

Chapter 1

**An Introduction to  
Money and the  
Financial System**

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**Five Parts of the Financial System**

1. Money (forms of Money)  
To pay for purchases and store wealth
2. Financial Instruments (MF, T-bills...)  
To transfer wealth from savers to investors and to transfer risk to those best equipped to bear it.

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**Five Parts of the Financial System**

3. Financial Markets (NYSE)  
Buy and sell financial instruments
4. Financial Institutions (Banks)  
Provide access to financial markets
5. Central Banks (The Fed)  
Monitor financial Institutions and stabilize the Economy

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## Five Core Principles of Money and Banking

### 1. Time has Value

- Time affects the value of financial instruments (Car loan).
- Interest payments exist because of time properties of financial instruments

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## Five Core Principles of Money and Banking

### 2. Risk Requires Compensation

- In a world of uncertainty, individuals will accept risk only if they are compensated in some form (Car insurance).

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## Five Core Principles of Money and Banking

### 3. Information is the basis for decisions

- The collection and processing of information is the basis of foundation of the financial system. If using cash or stocks, no need to collect information about the seller.

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## Five Core Principles of Money and Banking

### 4. Markets set prices and allocate resources.

- The “places” where buyers and sellers “meet” are the core of the economic system
- Markets are analyzed in Part II.
- The Instruments are studied in Chapters 6 and 7.

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## Five Core Principles of Money and Banking

### 5. Stability improves welfare.

- A stable economy reduces risk and improves everyone's welfare (Business Cycles, How can the Fed provide financial stability?)

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## Definitions

### Aggregate Output

Gross Domestic Product (GDP) = Value of all final goods and services produced in domestic economy during year

### Aggregate Income

Total income of factors of production (land, capital, labor) during year

### Distinction Between Nominal and Real

Nominal = values measured using current prices

Real = quantities, measured with constant prices

### Aggregate Price Level

$$\text{GDP Deflator} = \frac{\text{nominal GDP}}{\text{real GDP}}$$

$$\text{GDP Deflator} = \frac{\$10 \text{ trillion}}{\$9 \text{ trillion}} = 1.11$$

Consumer Price Index (CPI) price of “basket” of goods and services

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## Definitions

### Growth Rates and the Inflation Rate

$$\text{Growth Rate} = \frac{x_t - x_{t-1}}{x_{t-1}} \times 100$$

$$\text{GDP Growth Rate} = \frac{\$9.5 \text{ trillion} - \$9 \text{ trillion}}{\$9 \text{ trillion}} \times 100 = 5.6\%$$

$$\text{Inflation Rate} = \frac{113 - 111}{111} \times 100 = 1.8\%$$

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Chapter 1

End of Chapter

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