

MISHKIN

The Economics of Money, Banking,
and Financial Markets



TENTH EDITION

Chapter 1

Why Study Money, Banking, and Financial Markets?



Preview

- To examine how financial markets such as bond, stock and foreign exchange markets work
- To examine how financial institutions such as banks, investment and insurance companies work
- To examine the role of money in the economy



Why Study Financial Markets?

- Financial markets are 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

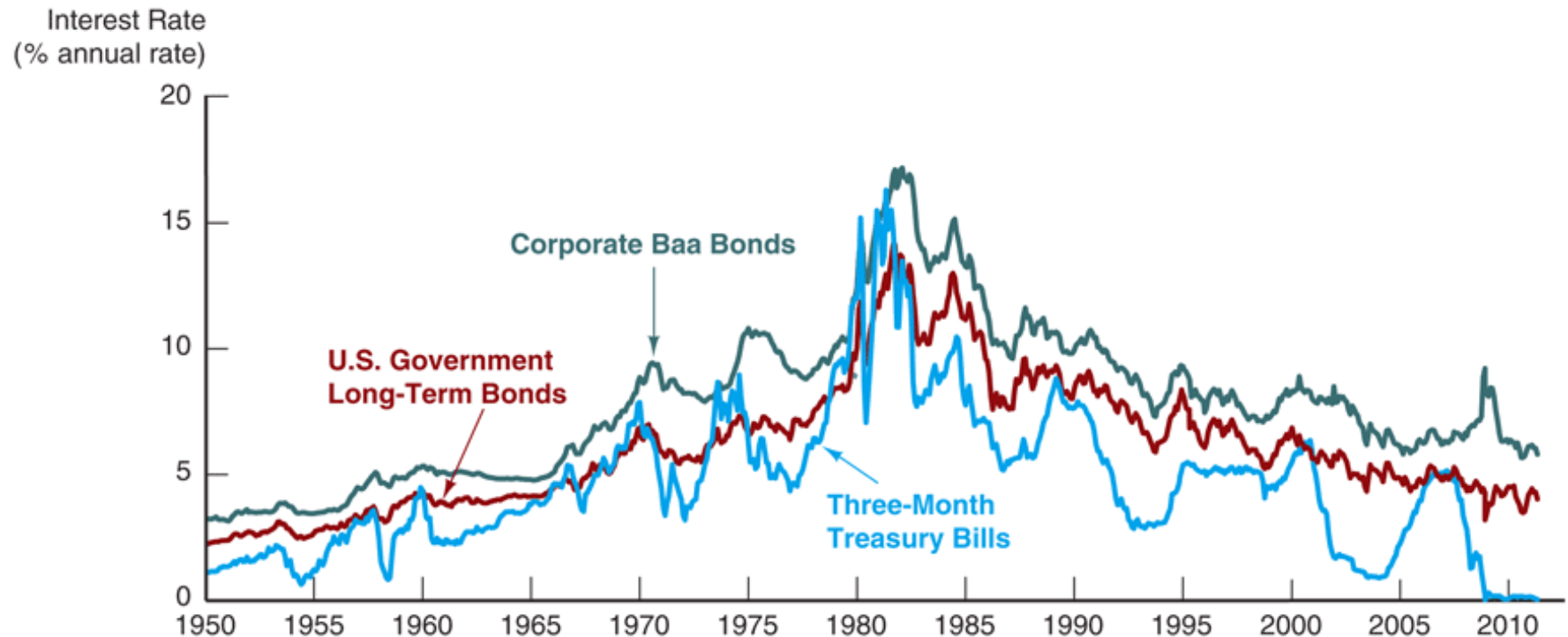


The Bond Market and Interest Rates

- A **security** (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.



Figure 1 Interest Rates on Selected Bonds, 1950–2011



Sources: Based on Federal Reserve Bulletin; www.federalreserve.gov/releases/H15/data.htm.



