

MONEY AND FINANCIAL INSTITUTIONS

Introduction

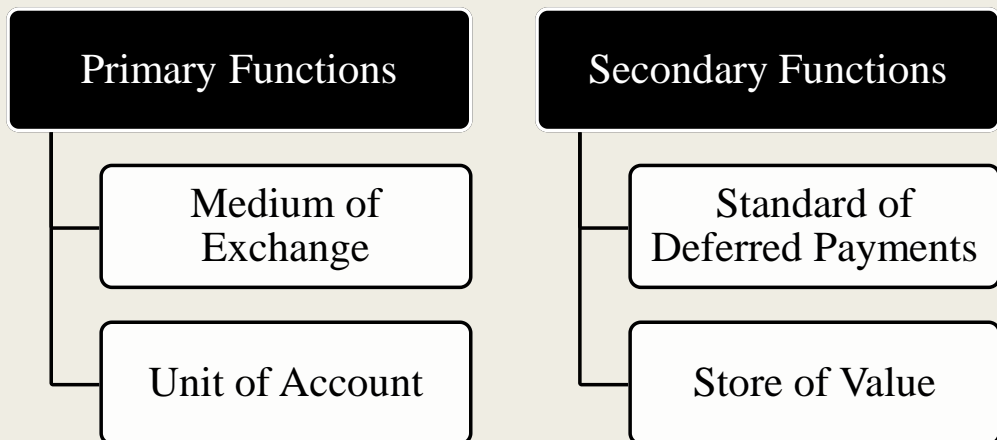
■ This lecture examines:

- *The definition of money*
- *The main functions of money*
- *Importance of Money*
- *What is direct finance?*
- *What is indirect finance?*

The definition of money

- There is no commonly acceptable definition of money
- Some define money as **anything acceptable** for the payment of goods and services or in settlement of debt.
- Some say money is anything that performs the function of medium of exchange, measure of value and store of value .

The main functions of money



Medium of Exchange

- **Money** is a particular type of asset in an economy that people use to buy goods and services from other people or businesses.
- A **medium of exchange** is something that buyers will exchange with a seller when they want to purchase goods or services from the seller.
- While many things could be used as a medium of exchange in an economy, money is the **most common** and useful medium of exchange in our society.

- Money helps to facilitate trade because people in the economy generally **recognize** it as **valuable**.
- Since most people recognize money as **valuable**, they are willing to **trade money** for **goods** and **services** with the intention of one day using the money they received as a seller to buy goods or services from someone else.
- If **people** stop **recognizing** money as **valuable**, then it will **cease** to be a **good medium of exchange** because people will not be willing to trade goods or services for it.

Unit of Account

- One of the most important characteristics of money is that it serves as a unit of account.
- A **unit of account** is something that can be used to value goods and services, record debts, and make calculations.
- In other words, it's a measurement for value.
- A unit of account has three important characteristics relevant to money:
 - *Divisible*
 - *Fungible*
 - *Countable*

Divisible:

- A unit of account can be divided so that its component parts will equal the original value.
- If you divide a dollar into four quarters, the total value of the four quarters still equals a dollar. Likewise, if you cut a bar of gold in half, the two pieces together will equal the same value as the original bar as a whole.

Fungible:

- One unit is viewed as the same as any other with **no change in value**.
- A dollar is the same as any other dollar.

Countable

- A unit of account is also countable and subject to mathematical operations.
- You can easily add, subtract, divide, and multiply units.
- This allows people to account for profits, losses, income, expenses, debt, and wealth.

Standard of Deferred Payments

- Lending and borrowing virtually come to halt in a moneyless economy.
- With the introduction of money, borrowing and lending have become easier.
- With the expansion of trade and commerce based on credit, money has become a standard of deferred payments.
- Deferred payments are those which are postponed for the future. Money enables current transactions to be discharged in future.

Store of Value

- In order to be a medium of exchange, money must hold its value over time; that is, it must be a store of value.
- If money could not be stored for some period of time and still remain valuable in exchange, it would not solve the double coincidence of wants problem and therefore would not be adopted as a medium of exchange.
- As a store of value, money is not unique; many other stores of value exist, such as land, works of art, and even baseball cards and stamps. Money may not even be the best store of value because it depreciates with inflation.
- However, money is more **liquid** than most other stores of value because as a medium of exchange, it is readily accepted everywhere.
- Furthermore, money is an easily transported store of value that is available in a number of convenient denominations.

Importance of Money

Direct importance in the field of Economics

- In consumption
- In production
- In exchange
- In trade
- In distribution
- In public finance
- Capital formation

Indirect importance in the field of Economics

- Freedom from barter
- Solution of Central Economic problems
- Basis of Credit
- Index of Economic Development
- Increase in mobility of capital
- Measure of social welfare
- National and international unity

Direct Finance

Channelling of Funds

- In a simple economy we have firms and households
- **Households** are the **savers** and **firms** are the **investors**.
- The mechanism by which households save is by **demanding securities** from **firms**.
- The mechanism by which firms invest is by **supplying securities** to households
- These **securities** are claims to the **assets** of the firm.

