

# **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

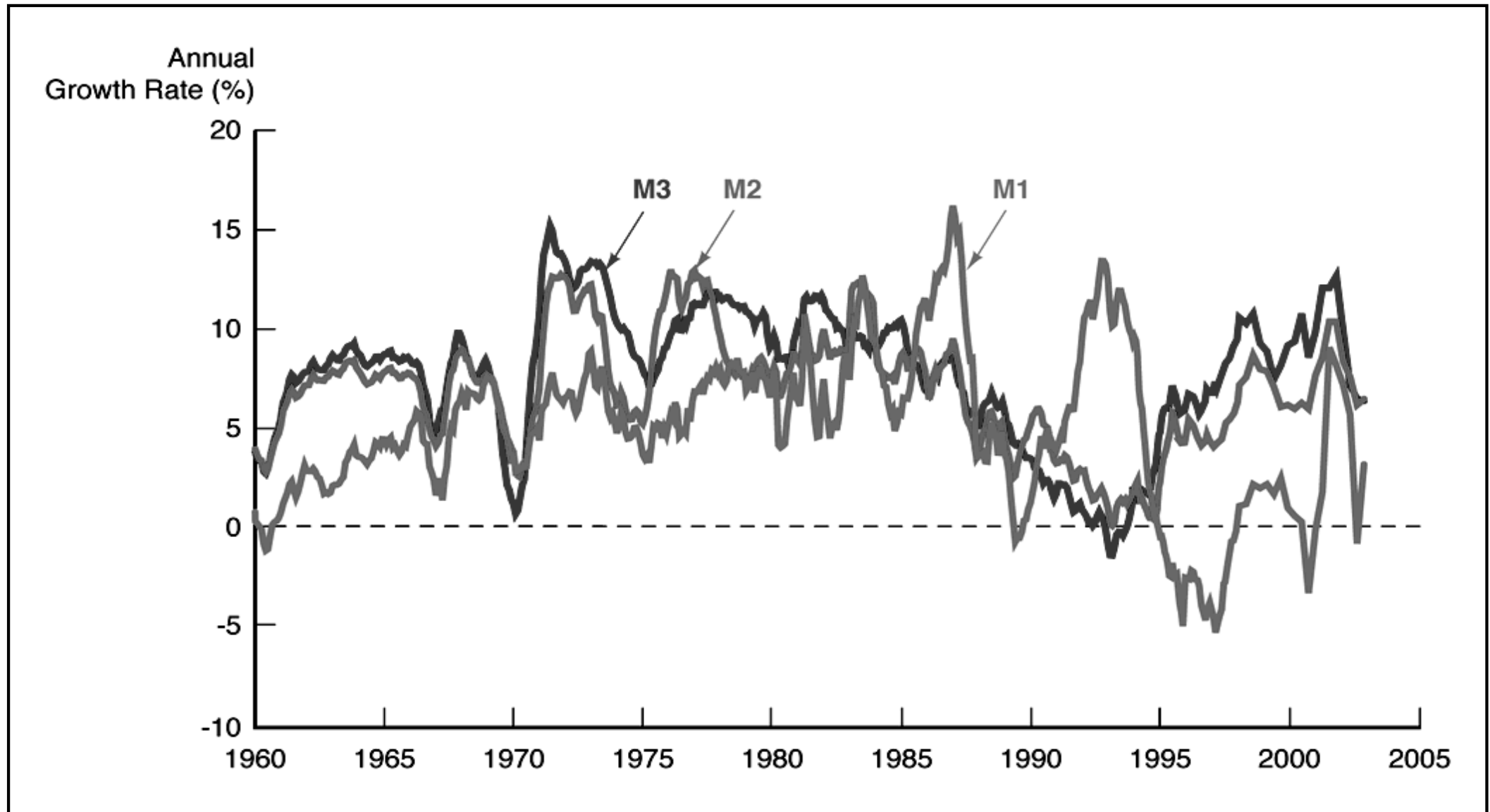
**Table 1 Measures of the Monetary Aggregates**

