

Financial Markets +
Institutions

fifth edition



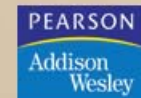
Frederic S. Mishkin

Stanley G. Eakins

Class 1

Introduction to Financial Markets

Copyright © 2006 Pearson Addison-Wesley. All rights reserved.





Subject of this course: Financial institutions

- Basic questions
 - What?
 - Why?
 - How?
 - Where to?

The background image is a collage. On the left, there's a close-up of a building facade with the word 'NEW YORK' visible in large, raised letters. On the right, there's a group of people in a dark setting, possibly a stock exchange floor, with some individuals looking towards the camera. The overall tone is professional and financial.

Financial markets

- *What:* Transfer funds from savers to borrowers
- *Why:* Promoting allocation efficiency and risk sharing
- *How:* Via the use of securities and financial intermediaries
- *Whereto:* That become more advanced to satisfy different demands

Major financial innovations

- Money
 - Skins (“bucks”) → coins → paper → electronic money
 - Lower costs of trade → enormous expansion of commerce, specialization of production
 - Functions: medium of exchange / unit of account / storage of value
- Stock market
 - Separation of ownership and control
 - Investors can diversify across many risky projects, with limited liability

Major financial innovations

- Futures markets
 - Hedging future risks, e.g., grain / exchange rates / weather
 - Even without owning the underlying asset!
- Insurance for a car / house / health / life



Functions of financial markets

- Channeling funds from agents without investment opportunities: “Lender-Savers”...
- to those who have them: “Borrower-Spenders”
 - Households
 - Business firms
 - Government
 - Foreigners

Segments of financial markets

- Direct Finance: the “arm’s-length system”
 - Borrowers borrow directly from lenders in financial markets by selling financial instruments
 - Claims on the borrower’s future income or assets
 - Stocks, bonds, derivatives
- Indirect Finance: the “relationship-based system”
 - Borrowers borrow indirectly from lenders via financial intermediaries
 - Matching available funds and loan opportunities
 - Banks, investment companies (e.g., mutual funds)

Financial Markets +
Institutions

fifth edition



Frederic S. Mishkin

Stanley G. Eakins

Discussion topic

What explains the tremendous growth of the financial industry?



Financial development vs. economic growth

- Empirically: positive relation
 - Large economy needs a larger financial sector
 - Financial intermediaries help the real sector to allocate the funds more efficiently
 - Both driven by a third factor: e.g., saving rate, culture, legal and regulatory environment



How to measure financial development?

- Stock market size and liquidity
 - Market equity cap to GDP
 - # instruments (actively) traded locally, # IPOs
 - Trading volume / turnover rate
 - Transaction costs / bid-ask spread
- Banking system
 - Bank credits to GDP



What explains the level of financial development?

- Protection of property rights
 - Laws and enforcement
- Openness of capital account
 - Liberalization leads to higher competition and diversification, lower cost of capital
 - But only after ensuring property rights

What explains the level of financial development?

- Legal origin
 - Common law countries: prevalent role of financial markets
 - Require transparency and protection of (small) investors
 - Continental Europe and Asia: led by financial intermediaries (banks)
 - FIs establish deep relations with the clients and have enough power to protect their interests
- Synergy between banks and financial markets

How does financial development contribute to economic growth?

- Increases allocation efficiency
 - Channeling resources to their most productive uses
- Allows risk sharing
 - Placing risks where they are best borne



Mini-case 1: micro-finance

- 2006 Nobel peace prize: for the first time to the financier
 - Grameen bank and its founder Muhammad Yunus (Bangladesh, PhD Vanderbilt 1969)
 - “for the efforts to initiate economic and social development from below”
- Typical example
 - A woman earns only 2 cents on the borrowed 9 cents
 - The whole village needed only \$27 to buy the necessary materials!



