Economic tools and their effect in financial markets

Executive Summary

This essay explores how different economic factors affect the financial systems and how they are used to manipulate the economy. The first aspect I discuss is how the Bank of Mexico and the Fed change the level of interest rates, and uses this as a tool, to encourage its market participants to invest more or less which significantly impacts the economy. This is followed by introducing quantitative easing, and how greatly it has impacted the market after the financial crises. Lastly, I discuss how the Fed's current economic policies are being used to promote a healthy and stable economy, and how this will affect our economies future.

Introduction

Financial markets and institutions are crucial aspects to all countries around the world, since they are vital in allocating capital within a country's economy. A financial market is a marketplace where financial assets such as derivatives, bonds, equity, and currencies are created and traded. The financial market plays an intermediary role between investors and savers through the transfers of funds between them. This then creates a competitive a marketplace where buyers and sellers get together to trade assets at a price that is determined by supply and demand. The market participants then make decisions on these interest rates as well as expected interest rates, hoping to capitalize on their investments. In this paper I will discuss how interest rate levels and other economic tools are used to manipulate economic growth and policy, as well as how the market reacts to these changes in rates.

The Level of Interest Rates

Interest rates are the costs incurred after borrowing money from individuals or financial organizations to buy goods and services. Interest rates are expressed as a percentage of the total amount of the loan. They are important economic variables because they directly influence consumer and business spending. As talked about in chapter 4, interest rates help in allocating funds between surplus spending units and the deficit spending units for financial markets.[1]For instance, in reference to the Wall Street Journal, the Bank of Mexico raised the interest rates claiming that the market concerns over the next economic policies of the government have primarily impacted to peso weakening as well as contributing to an increase in the local debt yields (Harrup, Anthony, 2018). A weaker peso will affect the rate of returns for foreign investors and the peso will be worth less in the international market. To correct its weakening currency, the Bank of Mexico raised its interest rates to attract investors (surplus spending units) to make investments, since higher interest rates means a larger return. In-exchange, foreign investment will strengthen the Mexican economy, as well as strengthening the peso. The change of Interest rates are important tools that directly influence how money is transferred within the market. By adjusting the level of interest rates, governments can encourage or discourage investing.

Additionally, In the United States, the Fed is increasing interest rates gradually to keep the growing economy from " overheating" and increased inflation.[2]Although the Fed has increased the interest rates 8 times since 2018, it is evident that the borrowing costs are still a hindrance to economic growth (Kiernan, Paul, 2018). Mr. Kiernan here explains that although the economy is growing, so are borrowing costs. When people borrow less, they have less money to spend, causing less money to be in circulation. Since the economy is already growing at a rapid pace, lower interest rates would only add more money into circulation which would lead to an increase in inflation. In order to combat this problem, the Fed continues to raise interest rates gradually to reduce the demand for funds, leading to a reduction in inflation. As shown in both examples above, change in interest rates are used in different ways to promote different policies. Every day the economy changes and is highly affected by these factors, so it is crucial to have a basic understanding of why governments implement different economic policies and what they are trying to achieve.

Quantitative Easing

Chapter 6 talks about how interest rates vary among the financial products through the business cycle. The difference in the interest rates are categorized by five major characteristics; (1) term-to-maturity, (2) default risk, (3) tax treatment, (4) marketability or liquidity, and (5) special features such as call and put options. The relationship between these factors and the interest rates are analyzed using the yield curve, and then the yield curve can be explained by different economic theories such as the Liquidity Premium Theory.[3]For instance, in the 2008 financial crisis and recession, the Fed adopted powerful tools to buy trillions of dollars bonds and near-zero interest rates promises for extended periods of time (Timiraos, Nick, 2018). In order to recuperate the economy from the financial crises, the fed needed to find a way to lower interest rates long term. The fed started purchasing risky assets such as MBS, trying to help banks get rid of these assets from their balance sheets and reduce interest rates. This did not help the economy recover enough, so it had to implement new policy. The Fed then implemented a new tool, Quantitative Easing which we learned about in Chapter 2. “ Quantitative easing is purchasing bonds and creating more reserves even when interest rates are near zero (Textbook).” The Fed started purchasing trillions of dollars’ worth of bonds and securities. This lasted from 2008–2012 and included 3 rounds. This added liquidity to the market since buying bonds increases the money supply, which leads to a decrease in long term interest rates. This has stimulated the economy causing upward pressure on bond prices and increased spending for both consumer and businesses. In this example, the Fed had to do the opposite of what it is trying to do now. In times of a weak economy the Fed has to increase consumer spending and investing. When an economy is strong and growing, it must slow down the rate of inflation.