The Stock Market

- Common stock represents a share of ownership in a corporation
- A share of stock is a claim on the residual earnings and assets of the corporation

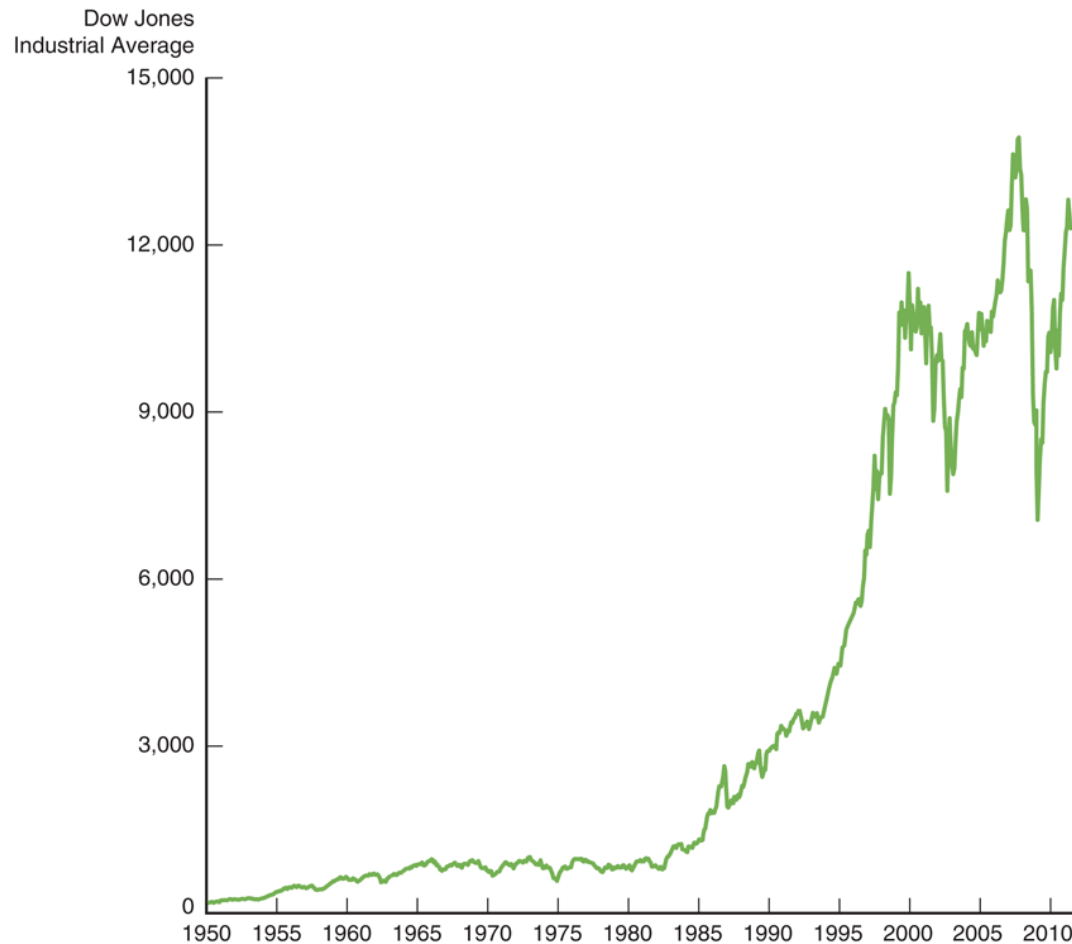


Why Study Financial Institutions and Banking?

- Financial Intermediaries: institutions that borrow funds from people who have saved and make loans to other people:
 - Banks: accept deposits and make loans
 - Other Financial Institutions: insurance companies, finance companies, pension funds, mutual funds and investment companies
- Financial Innovation: the development of new financial products and services
 - Can be an important force for good by making the financial system more efficient



Figure 2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2011



Source: Based on Dow Jones Indexes: <http://nance.yahoo.com/?u>.



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.



Why Study Money and Monetary Policy?

- Evidence suggests that money plays an important role in generating business cycles
- Recessions (unemployment) and expansions affect all of us
- Monetary Theory ties changes in the money supply to changes in aggregate economic activity and the price level

