Chapter 1: Why study money, banking, and financial markets?  
& Chapter 2. An overview of the financial system

**Keywords:** Financial markets, financial institutions, and the role of money

**Learning Objective:**
1) To recognize the importance of financial markets in the economy
2) To understand the impact of financial intermediation and innovation on banking and the economy
3) To figure out the basic links among monetary policy, the business cycle, and economic variables
4) To compare direct and indirect finance

1. Financial markets:

   Definition: markets in which funds are transferred from people and firms who have an excess of available funds to people and firms who have a need of funds.

   - Security: a financial instrument and a claim on the issuer’s future income or assets
   - Interest rate: the price of money (the cost of borrowing or the price paid for the rental of funds)

1) The stock (equity) market

   - Common stock: a share of ownership in a corporation
A share of stock: a claim on the residual earnings and assets of the corporation. When the corporation makes profit, the owners of the stock will have dividends.

2) The bond (debt) market

- Bond: a debt security that promises to make payments periodically for a specified period of time—maturity.

3) The derivatives market

Q1. The financial system consists of ______?
A. all the securities, intermediaries, and markets that exist to match savers and borrowers
B. all transactions occurring in the goods market during a financial year

Q2. In the financial system, savers transfer funds to borrowers in exchange for
A. cash     B. gold     C. financial securities     D. Derivative securities

Q3. A contract that promises to pay a given amount of money to the owner of a security at specific dates in the future is known as
A. a debt security     B. an equity security     C. stock     D. an option

Q4. A contract that makes the owner of a security a part owner of the company that issued the security is known as
A. a debt security     B. an equity security     C. a bond     D. an option

Q5. The owner of a financial security is known as
A. an investor     B. a debtor     C. a broker     D. a securitor

2. Financial intermediaries:

Definition: institutions that borrow funds and in turn make loans. They allow “small” savers and borrowers to benefit from the existence of financial markets.

1) Commercial banks

2) Nonbank finance: insurance company, investment banks, venture capital, etc.

Q6. In the United States, the biggest investors in equity securities are
A. households     B. business firms     C. governments     D. financial intermediaries
3. Primary and secondary markets:
   - Investment banks underwrite securities in the primary markets
   - Brokers and dealers work in secondary markets

4. Exchanges vs. OTC markets
   - Exchanges: NYSE, Chicago Board of Trade
   - Over-the-Counter (OTC) markets: Foreign exchange, federal funds

5. Money vs. capital markets
   - Money markets: it deals in short-term debt instruments
   - Capital markets: it deals in longer-term debt and equity instruments

6. Money and monetary policy:
   1) Money plays an important role in generating business cycles.
   2) Recession or inflation affects all economic players.
   3) The relationship between money supply and the aggregate price level may exist.
   4) Monetary policy is the management of the money supply and interest rates.