

Chapter 1

Why Study Money, Banking, and Financial Markets?

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Why Study Money, Banking, and Financial Markets

- To examine how financial markets such as bond, stock and foreign exchange markets work
- To examine how financial institutions such as banks and insurance companies work
- To examine the role of money in the economy



Financial Markets

- Markets in which funds are transferred from people who have an excess of available funds to people who have a shortage of funds



The Bond Market and Interest Rates

- A security (financial instrument) is a claim on the issuer's future income or assets
- A bond is a debt security that promises to make payments periodically for a specified period of time
- An interest rate is the cost of borrowing or the price paid for the rental of funds

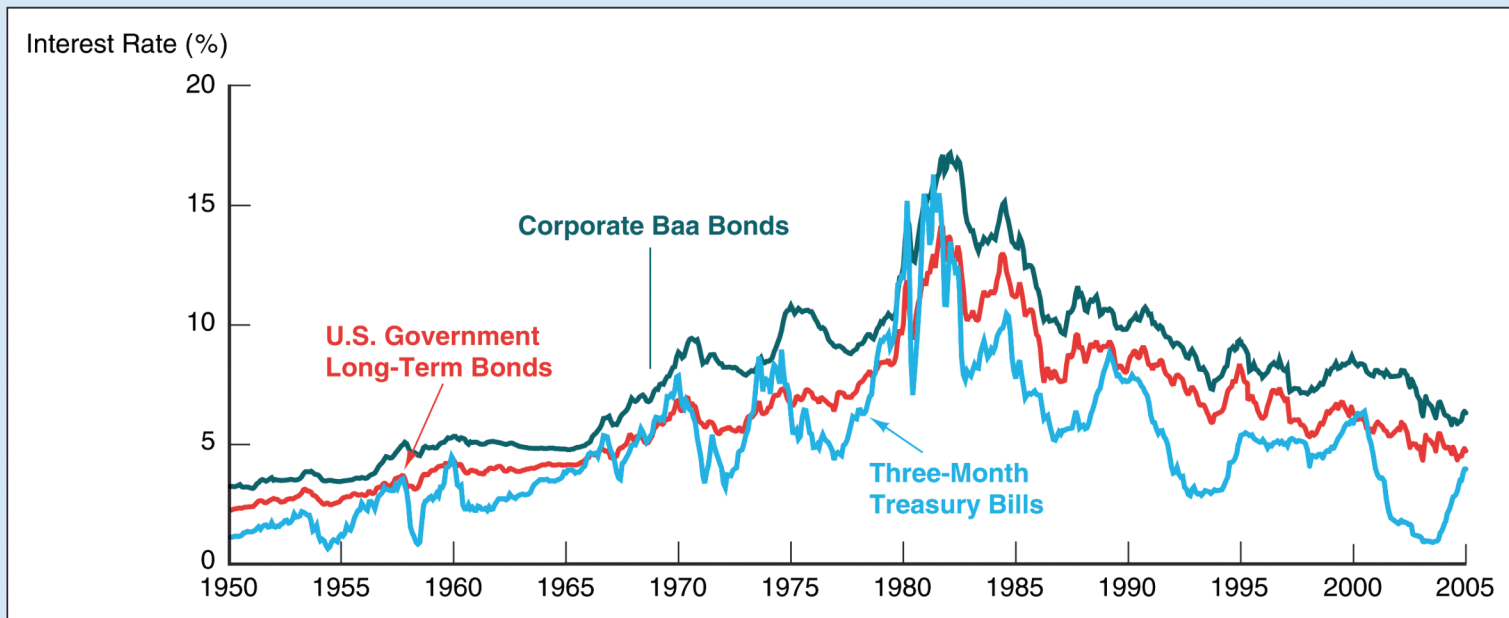


FIGURE 1 Interest Rates on Selected Bonds, 1950–2005

Sources: Federal Reserve *Bulletin*; www.federalreserve.gov/releases/H15/data.htm.



The Stock Market

- Common stock represents a share of ownership in a corporation
- A share of stock is a claim on the earnings and assets of the corporation