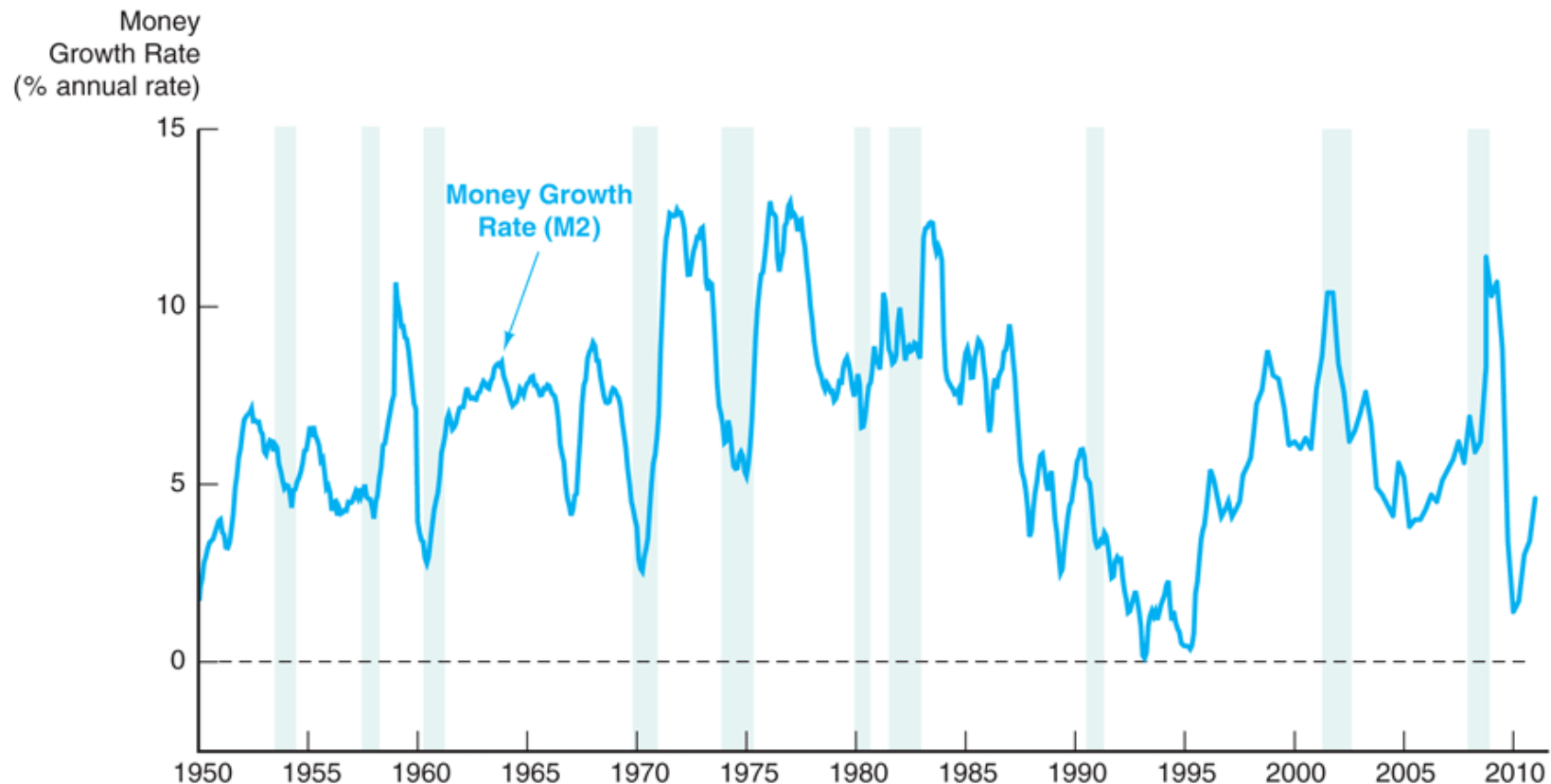


Money, Business Cycles and Inflation

- The aggregate price level is the average price of goods and services in an economy
- A continual rise in the price level (inflation) affects all economic players
- Data shows a connection between the money supply and the price level



