Chapter 14

Money, Banking and the Fed

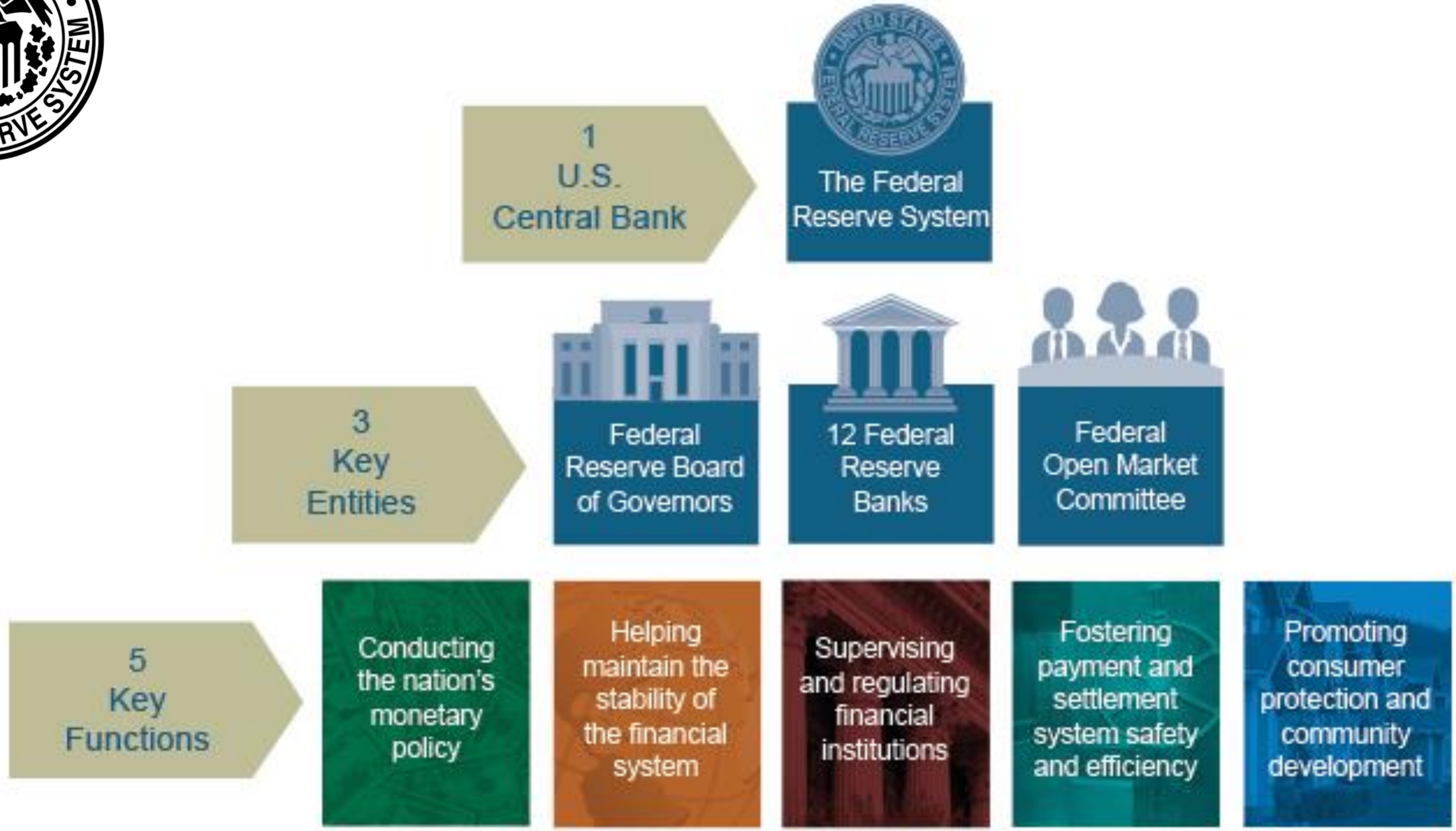
Vocabulary

Define:

1. Monetary policy:
2. Easy money policy:
3. Tight money policy:
4. Interest rate:
5. Bank run:

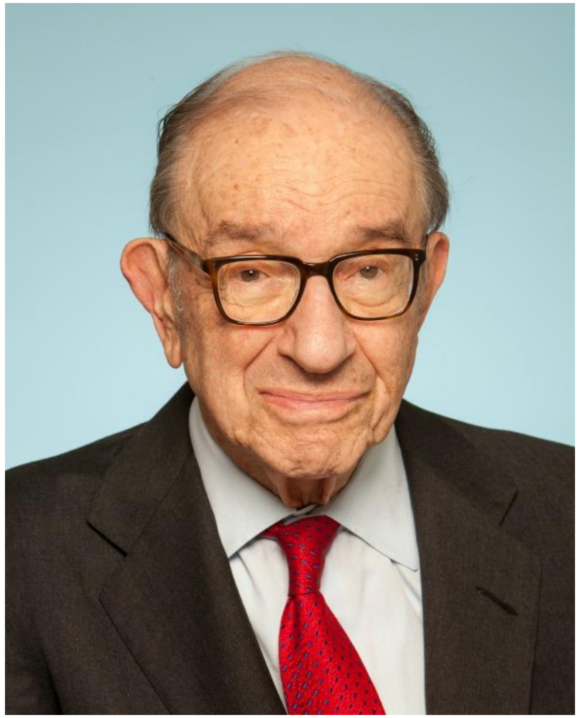
What if I told you there was a group that controlled the economy?

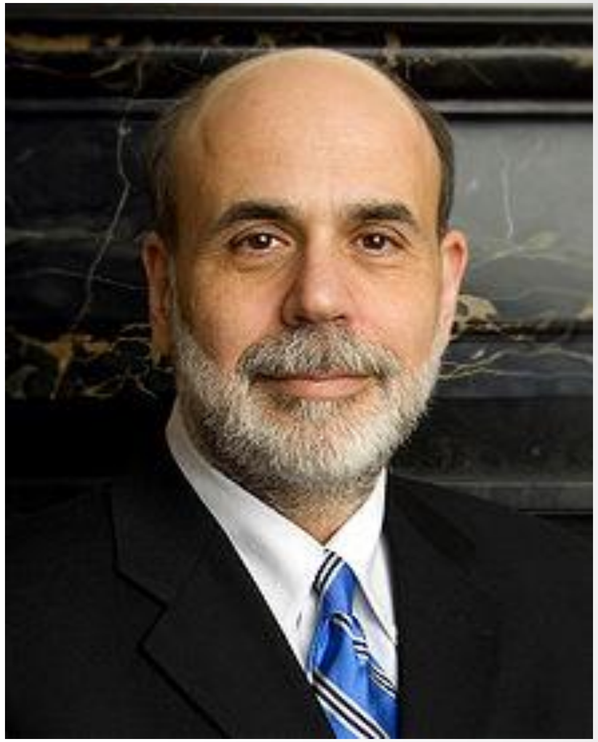
What is the FED?