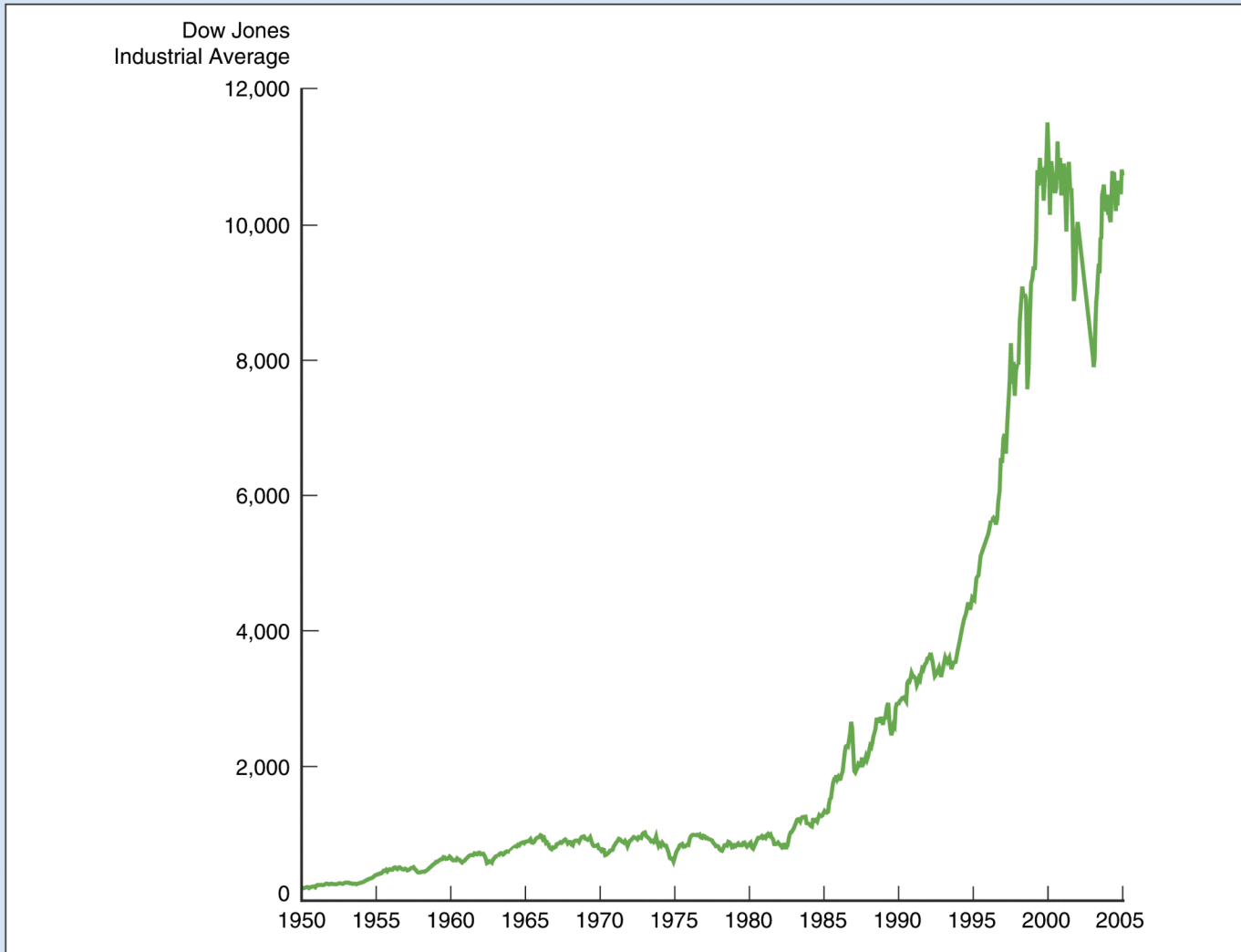


FIGURE 2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2005

Source: Dow Jones Indexes: <http://finance.yahoo.com/?u>.



The Foreign Exchange Market

- The foreign exchange market is where funds are converted from one currency into another
- The foreign exchange rate is the price of one currency in terms of another currency
- The foreign exchange market determines the foreign exchange rate

