

CHAPTER 1

Introduction and Overview

Learning Objectives

- The subject matter of economics and finance
- The general role of the financial system in a modern economy
- The major functions of financial markets and financial intermediaries
- What saving is and its uses
- How the financial system channels funds from lenders to borrowers
- The role of the Federal Reserve and its regulatory and monetary policy responsibilities

Chapter Outline/Lectures Notes

- I. What this book is about—Economic and financial analysis of an ever-changing system
 - A. This book is about the study of money and the financial system in an ever-changing environment.
 - B. **Economics** is about how society decides what gets produced, how it gets produced and who gets what. **Finance** is about how the financial system coordinates the flow of funds from lenders to borrowers and how new funds are created by financial intermediaries in the borrowing process. **Microeconomics** studies about individual decision making units. **Macroeconomics** deals with aggregate or total behavior of all households and firms.
 - C. Historically, the financial system has been highly regulated since a smooth functioning, efficient financial system is vital to a healthy economy.
 - D. In recent years, the financial system has been changing due to new ways to raise and use money through financial intermediation, increased globalization, and **deregulation**.
- II. Finance in our daily lives
 - A. **Money** is something generally acceptable and generally used to make payments. **Saving** is income not spent on consumption. Both households and firms save. Since businesses do not spend on consumption, all of business income except that distributed as dividends is saving. Household saving is income not spent on consumption. Part of saving is used for investment. Households invest in newly constructed residential homes and businesses invest in capital and inventories. If there is saving left over after investment spending by households and firms, that saving is surplus funds available to be lent in financial markets.
 - B. **Net lenders** are spending units whose incomes are greater than spending. **Net borrowers** are spending units whose incomes are less than spending. Household saving may be used to invest in new houses or to acquire financial assets. Business saving may be used to invest in capital or inventories or to acquire financial assets.
- III. Introducing the financial system—Depository institutions and other types of intermediaries

- A. The financial system consists of financial markets and financial intermediaries. **Financial markets** are markets where spending units trade financial claims. **Direct finance** is when net lenders lend their funds directly to net borrowers. **Financial intermediaries** are institutions that borrow from net lenders for the purpose of lending to net borrowers. **Indirect finance** is when net borrowers borrow from financial intermediaries that have acquired the funds to lend from net lenders.
- B. Financial intermediaries reduce the **transactions costs** associated with borrowing and lending by pooling the funds of many small savers, appraising the risks of lending, and diversifying. The secondary claims that financial intermediaries issue are also more **liquid** than primary claims. **Depository institutions** that issue **checkable deposits** (commercial banks, savings and loans, credit unions, and mutual savings banks) are the most important intermediaries. Other intermediaries include life and casualty insurance companies, pension funds, mutual funds, money market mutual funds, and finance companies.

IV. The Federal Reserve System

- A. **The Federal Reserve System (Fed)** is the central bank of the United States that regulates the financial system and determines monetary policy. **Monetary policy** is all of the efforts by the Fed to promote the overall health and stability of the financial system.

V. The role of policy and changing views

- A. The economy experiences short run fluctuations which are called the **business cycle**. The phases of the business cycle are the **expansion**, the peak, the **recession**, and the trough. In addition to monetary policy, government may also use **fiscal policy** which is changing government spending or taxes to affect the level of economic activity.
- B. Prior to the Great Depression, the predominant view of the role for government was **laissez faire**. Since the Depression, a more “activist” role has been favored by policymakers. Following the poor performance of the economy in the 1970s, views have shifted somewhat back the “less government intervention is better” perspective.
- C. In the early 2000s, the United States experienced a recession following the longest expansion in history throughout the 1990s and a stock market bubble. The recession of the early 2000s was complicated by the terrorist attack on 9/11 and the subsequent War on Terror. The government surplus turned into a large deficit and interest rates were driven to the lowest level in over 40 years. By 2004, the economy was in an ongoing albeit slow recovery.

Answers to Review Questions

1. Provide a short discussion or definition of the following terms: economics, finance, the financial system, net lenders, net borrowers, direct and indirect finance, financial markets, financial intermediaries, liquidity, the business cycle, depository institutions, and monetary policy.

