

Chapter 2

1. The basic function of financial markets is to channel funds from savers who have an excess of funds to spenders who have a shortage of funds. Financial markets can do this either through direct finance, in which borrowers borrow funds directly from lenders by selling them securities, or through indirect finance, which involves a financial intermediary that stands between the lender-savers and the borrower-spenders and helps transfer funds from one to the other. This channeling of funds improves the economic welfare of everyone in society. Because they allow funds to move from people who have no productive investment opportunities to those who have such opportunities, financial markets contribute to economic efficiency. In addition, channeling of funds directly benefits consumers by allowing them to make purchases when they need them most.
2. Financial markets can be classified as debt and equity markets, primary and secondary markets, exchanges and over-the-counter markets, and money and capital markets.
3. The principal money market instruments (debt instruments with maturities of less than one year) are U.S. Treasury bills, negotiable bank certificates of deposit, commercial paper, repurchase agreements, and federal funds. The principal capital market instruments (debt and equity instruments with maturities greater than one year) are stocks, mortgages, corporate bonds, U.S. government securities, U.S. government agency securities, state and local government bonds, and consumer and bank commercial loans.
4. An important trend in recent years is the growing internationalization of financial markets. Eurobonds, which are denominated in a currency other than that of the country in which they are sold, are now the dominant security in the international bond market and have surpassed U.S. corporate bonds as a source of new funds. Eurodollars, which are U.S. dollars deposited in foreign banks, are an important source of funds for American banks.
5. Financial intermediaries are financial institutions that acquire funds by issuing liabilities and, in turn, use those funds to acquire assets by purchasing securities or making loans. Financial intermediaries play an important role in the financial system because they reduce transaction costs, allow risk sharing, and solve problems created by adverse selection and moral hazard. As a result, financial intermediaries allow small savers and borrowers to benefit from the existence of financial markets, thereby increasing the efficiency of the economy. However, the economies of scope that help make financial intermediaries successful can lead to conflicts of interest that make the financial system less efficient.
6. The principal financial intermediaries fall into three categories: (a) banks—commercial banks, savings and loan associations, mutual savings banks, and credit unions; (b) contractual savings institutions—life insurance companies, fire and casualty insurance companies, and pension funds; and (c) investment intermediaries—finance companies, mutual funds, and money market mutual funds.
7. The government regulates financial markets and financial intermediaries for two main reasons: to increase the information available to investors and to ensure the soundness of the financial system. Regulations include requiring disclosure of information to the public, restrictions on who can set up a financial intermediary, restrictions on what assets financial intermediaries can hold, the provision of deposit insurance, limits on competition, and restrictions on interest rates.

Chapter 3

1. To economists, the word *money* has a different meaning from *income* or *wealth*. Money is anything that is generally accepted as payment for goods or services or in the repayment of debts.
2. Money serves three primary functions: as a medium of exchange, as a unit of account, and as a store of value. Money as a medium of exchange avoids the problem of double coincidence of wants that arises in a barter economy, and thus lowers transaction costs and encourages specialization and the division of labor. Money as a unit of account reduces the number of prices needed in the economy, which also reduces transaction costs. Money also functions as a store of value, but performs this role poorly if it is rapidly losing value due to inflation.
3. The payments system has evolved over time. Until several hundred years ago, the payments system in all but the most primitive societies was based primarily on

precious metals. The introduction of paper currency lowered the cost of transporting money. The next major advance was the introduction of checks, which lowered transaction costs still further. We are currently moving toward an electronic payments system in which paper is eliminated and all transactions are handled by computers. Despite the potential efficiency of such a system, obstacles are slowing the movement to a checkless society and the development of new forms of electronic money.