

# 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



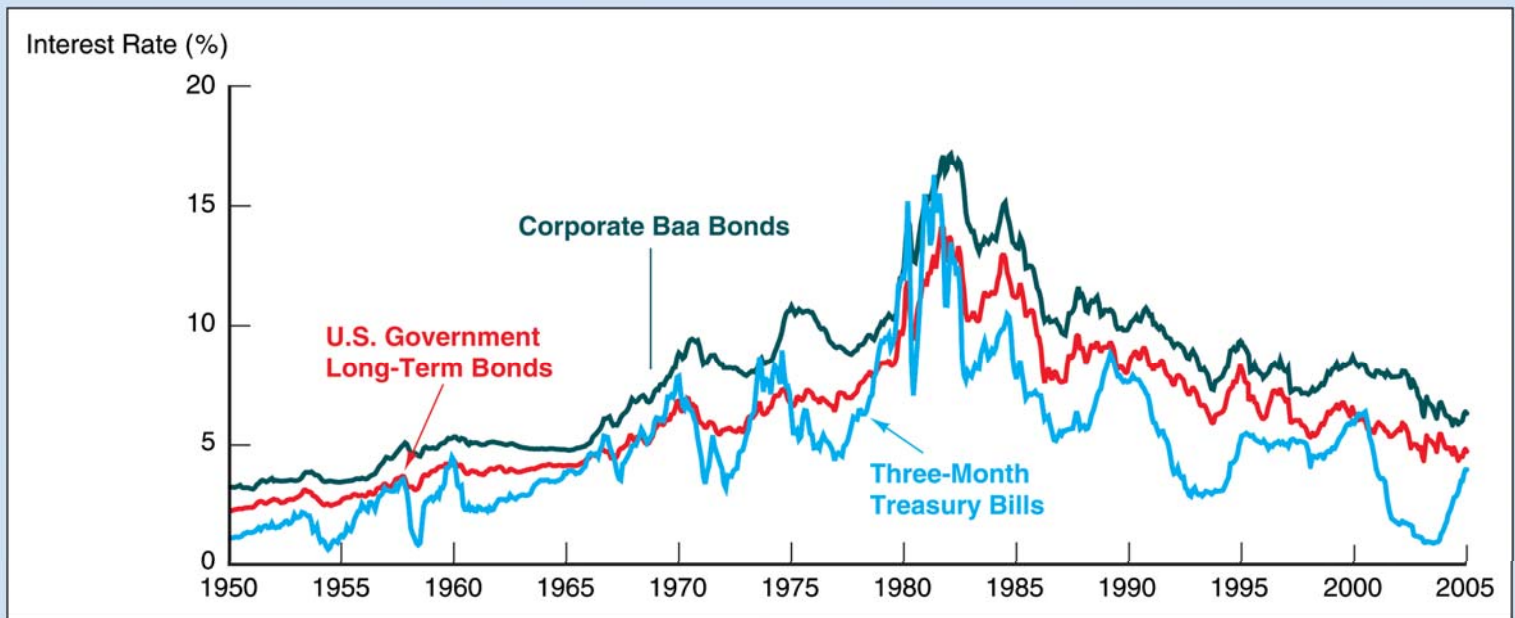
# Financial Markets

- 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



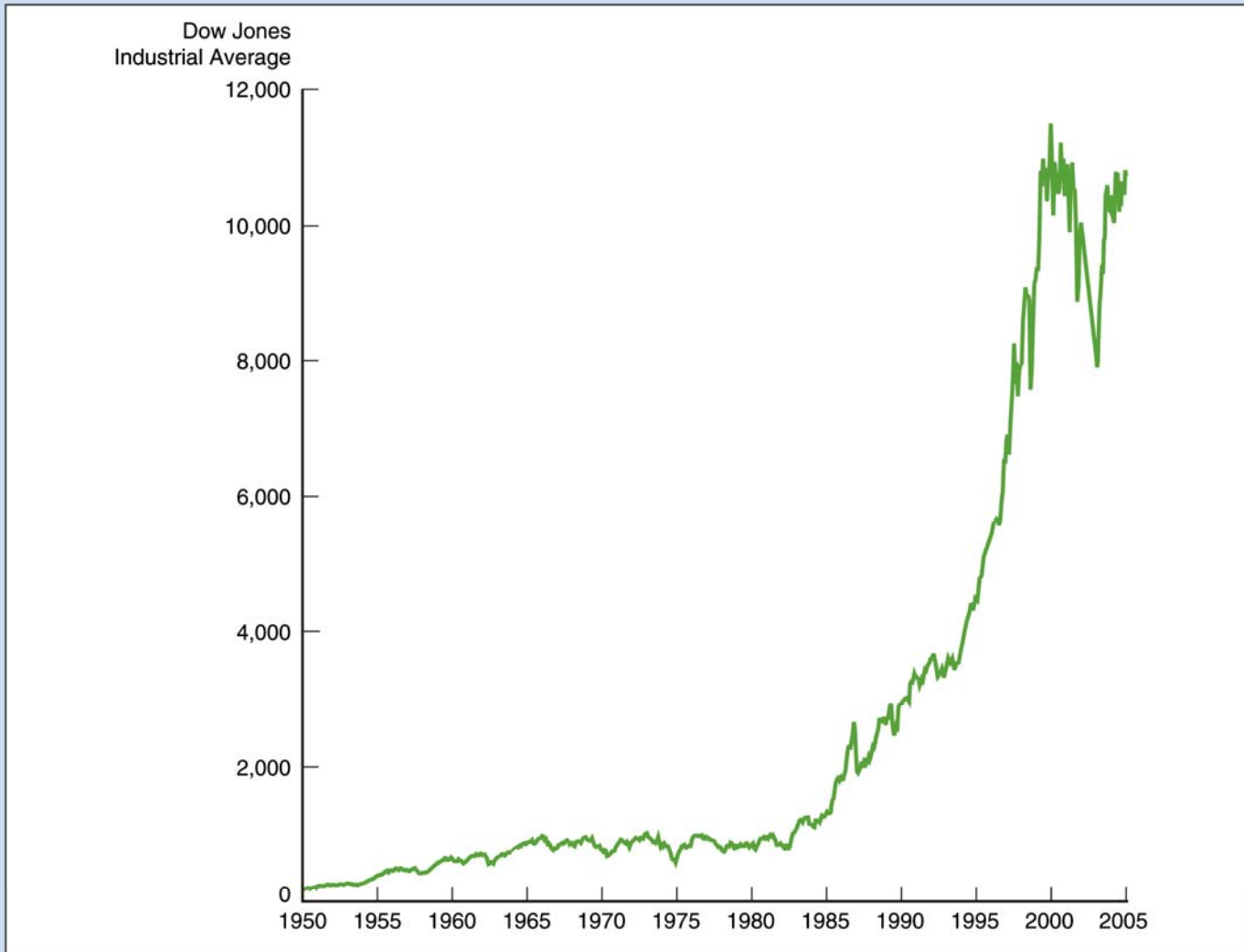
