
ECN 135 Lecture 1 Money, Banks & Financial Institutions

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Lecture 1 ECN135

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Practical Matters I

- Prerequisites:
 - ECN 101 (or 105)
- Attendance:
 - desirable, but not mandatory
- 5 (4) Home Assignments
 - 4 (3) problem sets and
 - 1 case study: a near-collapse of Long Term Capital Management (LTCM)

Practical Matters II

- Evaluation:
 - Midterm Exam 40%
 - Final Exam 60%
 - Home Assignments: completed and 2/3 correct
 - Class participation: rewarded by points added to exam score (midterm or final)
- Textbook: [M] Frederic S. Mishkin, 7th ed., *Economics of Money, Banking, and Financial Markets*

Practical Matters III

- How to find me
 - E-mail: gaschwartz@ucdavis.edu
 - Office: 1102 SSH
 - Office Hours: Tues. & Thurs., 6:00pm - 7:00pm
or by appointment
- For course info see [ECN135 Web Page](#)
 - <http://www.econ.ucdavis.edu/faculty/gala/ECN135/>
 - Lecture outlines
 - Course readings
 - Home assignments
 - [Syllabus](#) & [Calendar and due dates](#)

ECN135 Outline

- Course has two parts:
 - I. Financial Intermediation, [M], Ch. 1-13
 - II. Federal Reserve System, [M], Ch. 13-26
 - Overview
 - Models
 - Policies
- Application of theoretical framework to policy issues: we will study examples - to make the concepts & the models "alive"

Why Study Financial Markets?

Financial Markets:

- 1. Channel funds from savers to investors, thereby promoting economic efficiency
- 2. Affect economic outcomes
 - personal wealth
 - behavior of business firms
- **Why Financial Intermediation (FI)? [Banking & Financial Institutions]**
 - 1. Financial Intermediation
 - Helps get funds from savers to investors
 - 2. Banks and Money Supply
 - Crucial role in creation of money
 - 3. Financial Innovation
 - Affect efficiency of FI (search for profit results in efficiency gains)
 - We will look at past developments
- **Why Study Money and Monetary Policy? Influence on**
 - business cycles [M] p. 9
 - inflation & Inflation rate [M] p. 10-11
 - interest rates [M] p. 4

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Business Cycle is the upward & downward movement of aggregate output of the economy [M], p. 9

Inflation is a continual increase of price level [M] p. 10

Inflation rate is the rate of change in the price level (usually per year) [M], p. 11

Interest rate cost of borrowing or the price paid for rented funds (usually as percentage of rental of \$100) [M] p. 4

Definitions: a reminder I

- Security or financial instrument is a claim on the issuer's future income or assets [M] p. 3
- Asset is any financial claim or piece of property that is subject to **ownership** [M] p. 3
- Stock is a share of ownership of the corporation [M] p. 5
- Bond is a debt security promising to make periodic payments for a specified time period [M] p. 3

Definitions: a reminder II

- Financial Intermediaries [FI] [M] p. 8
 - Banks are financial institutions that accept deposits and make loans [M] p. 8
 - Commercial banks
 - Savings and loans associations
 - Mutual savings banks
 - Credit unions
 - other financial institutions
 - investment banks
 - insurance companies
 - pension funds
 - mutual funds
- Tasks of FI
 - Credit provision (evaluation & allocation) & Risk management

Financial Markets

- Financial Markets [M] p. 17
- Main markets are:
 - Bond Market (interest rates are determined)
 - Stock Market (major effect on people's wealth & firms' investment decisions)
 - Foreign Exchange Market (ForEx fluctuations have major consequences for the US economy)
 - Foreign Exchange Rate: Exchange rate - is a price of one currency in terms of another currency

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Foreign Exchange Market where currency conversion takes place [M] p. 5
Exchange rate – is a price of one currency in terms of another currency.

