Why study Money and Banking?

FIN204 Lecture 1.1.

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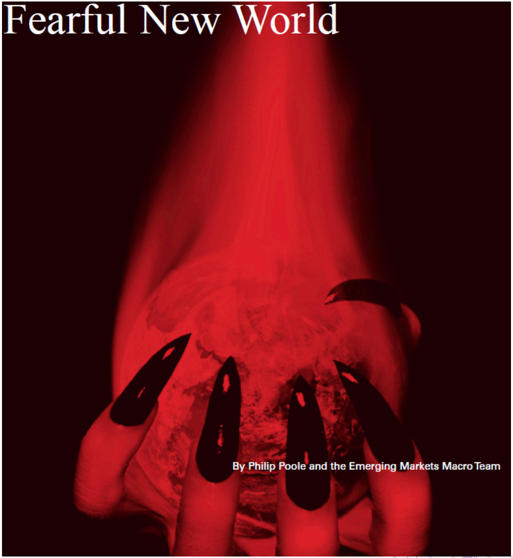
Outline

1. Motivation

2. Outline of the course

3. Administration of the course



Fearful New World
By Philip Poole and the Emerging Markets Macro Team

What happened on the financial markets in 2008-2009?

What happened on the financial markets in 2008-2009?

What happened on the global markets in the last year?

- *Stock market indices* falling sharply around the world, and then going back up since March.
- Governments designing "*rescue plans*" for their economies; and then, designing "exit strategies."
- Major economies going into *recessions* simultaneously; and also coming out recently.
- Central banks desperately throw *liquidity* on the markets; but until when?

Motivation

The content of the course

- Why are these things happening?
- What is their impact on incomes, investment, savings of the local economy, on inflation and exchange rates?
- What can the central banks do in situations like this?
- How are the effects from one stock market transferring to another?
- How are banks and the other financial institutions working? (And why are they failing?)
- What are the functions of money?

Financial markets and interest rates

What are the financial markets?

Definition: 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

Why are the financial markets important?

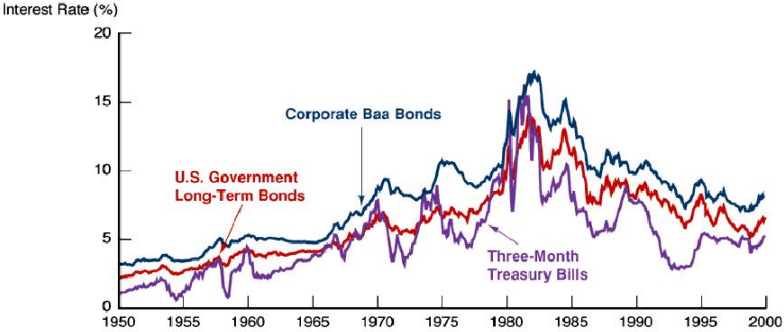
- promote greater economic efficiency
- affect personal wealth and behavior of business firms
- factor for growth: imagine an economy with banks only
- determine interest rates

What is an interest rate?

Definition: Interest rate

An interest rate is the cost of borrowing or the price paid for the rental of funds (usually expressed as a percentage of the rental of 100 per year)

How are the interest rates moving during the last 50 years?



What is a stock?

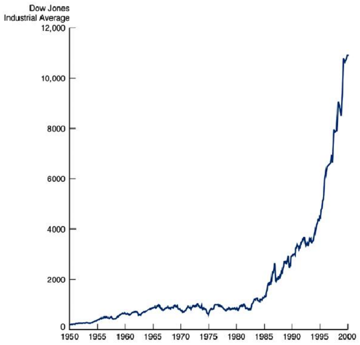
Definition: A stock

A share of ownership in a corporation. It is a security that is a claim on the earnings and assets of the corporation.

The stock market is where stocks are traded:

- Do you think you can make money on it?
- How do you think it affects your wealth, your spending attitudes, your savings?

How is the stock market moving during the last 50 years?



- Do you think it can have any impact on investments in the economy?

The stock and the bond markets

What is a bond?

Definition: A bond

A bond is a debt security that promises to make payments periodically for a specified period of time.

The bond market is where bonds are traded. Why is the bond market important?

- it enables corporations or governments to borrow to finance their activities
- it is where interest rates are determined

Definition: A security

A security is a claim on the issuer's future income

Definition: An asset

Any financial claim or piece of property that is subject to ownership

The Foreign Exchange Market

What is a foreign exchange market?

Definition: A foreign exchange market

A market where funds are converted from one currency to another

Why do firms and citizen need this conversion?

- to transfer funds from one country to another
- for safety reasons

Definition: A foreign exchange rate

A price of one currency in terms of another

What is the Euro-Dollar exchange rate for 2000-2008?

© European Central Bank

The Foreign Exchange Market - Graphs

How is the US dollar moving in terms of other currencies?

- What do these graphs mean?
- What happens when the Euro becomes expensive? For citizen, and for firms...

Banking and Financial Institutions

What is the most important function of banks and other financial institutions?