**FIGURE 1** Interest Rates on Selected Bonds, 1950–2005

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

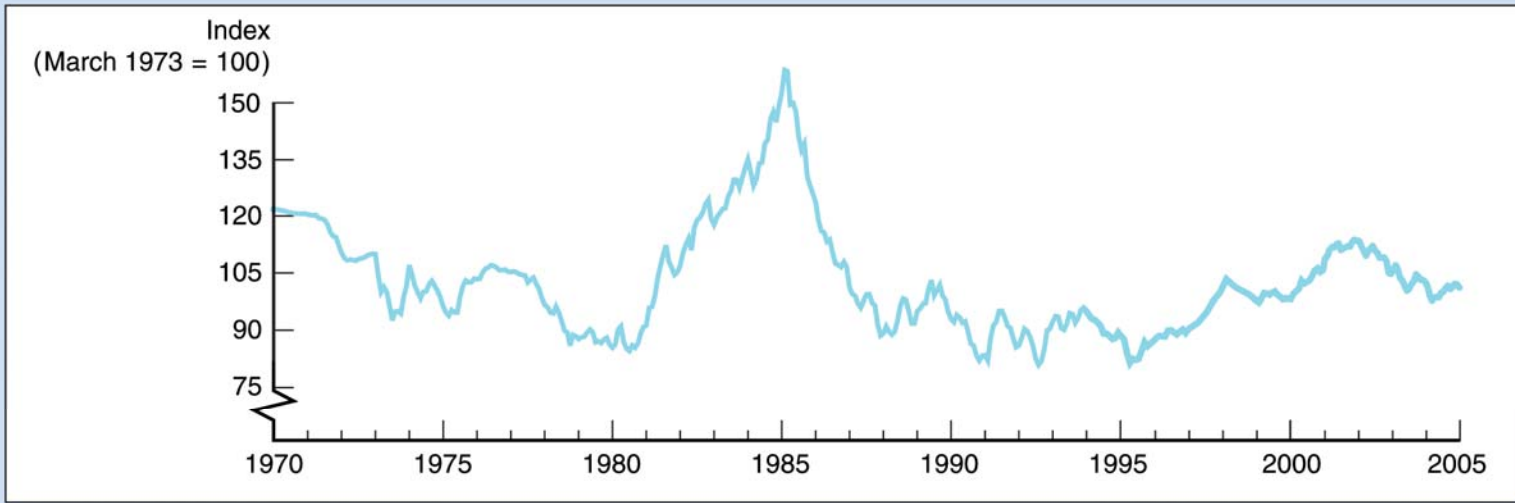
Source: Dow Jones Indexes: <http://finance.yahoo.com/?u>.



