Monetary Law and Monetary Policy

2. Context: role of money within wider economy. Basic introduction into financial markets

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Financial markets

- Markets in which funds are channelled from savers/investors (people who have available funds but no productive use for them) to enterpreneurs/corporations (but also the state or other public sector entities) for the purpose of financing their operations and achieving growth

- Investors seek returns for putting their capital at disposal (e.g. interest on loans, dividends)
- Borrowers/corporations share their income with the investors (e.g. by paying interest or dividends)
- Intermediaries (e.g. banks, brokerage firms, investment funds) facilitate this process and earn their share in return

Securities

- Security – a certificate representing a claim on the issuer's future income or assets
- Bond – **debt** security representing a claim against the issuer for a certain amount of money, payable at a specified time. Function: similar to a **loan.**
- Share – **equity** security, unit of ownership in a corporation, representing a claim on (uncertain) future income of the issuer and on its assets in case of its liquidation
- Financial instrument: „any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity" (International Accounting Standards) – securities or more complex arrangements (e.g. derivatives)

Bond market

- Bond market – enables corporations and governments to borrow in order to finance their needs. Cost of borrowing results from the **interest rate** applied (interest rate = cost of money).
- Interest rates depend on the creditworthiness of the issuer/debtor, available collateral, and general **availability of credit** in the economy (resulting from general **money supply**). They vary but they tend to change in a similar way.
- Monetary policy of a central bank can usually influence general level of interest rates in the economy. Increase in money supply = lower interest rates and better availability of credit.

Stock market

- Stock market – enables corporations to raise capital by issuing shares and giving shareholders equity interest in the company. Amount of capital to be raised depends on expected returns, alternative investments (including interest rates on bonds and deposits) and general situation of the economy.
- High volatility of stock prices.
- Less direct link to the monetary policy. Increase in money supply = more liquidity on the market = increased willingness to invest in stock = increase in stock prices.

Banking system

- Banks are financial intermediaries – taking **deposits** from the general public and extending **credit** (**loans**) financed by deposits.
- Deposits and loans are priced by **interest rates**.
- Interest rates result from market conditions (similarly to those on the bond market) and are directly influenced by interest rates set by the central bank, used as a monetary policy instrument.
- Bank deposits and loans are main instrument of **money creation** in the economy (→ money multiplier) and serve as **transmission mechanism** for the monetary policy of the central bank

Financial innovation

- Development of new financial services and instruments – e.g. more and more complex derivatives.
- Improves efficiency.
- Creates new complex financial products enabling refinancing, hedging and risk-sharing.
- Danger resulting from unpredictable re-allocation of risk.
- Possible result – lack of confidence on the market results in reduced willingness to grant credit → the transmission mechanism does not function properly even if central bank cuts interest rates.

Fiscal policy

- Government spending and revenues (mostly from taxation)
- Budget deficit – excess of government spending over revenues, financed by accumulating **public debt**
- Government borrowing – issue of **sovereign bonds**, cost depending on interest rate (bond yields)
- By volume, sovereign bonds represent a large part of securities on the financial market → significance for monetary policy
- Prohibition of direct borrowing by government from the central bank (**monetary financing**)

Currency policy and foreign exchange market

- Conversions between currencies, according to an **exchange rate**
- Significance for competitiveness of the economy, international trade and balance of payments
- Fluctuations in the exchange rate can have a significant impact on price stability, lead to capital flows and influence money supply.

Reading and reference materials

- F. Mishkin, The Economics of Money, Banking, and Financial Markets, Pearson, 13th ed. 2022 – Chapter 1 „Why Study Money, Banking and Financial Markets?", p. 50-62 (mandatory)