Economics: The study of how a society decides what to produce, how to produce, and who gets what; the study of how scarce resources get allocated to satisfy unlimited wants.

Finance: The study of how the financial system coordinates and channels the flow of funds from lenders to borrowers—and vice versa—and how new funds are created by depository

institutions during the borrowing process; the raising and using of money by households, firms, governments, and the “rest of the world” (foreign) sectors.

Net lenders: Spending units such as households and firms whose spending on consumption and investment is less than income.

Net borrowers: Spending units such as households and firms whose spending on consumption and investment is more than income.

Direct finance: When net lenders lend their surplus funds directly to net borrowers.

Indirect finance: When net lenders deposit their surplus funds into financial intermediaries which in turn, lend the funds to net borrowers; when net borrowers borrow funds from financial intermediaries that have acquired funds to lend from net lenders and that issue their own liabilities.

Financial intermediaries: Financial institutions that borrow from net lenders for the purpose of lending to net borrowers; financial intermediaries such as banks, savings and loan associations, credit unions, mutual funds, insurance companies, and finance companies issue monetary and other claims on themselves; they serve as go-betweens to link up net lenders and net borrowers.

Liquidity: The ease with which a financial or real asset can be converted to cash without loss of value.

Business cycle: Short-run fluctuations in the level of economic activity as measured by the output of goods and services in the economy.

Depository institutions: Financial intermediaries that offer checkable deposits which are subject to withdrawal by writing a check to a third party and which are part of the nation's money supply.

Monetary policy: The Fed's effort to promote the overall health and stability of the economy.

2. Some people have money; some people need money. Explain how the financial system links these people together.

Net lenders deposit surplus funds into financial intermediaries that in turn lend the funds to net borrowers. Net lenders gain interest payments from the financial intermediaries for the use of their funds. Net borrowers make interest payments to the financial intermediaries for the use of the borrowed funds. The profit to financial intermediaries is the difference between the cost of their liabilities and the earnings on their loans and investments.

3. Discuss the statement: “Since I have high credit card limits, I have lots of money.” Are credit cards money? Why or why not? (Hint: See Endnote 2.)

Credit cards are not money. When an individual uses a credit card, he or she is taking out a loan by authorizing the institution that issued the credit card to make a payment with money on his or her behalf. Ultimately, the individual must pay credit card balances with money.

4. When are the surplus funds I have available to lend in financial markets equal to my saving?

The surplus funds I have available to lend in financial markets are equal to my saving when my investment spending in newly constructed residential housing is zero.

5. Why do financial intermediaries exist? What services do they provide to the public? Are all financial institutions financial intermediaries?

Financial intermediaries exist to link up net lenders and net borrowers and to help minimize the transactions costs associated with borrowing and lending. Financial services provided by financial intermediaries include appraising and diversifying risk, offering a menu of financial claims that are relatively safe and liquid, and pooling funds from individual net lenders. Not all financial institutions are financial intermediaries. Financial intermediaries are a type of financial institution that issue claims on themselves. Other financial institutions, such as stock and bond brokers merely link up net lenders and net borrowers for a fee and do not issue claims on themselves.

6. What are transactions costs? Does financial intermediation increase or decrease transactions costs?

Transaction costs are all the costs associated with the borrowing and lending of funds. Financial intermediation decreases these costs because financial intermediaries use experts to evaluate credit risk and to diversify. Also, liabilities of some financial intermediaries (depository institutions) are insured.

7. What is a depository institution? What is a checkable deposit? How does a depository institution differ from other intermediaries? Give three examples of depository institutions.

Depository institutions are financial intermediaries that issue checkable deposits. They are the most familiar and the largest type of financial intermediary. Checkable deposits are deposits that are subject to withdrawal by writing a check to a third party. Such deposits are money per se since they can be used in their present form as a means of payment.

Other types of intermediaries offer specialized secondary claims. For example, insurance companies offer financial protection against early death (life companies) or property losses (casualty companies), while pension plans provide financial resources for one's old age.

Commercial banks, savings and loan associations, credit unions, and mutual savings banks are depository institutions. Depository institutions are particularly popular with SSUs because the secondary claims purchased by SSUs from depository institutions—that is, the deposits—are often insured and therefore relatively safe.

