ECOS2004 MONEY AND BANKING LECTURE SUMMARIES

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WEEK 1 – Chapter 1: Why Study Money, Banking, and Financial Markets? Chapter 2: An Overview of the Financial System

Financial markets: Markets in which funds are transferred from people and firms who have an excess of available funds to people and firms who have a need of funds
- Promotes efficiency by producing an efficient allocation of capital, which increases production
- Directly improve the well-being of consumers by allowing them to schedule purchases better

Security: Claim on issuer's future income or assets

Bond: Debt security that promises to make payments periodically for specified period of time. Principal returned to lender at maturity

Interest Rate: Cost of borrowing or price of credit

Stock (Equity): Share of ownership in a corporation

Share of Stock: Claim on net earnings and assets of corporation

Financial Intermediaries: Institutions that borrow funds from people who have saved and in turn make loans to other people
- E.g. Banks – Accept deposits and make loans, Insurance companies

Financial Innovation: Development of new financial products and services

Financial Crises: Major disruptions in financial markets that are characterized by sharp declines in asset prices and the failures (or government rescues) of many financial and nonfinancial firms

Aggregate Price Level: Average price of goods and services in an economy

Inflation: Sustained rise in price level
- **Inflation Rate:** Percentage increase in aggregate price level

Monetary Policy: Management of interest rates and the central bank balance sheet
- Conducted by Fed in US, RBA in Aus

Fiscal Policy: Government spending and taxation
- **Budget Surplus:** Revenues > Expenditures
- **Budget Deficit:** Expenditures > Revenues
- Any deficit must be financed by borrowing or money creation

Foreign Exchange Market: Funds converted from one currency into another

Foreign Exchange Rate: Price of one currency in terms of another currency
- In a floating rate system, the market determines the foreign exchange rate

Gross Domestic Product (GDP): Market value of all final goods and services produced in a country during the course of a year
- Most commonly reported measure of aggregate output
- E.g. Total of aggregate income, total income of factors of production

Nominal Variable: Any variable whose scale is proportional to the general price level
- E.g. CPI, nominal interest rate, nominal GDP, money supply

Real Variable: Any variable whose scale does not depend on the general price level
- E.g. Real interest rate, real GDP, quantity of output

Direct Finance: Borrowers borrow funds directly from lenders in financial markets by selling them securities

Indirect Finance: Intermediary such as a bank stands between the borrower and lender

Debt and Equity Markets

- Debt instruments (maturity)
- Equities (dividends)

Primary and Secondary Markets

- Investment banks underwrite securities in primary markets
- Brokers and dealers work in secondary markets

Exchanges and Over-the-Counter Markets

- **Exchanges:** Market with formal location, i.e. Stock exchange
- **OTC Markets:** Dealers decentralized and linked electronically, i.e. Foreign exchange

Money and Capital Markets

- **Money Markets:** Deal in short-term debt instruments
- **Capital Markets:** Deal in longer-term debt and equity instruments

Function of Financial Intermediaries

- **Lower Transaction Costs:** Economies of scale, liquidity services
- **Reduce exposure of investors to risk:** Risk sharing, asset transformation, diversification
- **Dealing with adverse selection:** Avoiding the risky borrower by gathering information about them
- **Dealing with moral hazard:** Ensuring borrower will not engage in activities that will prevent him/her from repaying the loan
- Allows 'small' savers and borrowers to benefit from the presence of financial markets

Regulation of Financial System

- Increase information available to investors
- Reduce adverse selection and moral hazard problems
- Reduce insider trading and related violations
- **Ensure soundness of financial intermediaries:** Restrictions on entry, assets and activities, deposit insurance to avoid bank runs, limits on competition

Regulation of Australian Financial System

- **Council of Financial Regulators:** Coordinating body for Australia's main financial regulatory agencies
- Comprises RBA, APRA etc.
- Discuss regulatory issues and coordinate responses to potential threats to financial stability

Australia Prudential Regulation Authority (APRA): Prudential regulator of banks, insurance companies and superannuation funds, credit unions, building societies in Australia

Australia Securities and Investments Commission: Australia's corporate markets and financial services regulator

WEEK 2 – Chapter 3: What is Money?
Chapter 4: The Meaning of Interest Rates

Money/Money Supply/Money Stock: Anything that is generally accepted as payment for goods or services or in the repayment of debts

Stock: A unit measured at a point in time

Flow: A unit expressed per unit of time

Wealth: The total set of assets (i.e. property, money, securities) that serve to store value – stock

Income: Flow of earnings per unit of time – flow

Functions of Money

1. **Medium of Exchange**
- Eliminates the trouble of finding a double coincidence of wants (reduces transaction costs)
- Promotes specialization in production/labour services
- **Requirements:** Easily standardized, widely accepted, divisible, portable, durable

2. **Unit of Account**
- Used to measure value in the economy
- Reduces transaction costs

3. **Store of Value**
- Used to save purchasing power over time
- Money is the most liquid of all assets; a dollar of any type of money can be reliably converted into a dollar of currency at any time
- Money thus, has fixed nominal value, but loses real value during periods of inflation

Payment System

1. **Commodity Money:** Valuable, easily standardized and divisible commodities
2. **Fiat Money:** Paper money decreed by governments as legal tender
3. **Cheques:** Instruction to your bank to transfer money from your deposit account
4. **Electronic Payment:** Online bill payment, electronic deposit transfers, etc.
5. **E-Money:** Debit cards, stored-value cards, etc.

Measuring Money: U.S Definitions

1. **M1** (most liquid assets) = Currency + Traveller's checks + Demand deposits + Other checkable deposits
2. **M2** = M1 + Small-denomination time deposits + Savings deposits and money market deposit accounts + Money market mutual fund shares

Measuring Money: Australian Definitions

1. **Currency:** Notes and coins held by non-bank public
2. **M1:** Currency + Current deposits (transferable deposits) with commercial banks
3. **M3:** Currency + All bank deposits
4. **Broad Money:** M3 + Deposits with non-bank depository institutions

Present Value: A dollar paid to you one year from now is less valuable than a dollar paid to you today

- A dollar deposit today can earn interest and become $1 x (1 + i) one year from today
- In not having access to $1 today, you are constraining your opportunities to spend in the next year
- E.g. Let **i** = 10%
- **In one year:** $100 x (100% + 10%) = $110
- **In two years:** $110 x (100% + 10%) = $121
- **In n years:** $100 x $(1 + i)^n$