Example: 1.50 \$/£ is

dollar's exchange rate against pound

i.e., price of £ in terms of \$

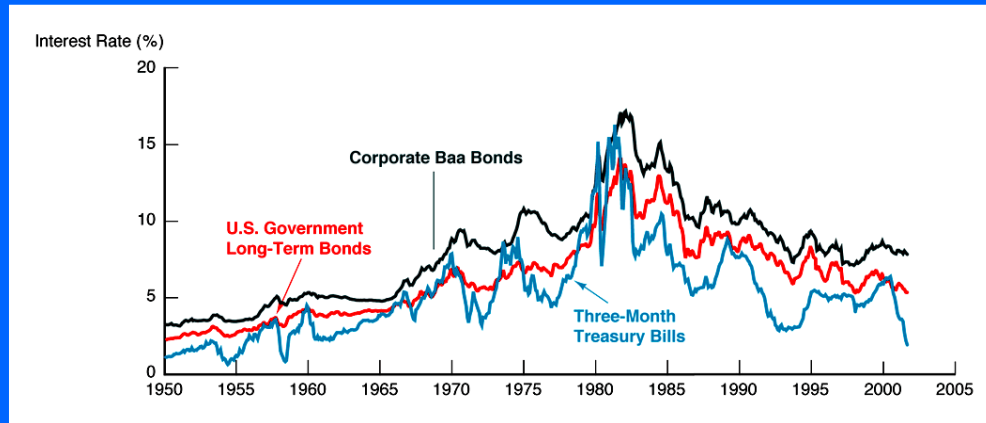
also called dollar/pound exchange rate

A corresponding pound/dollar exchange rate:

$$1/1.50 \text{ \$/£} = 0.67 \text{ £/\$}$$

it is price of £ in terms of \$

Bond Market



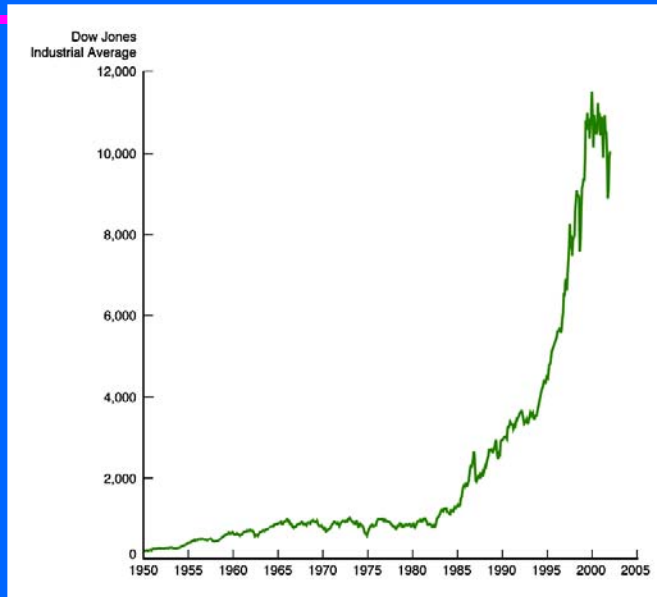
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Bond is a debt security promising to make periodic payments for a specified time period [M] p. 3

Stock Market



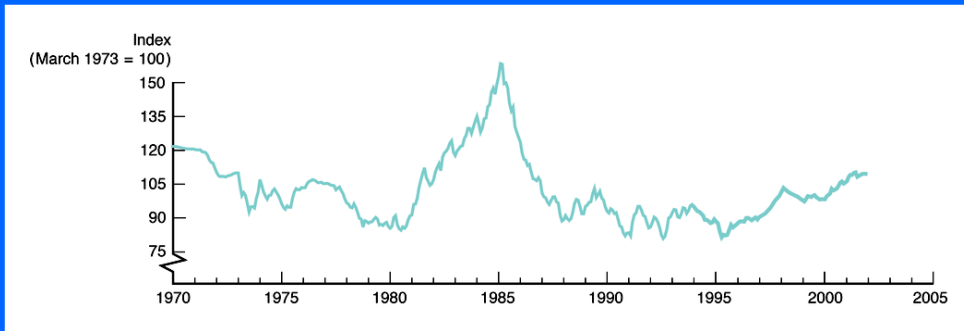
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Stock is a share of ownership of the corporation [M] p. 5

Foreign Exchange Market



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Foreign Exchange Market (ForEx fluctuations have major consequences for the US economy)

Foreign Exchange Rate: Exchange rate – is a price of one currency in terms of another currency

Q: In what years would you like to spend your vacation in Europe (London / Paris)?