	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

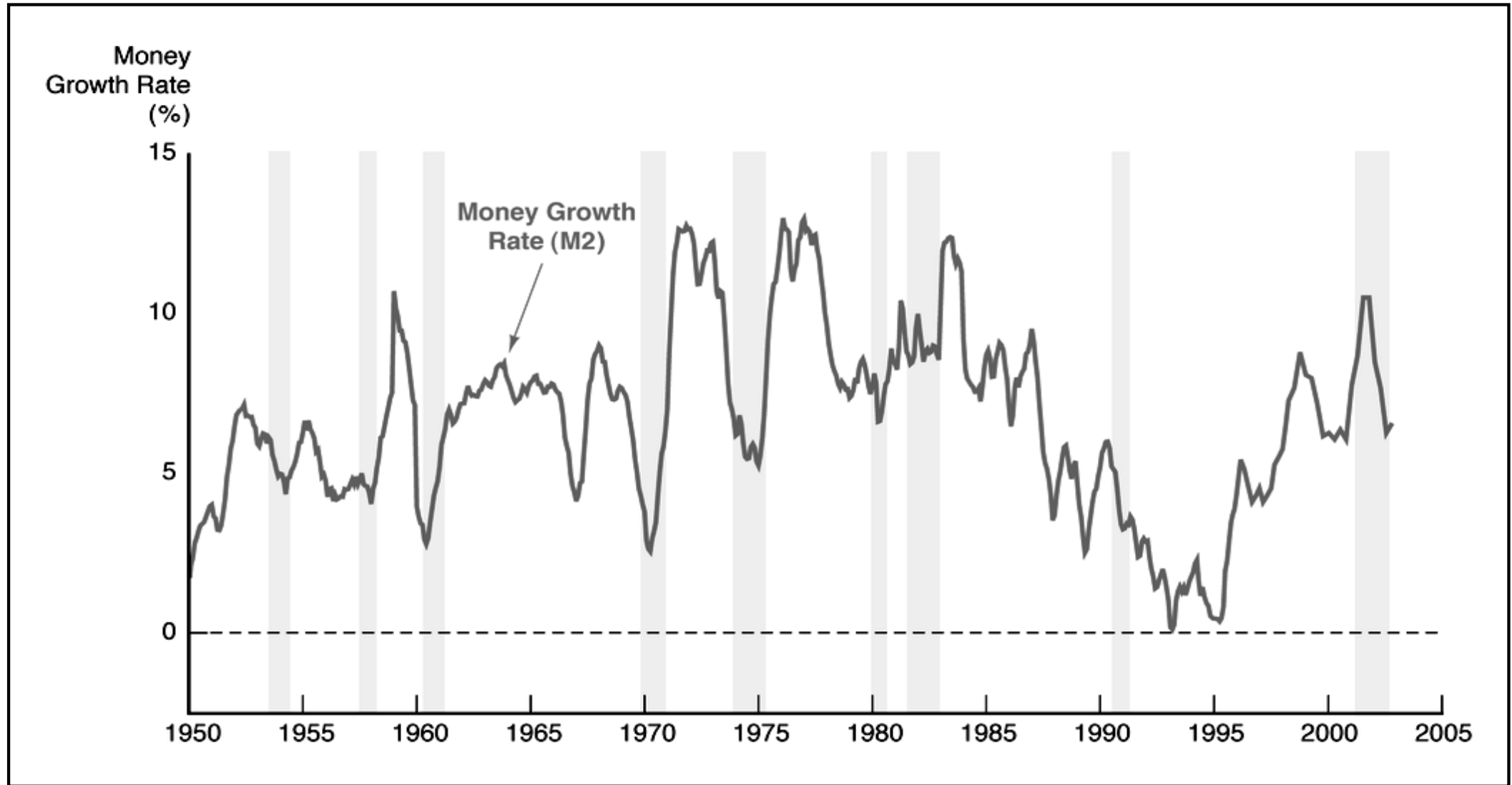
Source: [www.federalreserve.gov/releases/h6/hist](http://www.federalreserve.gov/releases/h6/hist).