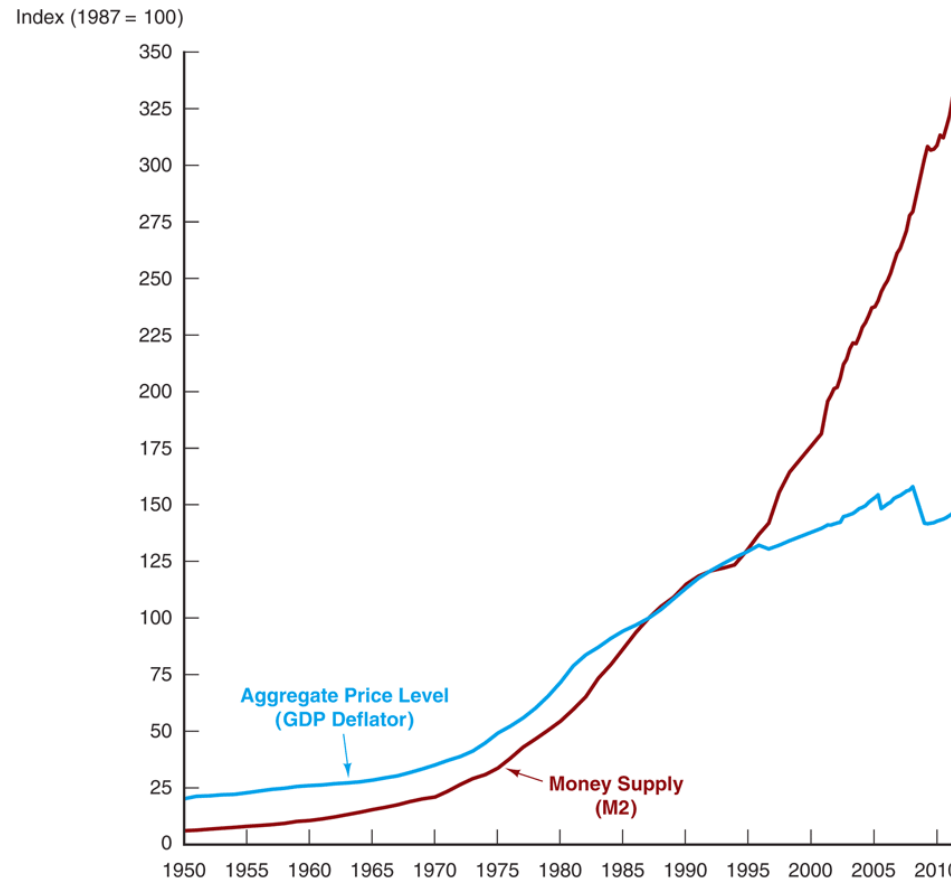
Figure 3 Money Growth (M2 Annual Rate) and the Business Cycle in the United States 1950–2011



Source: Based on Federal Reserve Bulletin, p. A4, Table 1.10;
www.federalreserve.gov/releases/h6/hist/h6hist1.txt.



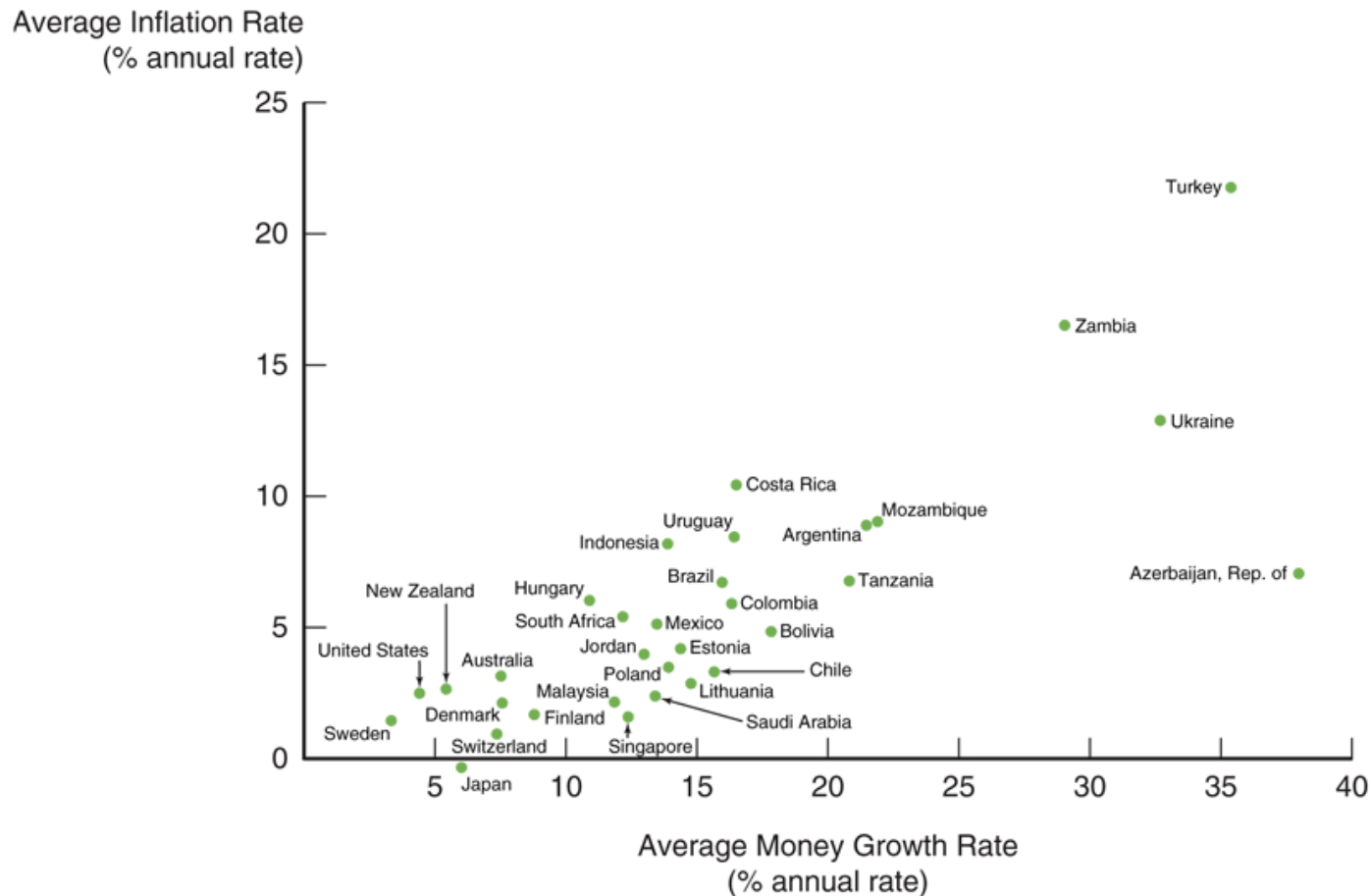
Figure 4 Aggregate Price Level and the Money Supply in the United States, 1950–2011



