



Money, Banking, and Financial Institutions

Chapter 1 : Why Study Money, Banking, and Financial Markets?

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Learning Objectives

1. Recognize the importance of financial markets in the economy.
2. Describe how financial intermediation affect banking and the economy.
3. Identify the basic links among monetary policy, the business cycle, and economic variables.
4. Explain the importance of exchange rates in a global economy.

Financial Markets

Why Study Financial Markets?

- ▶ **Financial Markets:** transfer funds from people who have an excess of available funds to people (and firm) with a shortage
 - ▷ Affects our lives, businesses, and economy
- ▶ Main financial markets: bond markets, interest rates, and stock markets

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- ▶ **The Bond Market and Interest Rates**
 - ▷ **A security** (or a financial instrument) is a claim on the issuer's future income or assets
 - ▷ **Bond:** a debt security that promises to make payments periodically for a specified period of time
 - ▷ **Interest rate:** the (promised) price paid for the rental of funds (hence the issuer's cost of funds)

► The Bond Market and Interest Rates

Figure 1: Interest Rates on Selected Bonds, 1977-2020

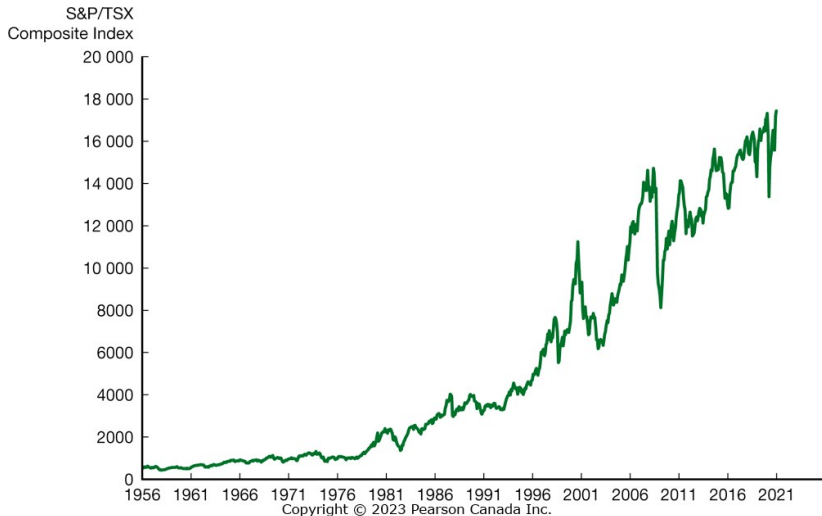


► The Stock Market

- ▷ A **stock** is a share of ownership in a corporation
 - Gives claim to the corporation's earnings and assets
- ▷ The value of stocks in the **stock market** reflects both the company's assets and expectations regarding their future growth
 - Big swings in stock prices / share prices
 - Stock prices affect business investment decisions : Affect the amount the company raises when issuing additional shares

► The Stock Market

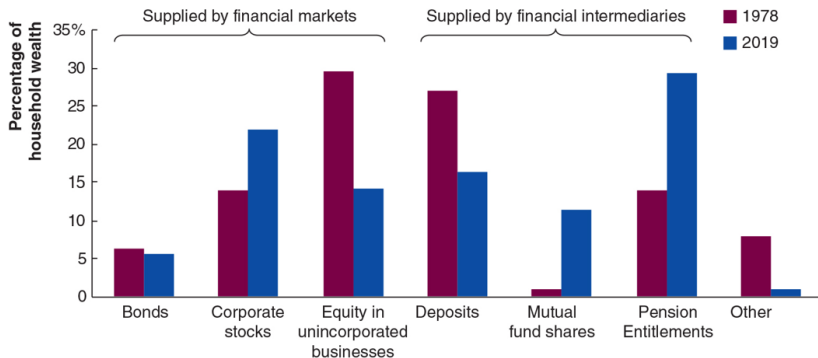
Figure 2: Stock Prices as Measured by the S&P/TSX Composite Index, 1956-2020



Apply the Concept: What Do People Do With Their Savings?

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Figure 3: Flow of Funds Accounts of the United States, various issues.



