PME Assignment - 4

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Q1.(a) What is the role of the financial System? Name & describe two financial markets & two financial intermediaries that are part of the financial system in US economy.

Ans a. Financial System function as an intermediary and facilitates the flow of funds from the area of surplus to the area of deficit.

-> Two financial markets -

(i) Bond Market - primarily includes government issued securities & corporate debts securities, & facilitates the transfer of fund from savers to organizations requiring capital for government needs & ongoing operations.

(ii) Stock Market - also called equity market is a market for trading of company stock (shares) and derivatives at an agreed price between sellers & buyers.

-> Two financial intermediaries -

(i) Mutual Funds - institution that sell shares to the public and use the proceeds to buy portfolios of stocks and bonds.

(ii) Bank - it takes deposits from people who wants to save & use the deposits to make loans to people in need. Banks provide intrest to depositers & charge borrowers

(b) Discuss how stock is different from bond.

Ans b

Stock	Bond
(i) It has high risk	(ii) It has comparatively low risk.

Stock	Bond
(ii) Stock has no maturity period.	(ii) Bond has a maturity period.
(iii) High liquidity	(iii) Low liquidity.
(iv) return is not guaranted. & if possible it is volatile.	(iv) return is guaranteed & is fixed.
(v) During bankruptcy. ~~they get~~ stockholders get their money after bondholders.	(v) During bankruptcy. bondholders recieve their money first.
(vi) equity instrument.	(vi) debt instrument.

(c) Does a stock holder get more diversification going from 1 to 20 stocks or going from 100 to 130 stocks?

Ans c. It is ideal to put the diversification because the risk associated with 1 stock is more than risk associated with 20 stocks. When you put your money in 100 to 130 Stocks, the risk factor might not be helpful in big combination of stocks. Thus diversification in 1 to 20 stocks helps to get better return on your investment.

Q2. (a) If the FED wants to increase the money supply with open market ~~opinion~~ operation, what does it do?

Ans a. It can purchase U.S. government bonds from the public on the open market. The purchase increases the number of dollars in hands of public, & injects money into money market. Thus money supply. increases.

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Q2(b) What is the discount rate?. What happens to the money supply when FED raises the discount rate.?

Ans b: Discount rate refers to interest rate charged to commercial banks & other financial institutions for short-term loans they take from the Federal Reserve Bank.
When FED raises discount rate, commercial banks excess reserves decreases & lending also decreases.
Thus, money supply will decrease.

Q2(c) Assume that the banking system has total reserve of \$200 billion. Assume also that required reserves are 10% of checking deposits & that bank hold no excess reserves & household hold no currency. What is money multiplier & money supply?

Ans c:

Total reserve = \$200 billion.

Reserve ratio(R) = 10%.

$$\text{Money Multiplier} = \frac{1}{R} = \frac{1}{10\%}$$

$$= \underline{10}$$

Money Supply = total reserve × money multiplier

= \$200 billion × 10

= $\underline{\$2000 \text{ billion}}$