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

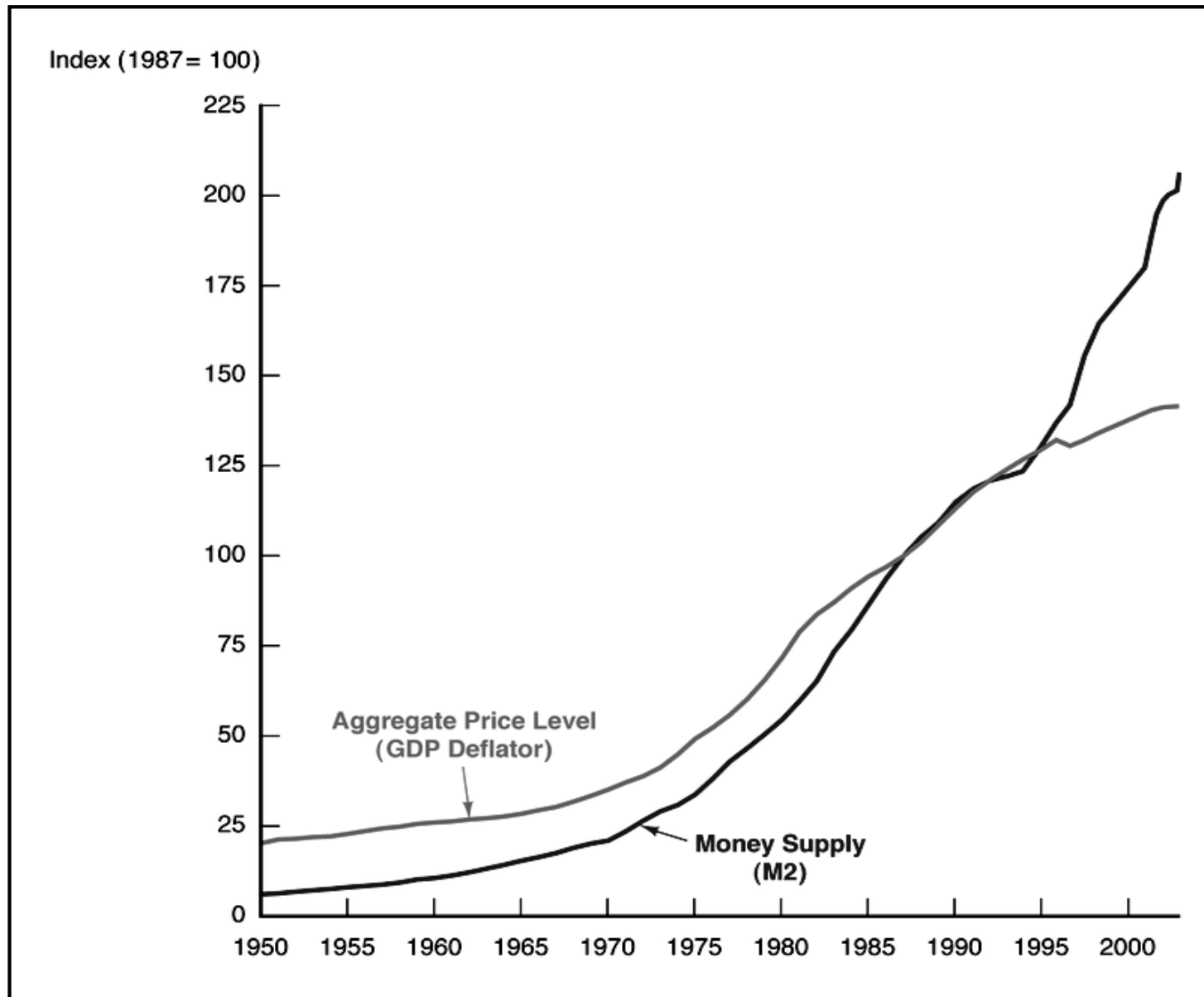


# Money and Business Cycles