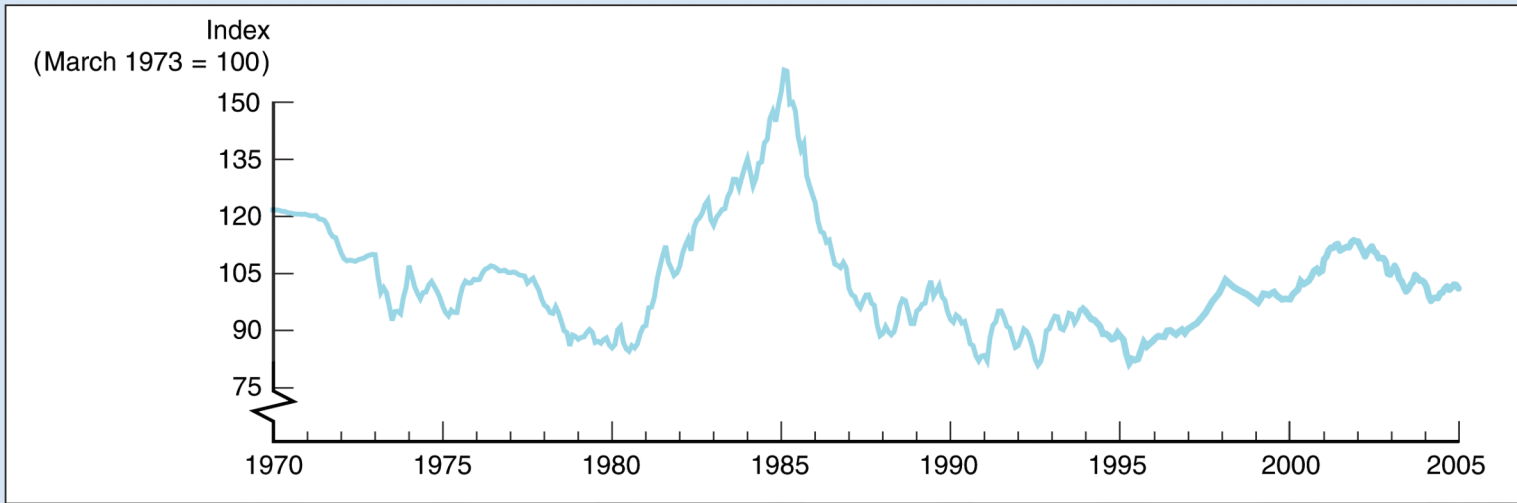


FIGURE 3 Exchange Rate of the U.S. Dollar, 1970–2005

Source: Federal Reserve: www.federalreserve.gov/releases/H10/summary/indexbc_m.txt/.



Banking and Financial Institutions

- Financial Intermediaries—institutions that borrow funds from people who have saved and make loans to other people
- Banks—institutions that accept deposits and make loans
- Other Financial Institutions—insurance companies, finance companies, pension funds, mutual funds and investment banks
- Financial Innovation—in particular, the advent of the information age and e-finance



Money and Business Cycles

- Evidence suggests that money plays an important role in generating business cycles
- Recessions (unemployment) and booms (inflation) affect all of us
- Monetary Theory ties changes in the money supply to changes in aggregate economic activity and the price level

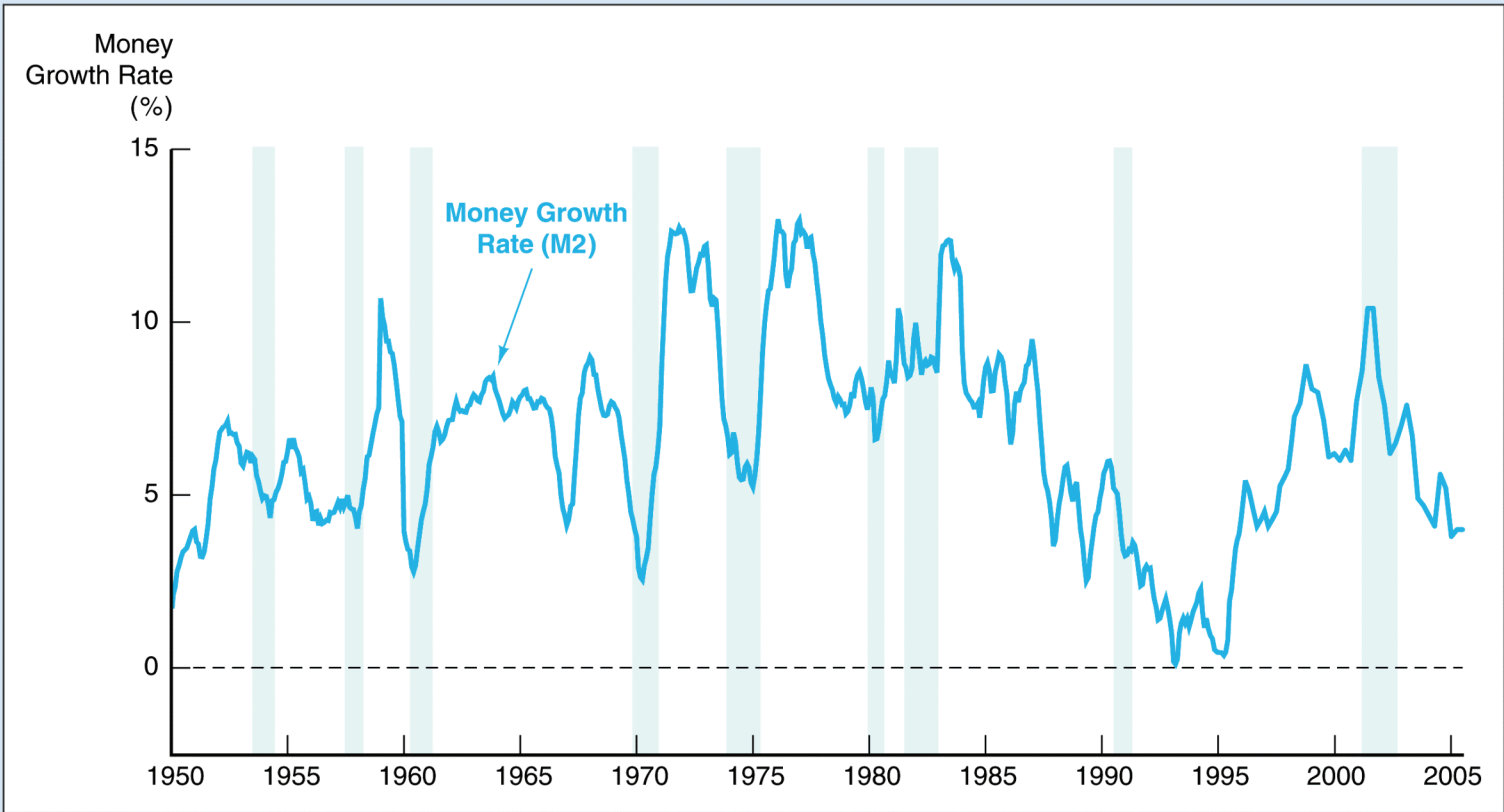


FIGURE 4 Money Growth (M2 Annual Rate) and the Business Cycle in the United States, 1950–2005

Note: Shaded areas represent recessions.

