Essex EC248-2-SP
Lecture 1

Money, Banking and
the Financial System:
An Introduction

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Plan of Talk

- **Introduction**: why study…
1. Money and payments: evolution
2. Money and macroeconomics: output, inflation, interest rates and macroeconomic policy
3. The financial system: markets and intermediaries
4. Regulation of the financial system
- **Wrap-up**

Aims and learning outcomes

- **Aims**
  - Illustrate the essence of *money*, *banking*, *payment systems* and *financial markets* in the economy
  - Build-up a perspective through which *monetary innovations* and *central banks* will be studied during the course
- **Learning outcomes**
  - Define and measure money
  - Summarise the evolution of money and payments
  - Discuss basic macroeconomic relationships
  - Understand the role of the financial system
  - Distinguish between direct and indirect finance
  - Justify why financial institutions need regulation

Why study…

… Money and monetary policy? => Influence on
1. Business cycles
2. Inflation
3. Interest rates

… Financial markets?
1. Channel funds from savers to investors, thereby promoting economic efficiency
2. Affect personal wealth and behavior of business firms

… Banks and financial intermediaries?
1. Financial intermediation
   Helps get funds from savers to investors
2. Banks and money supply
   Crucial role in creation of money
3. Financial innovation

Payments: Barter, Money and Credit

Economist's Meaning of Money

1. Anything generally accepted in payment for goods and services
2. Not the same as wealth or income

Functions of Money

1. Medium of exchange
2. Unit of account
3. Store of value

Evolution of Payments System

1. Precious metals like gold and silver
2. Paper currency (fiat money)
3. Checks
4. Electronic means of payment
5. Electronic money: debit, stored-value and smart cards, e-cash

Measures of Money

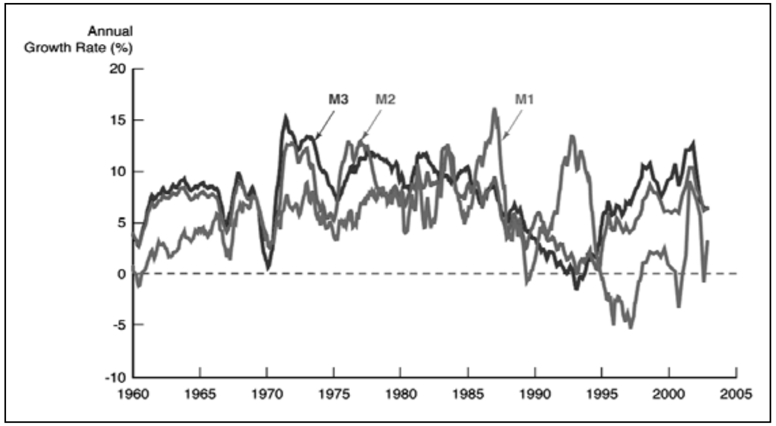
Table 1 Measures of the Monetary Aggregates

	Value as of December 2002 ($billions)
M1 = Currency	626.5
+ Traveler's checks	7.7
+ Demand deposits	290.7
+ Other checkable deposits	281.2
Total M1	1,206.1
M2 = M1	
+ Small-denomination time deposits and repurchase agreements	1,332.3
+ Savings deposits and money market deposit accounts	2,340.4
+ Money market mutual fund shares (noninstitutional)	923.7
Total M2	5,802.5
M3 = M2	
+ Large-denomination time deposits and repurchase agreements	1,105.2
+ Money market mutual fund shares (institutional)	767.7
+ Repurchase agreements	511.7
+ Eurodollars	341.1
Total M3	8,528.2

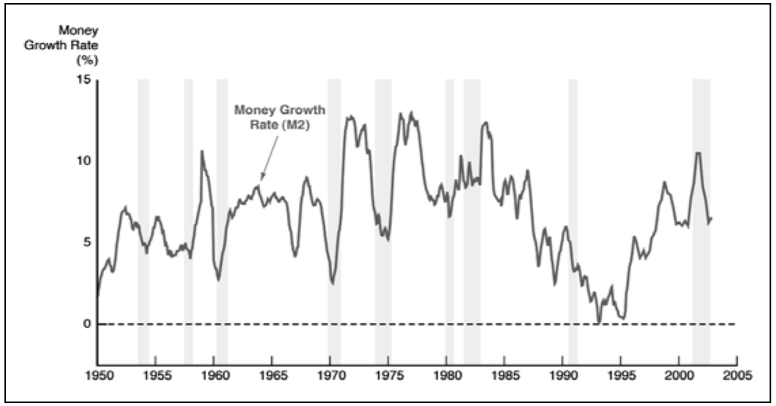
Source: www.federalreserve.gov/releases/h6/hist.

Note: The *Travelers checks* item includes only traveler's checks issued by non-banks, while traveler's checks issued by banks are included in the *Demand deposits* item, which also includes checkable deposits to businesses and which also do not pay interest.