They don't always cause you to lose money but when they do…

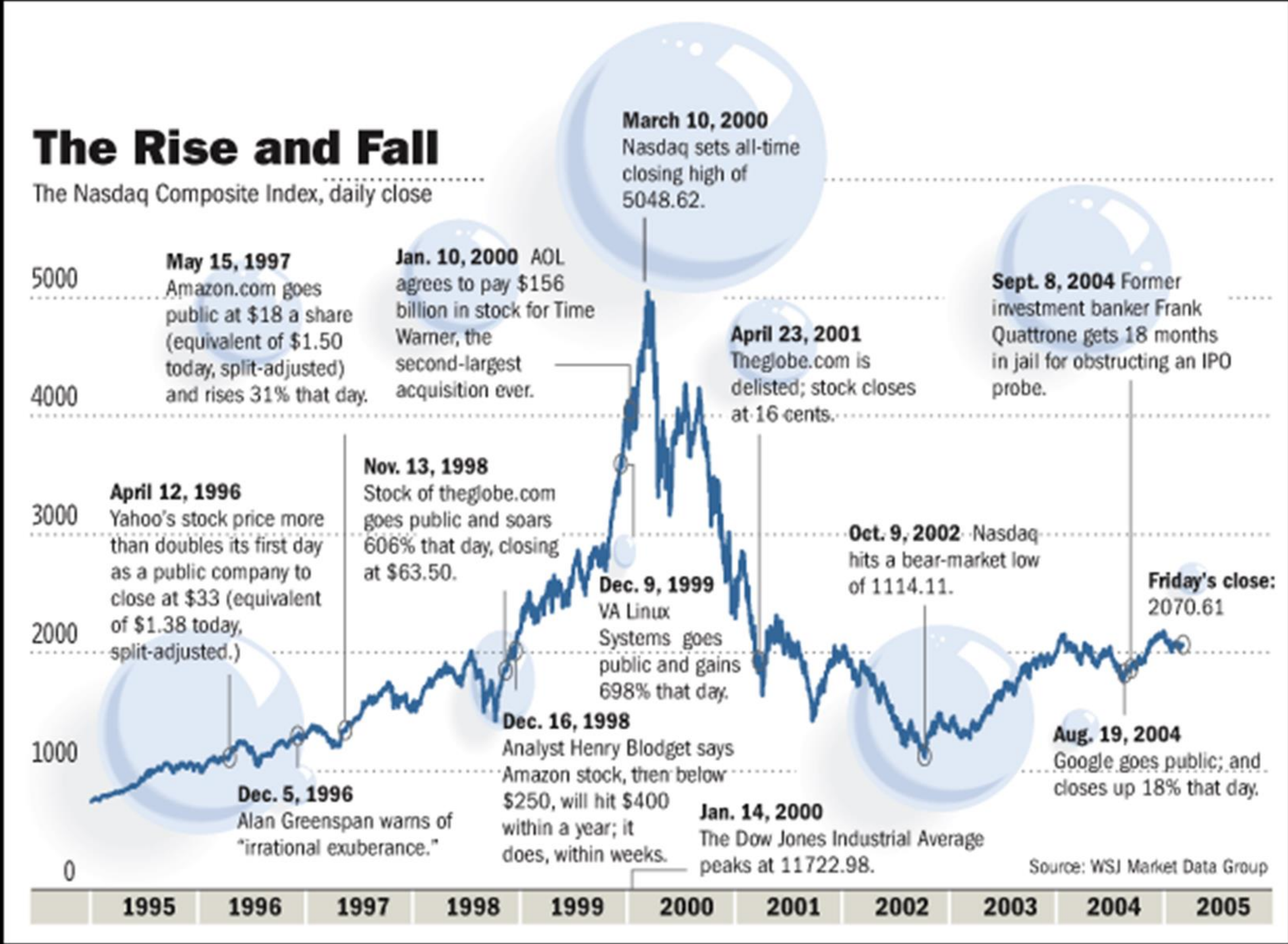
When Alan Greenspan stated that the market was dealing with "irrational exuberance" hinted at the collapse of the dot-com bubble





When Paul Volcker (Chair of the Fed 1979-1987) raised interest rates to 20%. Inflation fell from 14.8% to 3%. It also lead to two recessions

When Ben Bernanke (chair of Fed 2006-2014) said at a dinner he was worried about inflation the stock market dropped 250 points the next day


The Rise and Fall
The Nasdaq Composite Index, daily close
5000
4000
3000
2000
1000
0
May 15, 1997 Amazon.com goes public at $18 a share (equivalent of $1.50 today, split-adjusted) and rises 31% that day.
Jan. 10, 2000 AOL agrees to pay $156 billion in stock for Time Warner, the second-largest acquisition ever.
March 10, 2000 Nasdaq sets all-time closing high of 5048.62.
April 23, 2001 Theglobe.com is delisted; stock closes at 16 cents.
Sept. 8, 2004 Former investment banker Frank Quattrone gets 18 months in jail for obstructing an IPO probe.
April 12, 1996 Yahoo's stock price more than doubles its first day as a public company to close at $33 (equivalent of $1.38 today, split-adjusted.)
Nov. 13, 1998 Stock of theglobe.com goes public and soars 606% that day, closing at $63.50.
Dec. 9, 1999 VA Linux Systems goes public and gains 698% that day.
Oct. 9, 2002 Nasdaq hits a bear-market low of 1114.11.
Friday's close: 2070.61
Dec. 5, 1996 Alan Greenspan warns of "irrational exuberance."
Dec. 16, 1998 Analyst Henry Blodget says Amazon stock, then below $250, will hit $400 within a year; it does, within weeks.
Jan. 14, 2000 The Dow Jones Industrial Average peaks at 11722.98.
Aug. 19, 2004 Google goes public; and closes up 18% that day.
Source: WSJ Market Data Group
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005

History of Money

Commodity Money

Money that has an alternative use as an economic good: gun powder, flour, corn.

