Material for Lecture 2 & 3

Lecture 2 & 3 will use the following transparencies, plus Figure 1 and Tables 1 – 5 of Chapter 2 of the textbook.

Overview of the Financial System

1. The Functions of the Financial System
2. Financial Markets
3. Financial Intermediaries
4. Regulation
Functions of the Financial System

Financial Markets and Institutions

• Allow individuals to shift funds
  - across time periods
  - across situations (example: insurance)

• Allow society to transfer funds between lenders and borrowers
  - for better timing of consumption
  - to facilitate production

Classifying Financial Markets

• Debt v. Equity Markets
• Money v. Capital Markets
• Primary v. Secondary Markets
• Exchanges v. Over-the-Counter (OTC) Markets
• Liquid v. Illiquid Markets
Bonds

- Security: any claim on issuer’s future income or wealth

- Bond: security that promises to make payments periodically for a specified period of time (up to maturity)

- Sold at a per unit price

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Bonds

- ‘Interest rate’ on bond is what can be earned by investing one dollar in bond; can be calculated from bond price

- Failure to make promised payment may trigger bankruptcy

- Many types of bond exist -> many interest rates
  - maturity (-> term structure)
  - bankruptcy risk -> bond ratings, “junk bonds”
Stocks

- Share: security that represents a claim on the earnings and assets of a corporation
- Sold at a per unit price
- Often makes periodic payments (dividends); no maturity date

Stocks

- Equity holders are ‘residual claimants’
- Equity holders often have voting rights
- Stock prices fluctuate substantially over time
The Money Market

• Much more private money market instruments than public ones

• Many money market instruments issued and held by intermediaries; households almost never directly participate in the money market

• “Globalization”

The Capital Market

• Government is largest borrower in long term debt market

• Households and intermediaries (pension funds, mutual funds) hold capital market instruments

• Banks’ importance as lenders has declined, especially for lending to businesses
Exchanges and OTC Markets

- Exchange: buyers and sellers of securities meet in central locations

- OTC: dealers trade independently, but efficient information flows make it very competitive

- Government bond market: OTC

Primary and Secondary Markets

- Primary market
  - new issues
  - through investment banks

- Secondary market
  - resale
  - through brokers
Internationalization of Financial Markets

International Bond Market
1. Foreign bonds
2. Eurobonds
Now larger than U.S. corporate bond market

World Stock Markets
U.S. stock markets are no longer always the largest: Japan sometimes larger

Why Intermediaries

- Transactions Costs
- Asymmetric Information
  - Adverse Selection (Asym. Info before transaction)
  - Moral Hazard (Asym. Info after transaction)
Transactions Costs

- Financial intermediaries make profits by reducing transactions costs
- Reduce transactions costs by developing expertise and taking advantage of economies of scale

Adverse Selection

Example 1: The Used Car Market
- Quality of car unknown *before* it is bought
- Price will reflect average quality in pool
- Sellers of bad cars get a good deal
- Sellers of good cars get a bad deal
- Some sellers of good cars might withdraw
- ‘Adverse selection’ of cars remaining in the pool

Solution: car dealer
Adverse Selection

Example 2: The Loan Market

• Expected income (→ ability to repay) of borrower unknown before loan is made

• Loan rate will reflect average quality in pool

• Low income borrowers get good deal

• High income borrowers get bad deal

Adverse Selection: The Loan Market

• Some high income borrowers will not borrow

• ‘Adverse selection’ of borrowers remains

• Market may bread down

• One Solution: Bank
  – Checks up on borrowers
  – Develops reputation for repaying
Moral Hazard

Example 3: The Fire Insurance Market

• Insurance company cannot control how careful homeowner is

• Insured homeowner more ‘reckless’ than uninsured

• Premium must go up

• Homeowners end up not buying insurance

Solution: e.g. government regulation

Moral Hazard

Example 4: The Stock Market

• Shareholders cannot control whether manager undertakes useful projects or his own ‘pet projects’

• Managers with access to lot of funds will misuse it

• Investors reluctant to provide funds
Moral Hazard: The Stock Market

- Firm ends up not getting funded, useful projects not undertaken

One Solution: Bank

- Owns many shares or provides loan
- Therefore has power over manager, can prevent misuse

So who should borrow from intermediaries?

- Borrowers about whom there is a lot of asymmetric information
- Small, young firms, households
Regulation of Financial Markets

Three Main Reasons for Regulation

- Increase information to investors
- Ensuring the soundness of financial intermediaries
- Improving monetary control