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



Money and Inflation

- The aggregate price level is the average price of goods and services in an economy
- A continual rise in the price level (inflation) affects all economic players
- Data shows a connection between the money supply and the price level

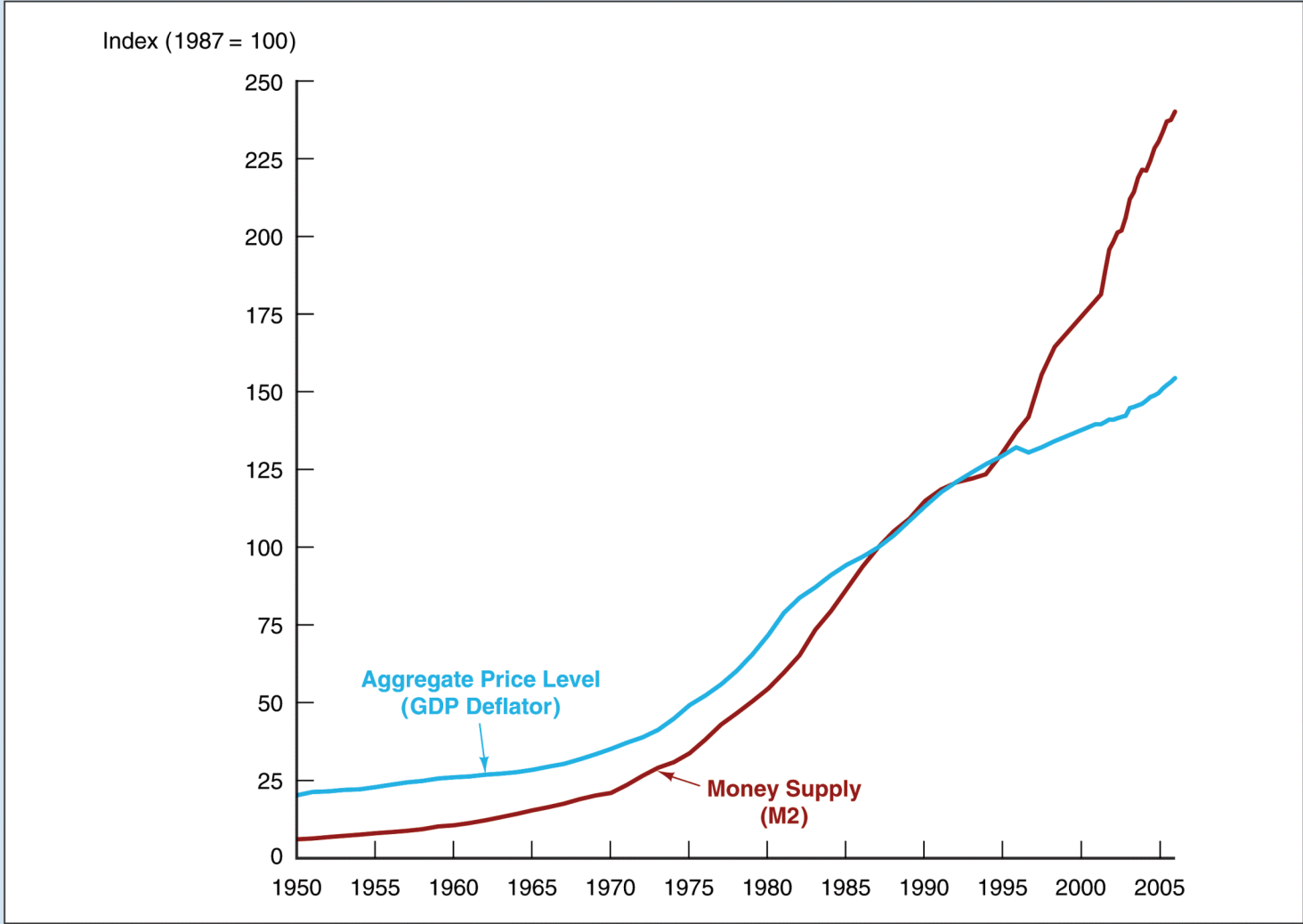


FIGURE 5 Aggregate Price Level and the Money Supply in the United States, 1950–2005

Sources: www.stls.frb.org/fred/data/gdp/gdpdef; www.federalreserve.gov/releases/h6/hist/h6hist10.txt.

