

## 16.14: Putting It Together- Financial Markets and System

### Synthesis



Still have that dollar bill handy that you pulled out earlier when you learned about the Federal Reserve System? Do you think about it the same way you did before you completed this module? Perhaps you do, but now you should have a better understanding of what that dollar bill represents, how it came into existence, and where its value comes from. Money will always exist in some form, whether it's based on NFC technology in your iPhone or we go back to a barter system where we trade seashells for bread. It will still motivate people to work, study, achieve, and unfortunately even break the law. But, as you consider everything you have read and heard in this module, is it the money itself that is the motivator or the “store of value” that we work to obtain? In fact, you can look at that dollar bill and, really, it's just a piece of paper with a picture of a dead president on its face—it has no intrinsic value. So where is the value in the dollar bill you're holding? Is it that our society recognizes it as having value, and business and individuals are willing to “trade” your dollars for shoes, cars, houses, food, and the other things that you need or want in your day-to-day life? Yes, we could go back to trading chickens for shoes, but technology is pushing us further and further away from that model, and as the monetary system evolves, it's unlikely that it will become less complex. That's one big reason you've spent all this time understanding this thing that “makes the world go 'round.”

### Summary

This module covered the financial markets and system. Below is a summary of the topics covered in this module.

#### Money

Money serves three basic functions:

- **Medium of exchange:** because you can use it to buy the goods and services you want, everyone's willing to trade things for money.
- **Measure of value:** it simplifies the exchange process because it's a means of indicating how much something costs.
- **Store of value:** people are willing to hold on to it because they're confident that it will keep its value over time.
- Virtual currencies, such as BitCoin, are using the traditional concept of “money” but as an alternative to the established Federal Reserve System. Although gaining in popularity, these virtual currencies are unregulated and pose some serious risks to those using this medium of exchange.
- Cashless payment systems such as Google Wallet and ApplePay allow consumers to carry their “cash” in their mobile devices. As more retailers move to “tap to pay” or scanning QR codes to complete transactions, the need to carry conventional paper money and coin diminishes. The question raised by this technology is not whether it will lead to a cashless society, but rather which mobile payment service will rise to the top and capture the market.

#### Role of Banks

- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below \$100,000.
- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
- A bank holds on to only a fraction of the money that it takes in—an amount called its **reserves**—and lends out the rest to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The **money multiplier** effect ensures that the cycle expands the money supply.

- Most large banks are members of the central banking system called the **Federal Reserve System** (commonly known as “the Fed”).
- The Fed’s goals include price stability, sustainable economic growth, and full employment. It uses *monetary policy* to regulate the money supply and the level of interest rates.
- To achieve these goals, the Fed has three tools:
  - it can raise or lower **reserve requirements**—the percentage of its funds that banks must set aside and can’t lend out;
  - it can raise or lower the **discount rate**—the rate of interest that the Fed charges member banks to borrow “reserve” funds;
  - it can conduct **open market operations**—buying or selling government securities on the open market.

## Financial Markets and Business

The four main ways that businesses raise financial capital are:

- **Early-stage capital:** business owner uses his/her own money or seeks money from an angel investor or venture capital firm
- **Profits:** profits from the business are reinvested in equipment, structures, research and development, etc.
- **Bonds:** a way to raise capital through borrowing, used by corporations and governments; an investment for the bondholder that creates return through regular, fixed, or floating interest payments on the debt and the repayment of principal at maturity; traded on bond exchanges through brokers.
- **Stocks:** a way to raise capital by selling ownership or equity; an investment for shareholders that creates return through the distribution of corporate profits as dividends or through gains (losses) in corporate value; traded on stock exchanges through member brokers.

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