LECTURE 1:
FEELING AT HOME WITH FINANCIAL MARKETS

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1. What Do Financial Markets Do?

Financial markets perform several essential functions in the economy. Every financial product or transaction carries out at least one of these functions, and often more than one at the same time.

The six main functions of financial markets are:

1. Transferring resources across time and space
2. Pooling resources and sharing ownership
3. Discovering financial prices
4. Dealing with information problems
5. Clearing and settling payments
6. Managing risks

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2. Transfer of Resources Across Time and Space

This function refers to moving purchasing power from one point in time to another, or from one location to another.

Transfer across time:
This happens when money is moved from the present to the future or vice versa. Common examples include:

- Borrowing
- Lending
- Saving
- Investing

For example, when someone borrows money today and repays it in the future, resources are transferred across time. Similarly, saving money now to use later is also a time transfer.

Transfer across space:
This occurs when money is moved from one person or place to another location.
Examples include:

- Sending money to another city or country
- International payments and remittances

In this case, financial markets help ensure that value can move efficiently across geographical locations.

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3. Pooling Resources and Sharing Ownership

In modern economies, expanding a business or improving financial conditions often requires large amounts of capital. Individual investors usually cannot afford this alone.

Financial markets allow people to:

- Combine (pool) their money and resources
- Share ownership of businesses or projects
- Share profits and losses

This is achieved through:

- Stocks (ownership shares in a company)
- Bonds (loans made to companies or governments)
- Other financial instruments

Because multiple people contribute different amounts, it is crucial to clearly define:

- Who owns how much
- How profits and losses are divided
- What rights each participant has

These details are handled through **written agreements and contracts**, which are fundamental to financial markets.

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4. Price Discovery

Price discovery is the process through which financial markets determine the prices of financial assets and services.

Prices are set through interaction between:

- **Suppliers:** individuals or companies offering financial assets or services
- **Demanders (buyers):** individuals or companies willing to pay for them

When buyers and sellers meet in the market, their actions collectively determine prices. This allows financial markets to signal value and allocate resources efficiently.

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5. Contracts as the Foundation of Financial Markets

The most important tool in financial markets is the **contract**.

Every financial transaction is based on an agreement between two or more parties. Contracts specify:

- Rights and obligations
- Payment terms
- Ownership claims

Written contracts provide legal security and trust. Without enforceable contracts, financial markets cannot function properly.

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6. Assets in Financial Markets

An **asset** is anything that stores value or provides future benefits.

Real assets:
These have value because they can be directly used to produce goods or services. Examples include:

- Land
- Buildings
- Machinery
- Physical commodities

Financial assets:
These are claims or contracts rather than physical objects. Examples include:

- Shares
- Bonds
- Bank deposits

Financial assets do not have value on their own. Their value comes from the real assets or future cash flows they represent.

Human capital:
This is a non-tangible asset and includes:

- Skills
- Education
- Experience
- Knowledge

Human capital generates income but is not directly traded in financial markets.

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7. Financial Instruments as Assets

Financial instruments, securities, contracts, and written financial documents are all considered assets. They represent legally enforceable claims on:

- Income
- Ownership
- Future payments

Although they may exist only as paper documents or digital records, their economic value is real.

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8. Key Takeaways

- Financial markets enable the movement of money across time and location.
- They allow people to pool resources and share ownership efficiently.
- Prices are discovered through supply and demand interactions.
- Contracts and written agreements are essential for trust and enforcement.
- Real assets create value directly, while financial assets represent claims on that value.

9. Additional Notes