ECOS 2004 Notes

Chapter 1: Why Study?

Definitions

- Financial Markets: facilitates the transfer of funds from those with excess to those with a shortage – ensure greatest efficiency.
- Security: claim on the issuer's future income/asset → asset for borrower, liability for lender
    - Bond: debt security that promises to make periodic payments for a specified period of time.
    - Stock: share of ownership in a corporation.
        - Changes in price affect individuals (wealth effect) and businesses
- Interest Rate: cost of borrowing/price paid for rental funds
- Banks = financial intermediaries
- Money Supply: anything generally accepted as payment for g+s or for settling debts
- Financial Innovation: development of new financial products and services → argued to promote efficiency.
- Financial Crises: major disruptions in financial markets that are characterised by sharp declines in asset prices and failures of firms.
- Monetary (interest rates and CB Balance Sheet) vs Fiscal Policy
- Internationalisation: exchange rate, financial stress and institutions (e.g. IMF)

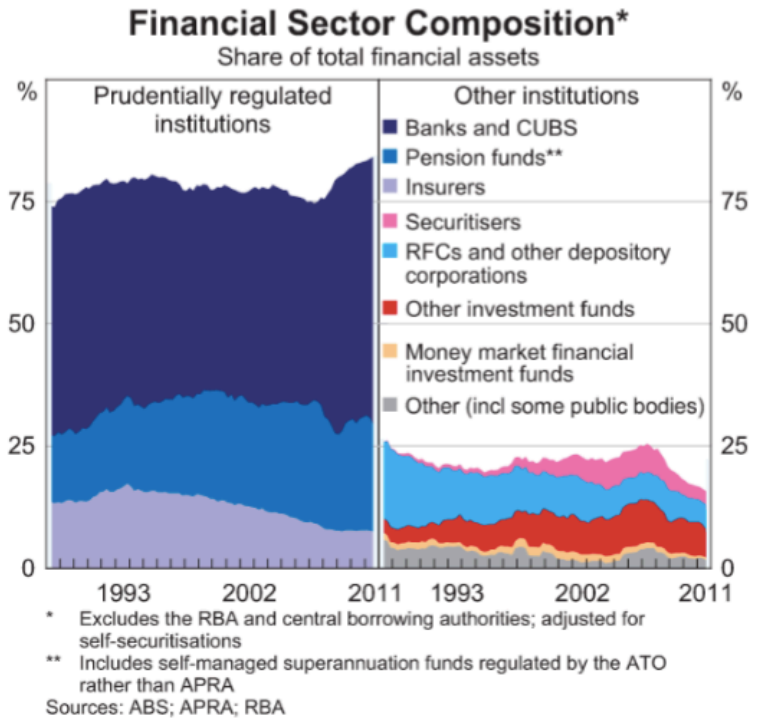
All basic, review of last years work – quick read of old macro notes would suffice.

Chapter 2: An overview of the financial system

- Function: financial systems ensure the efficient allocation of capital by transferring funds from those with an excess, to those with a shortage and availability of productive opportunities.
    - Direct Finance: borrow directly from lenders → through securities.
    - Indirect Finance: through an intermediary source such as a bank.
- Structure:
    - Debt Markets: primarily bonds, but also mortgages and the like.
        - Maturity Date: once total sum is paid back; if < 1year = short-term, 1-10years = intermediate-term, > 10years = long-term
    - Equity Markets: equity such as stocks – partial ownership of a business.
        - Benefits = income directly from profitability of a firm.
        - Cons = become a residual claimant – firm must pay all its debts before it pays its equity holders.
    - Primary vs Secondary Markets:
        - Primary: sale of new securities – generally involves investment banks underwriting securities.
        - Secondary: sale of second-hand securities → includes brokers (agents of investors) and dealers. Make securities more liquid. Determine primary market sale price.