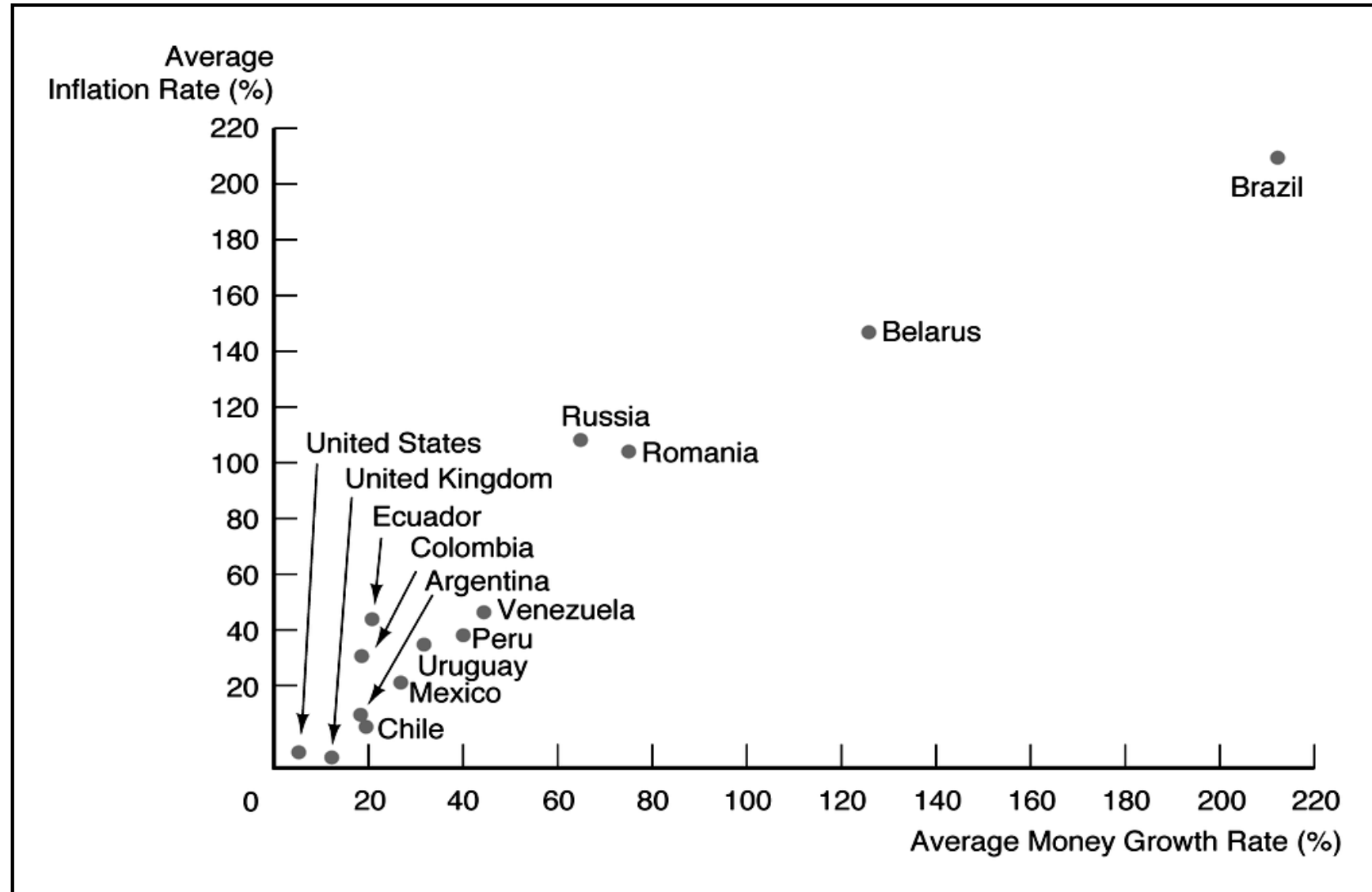




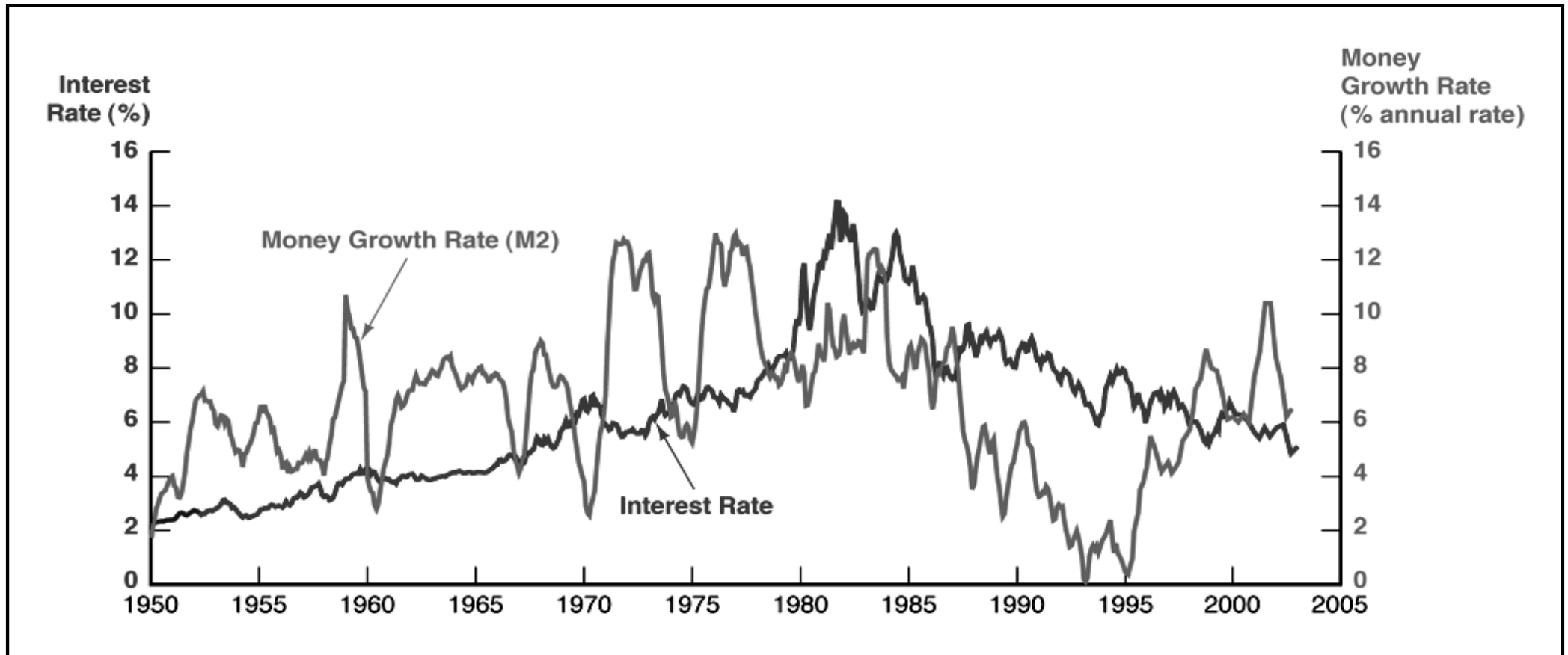
# Money and the Price Level



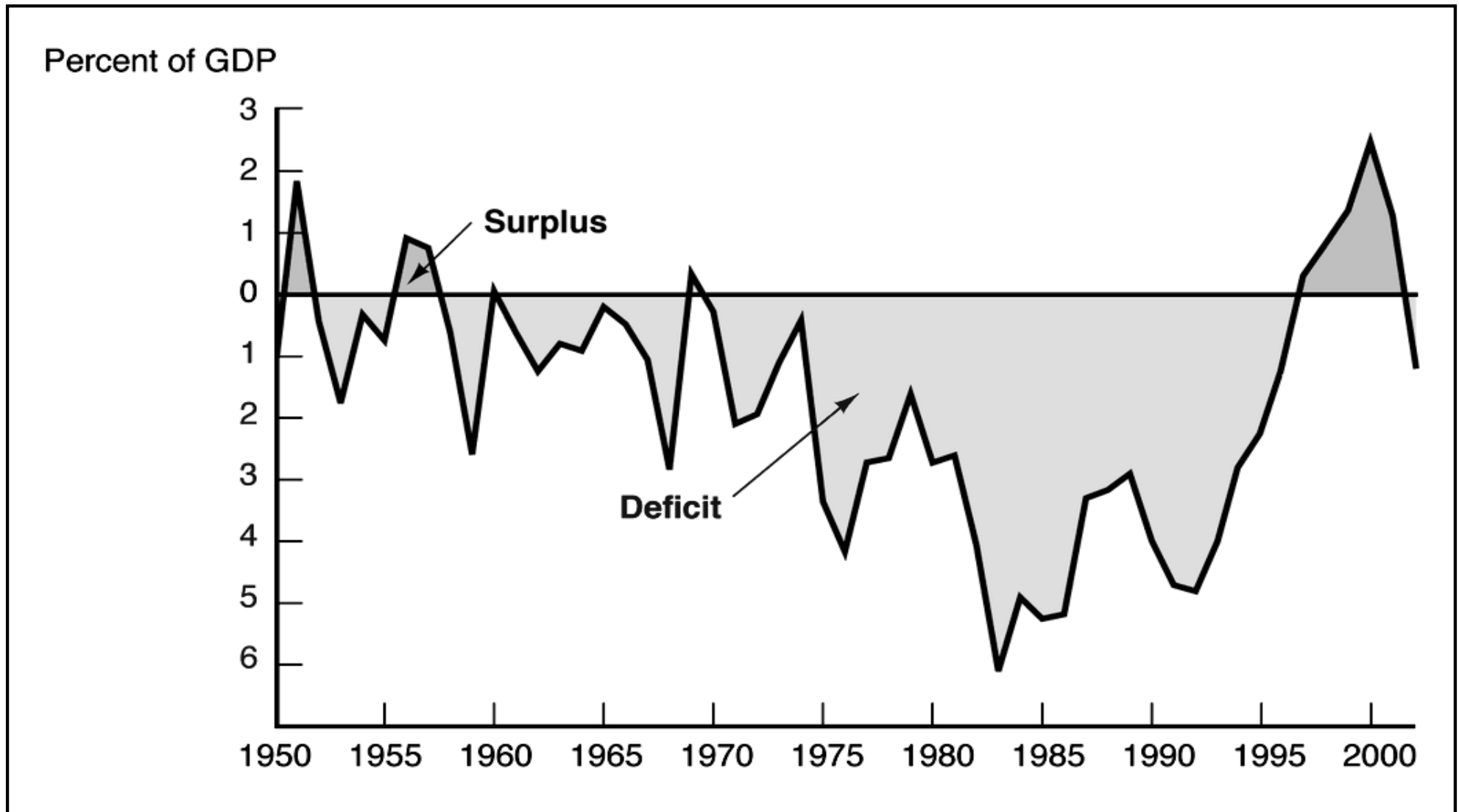
