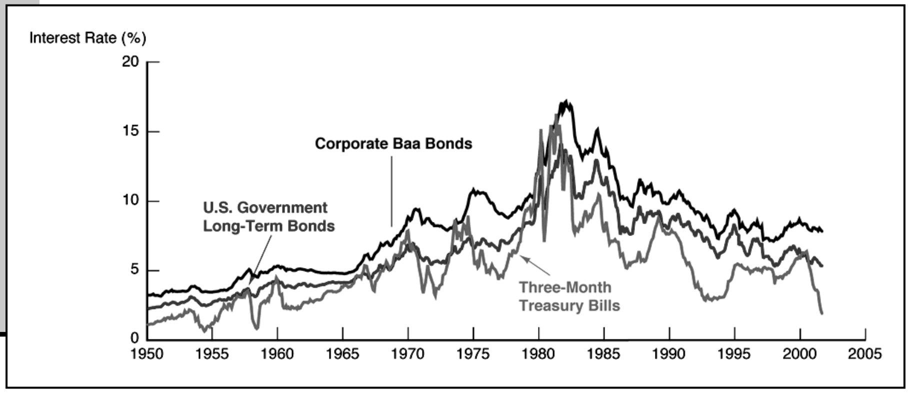
Chapter 1

Why Study Money, Banking, and
Financial Markets?

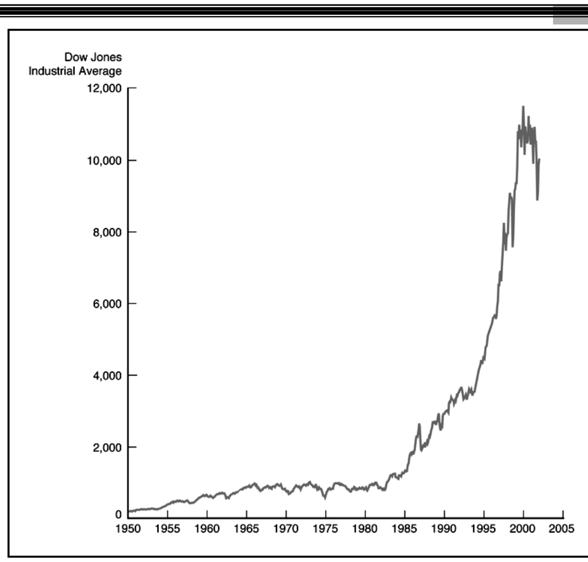
Financial Markets

- Why Study Financial Markets?
  - channel funds from savers to investors, thereby promoting economic efficiency
  - affect personal wealth and behavior of business firms
- Main Types of Financial Markets:
  - *bond market* – securities are claims on issuer's future income or assets (bonds are debt securities)
  - *stock market* – stocks are shares of ownership, so a claim on the earnings and assets of issuer
  - *foreign exchange market* – trades foreign currencies, the price of which is the foreign exchange rate

