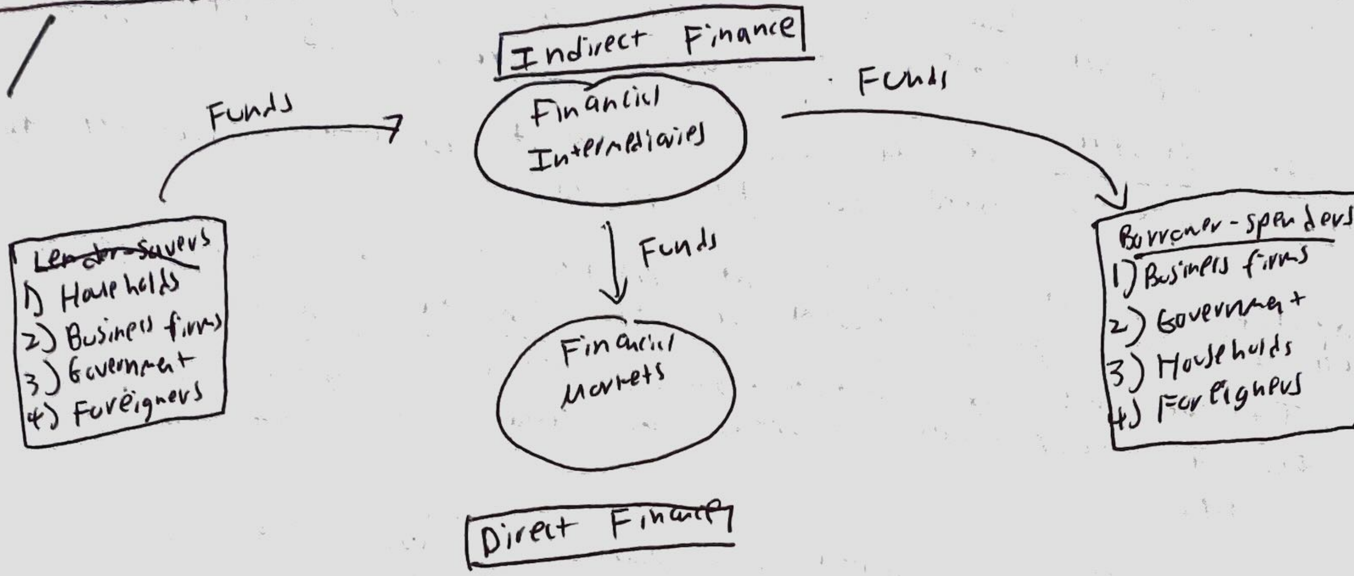
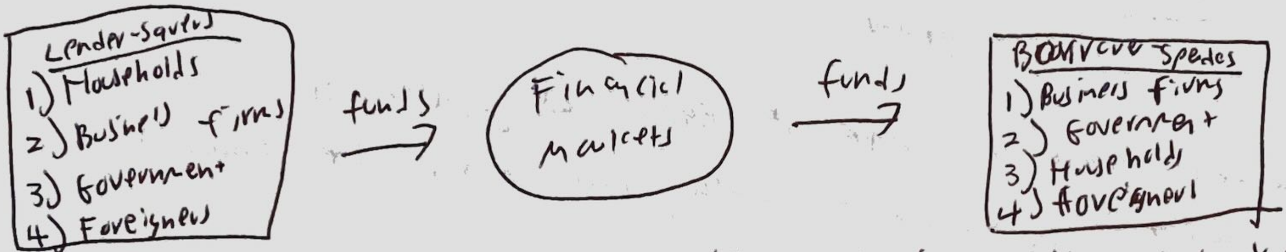
Chapter 2: Overview of Financial System





Securities are assets for people who buy them, but they are ~~assets~~ liabilities (IOUs or debts) for individual or firm that sells them

-Financial markets are critical for producing an ~~efficiency for~~ ~~the~~ an efficient allocation of capital (wealth, either financial or physical that is employed to produce more wealth), which contributes to higher production and efficiency for the overall economy.

The maturity of a debt instruments is the number of years (term) until that instrument's expiration date.

short-term - if maturity is less than a year.

long-term - if maturity is 10 years or longer.

Intermediate-term - maturity between 1-10 years

Equities - a common stock that are claims to share in the net income and assets to a business.

Equities often make periodic payments (dividends) to their holders and are considered long-term securities b/c they have no maturity date.

A <u>primary market</u> is a financial market in which new issues of security, such as a bond or a stock are sold to initial buyers by the corporation or gov agency borrowing the funds.

A <u>secondary market</u> is a financial market in which securities that have been previously issued can be resold.

An important financial institution that assists in the initial sale of securities in the primary market is the <u>investment bank</u>.

- It does this by <u>underwriting securities</u>: it guarantees a price for a corporation's securities and then sells them to the public.

<u>Brokers</u> are agents of investors who match buyers with sellers of securities; <u>dealers</u> link buyers and sellers by buying and selling securities at stated prices.

Secondary markets serve to make it easier and quicker to sell these financial instruments to raise cash, thus making the financial instruments more <u>liquid</u>.

One way to organize <u>exchanges</u> (buyers and sellers of securities meet in one central location to conduct trades)

<u>Over-the counter (OTC) market</u> - dealers at different locations who have an inventory of securities stand ready to buy and sell securities over the counter to anyone who comes to them and is willing to accept their prices by one another.

<u>Money market</u> is a financial market in which only short term debt instruments are traded.

The <u>capital market</u> is the market in which longer-term debt and equity instruments are traded

<u>Foreign bonds</u> are sold in a foreign country and are denominated in that countries currency

Eurobond - a bond denominated in a currency other than that of the country in which it is sold -

Eurocurrencies is a variant of Eurobond, which are foreign currencies deposited in banks outside the home country

Eurodollars - are U.S. dollars deposited in foreign banks outside the U.S. or in foreign branches of U.S. banks.

financial intermediation - primary ~~source~~ route for moving funds from lenders to borrowers.

Transaction costs - the time and money spent in carrying out financial transactions, are a major problem for people who have excess funds to lend.

Economies of scale - the reduction in transaction costs per dollar of transactions as the size (scale) of transactions increases.

liquidity services - services that make it easier for customers to conduct transactions.

- Another benefit made possible by low transaction costs of financial institutions is that they can help reduce the exposure of investors to risk (the uncertainty about the returns investors will earn on assets)

- Financial intermediaries do this through the process known as risk sharing. They create and sell assets with risk characteristics that people are comfortable with, and the intermediaries then use the funds they acquire by selling these assets to purchase other assets that may have far more risk.

Asymmetric information - when one party does not know enough about the other party to make accurate decisions.

Adverse selection is the problem created by asymmetric information before the transaction occurs. When one party to a transaction has information about hidden characteristic and takes economic advantage of this information by making an agreement with less informed parties.

Moral hazard is problem created by asymmetric information after the transaction occurs. Moral hazard occurs when an informed party takes a hidden (unobserved) action that harms the less informed party.

economies of scope - lowering cost of information production for each service by applying one information resource to many different services.

Conflicts of interest - a type of moral hazard problem that arises when a person or institution has multiple objectives and, as a result, has conflicts between these objectives.

Thrift institutions - accept deposits from individuals and institutions and make loans