

## Ch. 1

### Introduction to Financial System

- ✧ This course is about money, banking, and financial institutions and markets.
- ✧ We are going to study macroeconomics with a focus on monetary issues of the economy.
- ✧ Chapter 1 provides an overview of the topics that will be covered in later chapters.
- ✧ We study money, banking, and financial Markets
  1. To examine the role of money in the economy
  2. To examine how financial institutions such as banks and insurance companies work
  3. To examine how financial markets (such as bond, stock and foreign exchange markets) work

#### The Five Components of the Financial System

- ✧ The five components of the current financial system are money; financial institutions (including banks); financial instruments (including loans, stocks, and bonds); financial markets (like Bahrain Stock Exchange); and central banks (like the Central Bank of Bahrain (CBB)).

#### 1. Money

- ✧ **Money** is defined as anything that is generally accepted in payment for goods and services or in the repayment of debt.
- ✧ Monetary theory ties changes in the money supply to changes in aggregate economic activity and the price level

#### Money and Recession

- ✧ The periodic but irregular upward and downward movement of aggregate output produced in the economy is referred to as the **business cycle**.
- ✧ Sustained (persistent) downward movements in the business cycle are referred to as **recessions**.

- ✧ Sustained (persistent) upward movements in the business cycle are referred to as **expansions**.
- ✧ Recessions (unemployment) and booms or expansion (inflation) affect all of us
- ✧ Evidence from business cycle fluctuations in many countries indicates that recessions may be caused by steep declines in the growth rate of money.

### **Money and Inflation**

- ✧ The aggregate **price level** is the average price of goods and services in an economy
- ✧ Inflation is a continual rise in the price level. It affects all economic players.
- ✧ There is a strong positive association between inflation and growth rate of money over long periods of time. A sharp increase in the growth of the money supply is likely followed by an increase in the inflation rate.
- ✧ Countries that experience very high rates of inflation have rapidly growing money supplies.

## **2. Banking and Financial Institutions**

- ✧ **Financial Intermediaries** are institutions that channel funds from individuals with surplus funds to those desiring funds but have shortage of it.
- ✧ Among other services, they allow individuals to earn a decent return on their money while at the same time avoiding risk; e.g., banks, insurance companies, finance companies, investment banks, mutual funds, brokerage houses,
- ✧ **Banks** are financial institutions that accept deposits and make loans.
- ✧ Banks make the monetary system a lot more efficient by reducing our need to carry a lot of cash.
- ✧ People have tended to use checks instead of cash for large purchases and bills.
- ✧ Innovations in banking like debit cards, direct deposit, and automatic bill-paying reduce that inconvenience even further, and also reduce such bank-related inconveniences of time spent standing in line at the bank, writing checks, or visiting the ATM.

- ✧ **Financial innovation** refers to both technological advances, which facilitate access to information, trading and means of payment, and to the emergence of new financial instruments and services, new forms of organization and more developed and complete financial markets.
- ✧ To be successful, financial innovation must either reduce costs and risks or provide an improved service that meets the particular needs of financial system participants.
- ✧ **E-finance** is a delivery of financial services electronically
- ✧ Banks are important to the study of money and the economy because they have been a source of rapid financial innovation.

### 3. Financial Instruments

- ✧ **“Securities”** is a name that commonly refers to financial instruments that are traded on financial markets.
- ✧ A **security (financial instrument)** is a formal obligation that entitles one party to receive payments and/or a share of assets from another party; e.g., loans, stocks, bonds.
- ✧ Even an ordinary bank loan is a financial instrument.

### 4. Financial Markets

- ✧ **Financial markets** are mechanisms that allows people to easily buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect; e.g., Bahrain Stock Exchange, New York Stock Exchange, U.S. Treasury's online auction site for its bonds.
- ✧ Financial markets such as stock market and bond market are essential to promote greater economic efficiency by channeling funds from who do not have productive use of fund (savers) to those who do (investors).
- ✧ While well-functioning financial markets promote growth, poorly performing financial markets can be the cause of poverty.
- ✧ Thus, activities in financial markets may increase or decrease personal wealth

- ✧ Activities in financial markets affect business cycle.