Fiat Money

Money used by government decree; has no alternative value or use as a commodity.

The FED

- Created in 1913 by Congress the Federal Reserve is a **central bank** that loans money to other banks.

- **Legal reserves:** Currency deposits used to meet the reserve requirement.

- **Reserve requirement:** Formula used to compute the amount of a depository institution required reserves.

Easy money policy

- Expand the money supply
- Causes interest rates to fall

This stimulates the economy because more people start to borrow money (you pay less in interest) and spend more.

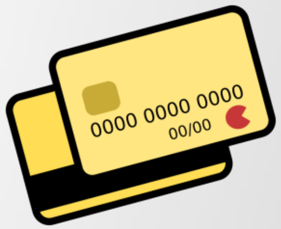
Tight Money Policy

- Restrict the money supply
- Causes interest rates to rise

This discourages spending and less people borrow money because of the higher interest rate (You pay more).

Why should you care?

	Mortgage Amount				
Rate	$100,000	$200,000	$300,000	$400,000	$500,000
6.00	599.55	1,199.10	1,798.65	2,398.20	2,997.75
5.75	583.57	1,167.15	1,750.72	2,334.29	2,917.86
5.50	567.79	1,135.58	1,703.37	2,271.16	2,838.95
5.25	552.20	1,104.41	1,656.61	2,208.81	2,761.02
5.00	536.82	1,073.64	1,610.46	2,147.29	2,684.11
4.75	521.65	1,043.29	1,564.94	2,086.59	2,608.24
4.50	506.69	1,013.37	1,520.06	2,026.74	2,533.43

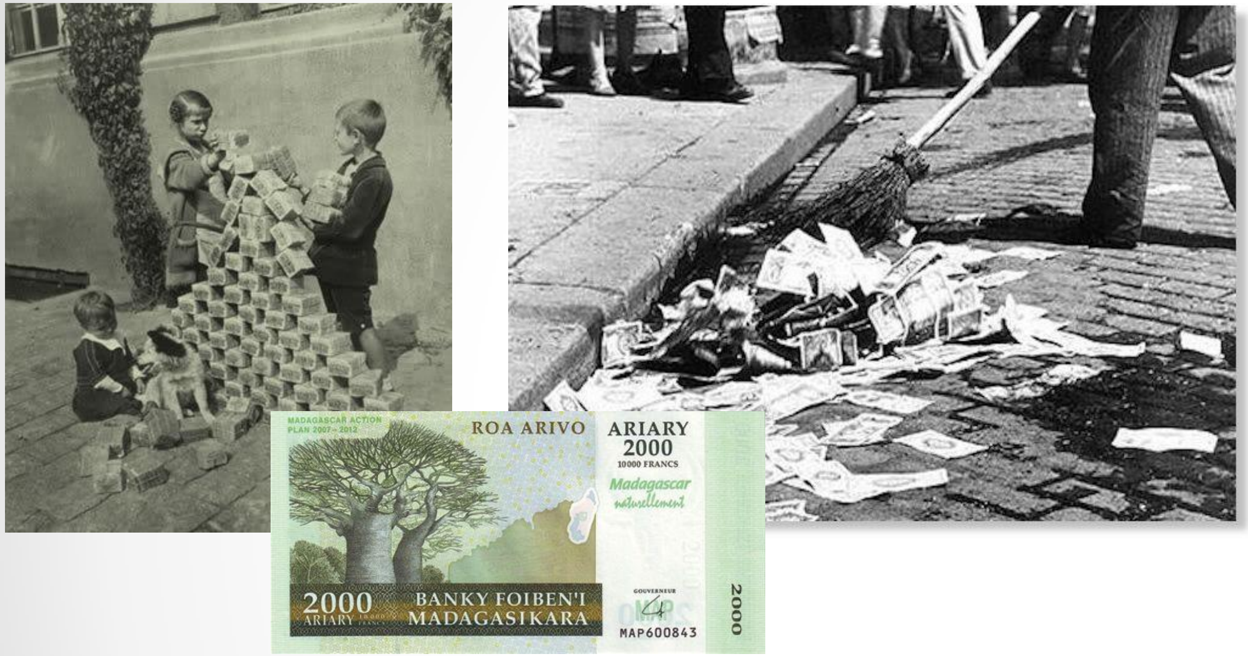


So does that mean that an easy money policy is better?