Sources: Based on www.stls.frb.org/fred/data/gdp/gdpdef; www.federalreserve.gov/releases/h6/hist/h6hist10.txt.



Figure 5 Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 2000-2010



Source: Based on International Financial Statistics. www.imfstatistics.org/imf.

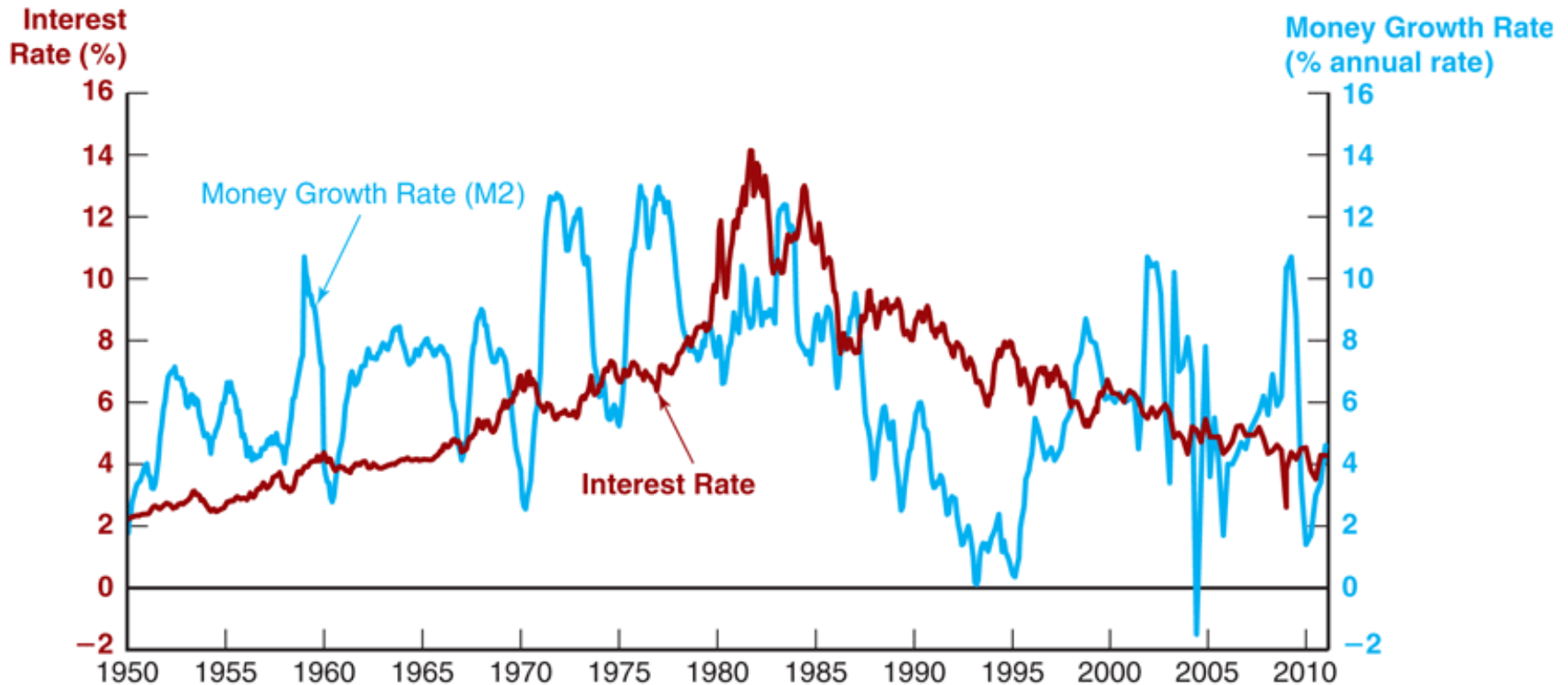


Money and Interest Rates

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



Figure 6 Money Growth (M2 Annual Rate) and Interest Rates (Long-Term U.S. Treasury Bonds), 1950–2011



Sources: Based on Federal Reserve Bulletin, p. A4, Table 1.10; www.federalreserve.gov/releases/h6/hist/h6hist1.txt.