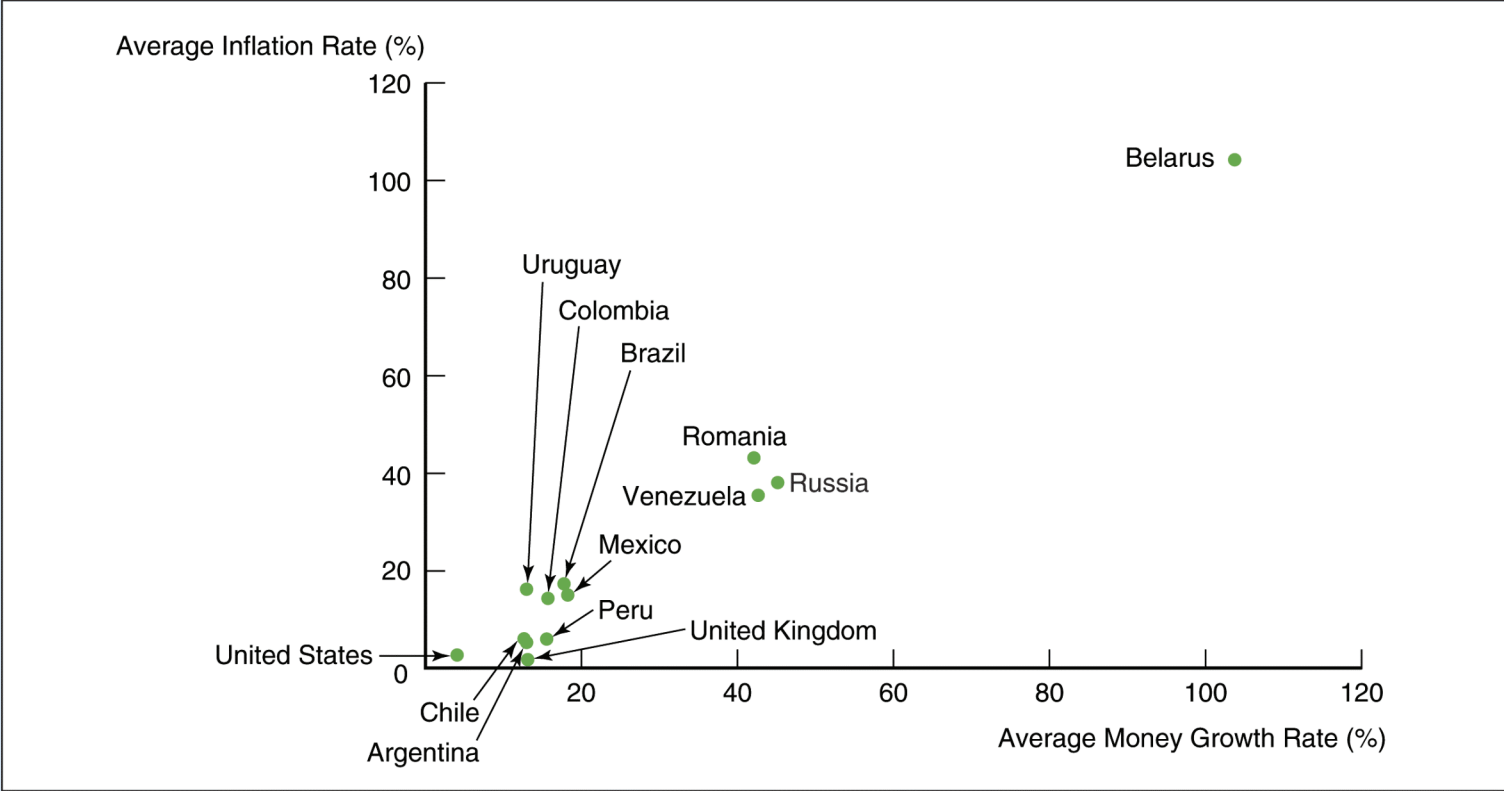


FIGURE 6 Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 1995–2004

Source: International Financial Statistics.



Money and Interest Rates

- Interest rates are the price of money
- Prior to 1980, the rate of money growth and the interest rate on long-term Treasury bonds were closely tied
- Since then, the relationship is less clear but still an important determinant of interest rates

