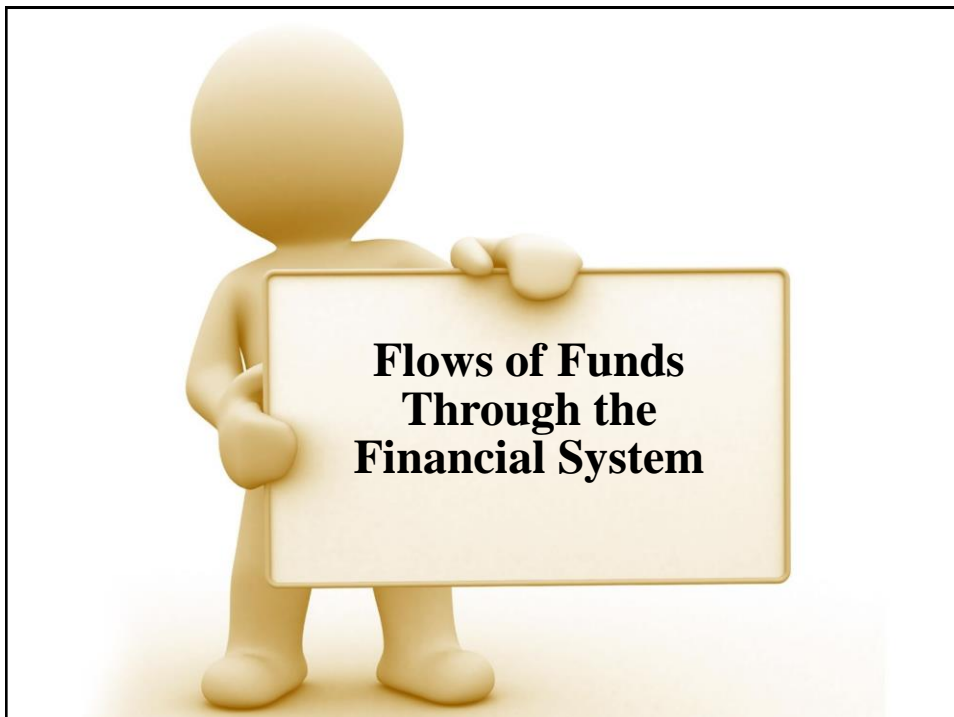


Chapter 2
An Overview
of the Financial System

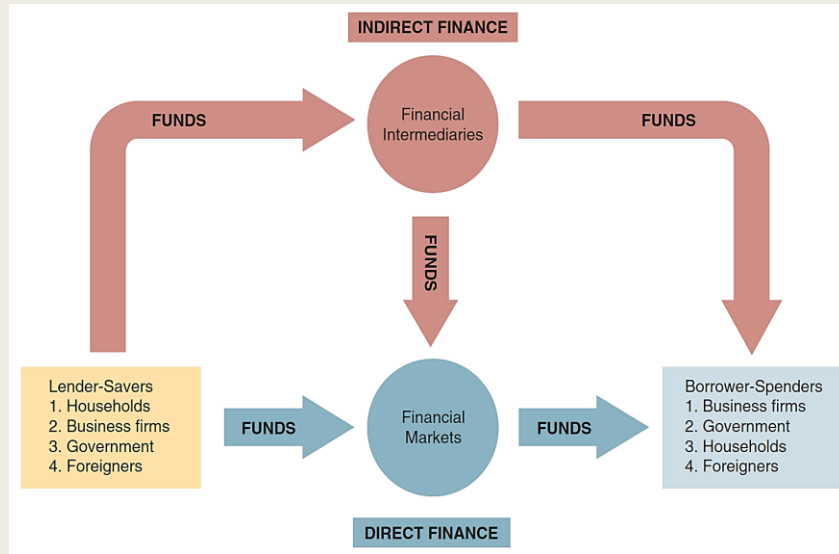


Function of Financial Markets

- 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

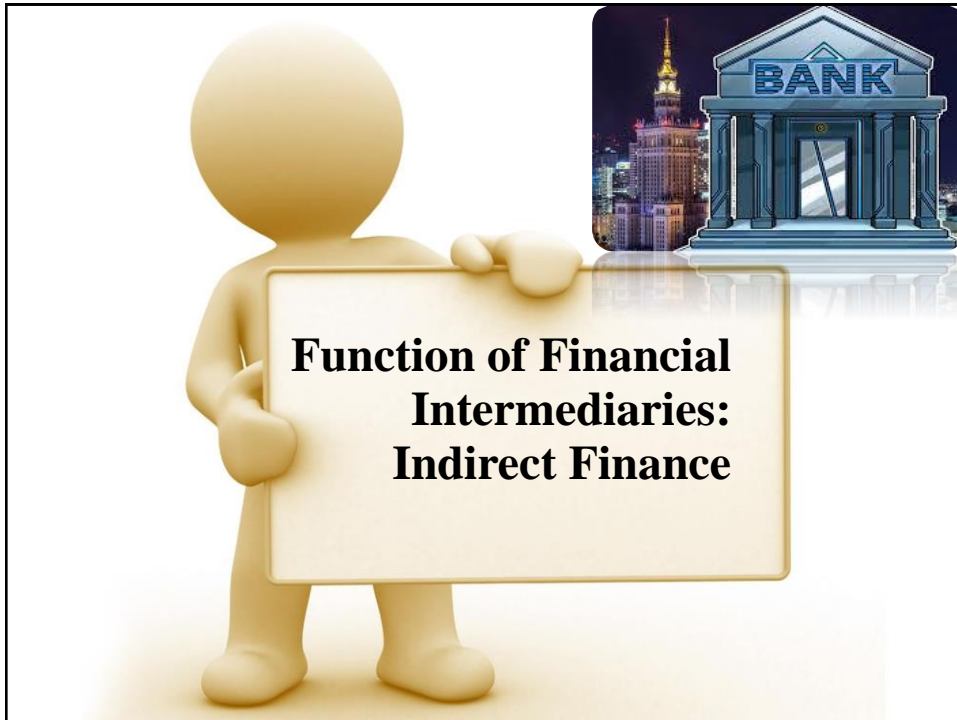
■ Money and Capital Markets:

- **Money markets** deal in short-term debt instruments
- **Capital markets** deal in longer-term debt and equity instruments



Internationalization of Financial Markets

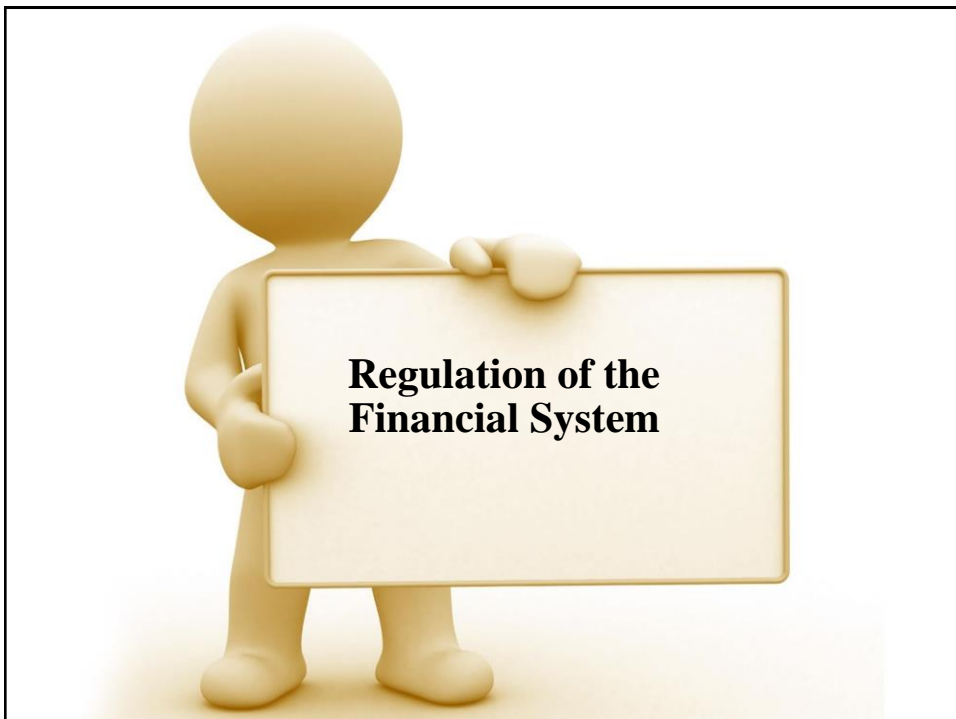
- **Foreign Bonds:** sold in a foreign country and denominated in that country's currency
- **Eurobond:** bond denominated in a currency other than that of the **country** in which it is **sold**
- **Eurocurrencies:** foreign currencies deposited in banks outside the home country
 - **Eurodollars:** 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

- 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).
Central banks act as a lender of last resort.
 - 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 nonpublic information about the company.

The End