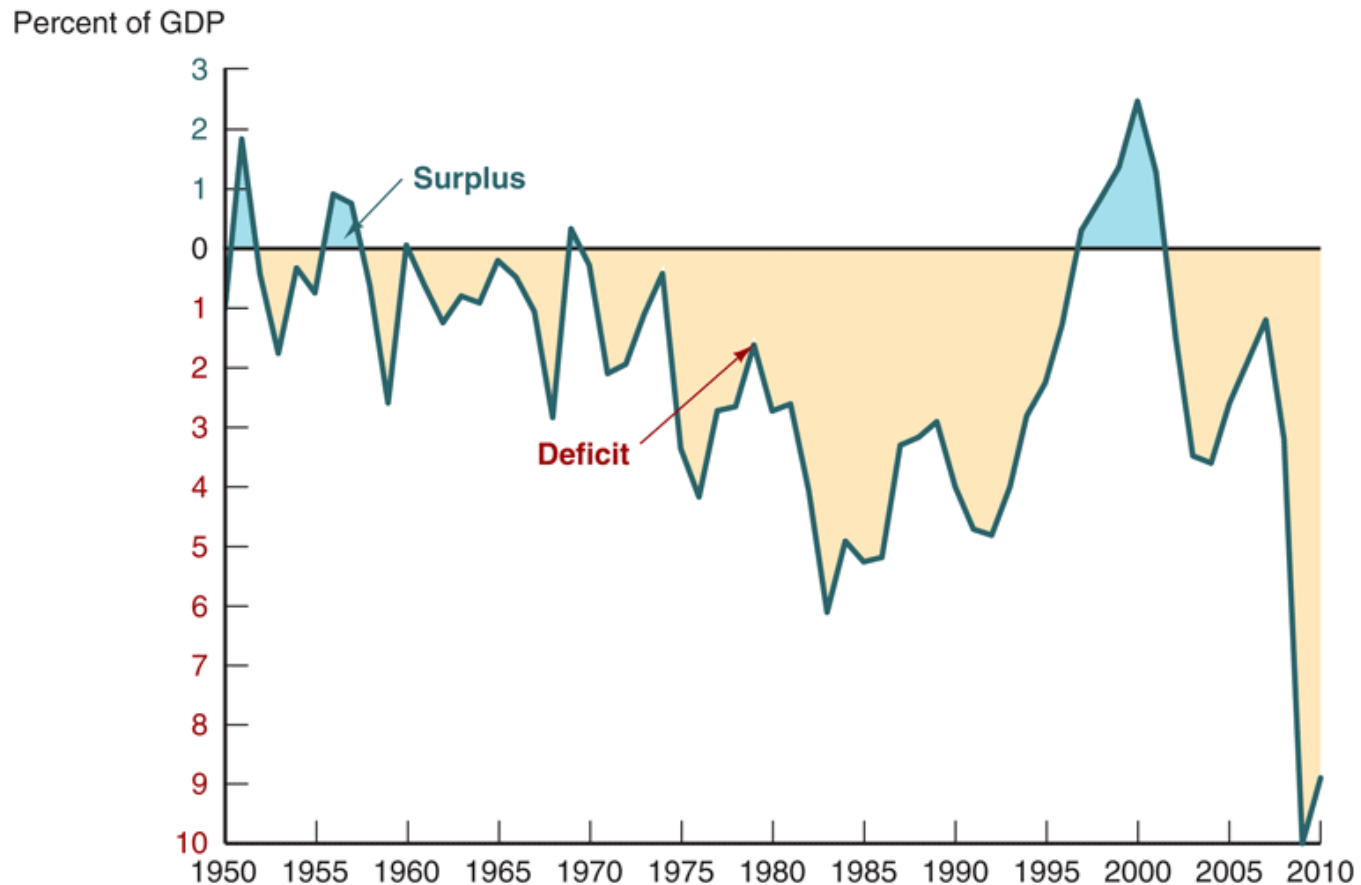


Fiscal Policy and Monetary Policy

- Monetary policy is the management of the money supply and interest rates
 - Conducted in the U.S. by the Federal Reserve System (Fed)
- Fiscal policy deals with government spending and taxation
 - Budget deficit is the excess of expenditures over revenues for a particular year
 - Budget surplus is the excess of revenues over expenditures for a particular year
 - Any deficit must be financed by borrowing



Figure 7 Government Budget Surplus or Deficit as a Percentage of Gross Domestic Product, 1950–2010



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

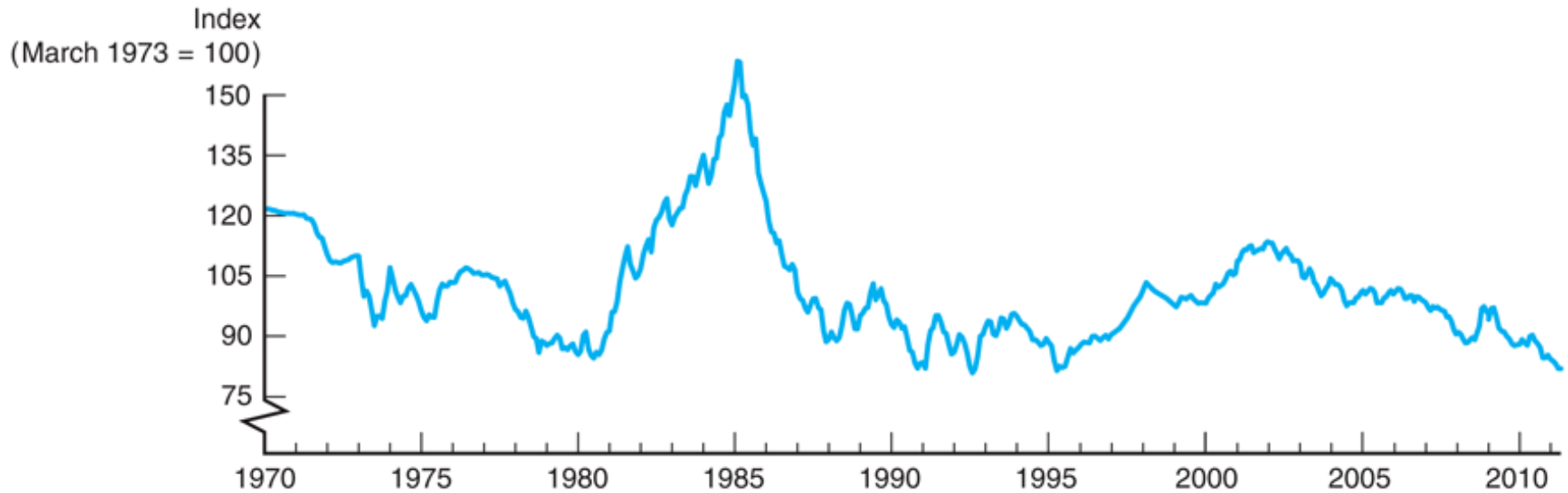


The Foreign Exchange Market

- The foreign exchange market is where funds are converted from one currency into another
- The foreign exchange rate is the price of one currency in terms of another currency
- The foreign exchange market determines the foreign exchange rate



Figure 8 Exchange Rate of the U.S. Dollar, 1970–2011



Source: Federal Reserve; www.federalreserve.gov/releases/H10/summary/indexbc_m.txt/.



The International Financial System

- Financial markets have become increasingly integrated throughout the world.
- The international financial system has tremendous impact on domestic economies:
 - How a country's choice of exchange rate policy affect its monetary policy?
 - How capital controls impact domestic financial systems and therefore the performance of the economy?
 - Which should be the role of international financial institutions like the IMF?