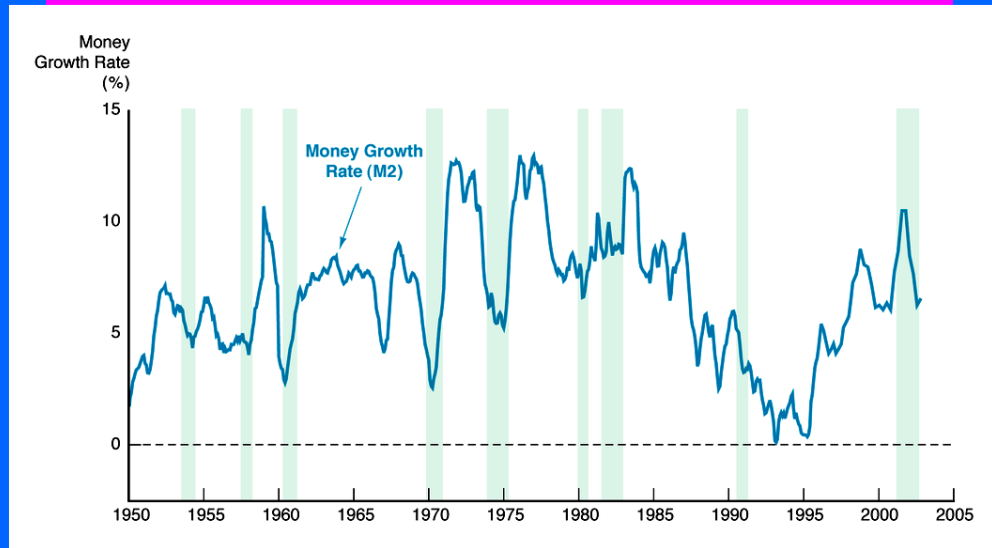
Definitions: a reminder III

- Central Bank [CB] conducts a nation's monetary policy [M] p. 12
 - Federal Reserve System or simply Fed is United States Central Bank [M] p. 12
 - Money & money supply Money (also referred as money supply) anything generally accepted in payment for goods (and services) or in repayment of debt [M] p. 8
 - Monetary policy is management of money and interest rates [M], p. 12

Definitions: a reminder IV

- Fiscal policy government policies about government spending & taxation [M] p. 12
- Budget: [M] p. 12 Let G - government expenditures & T - tax revenues
 - Budget Deficit $T-G < 0$
 - Budget Surplus $T-G > 0$
- Aggregate
 - Income = Output
 - Output
 - Price Level measure of average prices in the economy [M] p. 10
- Gross domestic product (GDP) measure of aggregate output [M] p. 12-13
- Business Cycle is the upward & downward movement of aggregate output of the economy [M], p. 9
 - Recession is a period of declining aggregate output [M], p. 9
 - Unemployment rate percentage of available labor force unemployed

Money and Business Cycles



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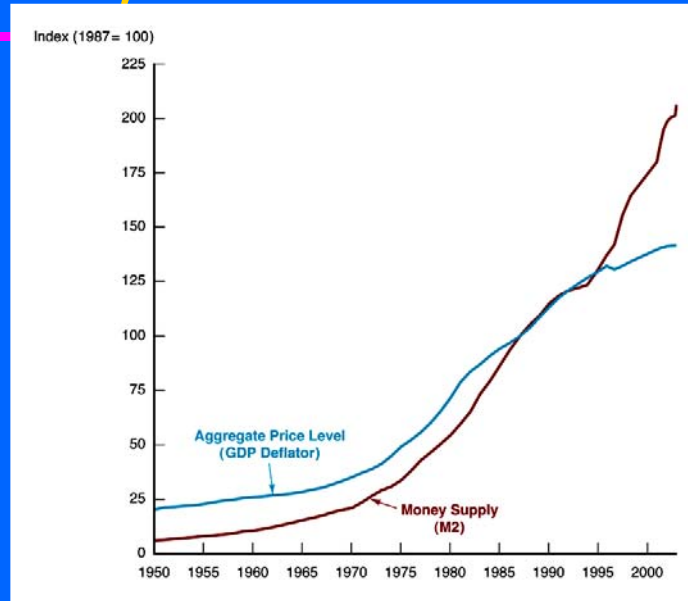
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Money and the Price Level



