Introduction to Financial and Money Markets

Economics 301: Money and Banking
Goals:
- Get an overview of money and financial markets.
- Understand why it is important to study these markets.

Learning Outcomes:
- Just touch on LO1: Describe how financial markets affect the overall functioning of the economy.
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Hubbard and O’Brien, Chapter 1.
**Financial Markets:** markets in which funds are transferred from people or institutions that save to those who want to borrow.

**Banking and financial institutions:** These are what make financial markets work. These businesses make a profit by moving funds around the economy.
Market for Money: supply and demand framework for money.

Money: Something generally accepted as a means of payment, typically earning 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:** *tradable* asset issued by an institution which is a claim on the institution’s assets or future income.
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*.

Common for large, widely recognized businesses that can credibly communicate its profitability.

**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.
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.
  - Corporate bond rates.
  - Federal reserve rates: discount rate, federal funds rate.
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Interest Rates

- Low-Medium Grade Corporate Bonds
- 3 Month Treasury
- 30 Year Mortgage
- Prime Corporate Bond

Year:

Interest Rate (%): 0, 5, 10, 15

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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?
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- Security that is a claim on the earnings and assets of the corporation.
- Dividends: distribution of the corporation's earnings to the shareholders.
- Capital gain (loss): money earned (lost) by selling a stock for more (less) than you originally purchased it for.

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- 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?
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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, and
- purchase goods from that country.
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 8/26/16: 1.12 USD / EUR
  - Exchange rate on 8/26/16: 0.893 EUR / USD

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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.
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- 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.
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- 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!
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- 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.
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Due on Monday, September 12, 11:59 PM.

Short answer questions: End of chapter 1 questions 1.10, 1.11, and 1.12, pages 21-22.

Type your answers and upload it to the D2L dropbox labeled, “Homework 1: Intro to Financial System.”