Why is the financial Sector Important to the Macroeconomy?

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FINANCIAL SECTOR 3

Why is the Financial Sector Important to Macro?
- For every real transaction, there is a financial transaction that mirrors it
- The financial sector channels savings back into spending
- For every financial asset, there is a corresponding financial liability
  - Financial assets are assets such as stocks or bonds, whose benefit to the owner depends on the issuer of the asset meeting certain obligations
  - Financial liabilities are obligations by the issuer of the financial asset

The Financial Sector as a Conduit for Savings
Financial institutions channel savings back into the spending stream as loans
- Saving is outflows from the spending stream from government, households, and corporations
  - Savings deposits, bonds, stocks, life insurance
- Loans are made to government, households, and corporations
  - Business loans, venture capital loans, construction loans, investment loans
The Financial Sector as a Conduit for Savings

Financial institutions channel saving (outflows from the spending stream) back into the spending stream as loans.

The Role of Interest Rates in the Financial Sector

- The interest rate is the price paid for use of a financial asset.
- The long-term interest rate is the price paid for financial assets with long maturities:
  - The market for long-term financial assets is called the loanable funds market.
- The short-term interest rate is the price paid for financial assets with short maturities:
  - Short-term financial assets are called money.

The Price of Money

- Foregone interest is the opportunity cost (price) of money people choose to hold.
Why Hold Money
- John Maynard Keynes noted that people had three reasons for holding money
  - People hold money to make transactions
  - People hold money for precautionary reasons
  - People hold money to speculate

Why Hold money
- Economists have since identified four factors that influence the three Keynesian motives for holding money
  - The price level
  - Income
  - The interest rate
  - Credit availability

Why People Hold Money
- The only reason people would be willing to hold money is if they get some benefit from doing so
  - The transactions motive is the need to hold money for spending
  - The precautionary motive is holding money for unexpected expenses and impulse buying
  - The speculative motive is holding cash to avoid holding financial assets whose prices are falling
The Demand for Money

- The demand for money is the quantities of money people are willing and able to hold at alternative interest rates, ceteris paribus.
- A portfolio decision is the choice of how (where) to hold idle funds.

The Demand for Money

- Transactions demand for money – Money held for the purpose of making everyday market purchases.

The Keynesian Motives for Holding Money

- The transaction motive
  - Individuals have day-to-day purchases for which they pay in cash or by check
  - Individuals take care of their rent or mortgage payment, car payment, monthly bills and major purchases by check
  - Businesses need substantial checking accounts to pay their bills and meet their payrolls
The Demand for Money

- *Precautionary demand for money* – Money held for unexpected market transactions or for emergencies.

The Keynesian Motives for Holding Money

- The precautionary motive
  - People will keep money on hand just in case some unforeseen emergency arises
  - They do not actually expect to spend this money, but they want to be ready if the need arises

The Demand for Money

- *Speculative demand for money* – Money held for speculative purposes, for later financial opportunities.
The Keynesian Motives for Holding Money

- The speculative motive
  - When interest rates are very low you don’t stand to lose much holding your assets in the form of money
  - Alternatively, by tying up your assets in the form of bonds, you actually stand to lose money should interest rates rise
  - You would be locked into very low rates
  - This motive is based on the belief that better opportunities for investment will come along and that, in particular, interest rates will rise

The Many Interest Rates in the Economy

- The economy doesn’t have just a single interest rate; it has many
- Each financial asset will have an implicit interest rate associated with it
- In a multiple-asset market, the potential for the interest rate in the loanable funds market to differ from the interest rate in the market for a particular asset is large
  - The result can be a financial asset market bubble

The Many Interest Rates in the Economy

- An example of a financial asset market bubble:
  - In the early 2000s prices of houses increased by 10% to 15% per year
  - Many people bought houses for speculative purposes
  - In 2006, people lowered their expectations of housing price appreciation
  - The demand for housing decreased substantially, and the equilibrium price fell
Chapter Summary

- Money is a highly liquid financial asset that serves as a unit of account, a medium of exchange, and a store of wealth.
- There are various measures of money, the two most important are $M_1$ and $M_2$.
- Banks create money by loaning out deposits.
- The money multiplier is $\frac{1}{1-h}$, where $h$ is the loan to deposit ratio.
- The financial sector is the market where financial assets are created and exchanged.

Chapter Summary

- Interest rates play a crucial role in channeling savings back into the economy as investment.
- People hold money for three reasons: (1) the transactions motive, (2) the precautionary motive, and (3) the speculative motive. The demand for money is inversely related to the interest rate paid on money.
- Dramatically higher interest rates paid on particular assets compared to other financial assets can cause bubbles, which can cause problems for an economy.

Extra

- The following slides deals with what economists have identified as the four factors that influence the three Keynesian motives for holding money.
Four Influences on the Demand for Money

- The price level
  - As the price level rises, people need to hold higher money balances to carry out day-to-day transactions.
  - As the price level rises, the purchasing power of the dollar declines, so the longer you hold money, the less that money is worth.
  - Even though people tend to cut down on their money balances during periods of inflation, as the price level rises people will hold larger money balances.

Four Influences on the Demand for Money

- Income
  - The more you make, the more you spend.
  - The more you spend, the more money you need to hold as cash or in your checking account.
  - Therefore as income rises, so does the demand for money balances.

Four Influences on the Demand for Money

- Interest rates
  - The quantity of money demanded (held) goes down as interest rates rise.
  - The alternative to holding your assets in the form of money is to hold them in some type of interest-bearing paper.
  - As interest rates rise, these assets become more attractive than money balances.
Four Influences on the Demand for Money

- Credit availability
  - If you can get credit, you don’t need to hold so much money
  - The last three decades have seen a veritable explosion in consumer credit in the form of credit cards and bank loans
  - Over this period, increasing credit availability has been exerting a downward pressure on the demand for money

- Four generalizations
  - As interest rates rise, people tend to hold less money
  - As the rate of inflation rises, people tend to hold more money
  - As the level of income rises, people tend to hold more money
  - As credit availability increases, people tend to hold less money