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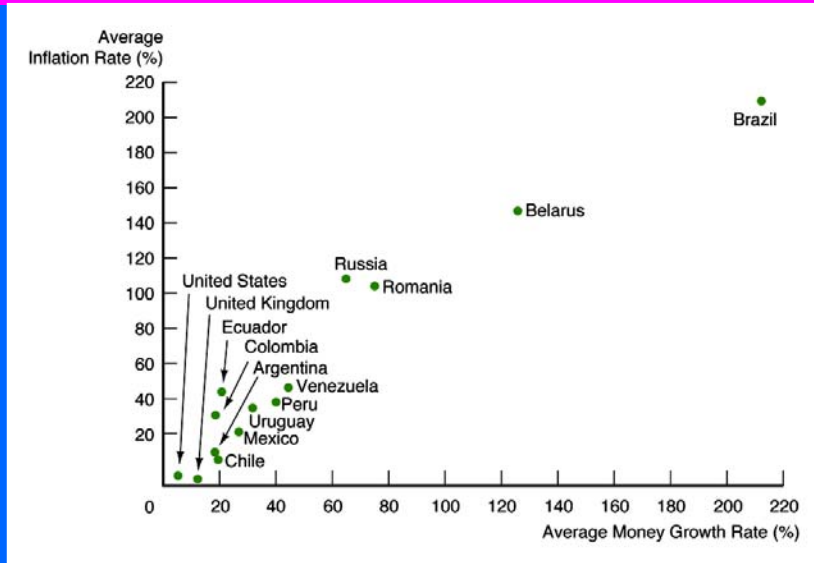
Price Level measure of average prices in the economy [M] p. 10

Consumer Price Index (CPI) price of "basket" of goods and services

Money & money supply Money (also referred as money supply) anything generally accepted in payment for goods (and services) or in repayment of debt [M] p. 8

Monetary policy is management of money and interest rates [M], p. 12

Money Growth and Inflation



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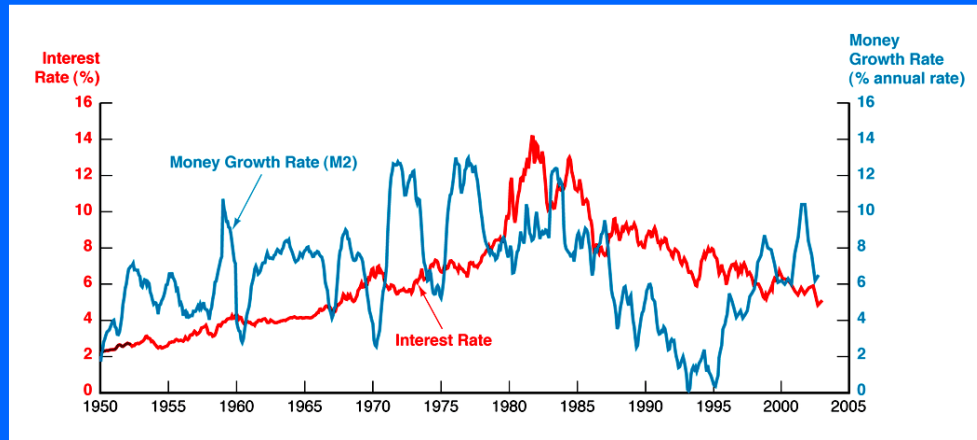
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Inflation is a continual increase of price level [M] p. 10

Inflation rate is the rate of change in the price level (usually per year) [M], p. 11

