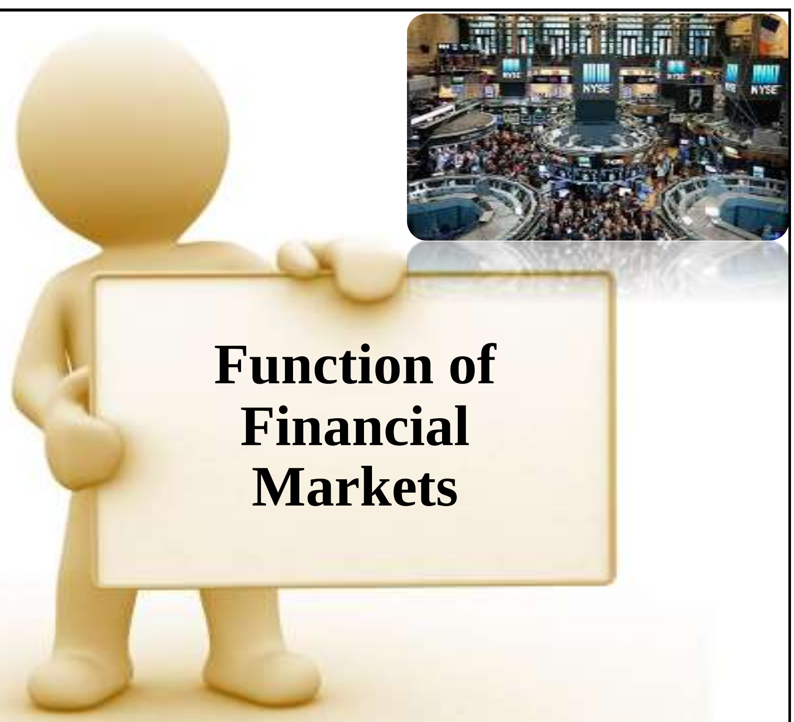
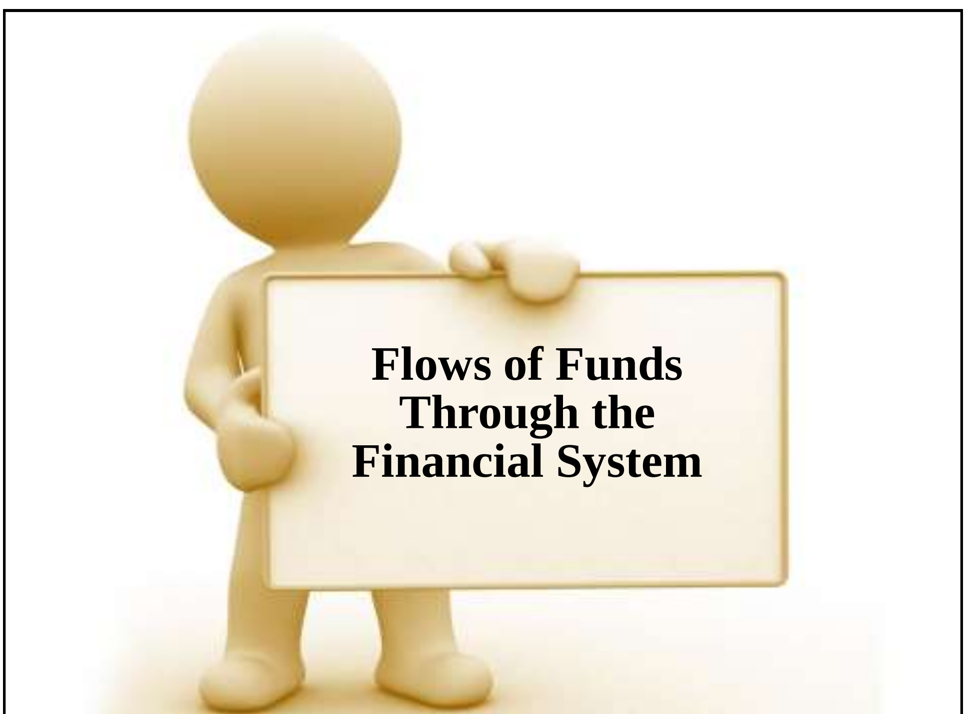
An Overview of the Financial System



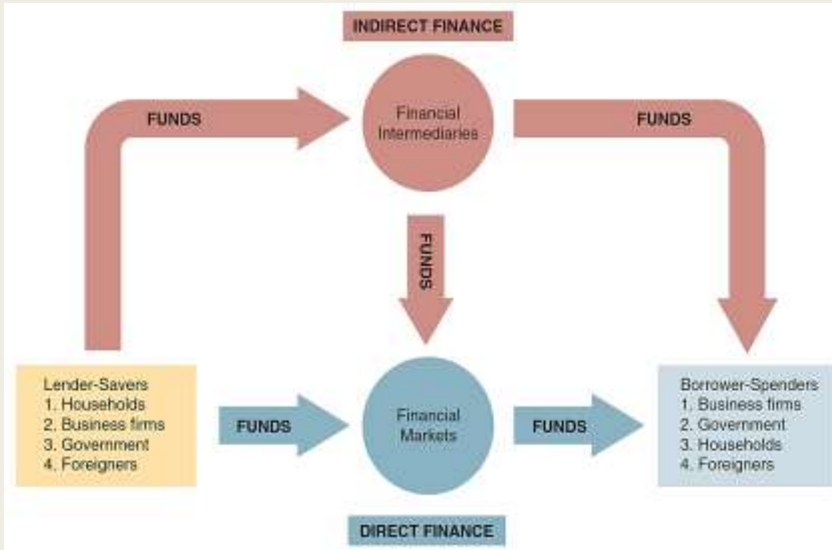
Function of Financial Markets

Function of Financial Markets

- Performs the essential function of **channeling funds** from economic players that have saved **surplus funds** to those that have a **shortage** of **funds**
- **Direct finance**: **borrowers borrow** funds directly from **lenders** in financial markets by **selling** them securities
- **Promotes economic** efficiency by producing an **efficient allocation** of **capital**, which increases production
- Directly improve the **well-being** of consumers by allowing them to **time** purchases **better**