Financial Institutions FIs

- ▶ Banks and other FIs play a crucial role :
 - make financial markets work
 - FIs assist in the transfer of funds from savers to people and firms with investment opportunities, ideally productive investment opportunities

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 - make financial markets work
 - FIs assist in the transfer of funds from savers to people and firms with investment opportunities, ideally productive investment opportunities
- ▶ **Banks**: Accept deposits and make loans
 - chartered banks, trust and mortgage loan companies, and credit unions and caisses populaires
- ▶ **Other FIs**: insurance companies, finance companies, pension funds, mutual funds, investment banks, brokerage firms

Money and Monetary Policy

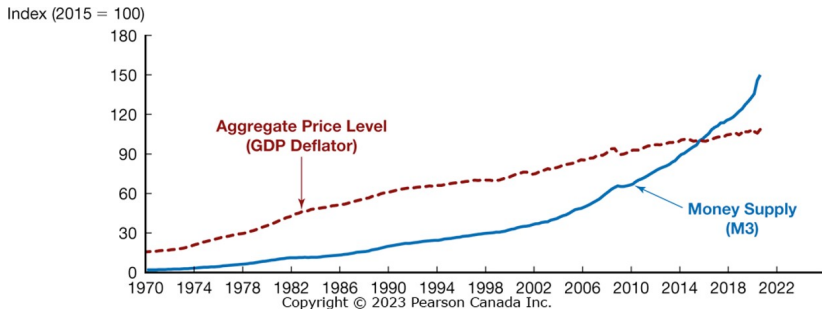
- ▶ **Money**: anything generally accepted as payment for goods or services, or to repay debts.
- ▶ Money indirectly, but strongly affects a wide variety of other economic variables:
 - Business Cycles
 - Inflation
 - Interest Rates
- ▶ Monetary policy influences the economy: central role of Bank of Canada

- ▶ **Business Cycles** are the upward and downward movement of aggregate output in the economy
 - Affect the **unemployment** rate (percentage of the available labor force that is unemployed)
- ▶ **Recessions** are periods of declining aggregate output
- ▶ Evidence suggests money supply plays a role in business cycles

- ▶ **Aggregate price level:** the average price of goods and services in an economy.
- ▶ **Inflation:** an increase in the aggregate price level
 - Affects individuals, businesses, and the government.
- ▶ What explains inflation?

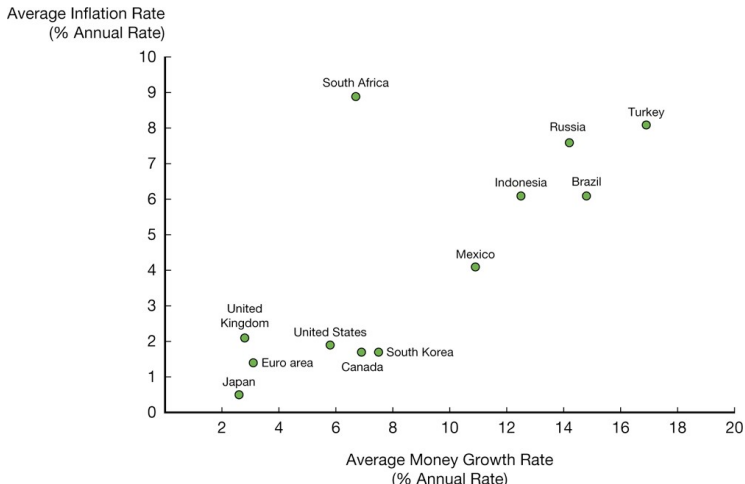
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- ▶ **Inflation rate** (percentage change of the price level) is affected by the growth rate of the **money supply**

Figure 4: Aggregate Price Level and the Money Supply in Canada, 1970-2020



Money and Inflation

Figure 5: Average Inflation Rate Versus Average Rate of Money Growth for Selected Countries, 2009-2019



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Fiscal and Monetary Policy

- ▶ **Monetary policy** involves managing the money supply and interest rates:
 - Conducted by the **Bank of Canada** using a variety of tools

- ▶ **Fiscal policy** involves setting government expenditures and tax revenue
 - Conducted by the government (Federal, Provincial)
 - Budget deficit is spending in excess of revenue
 - Budget surplus is spending less than revenue

Figure 6: Government Budget Surplus or Deficit as a Percentage of Gross Domestic Product, 1961-2020