# 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/](http://www.federalreserve.gov/releases/H10/summary/indexbc_m.txt/).



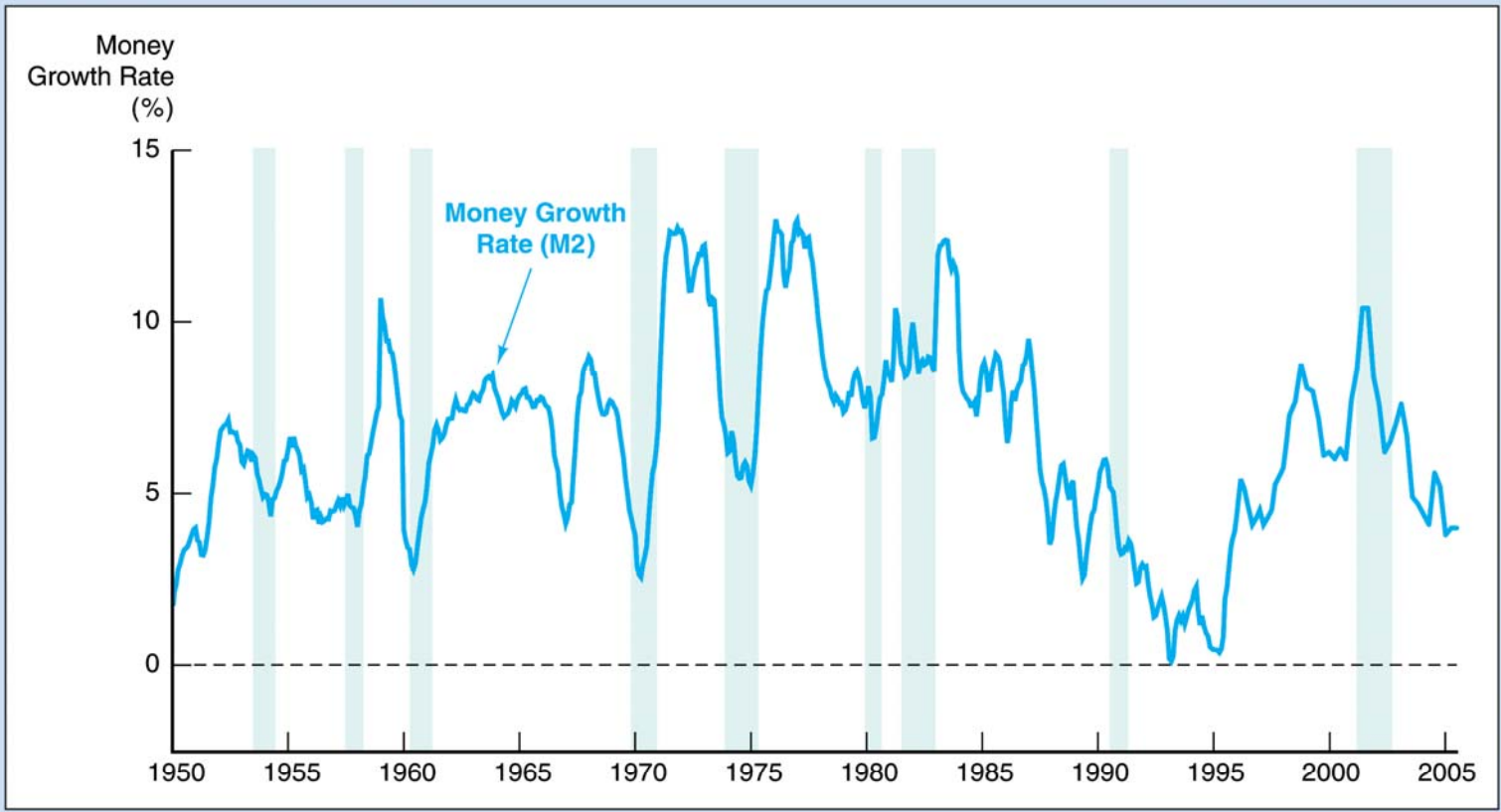