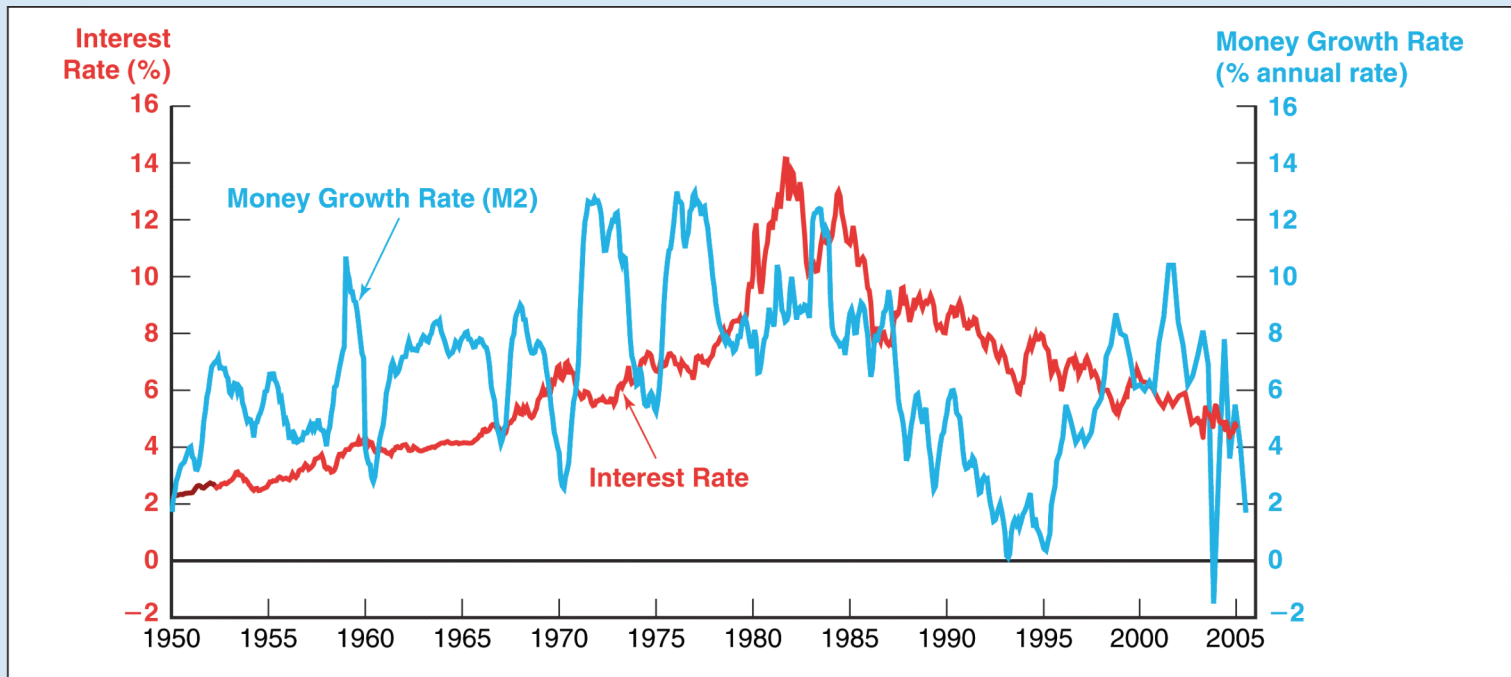


FIGURE 7 Money Growth (M2 Annual Rate) and Interest Rates (Long-Term U.S. Treasury Bonds), 1950–2005

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

A vertical stack of several coins, likely US quarters, is shown on the left side of the slide. The coins are stacked on top of each other, with the top coin being the most prominent. The background behind the coins is a light blue gradient.

Monetary and Fiscal Policy

- Monetary policy is the management of the money supply and interest rates
 - ◆ Conducted in the U.S. by the Federal Reserve Bank (Fed)
- Fiscal policy is government spending and taxation
 - ◆ Budget deficit is the excess of expenditures over revenues for a particular year
 - ◆ Budget surplus is the excess of revenues over expenditures for a particular year
 - ◆ Any deficit must be financed by borrowing

