Introduction to Financial and Money Markets

Economics 301: Money and Banking

1

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 Hubbard and O'Brien, 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; *tradable* claim on the institutions assets or future income.

2.2 Financial Markets vs. Intermediaries

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

  - Examples of financing include selling stocks and bonds.
  - Common for large (nationally or internationally recognized) businesses that can credibly communicate the profitability of the firm.
  - **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.

2.3 Bond Markets and Interest Rates

Bond Markets

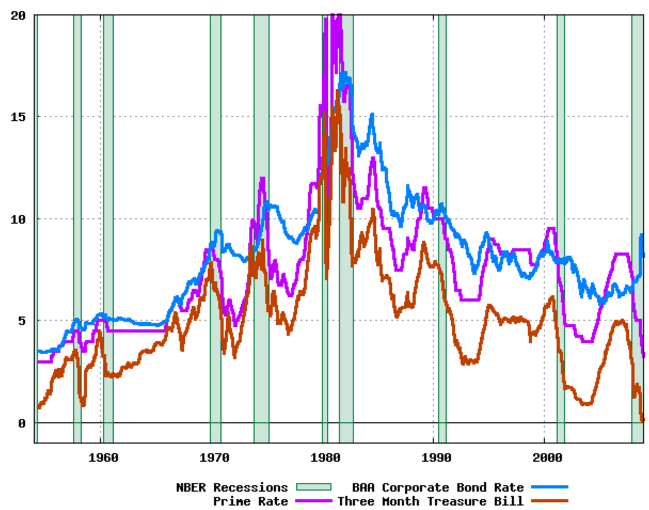
- **Bond:** Debt security that promises to make payments periodically for a specified period of time.

- **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

- 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.
  - What impact does an increase in interest rates have on consumers?

2.4 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?

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

3 Monetary Markets

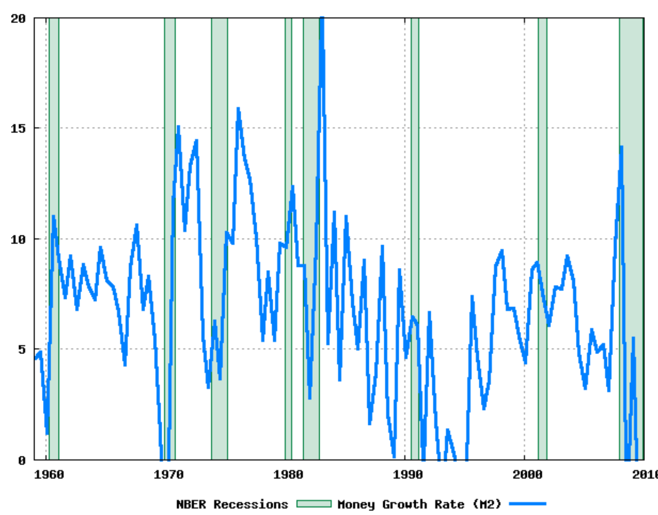
3.1 Macroeconomy

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



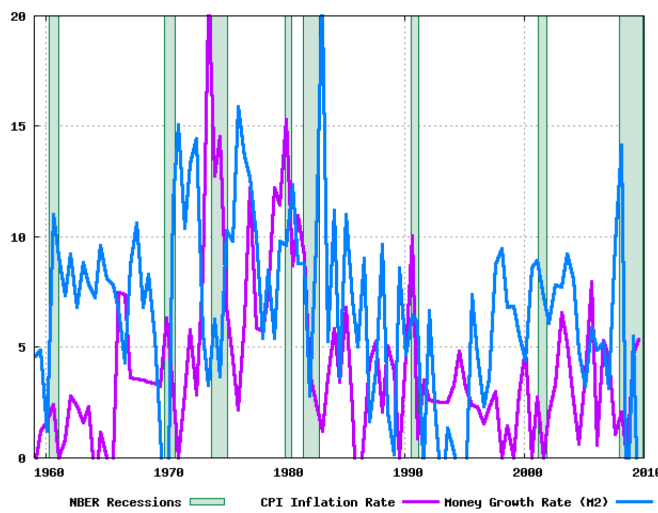
- Generally, there is a decrease in growth rate of money preceding recessions.

3.3 Inflation

Price Level and 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?

4.1 Origins of a Financial Crisis

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!

4.2 General Motivation

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.

4.3 Homework Assignment

Homework Assignment

- Due on Monday, February 3.
- Short answer questions: End of chapter 1 questions 1.10, 1.12, 1.13, and 1.14, page 23.
- Type your answers and upload it to the D2L dropbox labeled, "Homework 1: Intro to Financial System."