# Banking and Financial Institutions

- 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**

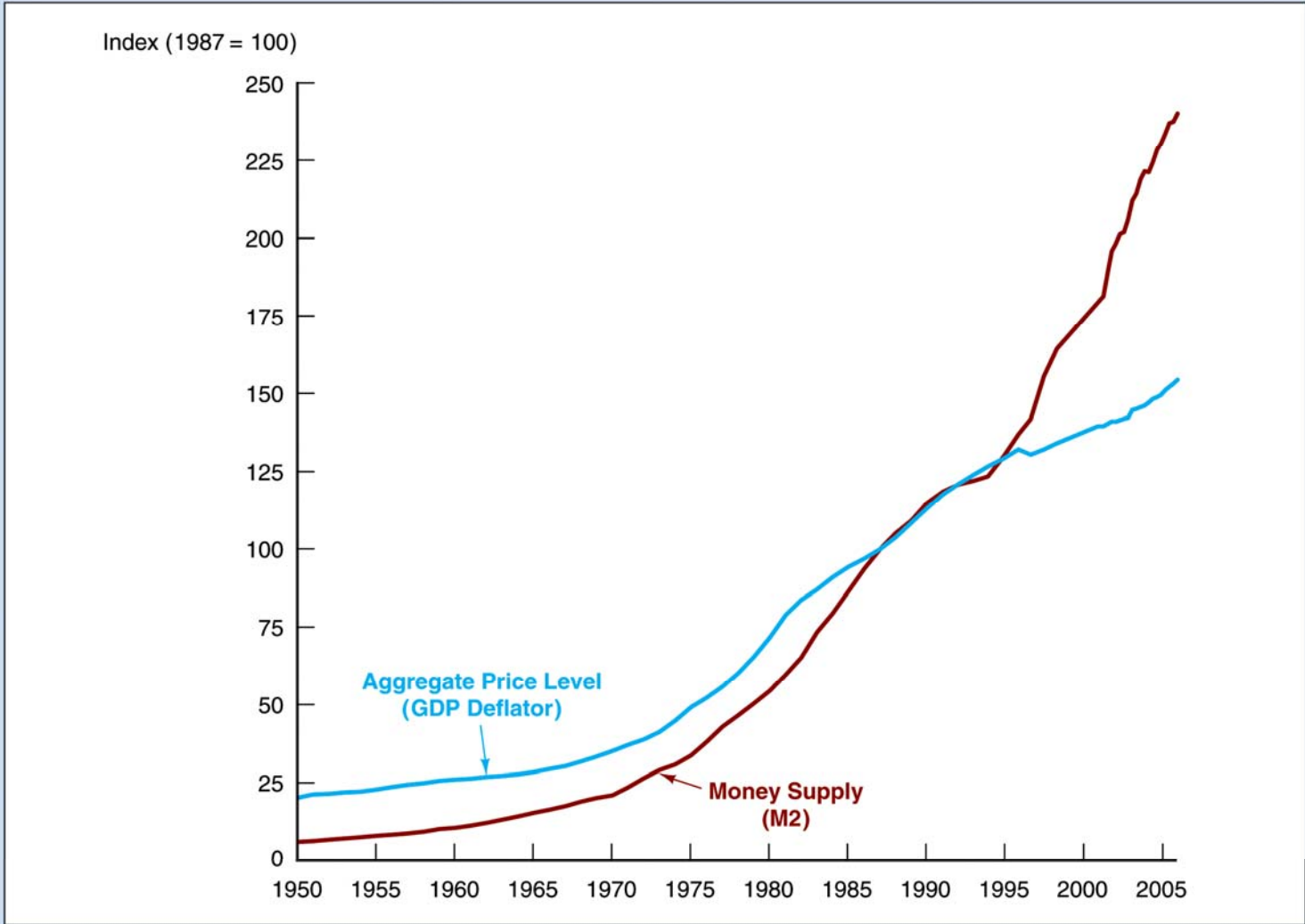
Note: Shaded areas represent recessions.