# Money Growth and Inflation



# Money Growth and Interest Rates

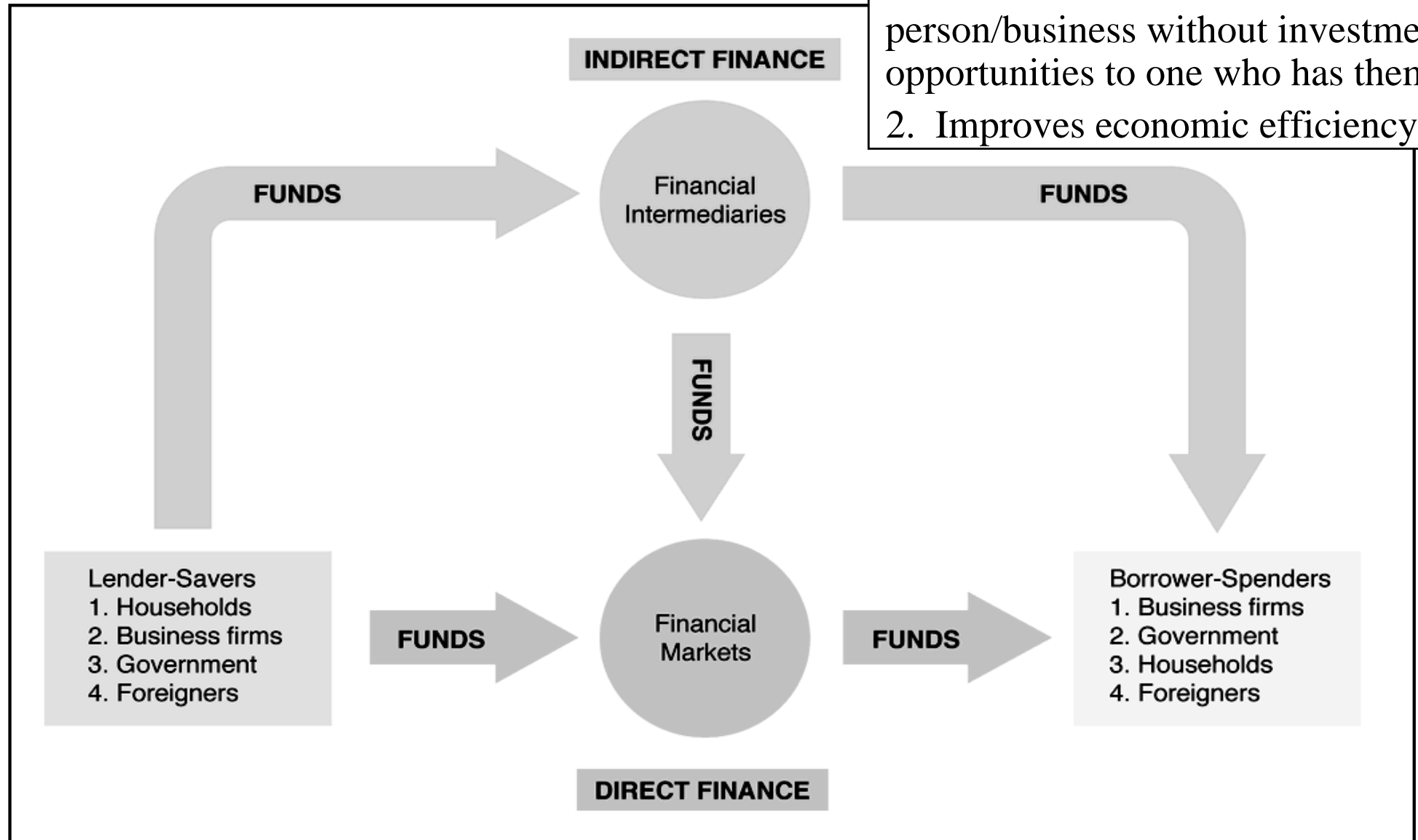


# Fiscal Policy and Monetary Policy



# 