- **A channel**: to move funds from people who save to people who have productive investment opportunities

Definition: Financial Intermediaries

Institutions (such as commercial and investment banks, insurance companies, pension funds, mutual funds, and finance companies) that borrow funds from people who saved and lend them to people or other institutions that need to make an investment

Which are the largest financial intermediaries?

- A separate lecture on how a bank is run, and how is the banking system doing as an industry

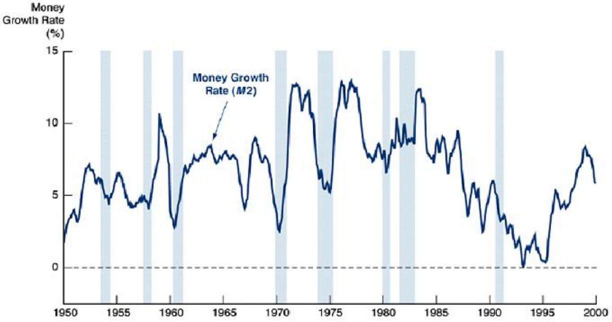
Money, Money Supply and Inflation

Banks create money.

Definition: Money

Money (also referred to as the money supply), is anything that is generally accepted in payment for goods or services or in the repayment of debts.

Money creates business cycles and inflation (M. Friedman).

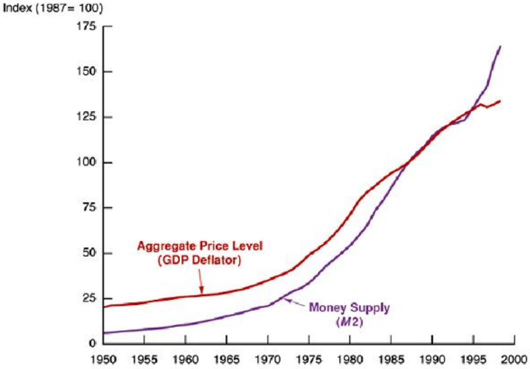


Money, Money Supply and Inflation

Another demonstration of Friedman's claim:

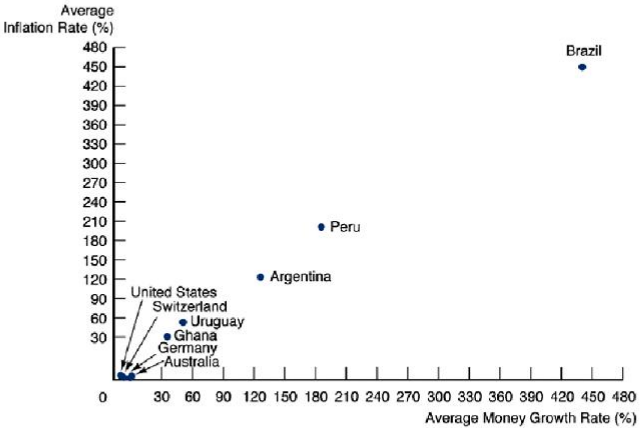
Friedman's Most Famous Claim

Inflation is always and everywhere a monetary phenomenon.



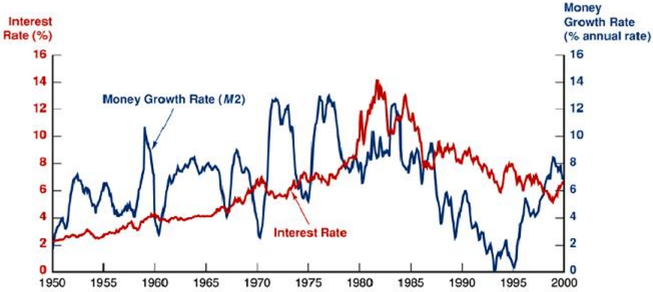
Do you agree that money supply explains inflation?

Further proof of causation: Money Supply Growth and Inflation, 1992 – 2002



Money and Interest rates

Money plays an important role in interest-rate fluctuations, which are of great concern to businesses and consumers:



- As the money growth rate rose in the 1960s and 1970s, the long-term bond rate rose with it
- The relationship between money growth and interest rates has been less clear-cut since 1980

The Conduct of Monetary Policy

What is the monetary policy?

Definition: Monetary Policy

Monetary policy is the management of money and interest rates

Who manages money and interest rates country-wide?

- The Czech National Bank (the central bank of the Czech Republic)
- In US: The Federal Reserve System (also called simply the Fed)
- In the Eurozone: The European Central Bank

The second part of the course will be mainly monetary policy-related.

Concluding Remarks

Why study money and banking?

- interest rates influence earnings on your savings
- and the payments on your loans you may seek on a car or a house
- monetary policy may affect your job prospects and the prices of goods in the future
- will be able to understand many of the things announced in the media
- will be able to comment on them in your future work

Administration of the course

This is how we do it...

How to get an excellent grade in Money and Banking?

- Attend and participate – 10%
- Study on a weekly basis
- Get ready for pop-up quizzes – 20% of the grade
- Do the HWs – 20% of the grade
- Don't screw up the exams ;-)
  - Midterm is 20%
  - Final exam is 30%!
- Don't cheat...