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



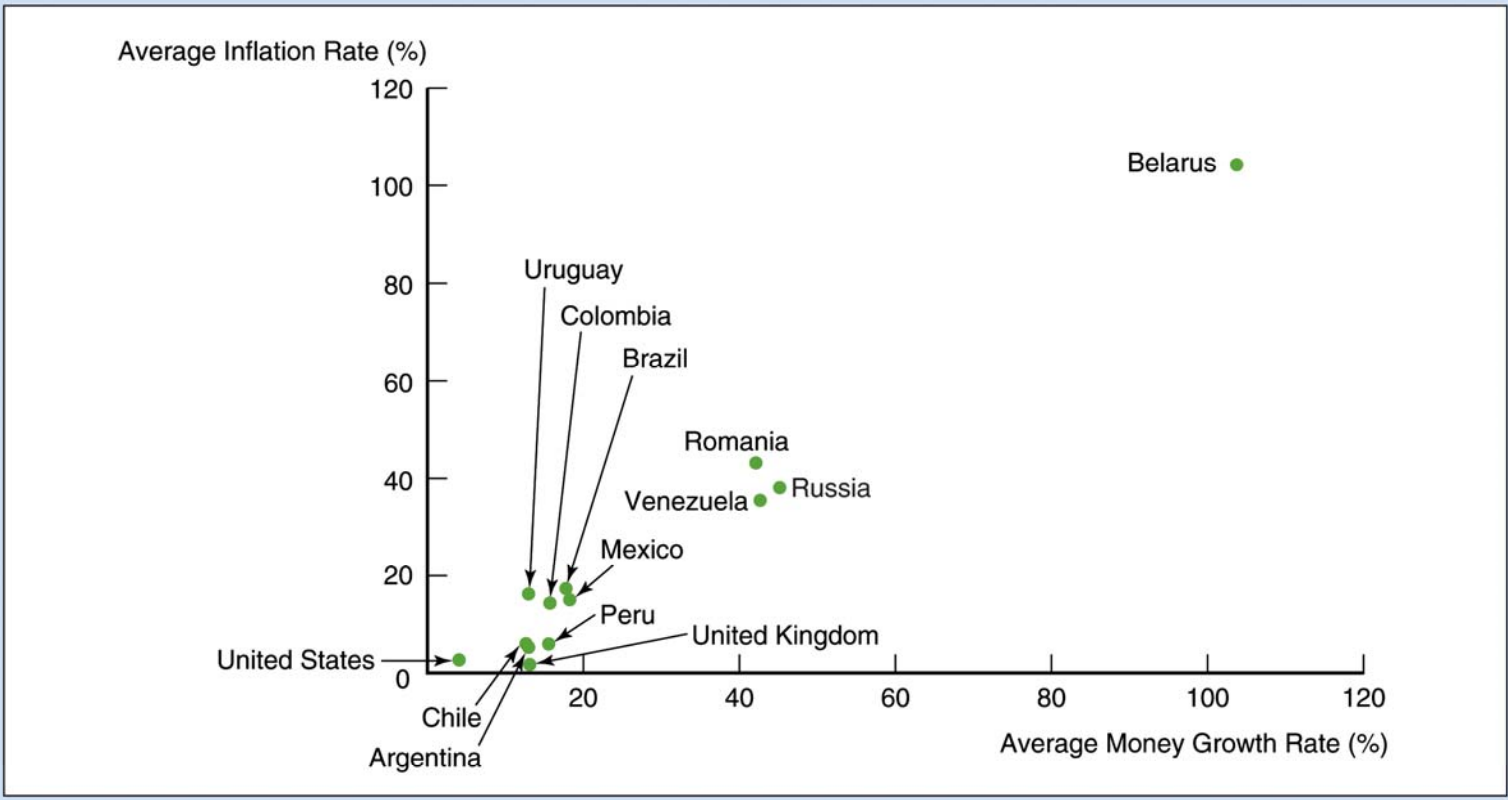
# Money and Inflation

- 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](http://www.stls.frb.org/fred/data/gdp/gdpdef); [www.federalreserve.gov/releases/h6/hist/h6hist10.txt](http://www.federalreserve.gov/releases/h6/hist/h6hist10.txt).