Not really an easy money policy creates inflations and bubbles

Monetary Policy

Hyperinflation

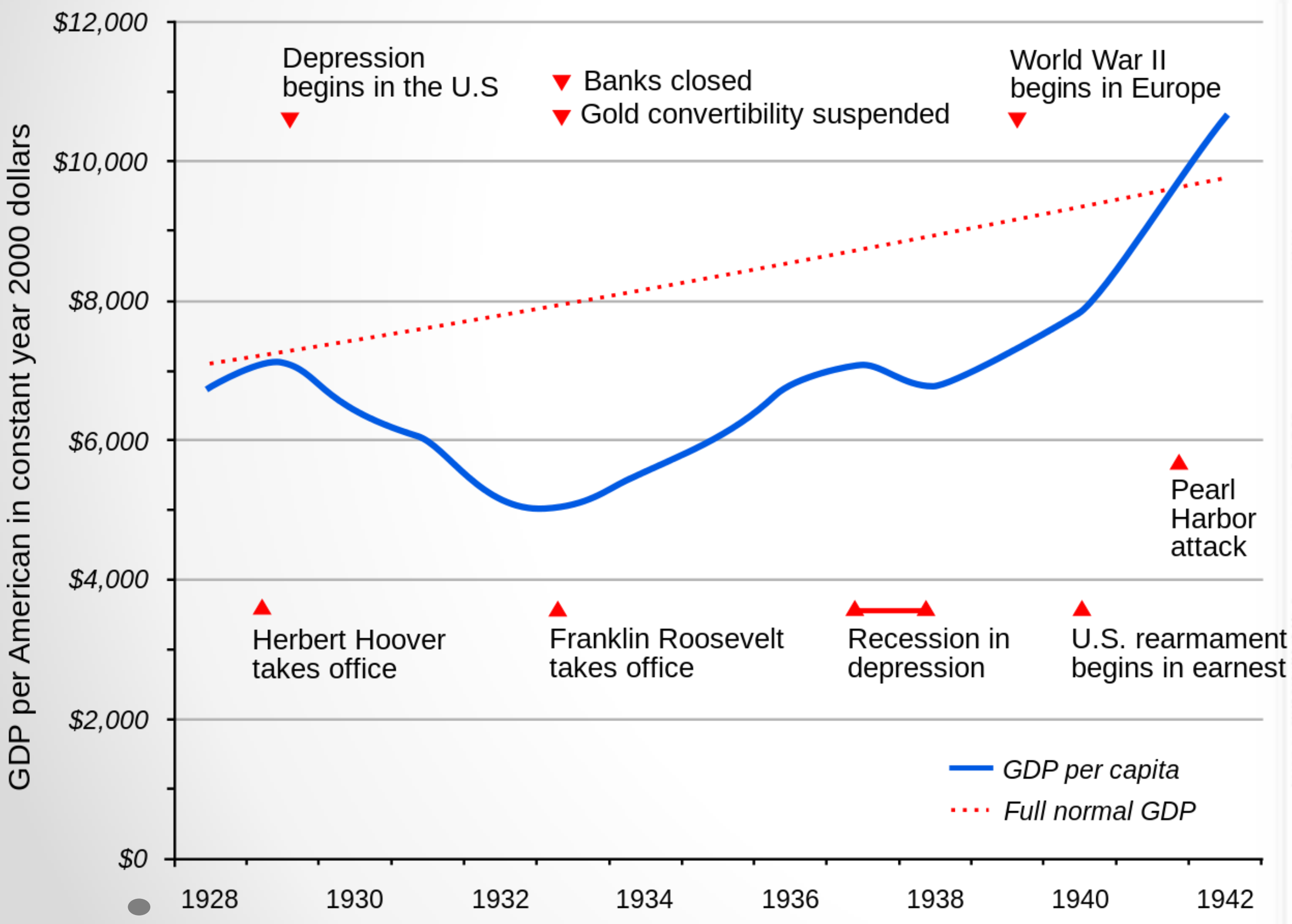


