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](http://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/?.

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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—insttitutions 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.
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: stls.frb.org/fred/data/gdp/gdpdef; federalreserve.gov/releases/h6/hist/h6hist10.txt.
**Figure 6** Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 1995–2004

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 Treasure 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.*
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
Figure 9  Federal Reserve Board Web Site

Federal Reserve Statistical Release

H.15

Selected Interest Rates (Weekly)

Release dates | Daily update | Historical data | About
Current release | Other formats: Screen reader | ASCII | PDF (17 KB)

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

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Figure 10  Excel Spreadsheet with Interest-Rate Data
Figure 11 Excel Graph of Interest-Rate Data