

Introduction to Economics for Finance

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Key concepts, terminology, and the link between economics and finance

1. What Is Economics?

Aspect	Definition
Microeconomics	Study of individual agents (consumers, firms, workers) and how they make choices under scarcity.
Macroeconomics	Study of the economy as a whole—aggregate output, inflation, unemployment, fiscal and monetary policy.
Positive vs. Normative	<i>Positive</i> : statements that can be tested (e.g., “A 1% rise in interest rates reduces investment by 0.5%”).* <i>Normative</i> : value judgments about what ought to be (e.g., “The government should lower taxes”).
Scarcity & Choice	Resources are limited; agents must allocate them to satisfy competing wants. This creates trade-offs and opportunity costs.

2. Core Economic Principles Relevant to Finance

Principle	Financial Implication
Opportunity Cost	The return you forgo by choosing one investment over another.
Time Value of Money (TVM)	A dollar today is worth more than a dollar tomorrow because it can be invested.
Risk-Return Trade-off	Higher expected returns compensate investors for taking on higher risk.
Marginal Analysis	Investment decisions are made by comparing marginal benefits (additional return) with marginal costs (additional risk).
Market Efficiency	In an efficient market, prices reflect all available information (EMH).
Supply & Demand	Determine asset prices, interest rates, and exchange rates.

3. How Economics Shapes Financial Markets

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1. Monetary Policy

- Central banks set short-term interest rates ? influences bond yields, equity valuations, and currency values.
- Tools: open-market operations, discount rate, reserve requirements.

2. Fiscal Policy

- Government spending and taxation affect aggregate demand ? impacts corporate earnings and credit risk.

3. Business Cycle

- Expansion ? higher corporate profits, rising equity prices.
- Recession ? lower profits, higher default risk, flight to safety (bonds, gold).

4. Inflation

- Erodes real returns; leads investors to demand higher nominal yields.
- Real assets (real estate, commodities) often act as hedges.

5. Exchange Rates

- Determined by relative interest rates, trade balances, and expectations ? affect multinational cash flows and valuation of foreign assets.

4. Fundamental Economic Models Used in Finance

Model	Purpose	Key Variables
IS?LM	Interaction of goods market (IS) and money market (LM) ? equilibrium output & interest rate.	Y (output), i (interest rate), G (government spending), M (money supply).
AD?AS	Aggregate demand & supply ? price level, output, inflation.	P (price level), Y, AD, AS.
Solow Growth Model	Long-run economic growth driven by capital, labor, technology.	K, L, A (technology), s (savings rate), ? (depreciation).

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Model	Purpose	Key Variables
CAPM (Capital Asset Pricing Model)	Relates expected return of an asset to its systematic risk (β).	$E(R_i)$, R_f , β_i , $E(R_m)$.
Black-Scholes	Pricing of European options under assumptions of log-normal returns.	S , K , r , σ , T .

**Heckscher-Ohlin /