

Econ 4200 Money and Banking

Lini Zhang

The Ohio State University

June,18 2012

Lecture 1

Why Study Money, Banking, and Financial Markets?

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¹Chapter 1, Frederic S. Mishkin, *The Economics of Money, Banking and Financial Markets*, 2010, the second edition of the business school edition, Pearson

Why study Money, Banking, and Financial Markets?

To examine

- ① how financial markets such as bond markets, stock markets and foreign exchange markets work
- ② how financial institutions such as banks and insurance companies work
- ③ the role of money in the economy

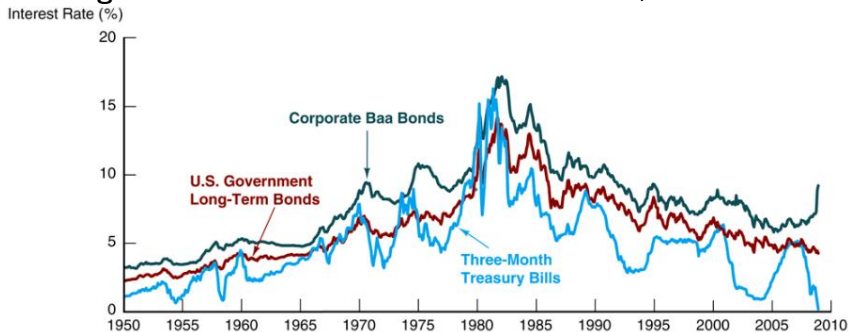
What is **Financial Markets**?

- ① markets in which funds are transferred from people who have an excess of available funds to people who have a shortage.
 - ▶ typical financial markets are bond, and stock markets

The Bond Market and Interest Rates

- A **security** (or *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
 - ▶ mortgage interest rates, car loan rates, and interest rates on different types of bonds.
 - ▶ is important on several levels.
 - ▶ different interest rates tend to move together.

Figure 1 Interest Rates on Selected Bonds, 1950-2008

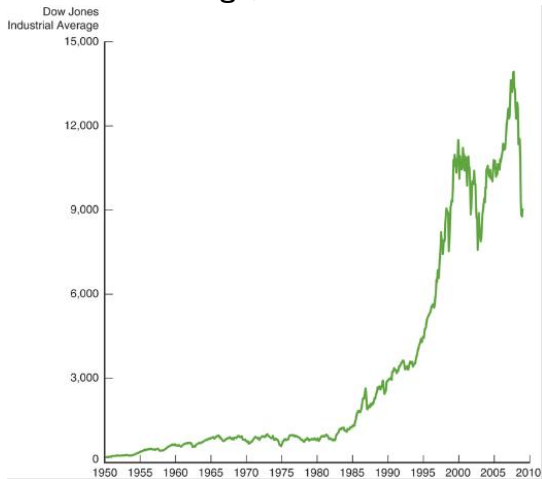


2.

The Stock Market

- A **common stock** (or **stock**) is a security that is a claim on the earnings and assets of the corporation.
 - ① represents a share of ownership in a corporation
 - ② issuing stock and selling it to the public is a way for corporations to raise funds to finance their activities.
- The stock market is the place in which the claims on the earnings of corporations (shares of stock) are traded.
 - ① stock prices are extremely volatile
 - ② The performance of stock market affects business investment decisions because it affects the amount of funds that can be raised by issuing new stocks.