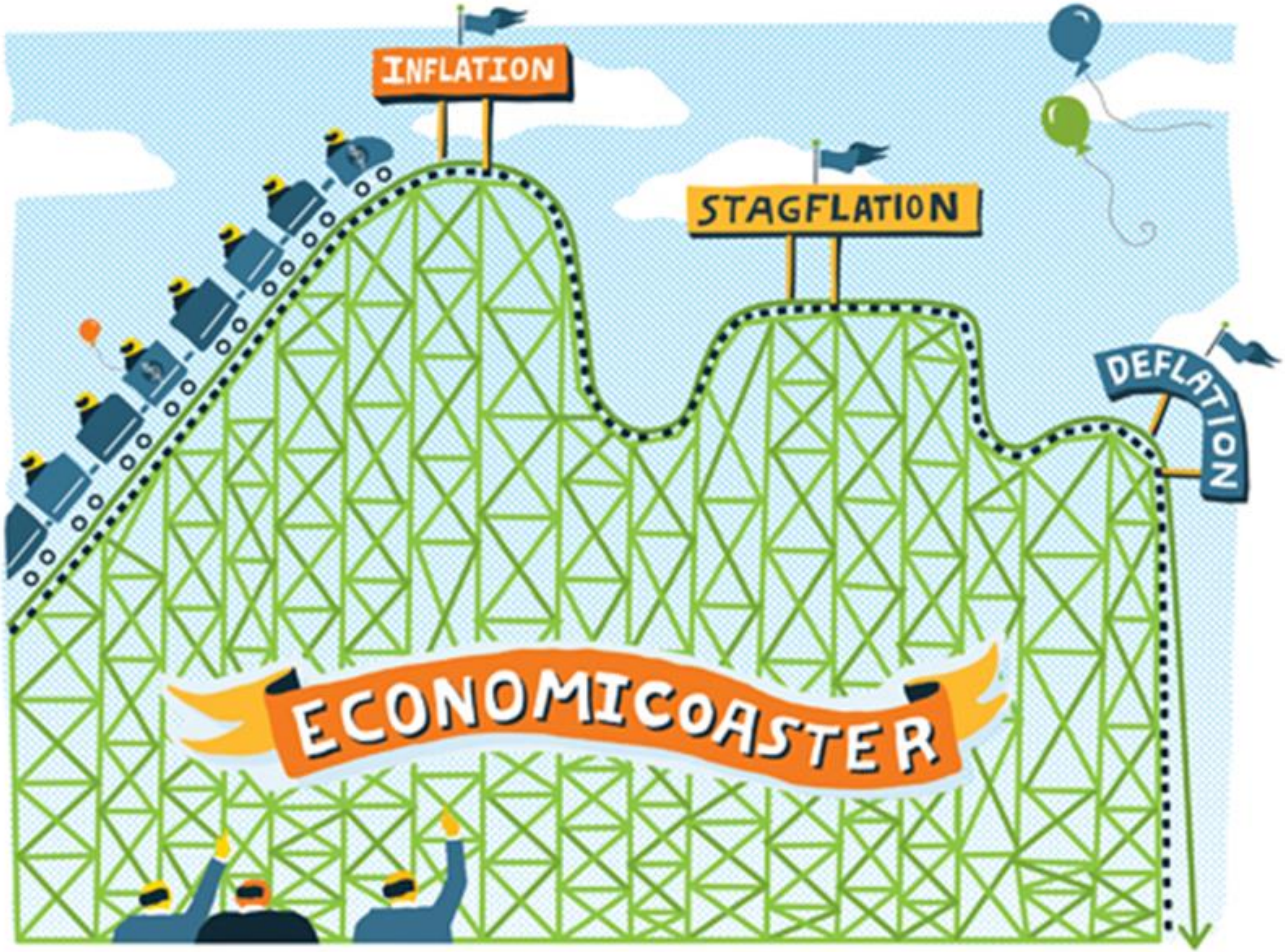
Significant increase in the money supply not supported by gross domestic product (GDP) growth

