Five Core Principles of Money and Banking

(1) **Time has values**: Time affects the value of financial transaction. A dollar today is not the same as a dollar tomorrow. This is because, if you have a dollar today, you can put it in some interest bearing account and get more than a dollar back tomorrow.

(2) **Risk requires compensation**: Think of car insurance. Driving entails some risks. You might damage your car or damage someone else’s car or even someone else. But you don’t want to bear that risk yourself. So, you transfer that risk to the insurance company. However, the insurance company will not bear this risk for you for free. You have to pay them to do so.

(3) **Information is the basis for decisions**: Think of a mortgage lending situation. The homebuyer has to submit a thick pile of forms with her information because the lender does not know whether she will be able to repay the loan. Even after that, she may have to buy homeowners insurance because the lender wants to make sure of the monthly payment. However, when merchants accept cash they don’t ask questions. In other words, they don’t need any information.

(4) **Markets set prices and allocate resources**: Markets are at the core of the economic system. Markets gather information from a large number of individual participants and aggregate it into a set of prices that signals what is valuable and what is not. It also allocates resources to the highest valued alternatives and channels goods and services to those who value them the most.

(5) **Stability improved welfare**: ‘Stability’ is a desirable quality, not just in our personal lives but also in the financial system as a whole. This is related to core principle 2 (risk has to be compensated). Volatility creates risk, reducing volatility reduces risk. Some of these volatilities cannot be controlled by the individual. Example: business cycles. These are output volatilities of the aggregate economy that the individual has no control over. Therefore, the government has to step in to stabilize such volatilities. Stabilizing the economy is the primary function of the central banks (Fed, or European central bank).

[Source: Stephen Cecchetti’s *Money, Banking, and Financial Markets*]