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

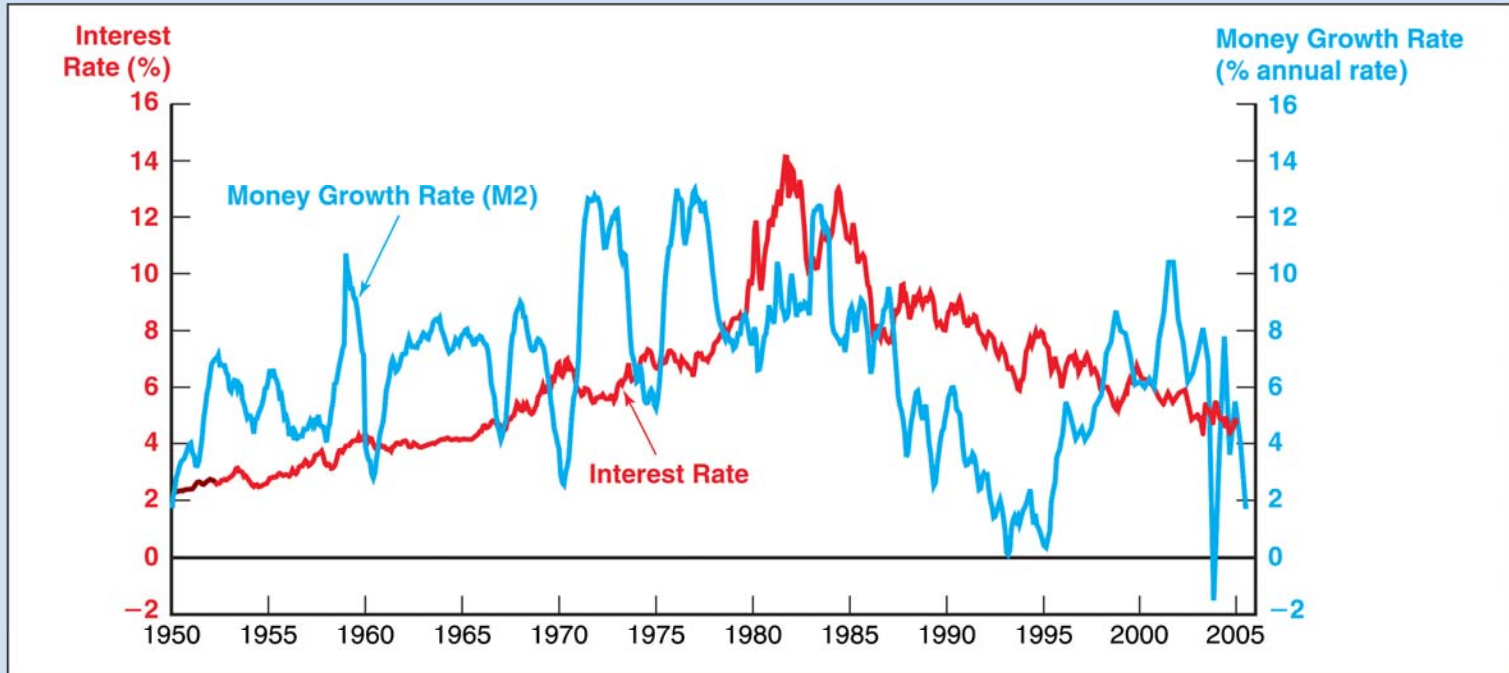
Source: International Financial Statistics.



# 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





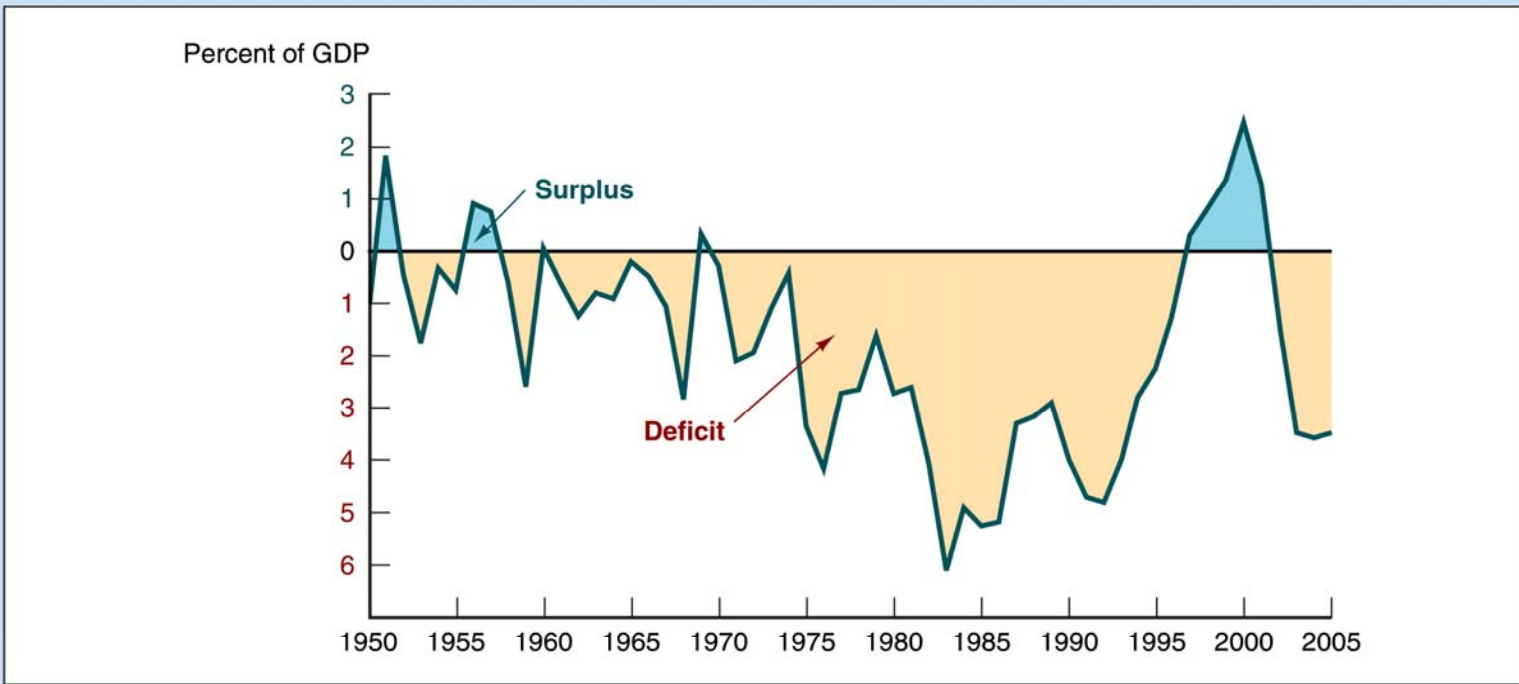
**FIGURE 7 Money Growth (M2 Annual Rate) and Interest Rates (Long-Term U.S. Treasury Bonds), 1950–2005**