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**

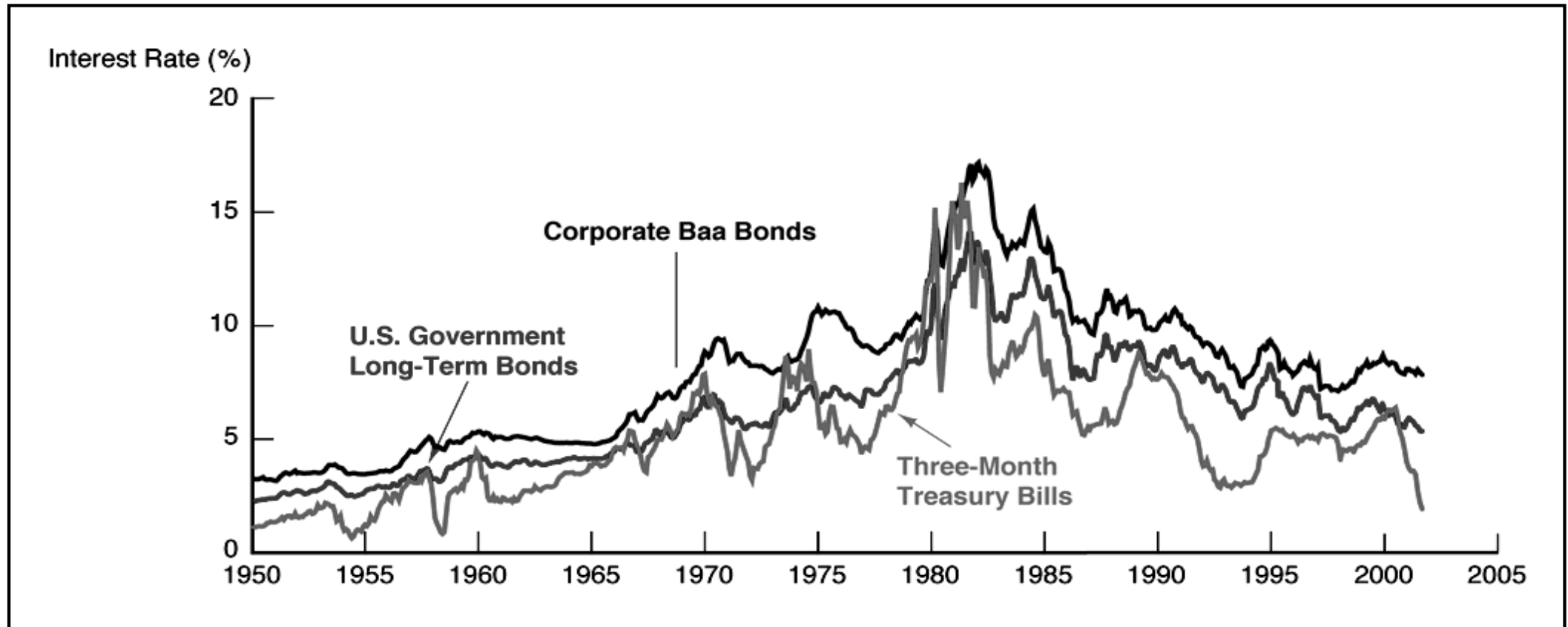
### **C.1 *Exchanges***

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