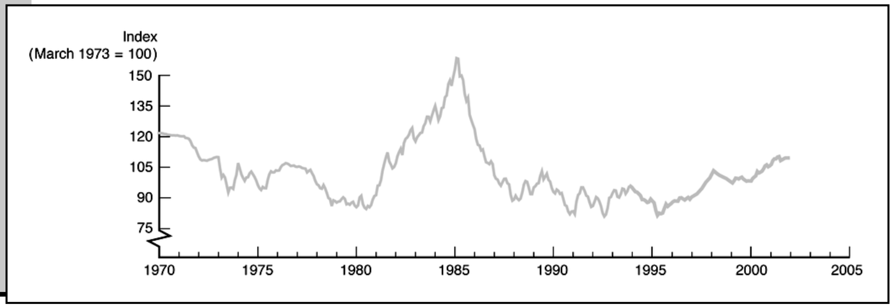
Bond Market



Stock Market



Foreign Exchange Market



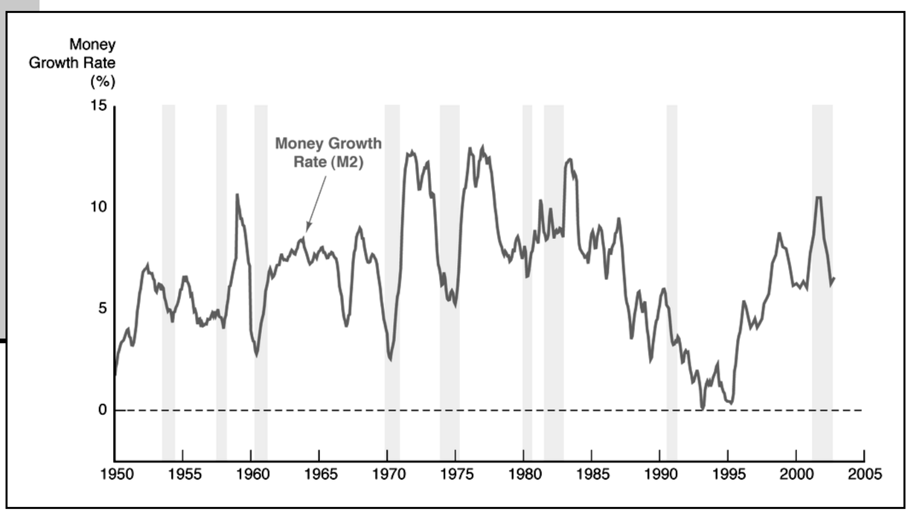
Why Study Banking and Financial Institutions?

- financial intermediation – helps get funds from savers to investors
- banks and money supply
  - crucial role in creation of money
  - other financial institutions: insurance companies, pension or mutual funds, investment banks, finance companies
- financial innovation – can lead to higher profits and more efficient products (for example, e-finance)

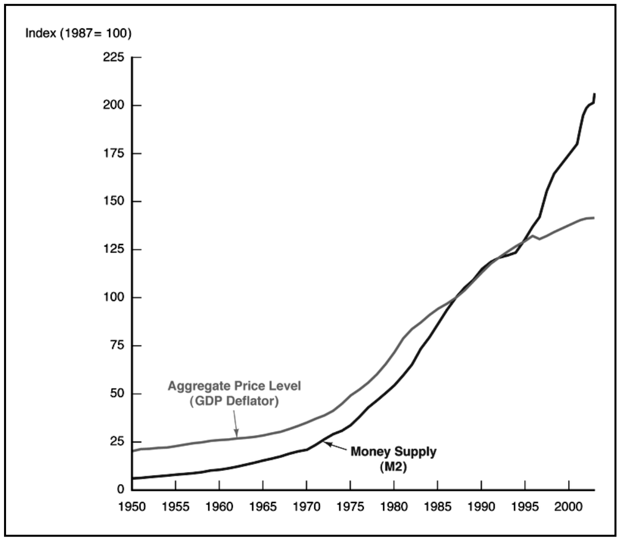
Why Study Money and Monetary Policy?

- influence on business cycles and inflation (not covered)
- influence on interest rates
  - monetary policy – through central banks (Fed)
  - interaction with fiscal policy