Figure 2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950-2008

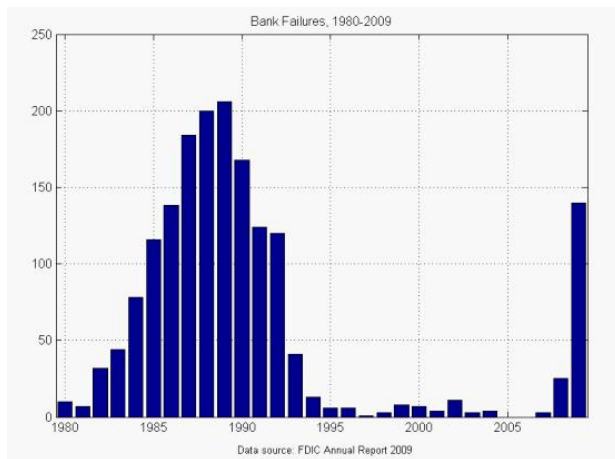


Financial Institutions and Banking

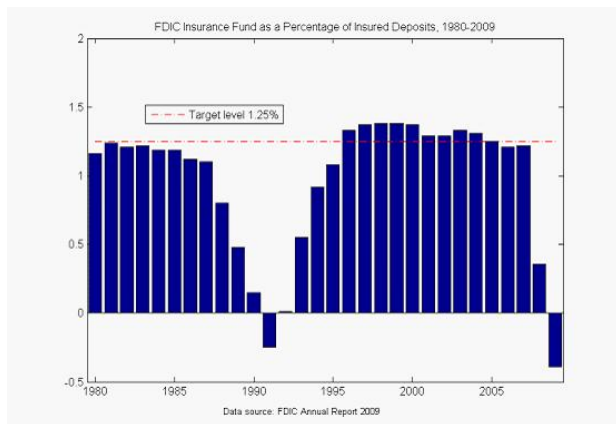
- **Financial Intermediaries** – institutions that borrow funds from people who have saved and in turn make loans to other people
 - ① very important to a well-functioning financial system.
 - ② reduce transaction cost and solve the asymmetric problems
 - ③ improve the efficiency of credit allocations in the economy
 - ④ the most heavily regulated business.
- Banks and other financial institutions.
 - ① Banks (accept deposits and make loans): commercial banks and thrift institutions.
 - ② Other Financial Institutions: insurance companies, finance companies, pension funds, mutual funds and investment banks
- Financial Innovation

Financial Crises

Financial crises are major disruptions in financial markets that are characterized by sharp declines in asset prices and the failures of many financial and nonfinancial firms



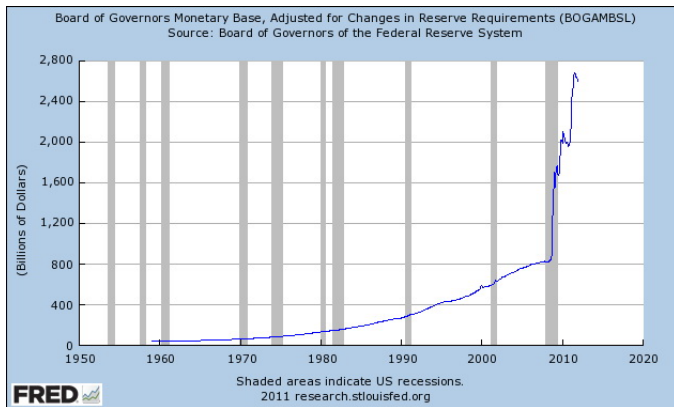
Financial Crises



- 1 2008 below statutory target level of 1.25% of insured deposits
- 2 2009 in hole at $-.39\%$! Recovered to $-.15\%$ by 9/2010 (not plotted)
- 3 1998-90 similar, reached $-.25\%$; back on target by 1995

Monetary Base Explosion

The monetary base more than doubled by the end of 2008, now has tripled.



- Beginning in 2008, Fed advanced \$1.8 trillion to bail out Fannie Mae, Freddie Mac, AIG, Bear Stearns, Mortgage Backed securities, etc.
- usually, this would double Money supply, Price Level through Quantity Theory of Money

Money and Inflation

High money growth is usually accompanied by high inflation.