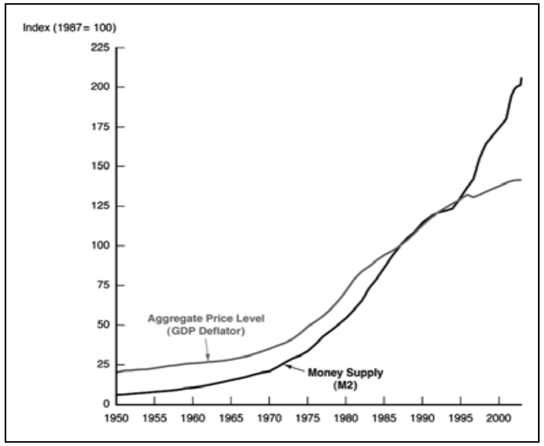
Monetary Aggregates



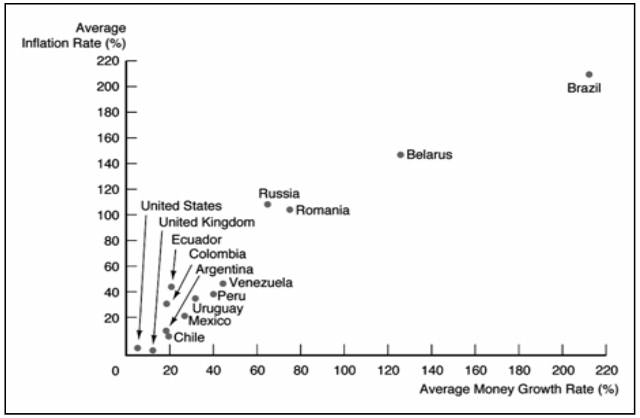
Money and Business Cycles



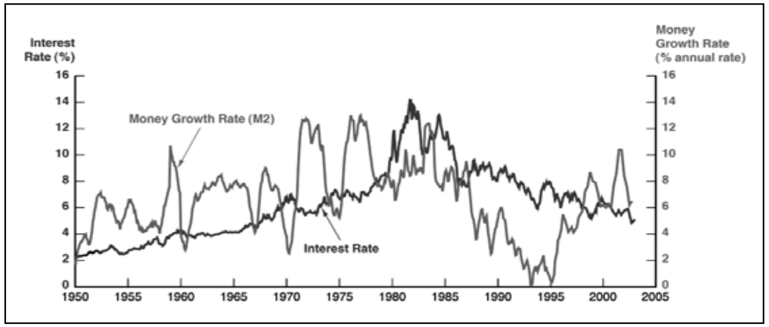
Money and the Price Level



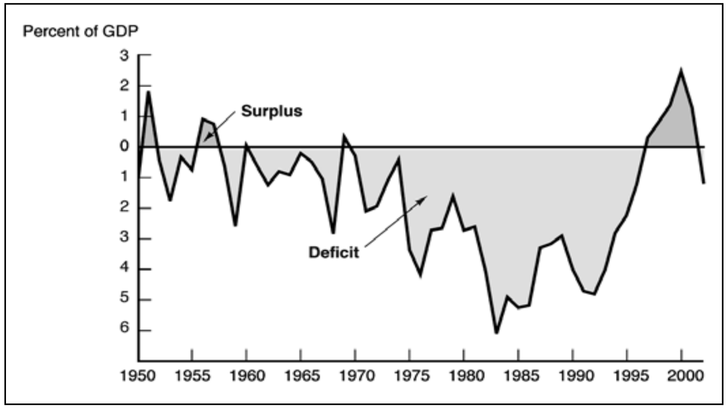
Money Growth and Inflation



Money Growth and Interest Rates

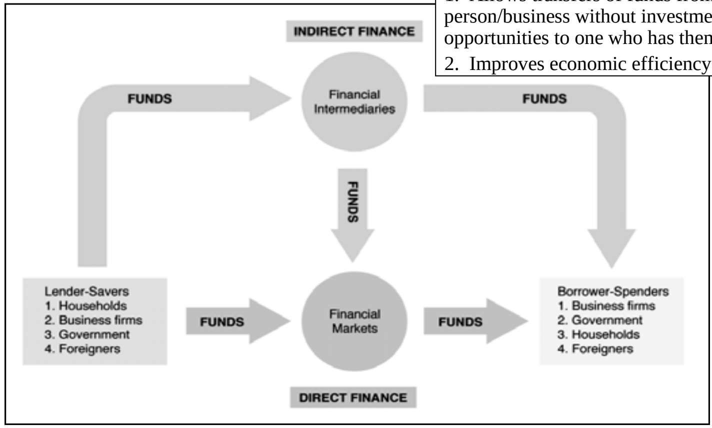


Fiscal Policy and Monetary Policy



The Financial System (Flow of Funds): Structure and Functions

1. Allows transfers of funds from person/business without investment opportunities to one who has them
2. Improves economic efficiency