### **The Bond Market and Interest Rates**

- ✧ A **bond** is a debt security that promises to make specified rate of interest payments periodically for a specified period of time, with principal to be repaid when the bond matures.
- ✧ An **interest rate** is the cost of borrowing or the price paid for the rental of borrowed funds(usually expressed as a percentage of the rental of \$100 per year)
- ✧ Everything else held constant, a decline in interest rates will cause consumption and investment to increase; e.g. spending on housing or cars would rise
- ✧ An increase in interest rates might encourage consumers to save more because more can be earned in interest income but discourage investors from taking loans. Thus, consumption and investment would decrease.
- ✧ The bond markets are important because they are the markets where interest rates are determined

### **The Stock Market**

- ✧ A **stock (a common stock)** represents a share of ownership of a corporation, or a claim on a firm's earnings/assets.
- ✧ Stocks are part of wealth, and changes in their value affect people's willingness to spend.
- ✧ Changes in stock prices affect a firm's ability to raise funds, and thus their investment.
- ✧ The stock market is important because it is the most widely followed financial market nowadays.
- ✧ A rising stock market index due to higher share prices increases people's wealth and as a result may increase their willingness to spend.
- ✧ When stock prices fall an individual's wealth may decrease and their willingness to spend may decrease.
- ✧ Changes in stock prices affect firms' decisions to sell stock to finance investment spending.

- ✧ Fear of a major recession causes stock prices to fall, everything else held constant, which in turn causes consumer spending to decrease

### **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
- ✧ Everything else constant, a stronger dollar will mean that vacationing in England becomes less expensive. And the country's goods exported abroad will cost more in foreign countries, and so foreigners will buy fewer of them.
- ✧ Everything else held constant, a stronger dollar benefits the country's consumers and hurts the country's businesses.
- ✧ Everything else held constant, a decrease in the value of the dollar relative to all foreign currencies means that the price of foreign goods purchased by Americans increases
- ✧ If the price of a euro (the European currency) increases from \$1.00 to \$1.10, then, everything else held constant, a European vacation becomes more expensive.

### **5. Central Banks**

- ✧ **A central bank** is a governmental body that regulates financial institutions, controls the supply of money and credit in the economy, handles the government's finances, and serves as the bank to commercial banks.
- ✧ Commercial banks deposit some of their reserves at the central bank, and the central bank is the "lender of last resort" to commercial banks in times of crisis.
- ✧ Monetary theory relates changes in the quantity of money to changes in aggregate economic activity and the price level.
- ✧ **Monetary policy** is the management of the money supply and interest rates and is conducted by a nation's central bank

- ✧ **Fiscal policy** involves decisions about 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
  - Budgets deficits can be a concern because deficits can result in higher rates of monetary growth and they might ultimately lead to higher inflation

## **Five Core Principles of Money and Banking**

### **1. Time has value.**

A dollar today is worth more than a dollar a year from now. This because inflation erodes the buying power of money over time; having the money now means you can spend it now; having the money now means you can invest it and turn it into more money.

### **2. Risk requires compensation.**

For securities like stocks and bonds, the higher the risk, the higher the return has to be. For individuals, minimizing the risk of such things as accidents, illness, and theft is worth the expense of monthly insurance premiums. (A note on usage: "Risk" refers to your potential losses, financial and otherwise, not merely to the probability of unwanted events. For example, fire insurance might not reduce the likelihood of your house burning down, but it will compensate you for the damage from your house burning down.)

### **3. Information is the basis for decisions.**

This rather general sentence relates to money, banking, and finance because we live in a world of imperfect information. It is hard for financial transactions to take place when one or both parties lack adequate information about the other, because one party could easily end up getting burned. As a result, banks and other financial institutions that make loans gather a considerable amount of information about their potential borrowers before advancing them money. The collection and

provision of company financial information by government agencies can aid the growth of financial markets by making them more transparent, thus reducing the information barrier for potential investors. Recent advances in computer and communications technology have greatly helped the spread of financial information, thereby paving the way for the growth of important new financial markets like the junk-bond market.

4. **Markets set prices and allocate resources.**

Financial institutions and markets, by connecting savers with borrowers, allow for people's leftover money (savings) to be channeled into productive investment in capital (e.g., new technology, machinery, and buildings). Financial markets for assets like stocks and bonds allow some companies, especially well-established companies, to obtain funds for new capital investment more cheaply than they could borrow from a bank.

5. **Stability improves welfare** (i.e., well-being).

In the interest of stability in the financial sector, governments have created central banks to try to guard against bank failures and financial panics. The tasks of central banks have grown in recent years, as they are now expected to keep inflation low and stable, and also to avoid or minimize recessions.

Bank deposit insurance is another example of a government intervention for the sake of financial and social stability.