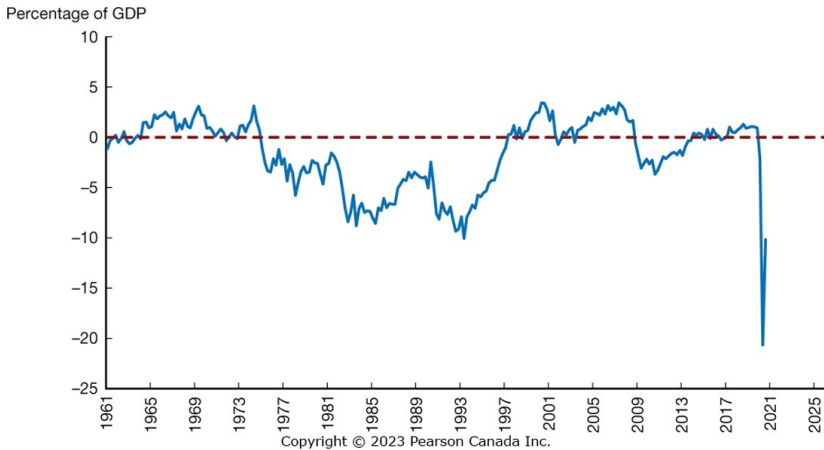
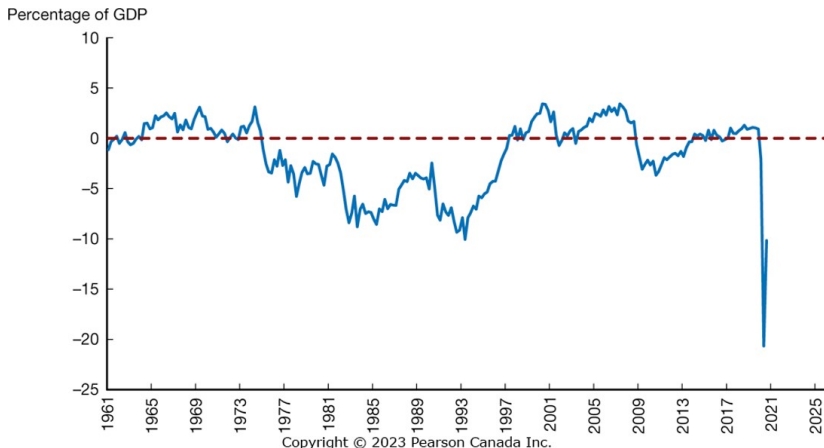


Figure 6: Government Budget Surplus or Deficit as a Percentage of Gross Domestic Product, 1961-2020



► The budget deficit rose to over 8% of GDP in 1993 and then fell, eventually leading to budget surpluses from 1997 to 2008. Subsequently, budget deficits climbed, peaking at over 3% of GDP in 2009, fell substantially thereafter, and then rose starting in 2016.

Foreign Exchange, the Market and Rates

Foreign Exchange, the Market and Rates

- ▶ The **foreign exchange market** is where funds are converted from one currency into another
- ▶ The **exchange rate** is the price of one currency in terms of another currency:
 - Determined in the foreign exchange market
 - For example: \$0.80 U.S. dollars to buy \$1 Canadian dollar, then the USD/CAD exchange rate is 0.80
 - Appreciation of the Canadian dollar is a rise in the price of the Canadian dollar
 - Depreciation is a fall in the value

Figure 7: Exchange Rate of the Canadian Dollar, 1971-2020



- ▶ The value of the Canadian dollar relative to the U.S. dollar has fluctuated substantially over the years.

How We Will Study Money, Banking, and Financial Institutions

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- ▶ We will develop an **economic way of thinking** :
 - A simplified approach to the demand for assets
 - The concept of equilibrium
 - Supply and demand to explain behavior in financial markets
 - Understanding financial structure based on transaction costs and asymmetric information
 - Role of incentives, such as the search for profits
 - Aggregate supply and demand analysis

- ▶ We will analyse models, case studies, applications, and current events in the news

Some Web Resources

Some Web Resources

- [Statistics Canada data tables](#)
- [Federal Reserve Bank of St. Louis: FRED database](#)
- [Bank of Canada website](#)
- [MyLab Economics](#)