Deflation

- Less government spending
- Less Business Investments
- Less Consumer Spending

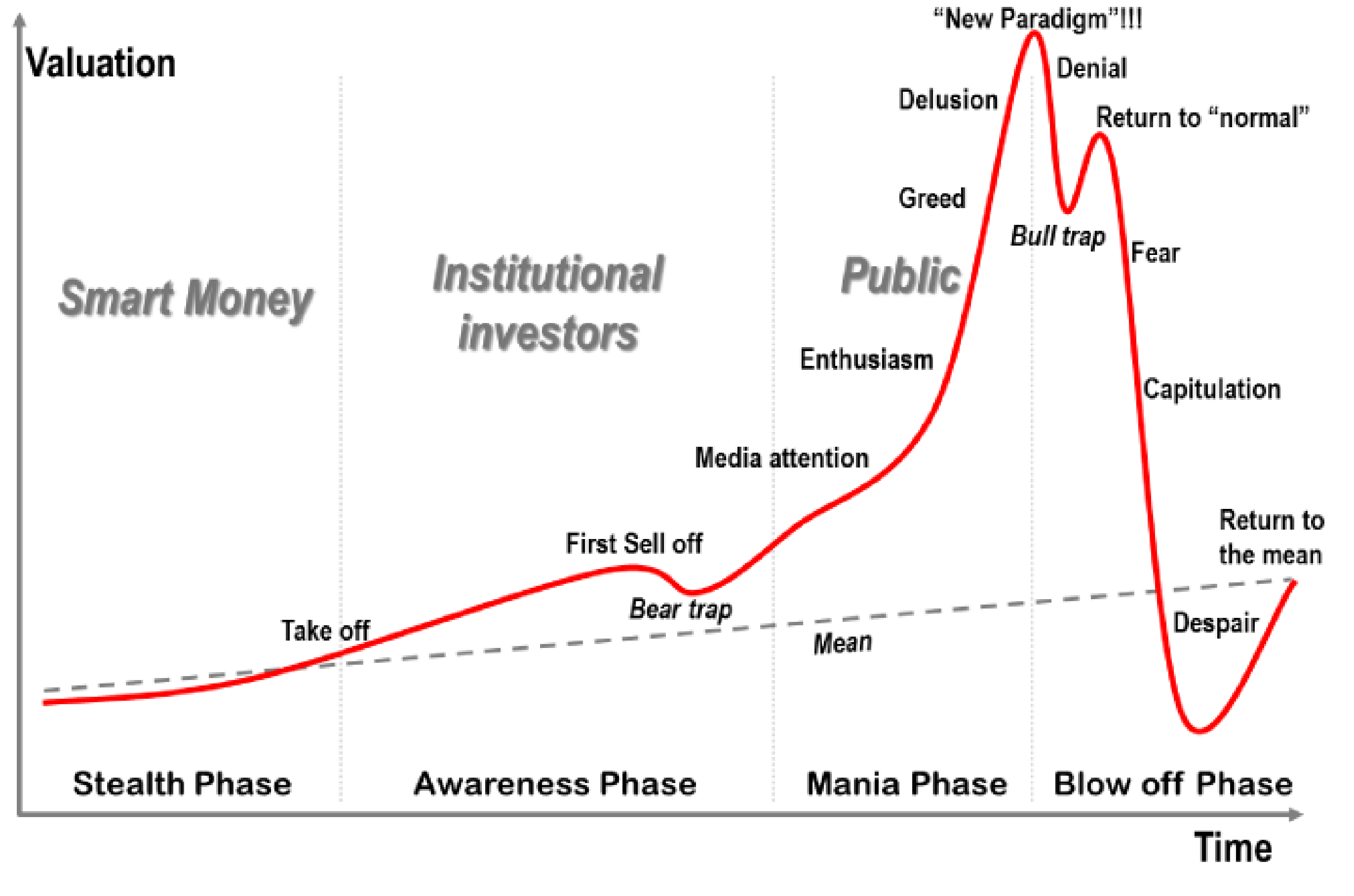
How Monetary Policy Works




INFLATION
STAGFLATION
DEFLATION
ECONOMICOASTER

Case Study: The Dot-Com Bubble

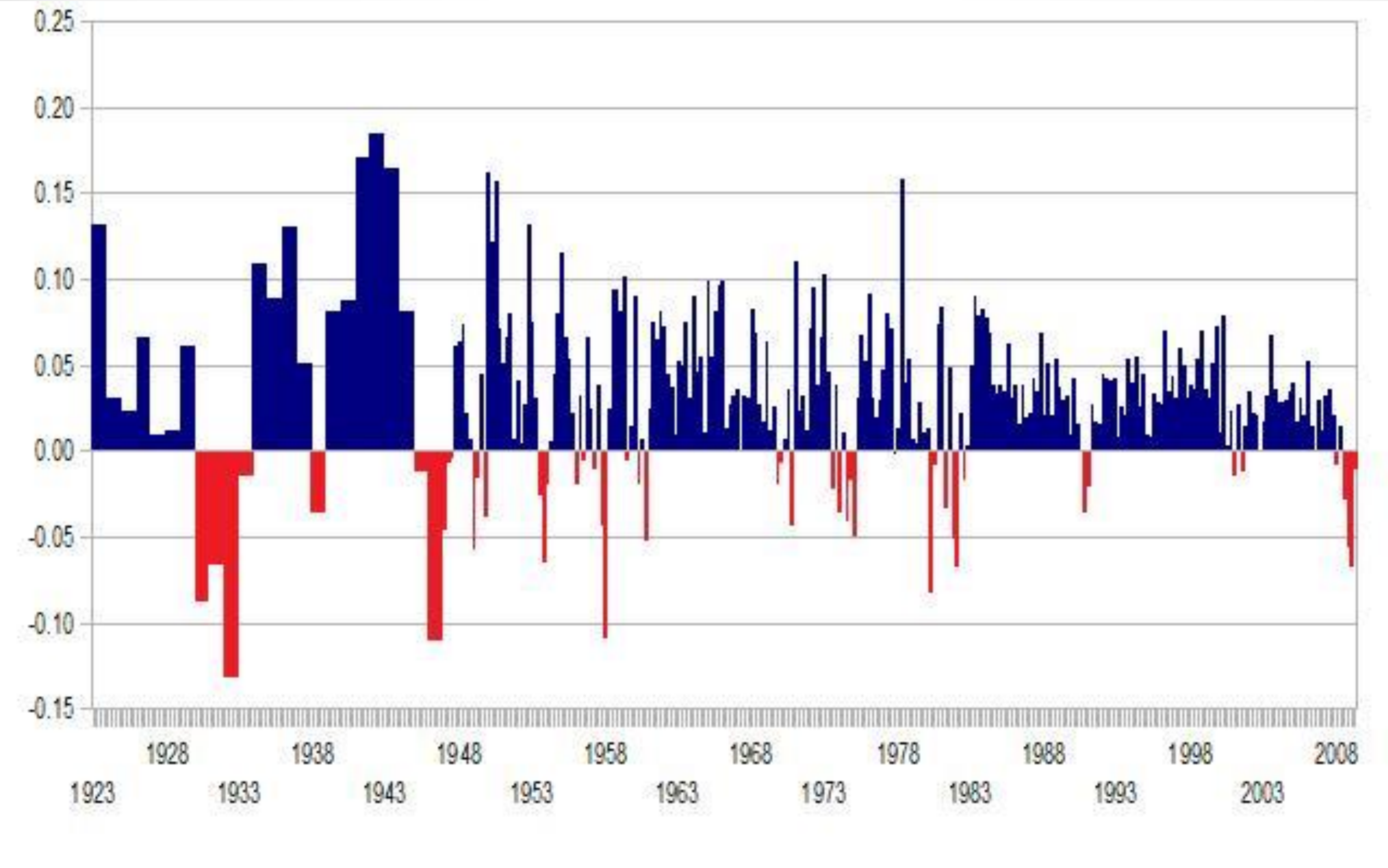
U.S. entered into its longest period of economic expansion, lasting exactly 10 years.[1] Growth was fueled by the Dot Com bubble, as corporations and the federal government made significant purchases of computer equipment and software, especially during the last six years of the expansion.



Case Study: The Great Recession: 12/2007- 6/2009

- The subprime mortgage crisis led to the collapse of the United States housing bubble. Falling housing-related assets contributed to a global financial crisis, even as oil and food prices soared. The crisis led to the failure or collapse of many of the United States' largest financial institutions: Fannie Mae, Freddie Mac, Lehman Brothers, Citi Bank and AIG, as well as a crisis in the automobile industry.

- The government responded with an unprecedented $700 billion bank bailout and $787 billion fiscal stimulus package. The National Bureau of Economic Research declared the end of this recession over a year after the end date. The Dow finally reached its lowest point on March 9, 2009.



GDP 1923-2008

Review

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