Simple model of direct finance



Direct Finance

- **Lending** and **borrowing** can occur as a result of **direct transacting**.
- But there are costs associated with direct finance
 - *Search costs* – searching for potential lenders
 - *Verification costs* – costs in evaluating investment proposals
 - *Monitoring costs* – costs of monitoring the actions of borrowing
 - *Enforcement costs* – costs of enforcing contracts

Notes on costs associated with direct finance

- Some of these **costs** can be reduced through the **organization** of a **market**.
- **Direct financing** requires the existence of an **efficient securities market**.
- However **not** all costs are **minimized** through a **securities market**.

Structure of Financial Markets

- A Firm obtains funds through the **debt market** or the **equity market**
- A **debt instrument** (bond) pays a **fixed income** stream over a **specified period** (usually long term period).
- **Equities** (common stock) are claims to **shares** in the **profits** and **assets** of a business.
- Equities pay **periodic sums** called **dividends**.
- The **disadvantage** of equity is that the holder is a **residual claimant**.

Primary and Secondary Markets

- **Primary market** is the market for new issues of securities, or initial public offerings (IPOs)
- **Secondary market** is where existing securities are traded (NYSE, NASDAQ, LSE, etc.)
- Some **IPOs** are well known and advertised and attract a lot of attention but many are of unknown enterprises and are underwritten by a known investment bank.
- **Brokers** are **agents of investors** who match buyers and sellers of securities. **Dealers** link buyers and sellers by buying and selling securities at **stated prices**.

Financial Intermediation

Money versus Capital Markets

- **Markets** are sometimes distinguished on the basis of **maturity** of the **securities** traded.
- The *Capital Market* is where **long term debt** (longer than one year such as bonds) and equities are traded.
- The *Money Market* is a financial market where **short term debt** instruments are traded (less than a year) – **Commercial paper, Bills** etc
- The money market is usually **more liquid** and more **traded** and so is used by financial institutions to earn income on surplus funds.

Liquidity describes the degree to which an asset or security can be **quickly bought or sold** in the market without affecting the **asset's price**.

Financial Intermediation

- The mechanism whereby surplus **funds** from ultimate savers are matched to deficits incurred by ultimate borrowers
- The process by which ultimate **savers** are matched to ultimate **borrowers**.
- $\text{Saving} = \text{Income} - \text{Consumption}$
- Typically **decisions** to **save** are made independently of **decisions** to **invest**

It should be noted that:

- The **maturity period** of finance for the firm is long term.
- The **maturity period** of the household is mostly short term.
- The **maturity mismatch** of households and firms provide the incentive for the development of intermediated finance.

Maturity is the **final payment** date of a loan or other **financial instrument**, at which point the principal (and all remaining interest) is due to be paid.

The maturity is **short term** if less than a year, long term if more than 10 years and **intermediate term** if in between,

Indirect (Intermediated) Finance

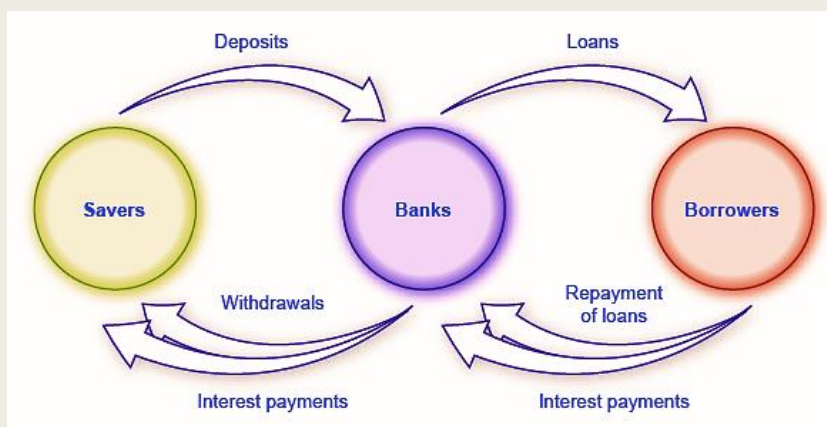


Figure: Distinction between direct and indirect finance



Who are the savers and borrowers?

- **Savers** or **lenders** are households, firms, governments and foreigners.
- **Savers** can **hold** corporate securities (shares), government securities (bonds), currency, bank deposits, foreign currency assets.
- **Investors** or **borrowers** are households, firms, governments and foreigners.
- **Borrowers** can **sell** shares, sell bonds, issue loans (credit).



The End