Flows of Funds Through the Financial System



Structure of Financial Markets

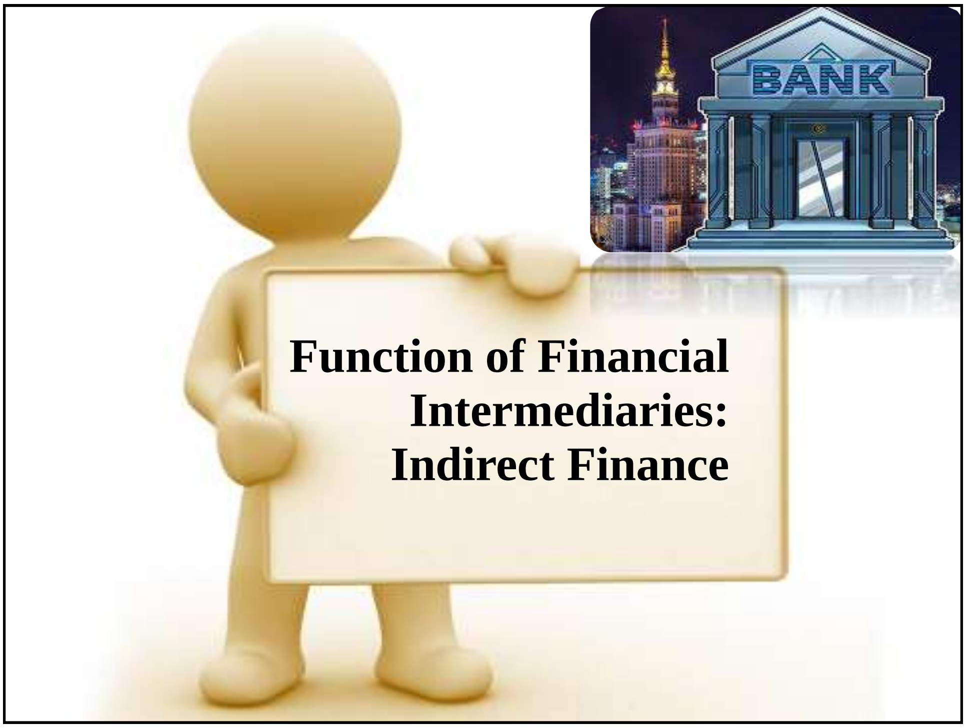
Structure of Financial Markets

- **Debt and Equity Markets**
  - Debt instruments (**maturity**)
  - **Equities (dividends)**
- **Primary and Secondary Markets**
  - **Investment banks underwrite** securities in **primary markets**.
  - **Brokers** and **dealers** work in **secondary markets**.

- Exchanges and Over-the-Counter (OTC) Markets:
  - **Exchanges**: NYSE, Chicago Board of Trade
  - **OTC markets**: Foreign exchange, Federal funds
- Money and Capital Markets:
  - **Money markets** deal in short-term debt instruments
  - **Capital markets** deal in longer-term debt and equity instruments

Internationalization of Financial Markets

- **Foreign Bonds**: sold in a foreign country and denominated in that country's currency
- **Eurobond**: bond denominated in a currency other than that of the **country** in which it is **sold**
- **Eurocurrencies**: foreign currencies deposited in banks outside the home country
  - **Eurodollars**: U.S. dollars deposited in foreign banks outside the U.S. or in foreign branches of U.S. banks
- **World Stock Markets**:
  - Also help **finance** the federal government



Function of Financial Intermediaries: Indirect Finance

- Financial intermediaries **allow** “**small**” **savers** and borrowers to **benefit** from the existence of financial markets.
- **Lower transaction costs** (time and money spent in carrying out financial transactions)
  - **Economies** of **scale**
  - **Liquidity services**
- Reduce the exposure of investors to risk
  - **Risk Sharing** (Asset Transformation)
  - **Diversification**

- Deal with **asymmetric information** problems:
  - **Adverse Selection** (before the transaction): try to avoid selecting the risky borrower by gathering information about them
  - **Moral Hazard** (after the transaction): ensure borrower will not engage in activities that will prevent him/her to repay the loan.

Regulation of the Financial System

Regulation of the Financial System

- To **increase** the **information** available to **investors**:
  - √ Reduce adverse selection and moral hazard problems
  - √ Reduce **insider trading**
- To ensure the **soundness** of financial intermediaries:
  - Restrictions on entry.
  - Disclosure of information.
  - Restrictions on Assets and Activities (control holding of risky assets).
  - Deposit Insurance (avoid bank runs). <u>Central banks act as a lender of last resort.</u>
  - Limits on Competition:
    - Restrictions on Interest Rates

What is **Insider trading?**

- **Insider trading** is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to <u>nonpublic information</u> about the company.

The End