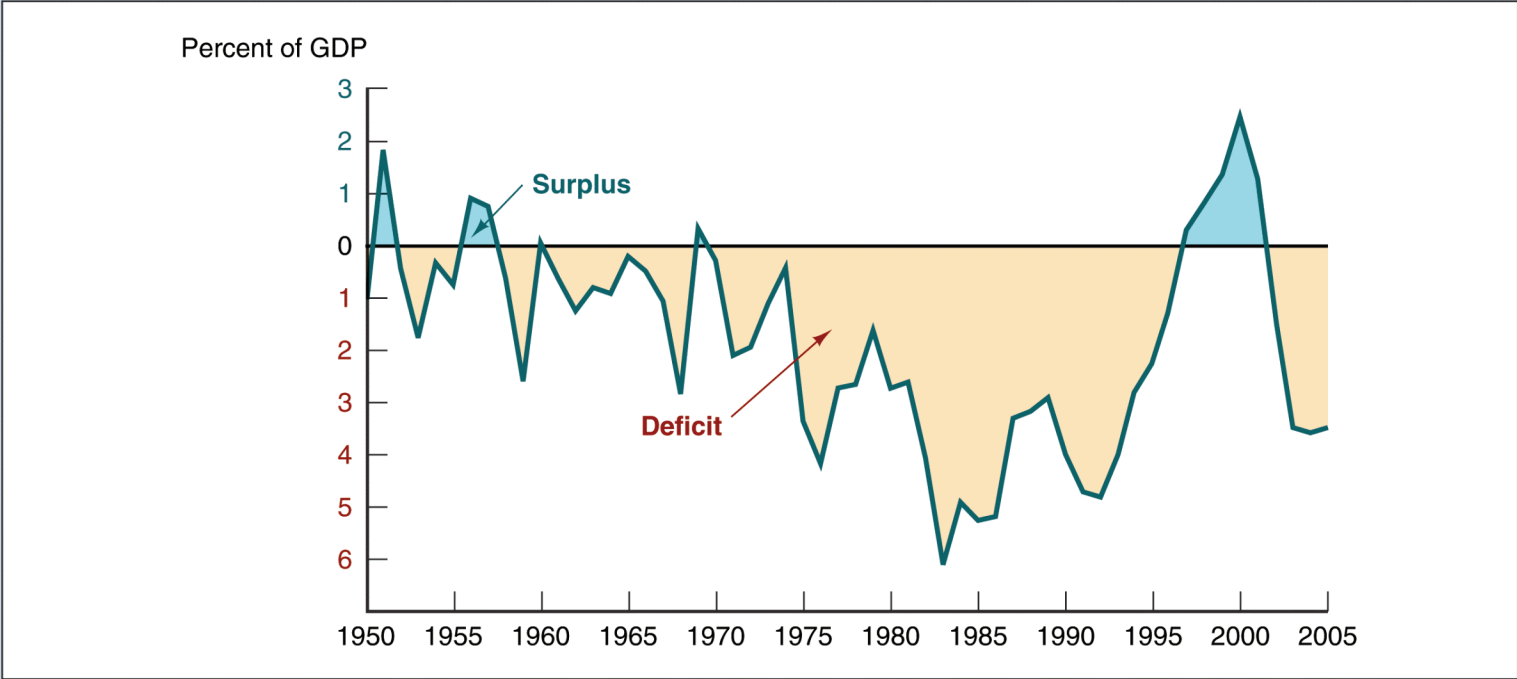


FIGURE 8 Government Budget Surplus or Deficit as a Percentage of Gross Domestic Product, 1950–2005

Source: www.gpoaccess.gov/usbudget/fy06/sheets/hist01z2.xls.



How We Will Study Money, Banking, and Financial Markets

- A simplified approach to the demand for assets
- The concept of equilibrium
- Basic supply and demand to explain behavior in financial markets
- The search for profits
- An approach to financial structure based on transaction costs and asymmetric information
- Aggregate supply and demand analysis



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Federal Reserve Statistical Release

H.15 Selected Interest Rates (Weekly)

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Release Dates

These data are released each Monday. The exact time may be obtained by calling 202-452-3206.

Announcements

[Addition of 20-Year Treasury Constant Maturity Inflation-Indexed Rate](#)

