Overview of Financial System

Economics 301: Money and Banking

Goals and Learning Outcomes

- Goals:
  - Learn some details about the types financial markets.
  - Learn some details about the types financial instruments.
- Learning Outcomes:
  - Touching on, getting background knowledge for LO1: Understand and appreciate the importance of financial markets for the overall functioning of the economy.

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Reading

- Read Mishkin, chapter 2.

Primary and Secondary Markets

- **Primary Market:** market in which new issues of financial securities are sold directly from the selling corporation or government agency, directly to initial buyers.
  - One function of **investment banks** are to assist corporations in their initial sale of securities.
  - The investment bank **underwrites** the securities: they guarantee a price for the securities, then sell them to the public.
- **Secondary Market:** market in which securities that have been previously issued are resold.
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Types of Secondary Markets

- **Exchanges:** secondary markets where buyers and sellers (or their agents) physically meet in one central location to conduct trading.
  - Examples: New York Stock Exchange, Chicago Board of Trade (commodities).
- **Over-the-counter (OTC) markets:** dealers at different locations sell securities to anyone who contacts them.
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Maturity

- **Debt instrument**: contractual agreement by a borrower to pay holder of the instrument fixed regular payments until a specified time.
- **Maturity**: number of years until a debt instrument's expiration date.
  - **Short-term** instruments are less than one year.
  - **Intermediate-term** instruments are between one year and ten years.
  - **Long-term** instruments are ten years or longer.
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Money Market Instruments: Treasure Bills

- Treasure Bills: short-term debt instruments issued by the U.S. government, issued in 30 day, three-month, and six-month maturities.
- Pay given amount at maturity, no other regular payments or interest payments.
- Sold at a discount: sold for a price smaller than the promised payment made at maturity date.
- Almost no possibility of default?
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Other Money Market Instruments

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  - **Negotiable Bank CDs:** CDs that are sold in secondary markets.
- **Commercial Paper:** short-term debt issued by banks and corporations.
  - Provides a means for corporations to borrow directly from the public, without having to go through a financial intermediary.
  - Tremendous growth since 1980: \$122 billion outstanding in 1980, \$2.180 trillion in August 2007.
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Banker's Acceptances

- **Banker's Acceptances**: guarantees by banks that a corporation is good for a debt.
- Corporation issues a bank draft that promises to pay a stated amount at some point in the future.
- Bank stamps it "accepted", guaranteeing the corporation will have the required funds in its account at the specified payment date.
- If corporation fails to pay, the bank is obligated to pay the debt.
- How are these money market instruments? Like Treasury bills, they are often sold at discounts in secondary markets.

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Repurchase Agreements

- **Repurchase Agreements:** Common way that corporations make very short-term (usually less than two weeks) loans to banks.
- Banks may need liquidity to meet depositors needs.
- Corporations at times have idle funds in their bank accounts.
- Corporation buys Treasury bills from the bank, holds it for specified period of time as collateral, then bank repurchases the Treasury bills for a slightly higher price than they sold it for.
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  - Some makes have excess reserves, others need more reserves to meet depositors needs and reserve requirements.
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Capital Market Instruments

- Stocks: equity claims on earnings and assets of a corporation. Stock holders are paid only after holders of debt instruments are paid.
- Mortgages: loans to households or firms to purchase housing, land, and other buildings, which serve as collateral.
  - Largest debt market in the United States.
  - Residential mortgages outstanding are more than 4 times commercial mortgages.
- Corporate bonds: long-term bonds issued by corporations, typically makes regular interest payments and pays off face value at maturity.
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International Financial Markets

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  - Example: if Toyota sold bonds in the U.S. issued in dollars.
  - Exposes the issuer to foreign exchange risk.
- **Eurobond:** bond denominated in a different currency than the market in which it is sold.
  - Has nothing to do with Europe.
  - Example: a bond denominated in U.S. dollars that is sold in Japan.
- **Eurocurrencies:** currencies deposited in banks in a country outside the currency's home.
  - Example: Yen deposited in a bank in Spain.
  - **Eurodollars:** U.S. dollars deposited in banks outside of U.S.

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  - Exposes the issuer to foreign exchange risk.
- **Eurobond:** bond denominated in a different currency than the market in which it is sold.
  - Has nothing to do with Europe.
  - Example: a bond denominated in U.S. dollars that is sold in Japan.
- **Eurocurrencies:** currencies deposited in banks in a country outside the currency's home.
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Financial Intermediaries

Three categories of intermediaries

1. Depository institutions, often simply referred to as *banks*, are financial intermediaries that accept deposits and make loans.
2. Contractual savings institutions: acquire funds at periodic intervals on a contractual basis.
   - Examples: life insurance, casualty insurance, pension and retirement funds.
3. Investment Intermediaries: examples include mutual funds, money market mutual funds, finance companies.

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Depository Institutions

- Commercial banks
  - Accept funds by accepting checkable, savings, and time deposits.
  - Make commercial, consumer, and mortgage loans, and invest in U.S government and municipal bonds.
  - Hold accounts at Federal Reserve, and are subject to regulations imposed by Federal Reserve.
- Savings and Loan Associations and Mutual Savings Banks
  - In the past, they were limited to types of services they could perform.
  - No longer the case, highly competitive with commercial banks.
- Credit unions: cooperative depository institutions, i.e. owned by its members.
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- Life insurance companies
  - Insurance function: insure against financial hazards caused by death.
  - Also sell retirement annuities.
  - Payouts are very predictable.
  - Collect premiums, and earn interest buying mortgages, corporate bonds, some stocks.
- Fire and casualty insurance companies.
  - Payouts not as predictable, could depend on natural disasters.
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Investment Intermediaries

- Investment banks: not a bank, do not accept deposits, etc.
  - Advice corporations on issuing stocks and bonds.
  - Underwrites initial security offerings.
  - Assist corporations in mergers and acquisitions.
- Mutual funds: acquire funds by selling shares, and purchase diversified portfolios of stocks and bonds.
  - Economize on transaction costs: shareholders to not need to research individual companies.
  - Allow individuals to hold more diversified portfolios.
- Money market mutual funds: mutual funds that invest in short-term debt securities.
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  - Depository institutions spread out risks of defaults across all its depositors.
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Adverse Selection

- **Asymmetric information:** situation when there are two parties involved in some sort of transaction, and one party does not have sufficient information about the other party to make an appropriate decision.
- **Adverse selection:** occurs when asymmetric information exists *before* a financial transaction takes place.
  - Situation in which it is impossible for lenders to obtain *complete* information about the risk of potential borrowers.
  - Lender necessarily makes interest rates to high for borrowers who privately know they have very low risk.
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  - Borrowers who choose (*select*) to make loans more highly represented by those with high risks.

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- Often occurs when payouts are asymmetric for borrowers facing risk.
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  - Bad outcome: borrower would make a loss if paid back full loan, but defaults instead.
- Moral hazard causes borrowers to make more risky decisions than if they were using their own funds.

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Next up...

- Understanding interest rates: chapter 4.
- Remember, MyEconLab homework is due this Wednesday.