Money Growth and Interest Rates



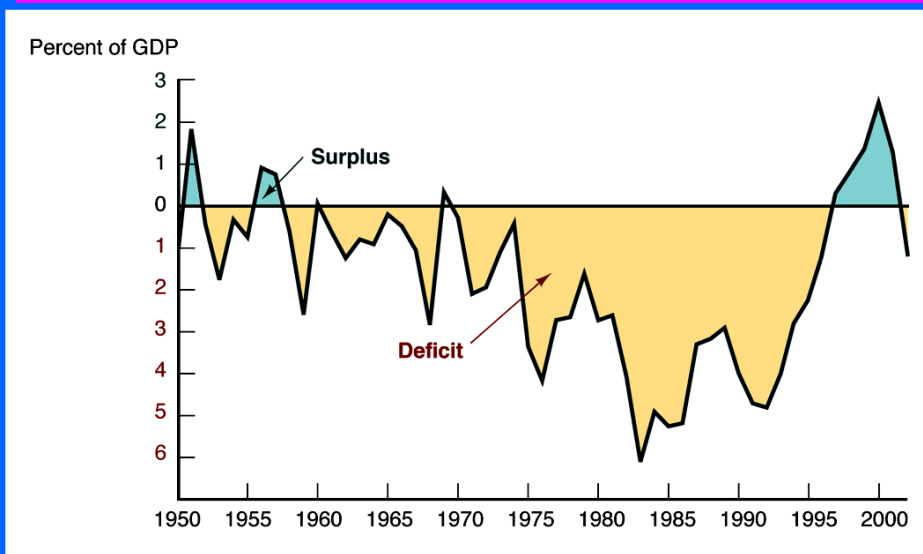
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Interest rate cost of borrowing or the price paid for rented funds (usually as percentage of rental of \$100) [M] p. 4

Government Budget: Surplus and Deficit as percent of GDP



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Fiscal policy government policies about government spending & taxation [M] p. 12
Budget: [M] p. 12 Let G – government expenditures & T – tax revenues

Budget Deficit $T-G < 0$

Budget Surplus $T-G > 0$

[M] Basic Analytic Framework

[M] uses the following framework

- 1. Simplified approach to the demand for assets
- 2. Concept of equilibrium
- 3. Basic supply and demand approach to understand behavior in financial markets
- 4. Search for profits
- 5. Transactions cost and asymmetric information approach to financial structure
- 6. Aggregate supply and demand analysis

Appendix to Ch. 1: Definitions

- **Aggregate Output** Gross Domestic Product (GDP) = Value of all final goods and services produced in domestic economy during year
- **Aggregate Income** Total income of factors of production (land, capital, labor) during year
- **Distinction Between Nominal and Real**
 - Nominal = values measured using current prices
 - Real = quantities, measured with constant prices
- **Aggregate Price Level**
 - GDP Deflator = $\text{Nominal GDP} / \text{Real GDP}$
- **Consumer Price Index (CPI)** is a price of a "basket". The "basket" is a list of goods & services bought by a typical urban household.

Appendix to Ch. 1: Definitions

Growth Rates and the Inflation Rate

$$\text{Growth Rate} = \frac{x_t - x_{t-1}}{x_{t-1}} \times 100$$

$$\text{GDP Growth Rate} = \frac{\$9.5 \text{ trillion} - \$9 \text{ trillion}}{\$9 \text{ trillion}} \times 100 = 5.6\%$$

$$\text{Inflation Rate} = \frac{113 - 111}{111} \times 100 = 1.8\%$$

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The inflation rate is defined as the growth rate of aggregate price level. [M] p. 22

Compare with more informal definition from p. 11:

Inflation rate is the rate of change in the price level (usually per year) [M], p. 11

Next Lecture

- Your preparation: read [M] Ch. 1 & 2, 8
- We will overview Financial System (mostly by covering a material of Ch. 2)

Summary of Today

- Organizational Matters
- Focus and Structure of ECN135
 - Main Concepts
 - Theoretical Framework
 - Application of the Framework to study business cases & policy issues
- Main concepts were reminded
- Have a Nice Evening & Weekend