FIGURE 9 Federal Reserve Board Web Site

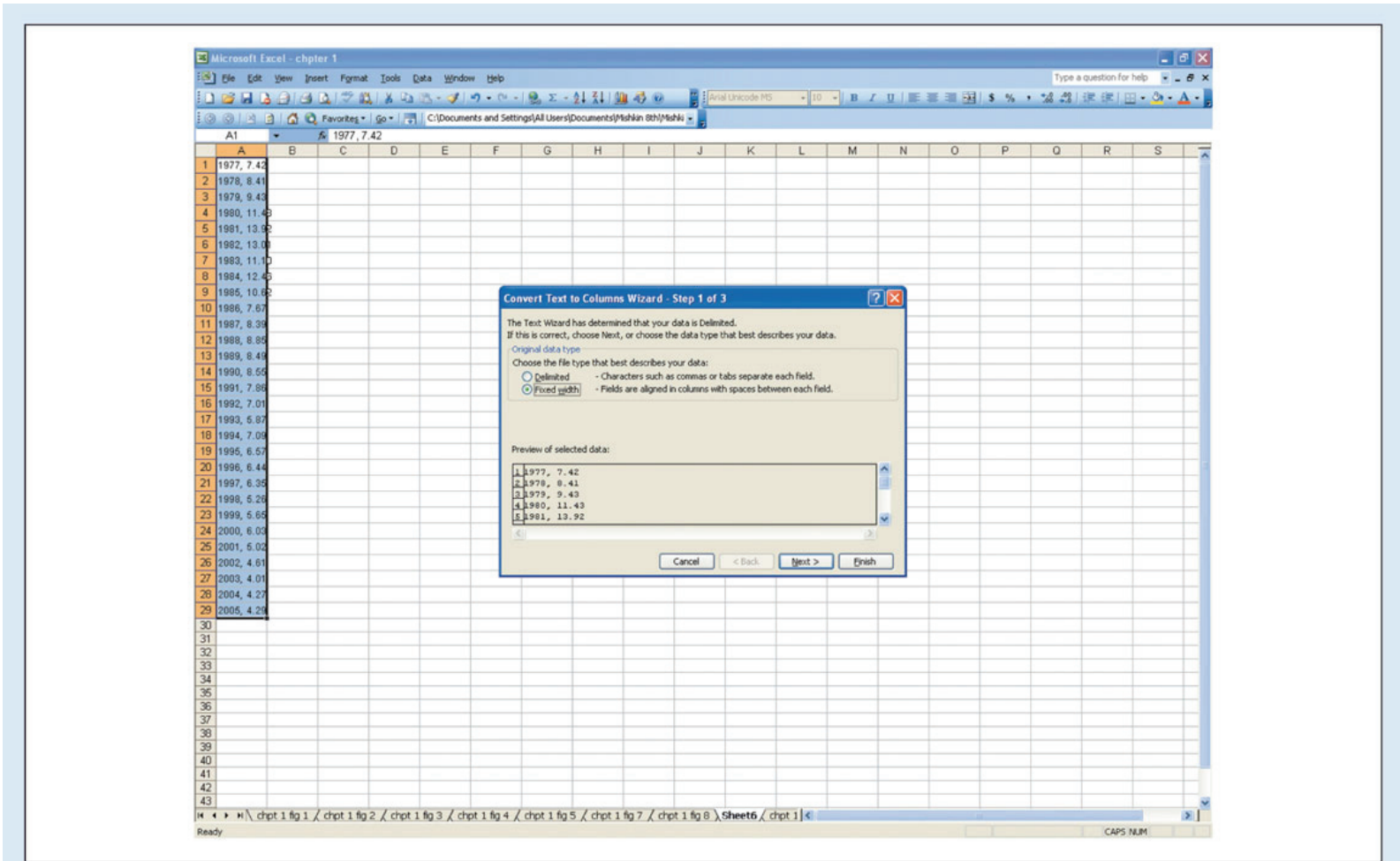


FIGURE 10 Excel Spreadsheet with Interest-Rate Data

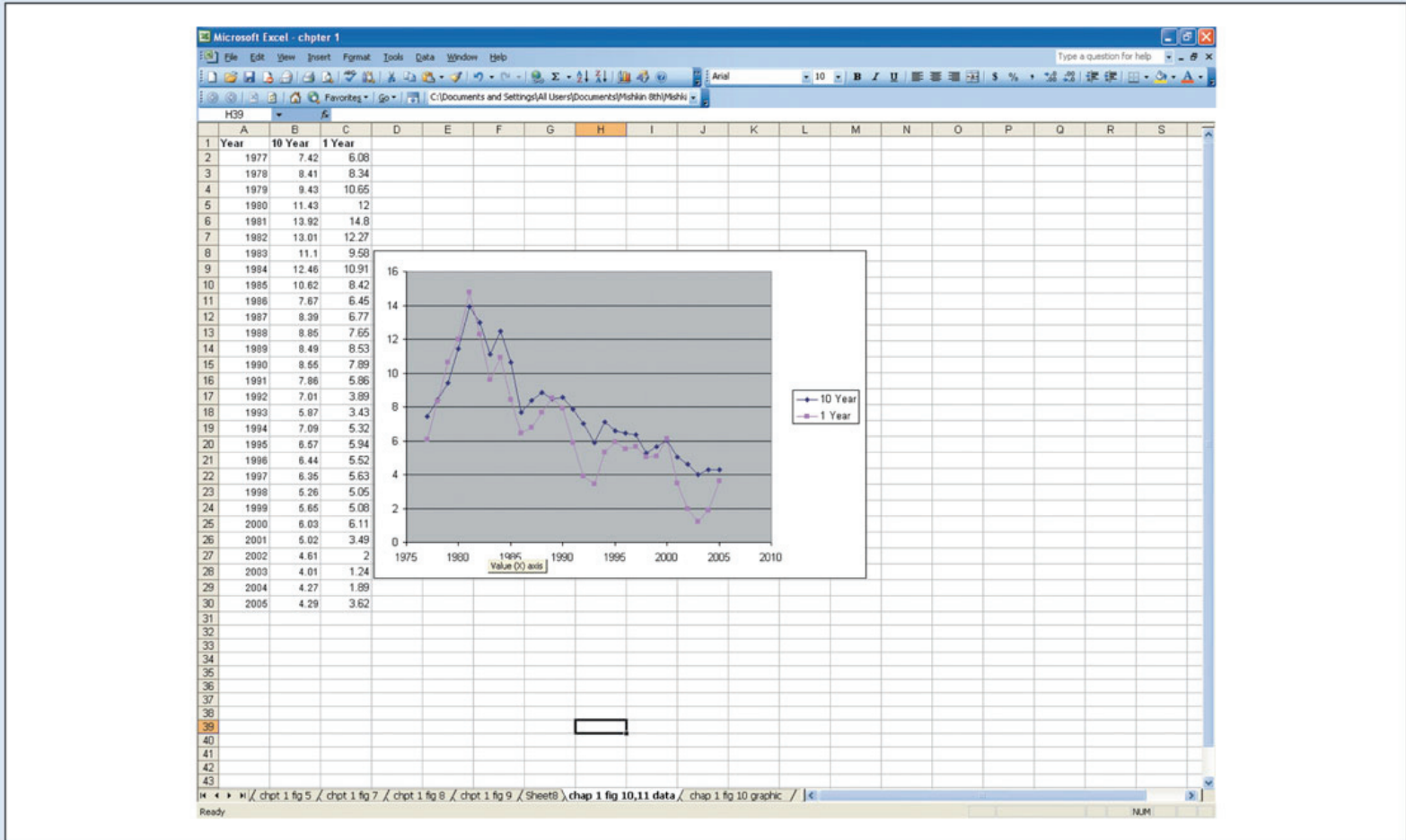


FIGURE 11 Excel Graph of Interest-Rate Data