Sources: Federal Reserve *Bulletin*, p. A4, Table 1.10; [www.federalreserve.gov/releases/h6/hist/h6hist1.txt](http://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](http://www.gpoaccess.gov/usbudget/fy06/sheets/hist01z2.xls).



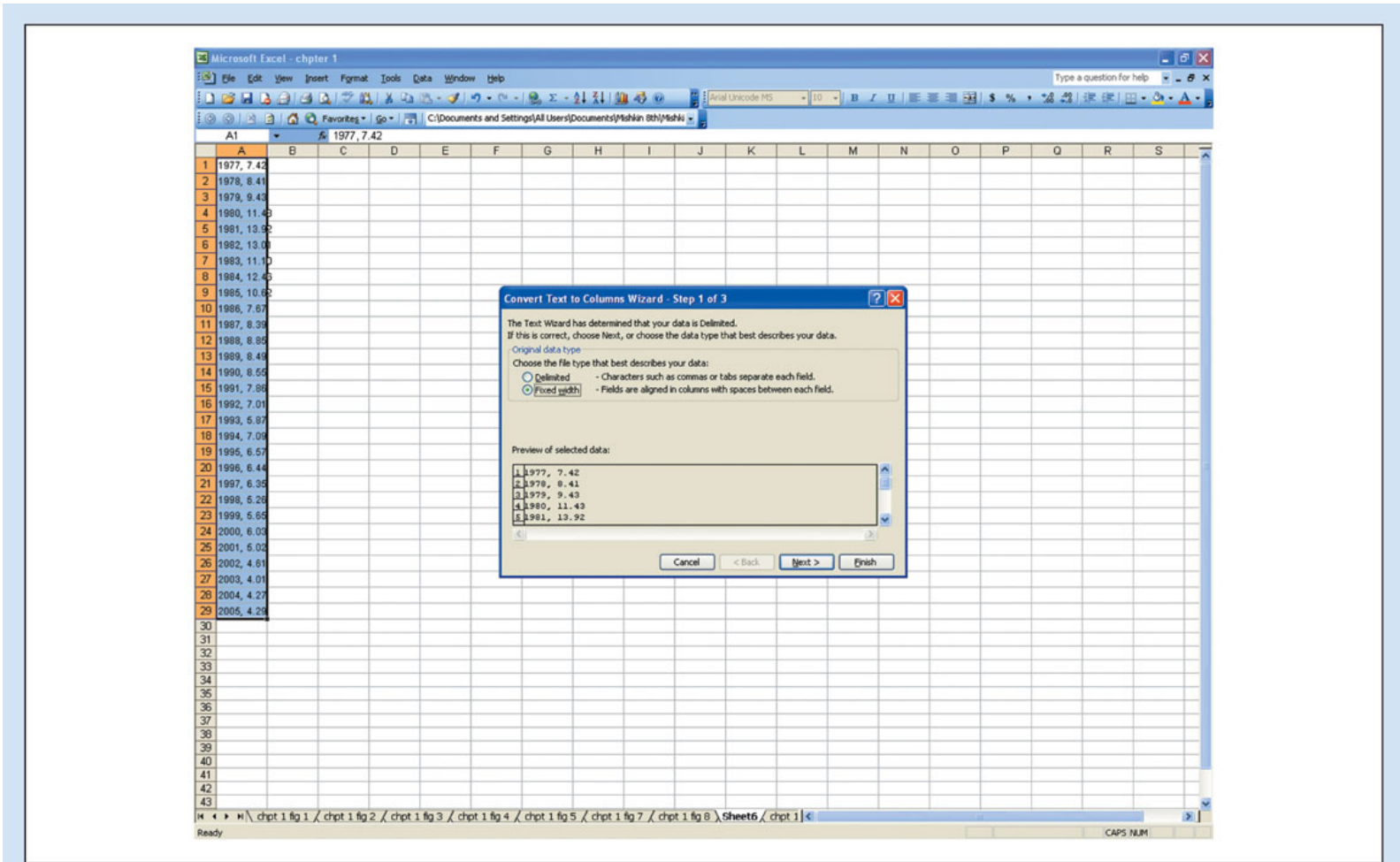
# How We Will Study Money, Banking, and Financial Markets

