2.4 Foreign Exchange Markets

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.
  - purchase final goods from that country.
  - purchase intermediate goods from that country.
- In order for an American to convert dollars to Euros, she/he must be able to find someone who wants to convert Euros to dollars.

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 1/25/10: 1.4139 \$/€.
  - Exchange rate on 1/25/10: 0.7073 €/\$.
- If the \$/€ exchange rate rises, is this a depreciation or appreciation of US Dollar? depreciation or appreciation of Euro?
- If the €/\$ exchange rate rises, is this a depreciation or appreciation of US Dollar? depreciation or appreciation of Euro?

3 Monetary Markets

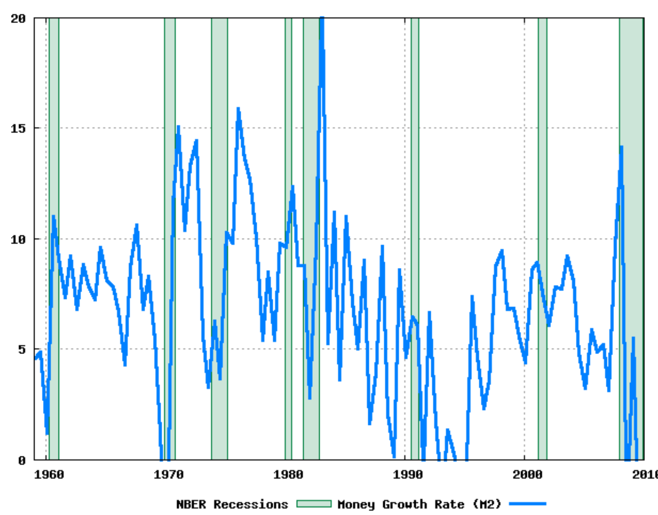
3.1 Macroeconomy

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.
  - **Recession:** period of declining *macroeconomic activity.*

3.2 Money Growth

Money Growth

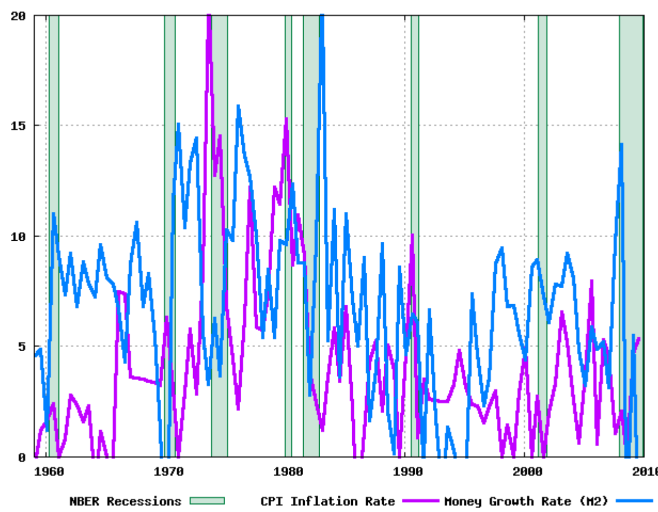


- Generally, there is a decrease in growth rate of money preceding recessions.

3.3 Inflation

- **Price level:** measure of the overall level of prices in the economy.
  - Consumer Price Index: price of a "basket of goods", scaled to equal 100 in base year.
  - GDP Deflator: ratio of nominal GDP to real GDP, scaled to equal 100 in base year.
- **Inflation:** growth rate of price level.
- In long run, money growth rate tends to equal inflation rate.
- In short run though, there can be big fluctuations.

Inflation and Money Growth



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4 Why Study Financial and Monetary Markets?

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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5.1 Up Next...

Up Next...

- Chapter 2: Overview on Financial System.
- MyEconLab homework due Wednesday, Feb 3.