

Econ 500: Introduction

- Chapter 1, 2, 3

1

Five Topics in Money and Finance

- Financial system and the economy
- Financial markets
- Financial institutions
- Money
- Economic approach

2

Financial System and the Economy

- Financial system: a network of markets and institutions
- Savers and borrowers: three potential groups
- Financial instruments

3

Purpose of the Financial System

- The **financial system** provides channels to transfer funds.
 - Savers are suppliers of funds.
 - Borrowers are demanders of funds.
- **Financial markets** issue claims on borrowers directly to savers.
- **Financial intermediaries or institutions** act as go-betweens.

4

Key Services Provided by the Financial System

1. The financial system provides **risk sharing** by allowing savers to hold many assets.
 - a. **Diversification** reduces risk.
 - b. Financial markets also can create instruments to transfer risks.
2. The financial system offers savers and borrowers **liquidity**.
 - Financial markets and intermediaries provide trading systems for making financial assets more liquid.

5

Key Services Provided by the Financial System

3. The financial system collects and communicates **information** (about borrowers and expectations about returns on financial assets).
 - particularly important in situations of **asymmetric information**.
 - Financial markets communicate information by incorporating it into the prices of stocks, bonds, and other financial assets.

6

Financial Markets

- Primary markets are those in which newly issued claims are sold to initial buyers.
 - The most commonly used claim is **debt and stock**.
- Secondary markets are those in which previously issued claims are resold.
- Risk-sharing, liquidity, and information services are provided in secondary markets.

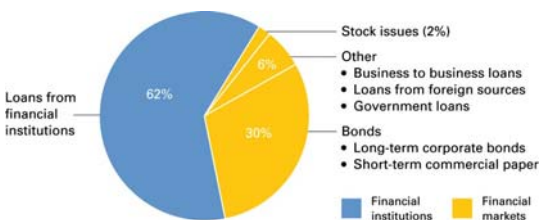
7

Types of Secondary Financial Markets

- Maturity: money and capital markets
- Trading places: auction and over-the-counter markets
- Settlement: cash or derivative

8

Figure 1.1 Sources of Funds for Nonfinancial Businesses



9

Money

Money: anything that people are willing to accept in payment for goods and services or to pay off debts.

- The **Federal Reserve System** is the central bank of the United States and collects data on the money supply.
- Monetary policy refers to the management of the money supply.
- Monetary theory examines the link between changes in the money supply and changes in economic activity and prices.

10

Economic Analysis as a Tool

1. helps explain current developments and predict future developments.
2. involves developing models linking the events with the key factors
3. used throughout the text to study money, financial markets, and financial institutions.

11