Classifications of Financial Markets

A. According to the *type* of the financial instruments sold

A.1 *Debt* Markets

Short-term (maturity < 1 year): *Money* Market

Long-term (maturity > 1 year): *Capital* Market

A.2 *Equity* Markets

Common stocks

B. As to whether the securities sold are of a new or old *issue*

B.1 *Primary* Market

New security issues sold to initial buyers

B.2 *Secondary* Market

Securities *previously* issued are bought and sold

C. As to whether the market can be *localised* geographically or not

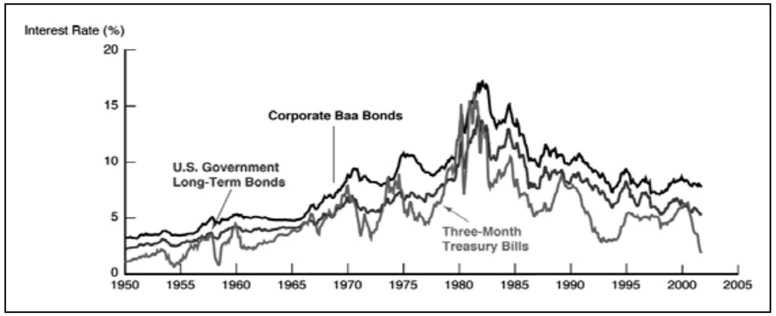
C.1 *Exchanges*

Trades conducted in central locations (e.g., New York Stock Exchange)

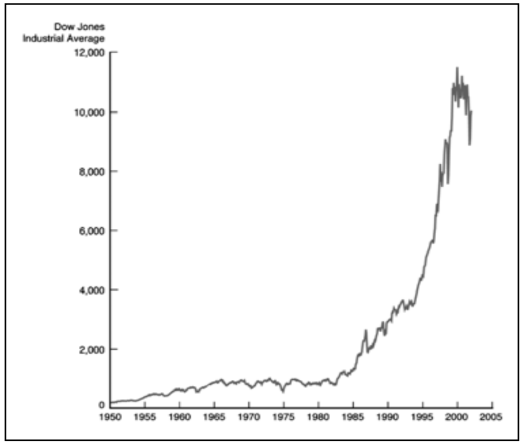
C.2 *Over-the-Counter (OTC)* Markets

Dealers at *different* locations buy and sell

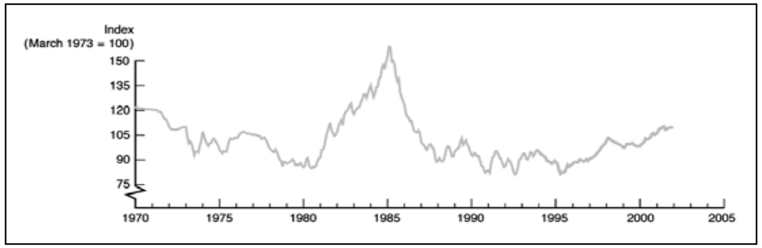
Bond Market



Stock Market



Foreign Exchange Market



Financial Intermediaries: Role

Activities

1. Engage in process of *indirect* finance
2. *More* important source of finance than securities markets
3. Needed because of (i) transactions costs and (ii) asymmetric information

Transactions Costs

1. Make profits by *reducing* transactions costs
2. Reduce transactions costs by developing *expertise* and taking advantage of *economies of scale*

Risk Sharing

1. Create and sell assets with *low* risk characteristics and then use the funds to buy assets with *more* risk = **asset *transformation***
2. Also *lower* risk by helping people to diversify portfolios = **asset *diversification***

Financial Intermediaries: Types of Asymmetric Information

Adverse Selection => screening (of projects)

1. *Before* transaction occurs
2. Potential borrowers most likely to produce adverse outcomes are ones most likely to seek loans and be selected

Moral Hazard => monitoring (of clients)

1. *After* transaction occurs
2. Hazard that borrower has incentives to engage in undesirable (immoral) activities making it more likely not to pay loan back

Financial intermediaries *reduce* adverse selection and moral hazard problems, *enabling* them to make profits

Why Regulation of the Financial System?

1. **Increases information to investors**
   - Decreases adverse selection and moral hazard problems
   - Obliges corporations to disclose information
2. **Ensuring the soundness of financial intermediaries**
   - thus (hopefully) preventing financial panics
3. **Types of regulation**
   - A. Chartering: restrictions on entry
   - B. Disclosure: reporting requirements
   - C. Restrictions on assets (to hold) and activities (to engage in)
   - D. Deposit insurance: by the government in case of bank failure
   - E. Restrictions on competition: too much competition harms?…
   - F. Restrictions on interest rates: Regulation Q in US until 1986

Concluding Wrap-Up

- **What have we learnt?**
  - Why it is interesting and useful to study money, financial markets and intermediaries /institutions/
  - What money is and how it affects the macroeconomy
  - How to distinguish indirect from direct finance
  - Why financial intermediation exists
  - Why the financial system is heavily regulated
- **Where we go next:** to a closer look at financial markets, with a focus on the determinants and role of interest rates