- 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

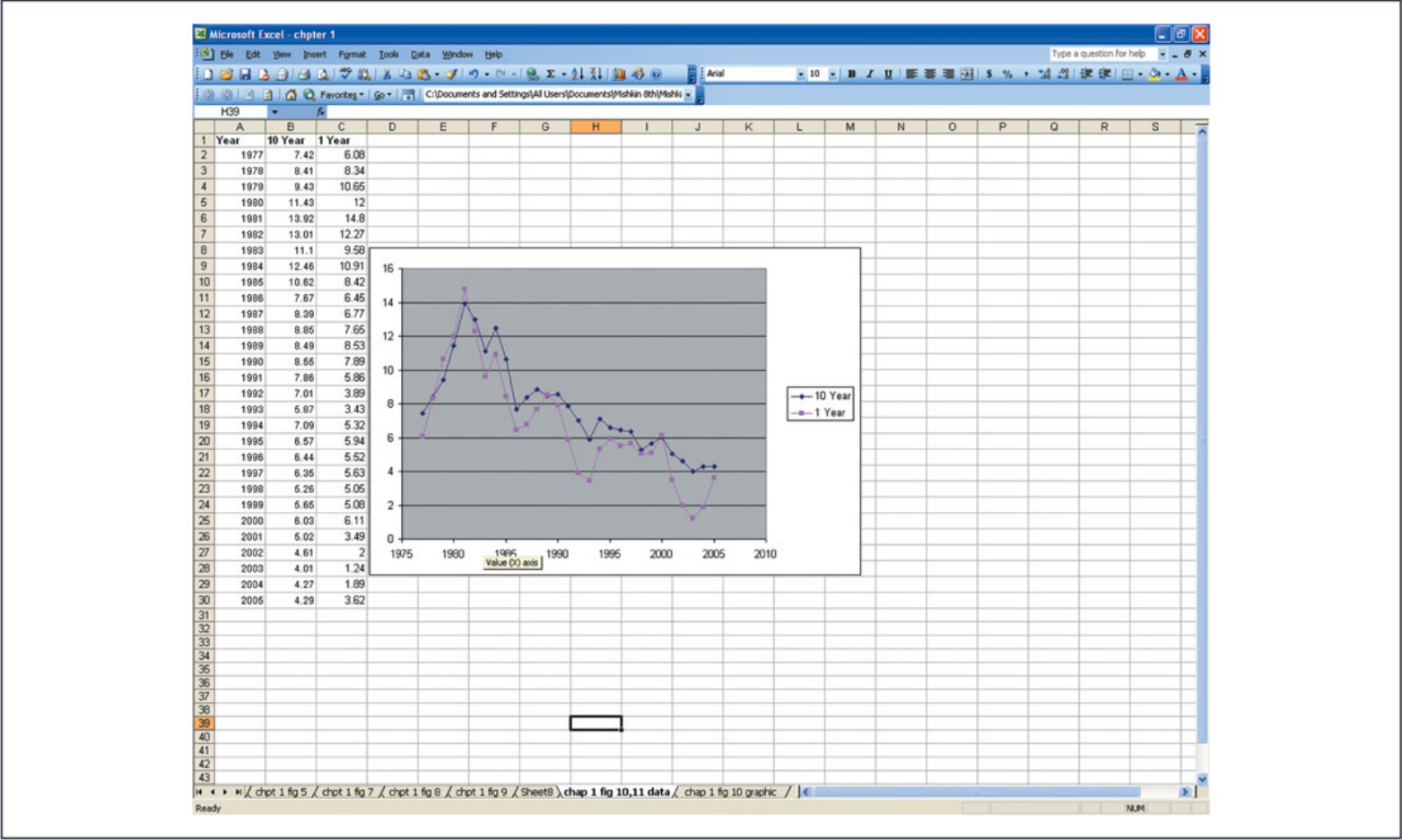


The screenshot shows a web browser window with the title "@ FRB: H.15 Release--Selected Interest Rates, R...". The address bar contains "http://www.federalreserve.gov/releases/H15/". The page content includes the heading "Federal Reserve Statistical Release" with a logo of an eagle. Below this is the section "H.15 Selected Interest Rates (Weekly)". A navigation menu includes links for "Release dates", "Daily update", "Historical data", "About", "Current release", "Screen reader", "ASCII", and "PDF (17 KB)". The "Release Dates" section states: "These data are released each Monday. The exact time may be obtained by calling 202-452-3206." There is also an "Announcements" section with a partially visible title "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