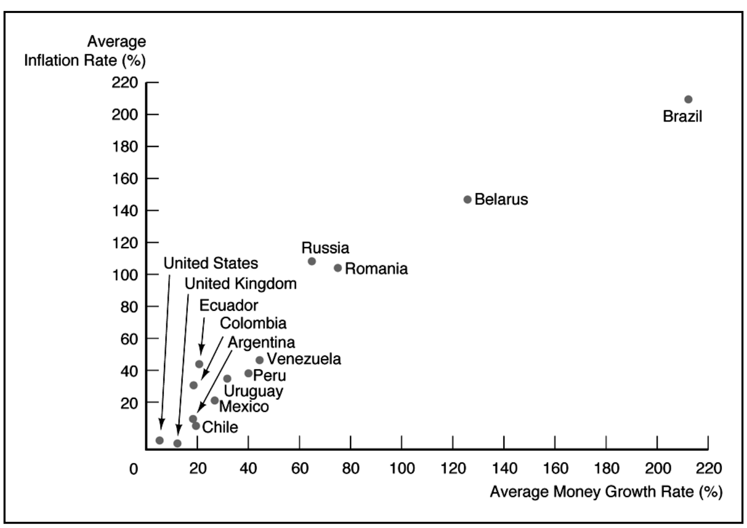
Money and Business Cycles



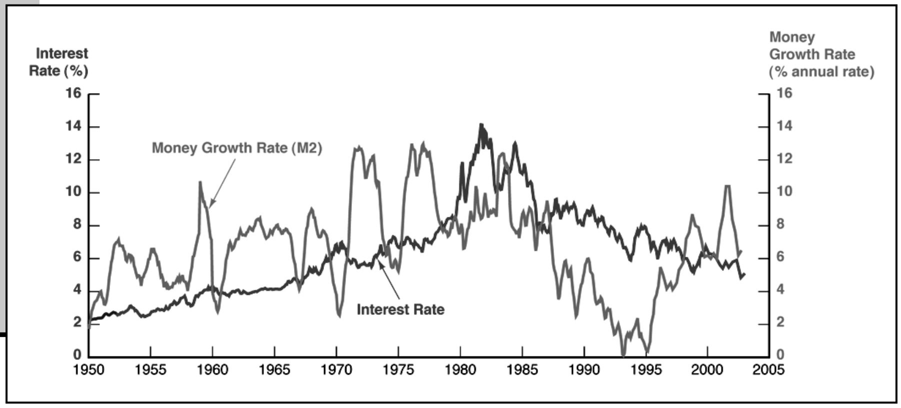
Money and the Price Level



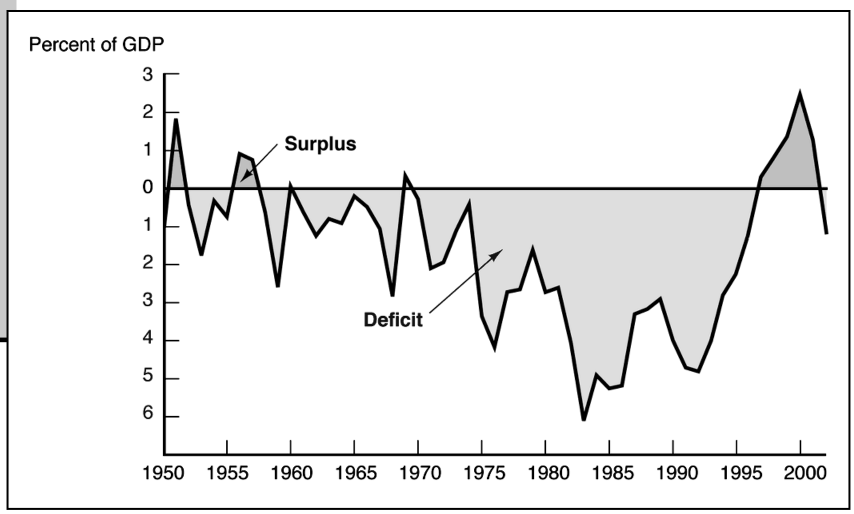
Money Growth and Inflation



Money Growth and Interest Rates



Fiscal Policy and Monetary Policy



How We Study Money and Banking

- Basic analytic framework
  - simplified approach to the demand for assets
  - concept of equilibrium
  - basic supply and demand approach to understand behavior in financial markets
  - search for profits
  - transactions cost and asymmetric information approach to financial structure
  - aggregate supply and demand analysis

Appendix: Definitions

- Aggregate output and income
  - *Gross Domestic Product* (*GDP*) = value of all final goods and services produced in domestic economy during year
  - *Aggregate Income* = total income of factors of production (land, capital, labor) during year
  - distinction between
    - *nominal* = values measured using current prices
    - *real* = quantities, measured with constant prices
- Aggregate price level
  - *GDP Deflator* = nominal GDP / real GDP
  - *Consumer Price Index* (*CPI*) = price of “basket” of goods and services

Appendix: Definitions (cont.)

- Growth rates
  - calculated as the ratio of change in value to initial value:

$$\text{Growth rate} = \frac{x_{t+1} - x_t}{x_t}$$

- Inflation rate
  - calculated as growth rate of GDP deflator or of CPI:

$$\text{Inflation} = \frac{GDPD_{t+1} - GDPD_t}{GDPD_t} \text{ or } \frac{CPI_{t+1} - CPI_t}{CPI_t}$$