8. Why does the Fed monitor the economy? What actions can the Fed take to affect the overall health of the economy?

The Fed monitors the economy in order to promote the overall health and stability of the economy. The Fed can influence the economy through monetary policy. The Fed implements monetary policy to affect the level of interest rates and credit availability. When interest rates decrease and credit availability increases, the level of economic activity speeds up. When interest rates increase and credit availability decreases, the level of economic activity slows down.

9. Why have views changed concerning the appropriate role of stabilization policies in managing the economy? Briefly discuss the historical evolution of these views.

Views on the appropriate role of policy in the economy—for instance, how “activist” policymakers should be in trying to manage the economy—have varied over time as circumstances change. Before the Great Depression, the main paradigm was “laissez faire” because it was believed that the economy was inherently stable and that disturbances to the economy were self-correcting. The Great Depression called into question the inherent stability of the economy and the self-correcting nature of disturbances. After the Great Depression, the paradigm shifted to a belief that the economy was inherently unstable and could operate with high levels of unemployment for a prolonged period of time. Therefore, there was a role for government to manipulate the level of economic activity. Following the relatively poor performance of the economy in the 1970s, the government’s ability to manipulate the economy was called into question and consequently, there was a resurgence of the pre-Depression laissez-faire attitude.

10. What are the pros and cons of lending to my next-door neighbor rather than putting my surplus funds in a bank?

Lending money to a friend can be very risky. For the most part, you have no assurance that your friend will pay you back. With a bank, deposits are insured for up to \$100,000. Also, by lending to your friend (assuming you are not charging interest), you forgo the interest the bank would have paid you for the use of your money. On the other hand, maybe you can develop an even closer relationship with your friend by lending him/her money. For some people, a close friendship is more important than having a bank pay them interest or the security of an insured deposit.

11. Define laissez-faire and fiscal policy. Who determines fiscal policy? Who determines monetary policy?

“Laissez-faire” is the view that the government should pursue a hands-off policy with regard to the economy. Fiscal policy consists of changes in government spending and taxing decisions in order to affect the level of economic activity. Fiscal policy is determined by Congress, while monetary policy is determined by the Fed.

Answers to Analytical Questions

12. Rank the following assets in terms of their liquidity, from least to most liquid: cash, savings deposits, gold, a house, a rare oil painting, a checkable deposit. Explain your rank order.

- 1—A rare oil painting—It is very hard to find someone who will purchase a rare oil painting for the asking price in a short period of time.
- 2—A house—It is difficult to sell a house in a short period of time without some loss of value.
- 3—Gold—It is not too hard to exchange gold for money, but the value of gold fluctuates.
- 4—Savings deposits—Up to an insured amount, there is no risk of losing savings deposits. Although new innovations have made it possible to use savings deposits as means of payment, in many cases, savings deposits still need to be converted into currency or checkable deposits before being accepted as a means of payment.

5—Checkable deposits—Checkable deposits are generally accepted as a means of payment in their original state.

6—Cash—accepted everywhere as a means of payment; it does not have to be converted to a means of payment.

13. Is each of the following an example of direct or indirect financing:

a. John purchases stock from the biotech firm that employs him.

Direct Financing (John has a direct claim on the biotech firm)

b. Mary purchases a newly issued government security.

Direct Financing (Mary lends directly to the government by purchasing the government security)

c. John places \$3,000 in a savings account at the local savings and loan.

Indirect Financing (assuming the savings and loan lends the funds)

d. John receives a loan from Mary.

Direct Financing (loan goes directly from Mary to John)

e. John receives a loan from Friendly Savings Bank.

Indirect Financing (loan is through a financial intermediary)

14. Bill's income is \$4,000. He spends \$3,000 on consumption and \$300 on an investment in a newly constructed house. He acquires \$700 in financial assets. What is his saving? What is the amount of surplus funds he has available to lend?

Bill's saving is his income (\$4,000) minus his consumption (\$3,000) or \$1,000. His surplus funds are equal to \$700. This is his income (\$4,000) minus his spending on consumption (\$3,000) and investment (\$300).