Today,[4]the economy is in “ good shape,” Mr. Powell said Thursday at a public event in Houston, adding that the recently released October employment report was “ very strong” (Elliot, Rebecca, 2018). With employment and wages going up, consumption and demand increases as well. Low unemployment means companies are competing to hire individuals, causing wages to rise. When consumers have more disposable income, they spend more.[5]Rising wages and low unemployment are great news for workers, Fed officials worry that labor shortages could eventually drive up wages and prices enough to cause inflation to accelerate (Kiernan, Paul, 2018). It is reasonable to assume that the Fed will continue to raise interest rates as a cautionary tool to keep inflation stable but must also monitor rising price levels associated with rising interest rates.[6]“ These are all things that point to prices going up,” said Diane Swonk, chief economist at Grant Thornton. (Huffor Austen and Gasparro Annie)

Conclusion

In conclusion, the financial market is a crucial aspect of the growth of the economy of any given country. Economic factors must be analyzed and can be used as tools to promote efficiencies within the financial market. These changes in the financial market, change the way capital is allocated by shifting the behavior of its participants. Economic tools such as the level of interest rates and quantitative easing affect the economy by impacting stock and bond interest rates, consumer and business spending, and inflation. The Bank of Mexico used these tools to correct its weak peso by raising interest rates to promote foreign investment. The U. S engaged in quantitative easing to rebuild the economy after the financial crises. By buying trillions of dollars’ worth of securities, the fed was able to promote liquidity and keep rates low for years to come. Today with a strong economy, the Fed has raised interest rates to offset inflation associated with economic growth and has kept the economy stable. It is absolutely evident, that different economic factors play a major role on how market participants react, and how that effects the economy as a whole.

1. Anthony Harrup, “ Bank of Mexico Raises Interest Rates,” WSJ, last modified November 15, 2018, https://www. wsj. com/articles/bank-of-mexico-raises-interest-rates-1542311679.

2. Paul Kiernan, “ Economists Expect Fed to Continue Raising Rates Through 2019,” WSJ, last modified November 15, 2018, https://www. wsj. com/articles/economists-expect-fed-to-continue-raising-rates-through-2019-1542294000.
3. Nick Timiraos, “ Fed Raises Interest Rates, Signals One More Increase This Year,” WSJ, last modified September 26, 2018, https://www. wsj. com/articles/fed-raises-interest-rates-signals-one-more-increase-this-year-1537984955.
4. Nick Timiraos, “ Federal Reserve Likely to Keep Interest Rates Steady,” WSJ, Last modified November, 8, 2018https://www. wsj. com/articles/federal-reserve-likely-to-keep-interest-rates-steady-1541673001
5. Paul Kiernanhttps, “ Fed Will Likely Raise Rates After Strong Jobs Report,” WSJ, last modified November, 2, 2018 www. wsj. com/articles/fed-will-likely-raise-rates-after-strong-jobs-report-1541176431? mod= article_inline
6. Austen Hufford and Annie Gasparro, ” That Big Mac and Coke Now Comes With a Side Order of Inflation” WSJ, Last modified October, 31, 2018 https://www. wsj. com/articles/companies-raise-prices-betting-consumers-can-pay-more-1540978200? mod= article_inline

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[1]Anthony Harrup, “ Bank of Mexico Raises Interest Rates,” WSJ, last modified November 15, 2018, https://www. wsj. com/articles/bank-of-mexico-raises-interest-rates-1542311679.

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[3]Nick Timiraos, “ Fed Raises Interest Rates, Signals One More Increase This Year,” WSJ, last modified September 26, 2018, https://www. wsj. com/articles/fed-raises-interest-rates-signals-one-more-increase-this-year-1537984955.

2. Timiraos, “ short title.”

[4]Nick Timiraos, “ Federal Reserve Likely to Keep Interest Rates Steady,” WSJ, Last modified November, 8, 2018https://www. wsj. com/articles/federal-reserve-likely-to-keep-interest-rates-steady-1541673001

[5]Paul Kiernanhttps, “ Fed Will Likely Raise Rates After Strong Jobs Report,” WSJ, last modified November, 2, 2018 www. wsj. com/articles/fed-will-likely-raise-rates-after-strong-jobs-report-1541176431? mod= article_inline

[6]Austen Hufford and Annie Gasparro, ” That Big Mac and Coke Now Comes With a Side Order of Inflation” WSJ, Last modified October, 31, 2018 https://www. wsj. com/articles/companies-raise-prices-betting-consumers-can-pay-more-1540978200? mod= article_inline