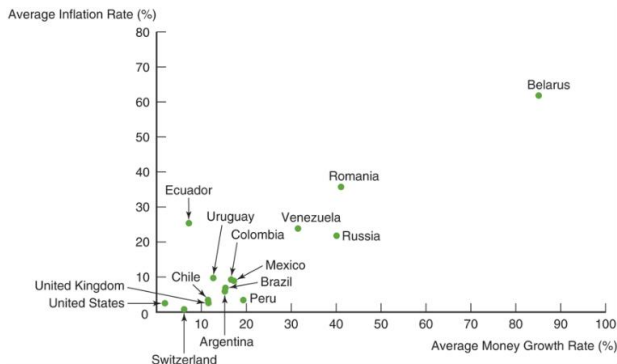
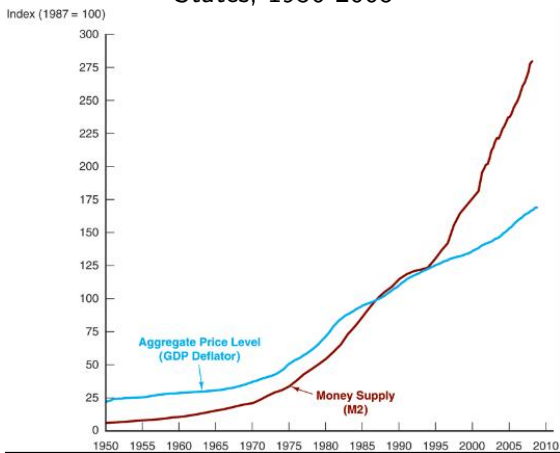


Figure 5 Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 1997-2007 ⁴

⁴Source: International Financial Statistics

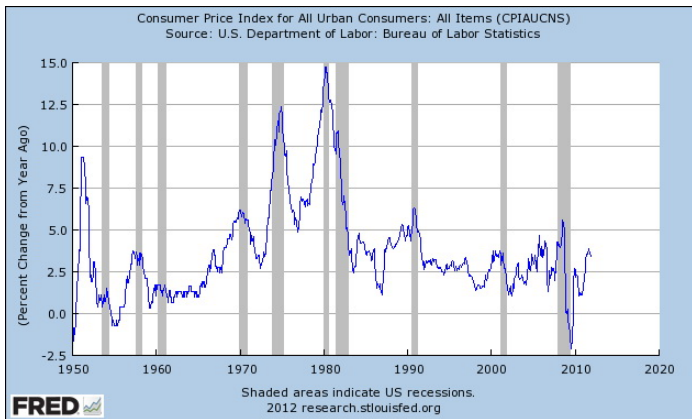
FIGURE 4 Aggregate Price Level and the Money Supply in the United States, 1950-2008



Money and Inflation

The U.S. is not immune from inflation

- Double digits 1973-75, 1978-81



Money and Business Cycles

- Evidence indicates that money plays an important role in generating business cycles
- **Business cycle** is the upward and downward movement of aggregate output
 - ① Aggregate output falls in economic recession and increases during economic recovery
 - ② Unemployment rate also fluctuates with business cycle
- Recessions and expansions of economy affect all of us

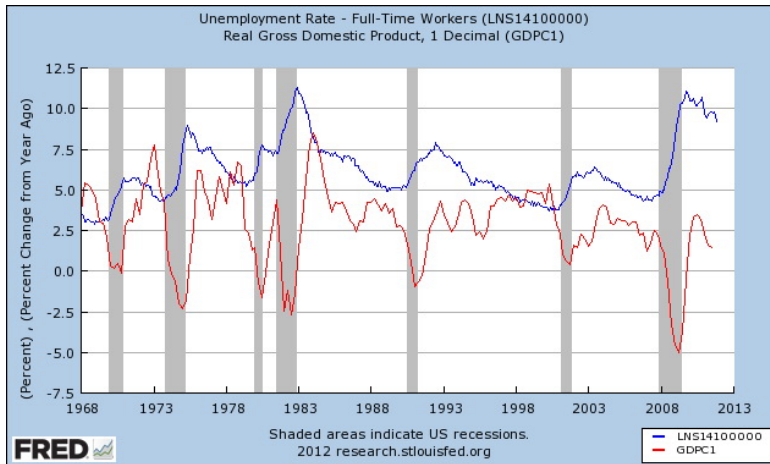
Money and Business Cycles

FIGURE 3 Money Growth (M2 Annual Rate) and the Business Cycle in the United States, 1950-2008



Unemployment Rate and Business Cycles

Usually, unemployment is low (high) when aggregate output is growing fast (slowly).