15. A firm spends \$100,000 on investment in plant and equipment. It has available funds of \$30,000 and borrows the additional funds from a bank. Is the firm a net borrower or a net lender? What is the amount of the surplus or deficit?

The firm is a net borrower because its spending (\$100,000) is greater than its income (\$30,000). It has a deficit of \$70,000 ($\$100,000 - \$30,000 = \$70,000$).

16. Diane Weil earns wages of \$45,000 and interest and dividend income of \$5,000. She spends \$8,000 as a down payment on a newly constructed mountain cabin and lends \$4,000 in financial markets. Assuming that Diane spends the remainder of her income on consumption, what is her saving? Is she a net lender or net borrower? What is her consumption?

Diane's income is \$50,000. Her consumption is \$38,000. Hence, her saving is \$12,000. She is a net lender.

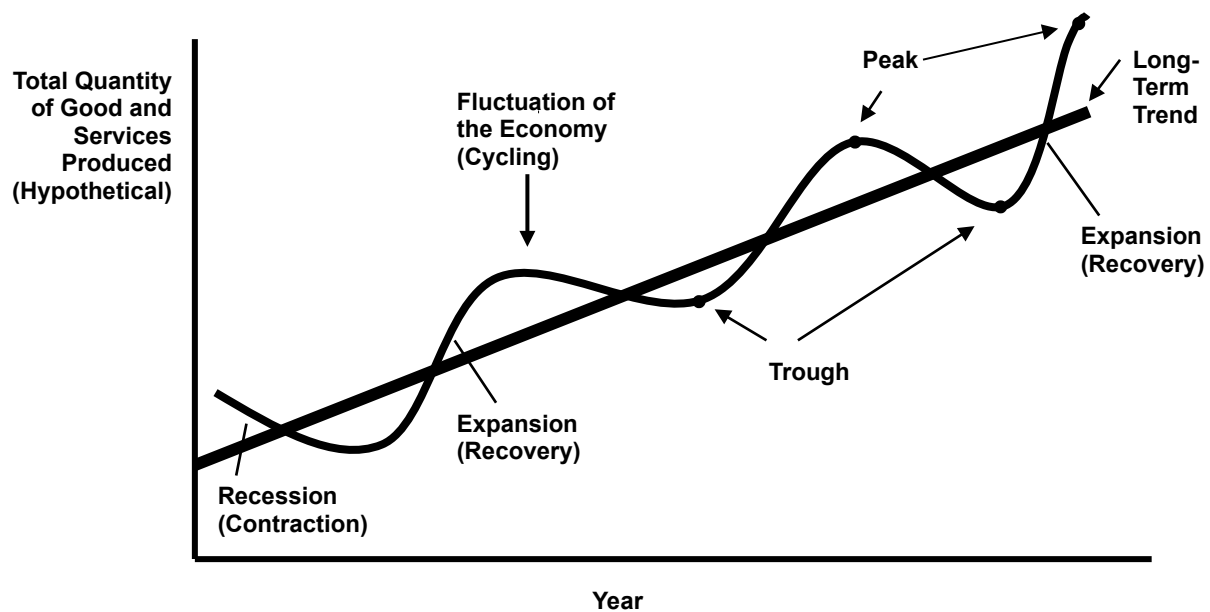
17. Tech Corp has gross sales of \$9 million and total expenses of \$8.5 million. Assume that Tech wants to undertake a capital investment of \$1 million. What is the minimum amount of bonds it would have to issue to do so? Assume that Tech pays out \$300,000 in dividends. Now what is the minimum amount it would have to borrow?

With \$9 million in sales and \$8.5 million in expenses, if not dividends are paid out, Tech has \$.5 million in saving. To undertake \$1 million in investment, Tech would have to issue \$.5 million in bonds. If Tech pays out \$300,000 in dividends, Tech would have to issue \$.8 million in bonds, or \$300,000 more than if it paid out no dividends.

18. What are the phases of a business cycle? Draw a graph of a typical business cycle and label the various phases.

The phases of the business cycle are expansion (recovery), peak, recession (contraction), and trough.

*Through 1st quarter 2004 only.



19. The *misery index* is defined as the sum of the unemployment and the inflation rates. Use exhibit 1-7 to calculate the misery index for each decade since 1960.

ANSWER