            - Exchange: one central location where brokers/agents meet to exchange.
            - Over-The-Counter (OTC): competitive (computers), dealers at different locations set prices
    - Money vs Capital Markets:
        - Money: short-term securities – more common and thus traded more often → more liquid.
            - Instruments: Treasury bills, commercial paper, repurchase agreements,
        - Capital: long-term securities – generally more stable.
            - Instruments: stocks, mortgages (and –backed securities), most bonds
- Internationalisation of Financial Markets:
    - Foreign Bonds: bonds from foreign nations denominated in domestic currency.
    - Eurobond: bond sold denominated in foreign currency.
    - Prominence of other stock exchanges (other than NY and American); particularly FTSE (UK), Nikkei 300 Average (Tokyo).
- Financial Intermediaries: *indirect finance*. Banks primary source. More important for firms than securities. Hard for economy to reach potential due to capital allocation issues (below).
    - Economies of Scale of banks lower transaction costs and provides liquidity services.
    - Risk Sharing: asset transformation – transform risky assets to safer investments for investors → Diversity. Risk handed to bank, shared between borrowers.
    - Overcome issues of asymmetric information – the fact that we don't have complete knowledge about the other party to make accurate decisions.
        - Adverse Selection (before transaction occurs): when the most undesirable borrowers receive loan because they are more inclined to actively seek out loan.
        - Moral Hazard (after transaction occurs): activities borrower may enact in are likely to result in loss of investment and not have it repaid.
    - Economies of Scope: by providing a particular service, financial intermediaries obtain information that support the provision of another service. Can lead to a Conflict of Interest.
    - Types: depository institutions, contractual savings institutions, investment intermediaries.
- Regulation:
    - Increase information available to investors – particularly to avoid issues of asymmetric information and insider trading.

- Ensuring the Soundness of Financial Intermediaries – restrictions on entry, disclosure, restrictions on assets and activity (limits risky behaviour), deposit insurance, limits on competition (not often AUS), restriction on interest rates.
- AUS:
  - Council of Financial Regulators: discusses regulatory issues and coordinates policy responses to said issues → Goal of financial stability.
    - RBA, APRA, ASIC, Treasury
  - APRA: prudential regulator; primarily banks and other ADI
  - ASIC: corporates, market and financial services regulator.



Chapter 3: What is Money?

- Money/Money Supply/Money Stock [M] (stock): anything that is generally used in the sale and purchase of g+s, and in the settlement of debts.
  - Currency: Paper money and coins
  - Wealth (stock): total collection of pieces of property that serve to store value
  - Income (flow): flow of earnings per unit of time.
- Functions:
  - Medium of Exchange: used to pay for g+s → eliminates double coincidence of wants.
    - Necessary to reduce transaction costs: reduce time and allow division and specialisation of labour → promoting efficiency.
    - Must be: standardised, widely accepted, divisible, easy to carry, not physically deteriorate quickly.
  - Unit of Account: used as a measure of value → relative prices – common scale

        - Reduces transaction costs as everything is priced in terms of money.
    - Store of Value: save purchasing power from the time income is received until the time it is spent.
        - All assets are a store of value. Benefit of money, particularly currency, is that it is liquid → can be converted into a medium of exchange with ease (as it is the medium of exchange).
        - M has a fixed nominal value (no price risk) → decreasing real value in inflation.
- Development of the Payments System: the method of conducting transactions within an economy.
    - Commodity Money: use of precious metals/other material (e.g. cigarettes) as money → difficult to transport → govt. stamps → dilute → shift to fiat.
    - Fiat Money: initially paper money was a guarantee to be transferred into commodity money → developed to become legal tender as decreed by authority (primarily government) issuing it.
        - Issues: trust in government/authority of fiat currency, counterfeit
    - Checks: instruction to your bank to transfer money from your deposit account
        - Ease of transportation, yet timing issues
    - Electronic Payment: e.g. electronic bill payment (can be recurring) and electronic deposits transfer.
    - E-Money: money that exists only in electronic form, such as debit cards.
        - Debit Cards
        - Stored-Value Cards (smart cards)
        - E-cash
- Movement to a cashless society?
    - Although development in non-cash money, it is unlikely that all money will be electronic due to:
        - Privacy and security concerns
        - Set up costs
    - Likely to see prominence of e-money in the future.
- **US** Measures of Money:
    - M1: most liquid assets: currency, traveler's checks, demand deposits and other checkable deposits
    - M2: M1 + other not-so-liquid assets: M1, small-denomination time deposits (<100k), savings deposits and money market deposit accounts, money market mutual fund (MMMF) shares. → closest to Aus broad money
        - "Shares" for MMMFs are basically cashable at original value. So they're very unlike holdings of stock in a firm. The latter are *not* counted in *M*.

    → differences between the two measures of money supply (SR) effect monetary policy – which measure is used? *Shift to inflation targeting*

    Generally, M is the non-bank private sector's holding of money

- **Currency**: notes and coin held by the non-bank public
- **M1**: currency, plus "current deposits" (transferable deposits) with commercial banks
- **M3**: currency, plus all bank deposits
- **Broad Money**: M3 plus deposits with nonbank depository institutions
- **Question**: who holds the currency (currently around $3,000 per head in Australia)?