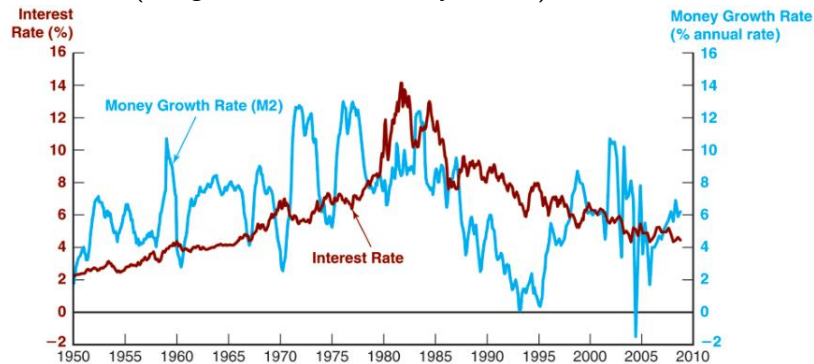


Money and Interest Rates

- ① Interest rates are the price of money
- ② Prior to 1980, the rate of money growth and the interest rate on long-term Treasury bonds were closely tied
- ③ Since then, the relationship is less clear but the rate of money growth is still an important determinant of interest rates

Money and Interest Rates

FIGURE 6 Money Growth (M2 Annual Rate) and Interest Rates (Long-Term U.S. Treasury Bonds), 1950-2008



Fiscal Policy and Monetary Policy

- Fiscal policy is decisions about government spending and taxation
- Budget deficit
- Budget surplus

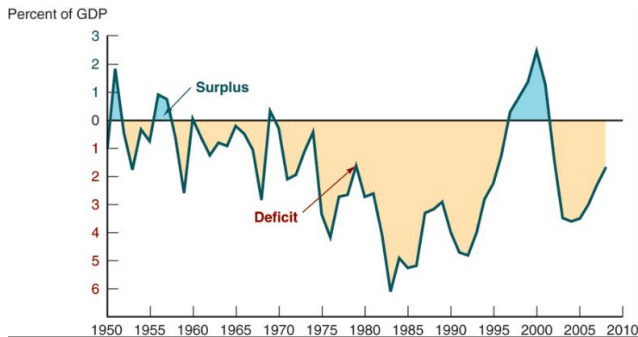
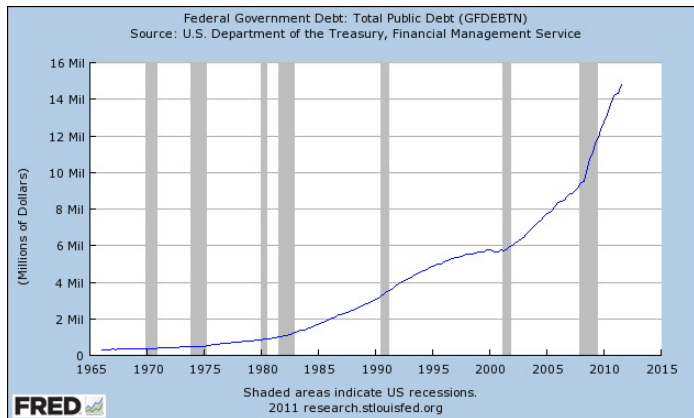


Figure 7 Government Budget Surplus or Deficit as a percentage of Gross Domestic Product, 1950-2008 ⁸

⁸Source: www.gpoaccess.gov/usbudget/fy06/sheets/hist01z2.xls

Fiscal Policy and Monetary Policy

Current total federal government public debt is about 14.8Mil millions of dollars.



- Has increased \$5 Trillion since 2008 \Rightarrow average taxpayer \$55,000 deeper in debt than 2008