How We Will Study Money, Banking, and Financial Markets

- A simplified approach to the demand for assets
- The concept of equilibrium
- Basic supply and demand to explain behavior in financial markets
- The search for profits
- An approach to financial structure based on transaction costs and asymmetric information
- Aggregate supply and demand analysis



Figure 9 Federal Reserve Board Website

Board of Governors of the Federal Reserve System

[About the Fed](#) [News & Events](#) [Monetary Policy](#) [Banking Information & Regulation](#) [Payment Systems](#) [Economic Research & Data](#) [Consumer Information](#) [Community Development](#)

[Home](#) > [Economic Research & Data](#) > [Statistical Releases and Historical Data](#)

Selected Interest Rates (Weekly) - H.15

[Current Release](#) [Release Dates](#) [Daily Update](#) [Historical Data](#) [About](#) [Announcements](#)

Release Dates

These data are released each Monday, generally at 2:30 p.m., unless Monday is a federal holiday, in which case the data will be released at 2:30 p.m. This site has H.15 releases for the following dates:

2011

2011					
August	<u>01</u>	<u>08*</u>			
July	<u>05</u>	<u>11</u>	<u>18</u>	<u>25</u>	
June	<u>06</u>	<u>13</u>	<u>20</u>	<u>27</u>	
May	<u>02</u>	<u>09</u>	<u>16</u>	<u>23</u>	<u>30</u>

Source: www.federalreserve.gov/releases/H15.



Figure 10 Excel Spreadsheet with Interest-Rate Data

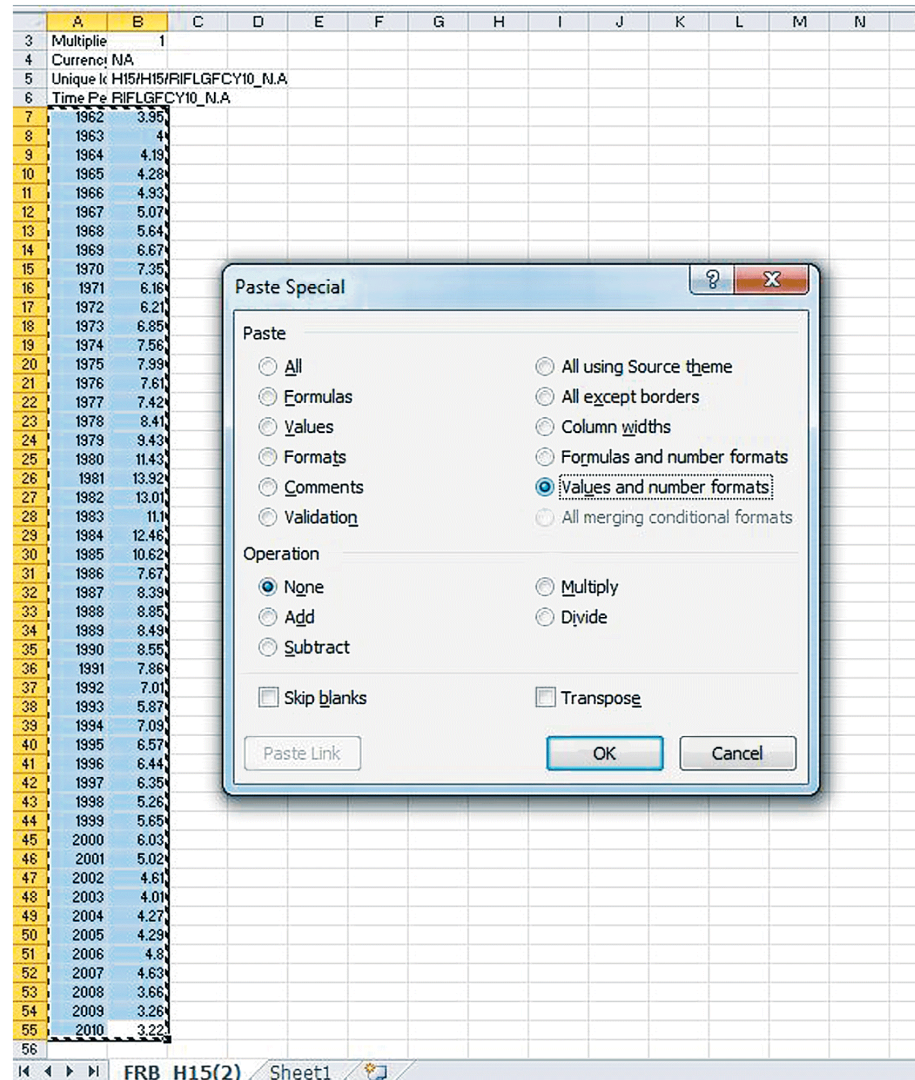




Figure 11 Excel Graph of Interest-Rate Data