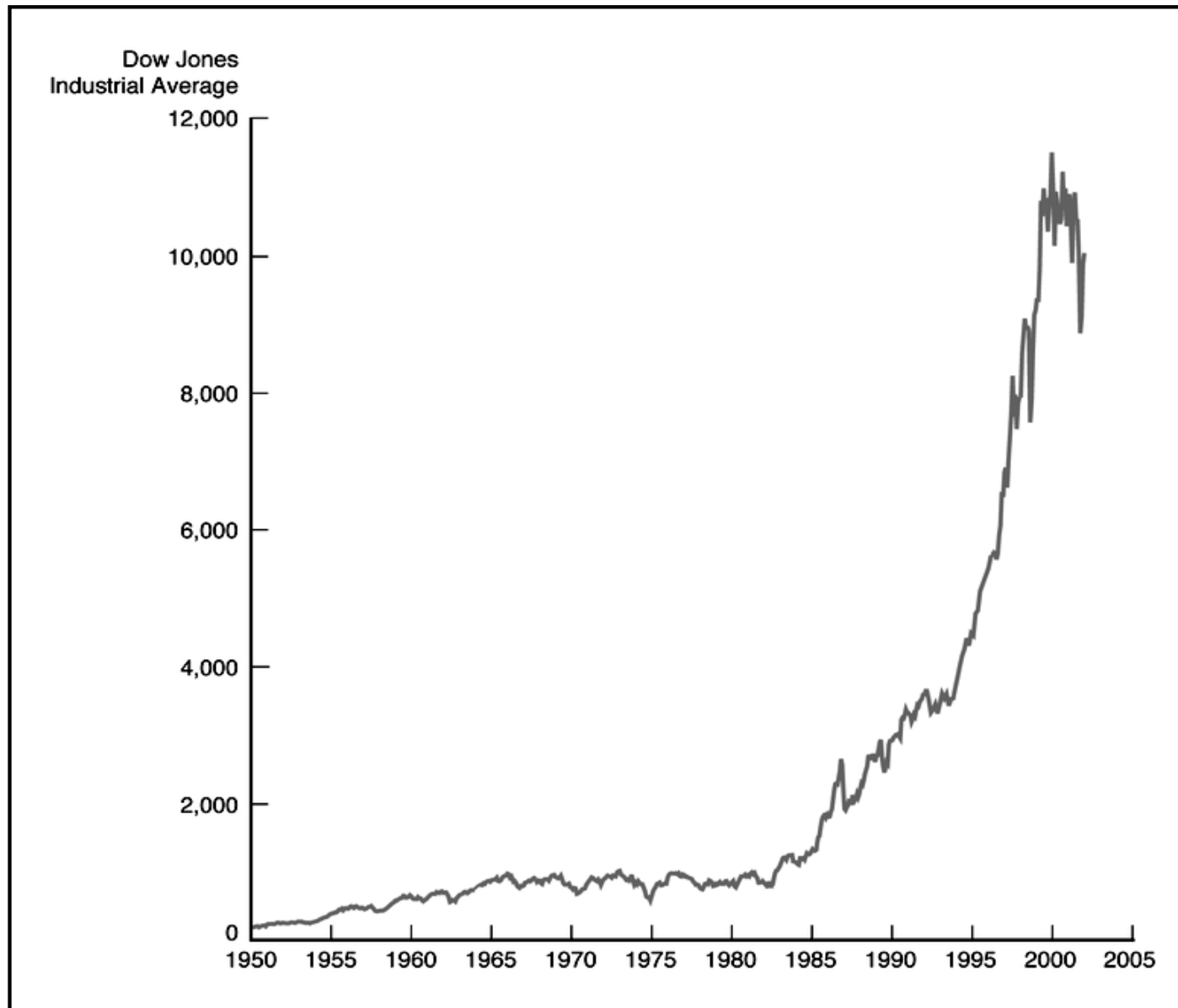
### **C.2 *Over-the-Counter (OTC)* Markets**

Dealers at *different* locations buy and sell

# Bond Market

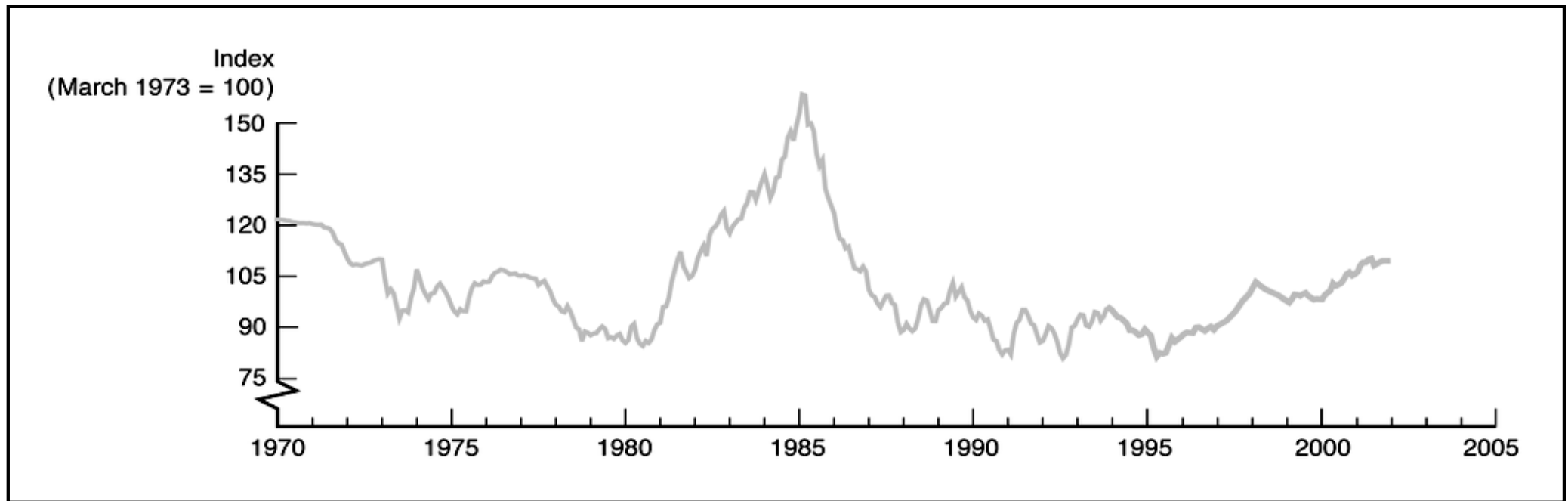


# Stock Market





# 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