Mini-case 1: micro-finance

- How to help the poor?
 - Financial aid? Bad incentives
 - Subsidies? Large costs
 - Loans? Too many defaults



Mini-case 1: micro-finance

- Banking for the poor
 - Loans granted to people with less than 2 sq.km, preferably women
 - Small loan (\$ tens to hundreds) to the group
 - No collateral, (mutual) guarantees from the partners
 - Small fixed weekly payments
 - Flexible restructuring in case of temporary difficulties (after the 1998 flood)

Mini-case 1: micro-finance

- Results
 - 6.61 mln clients (97% women)
 - Loans totaling \$5.72 bln with 11% default rate
 - Net profit over \$15.2 mln in 2005
 - Helped 70 mln people to improve their living (out of 130 mln)

Overview of the financial system

- Security (financial instrument)
 - A claim on future income or assets
- Debt: fixed income instruments (bills, bonds, notes, etc.)
 - Periodic pre-specified payments for a specified period of time
 - Control rights only in case of bankruptcy
- Equity: (common) stocks
 - Share in residual value of the project (firm)
 - Control rights until bankruptcy
- Foreign exchange: relative prices of national currencies

Bond Market and Interest Rates

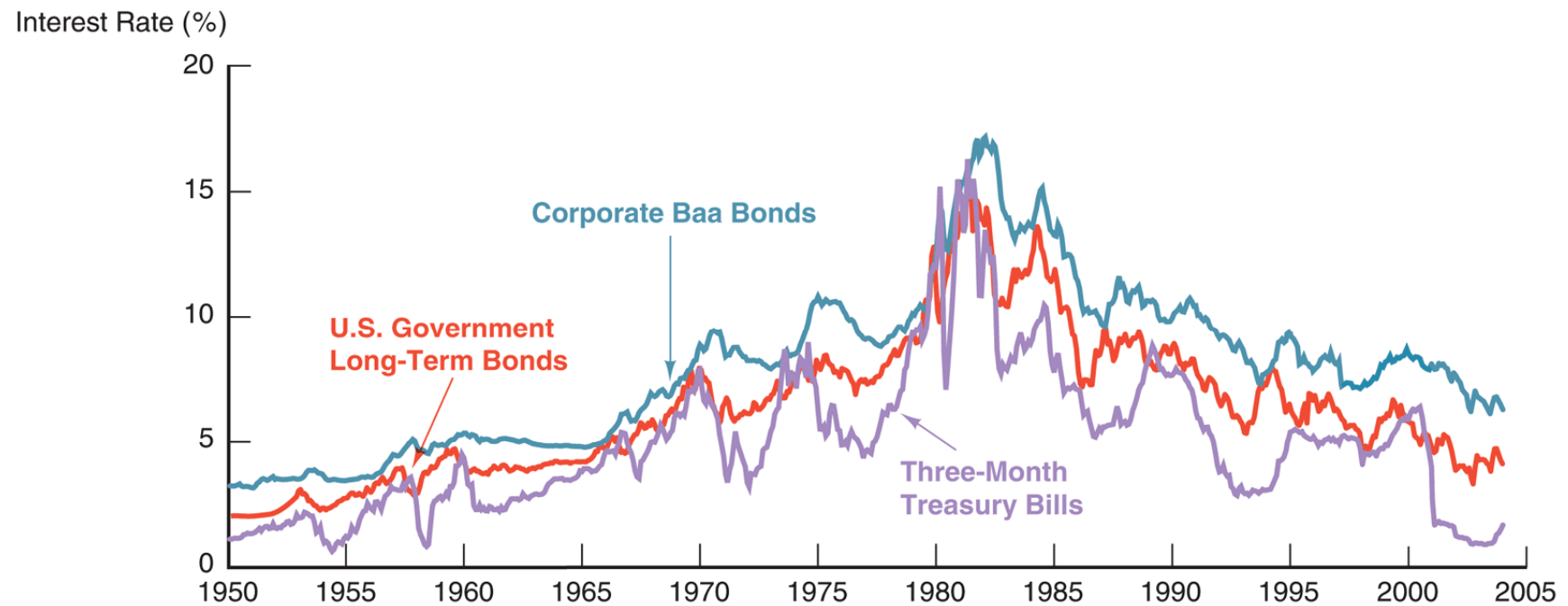


Figure 1.1 Interest Rates on Selected Bonds, 1950–2001

Stock Market

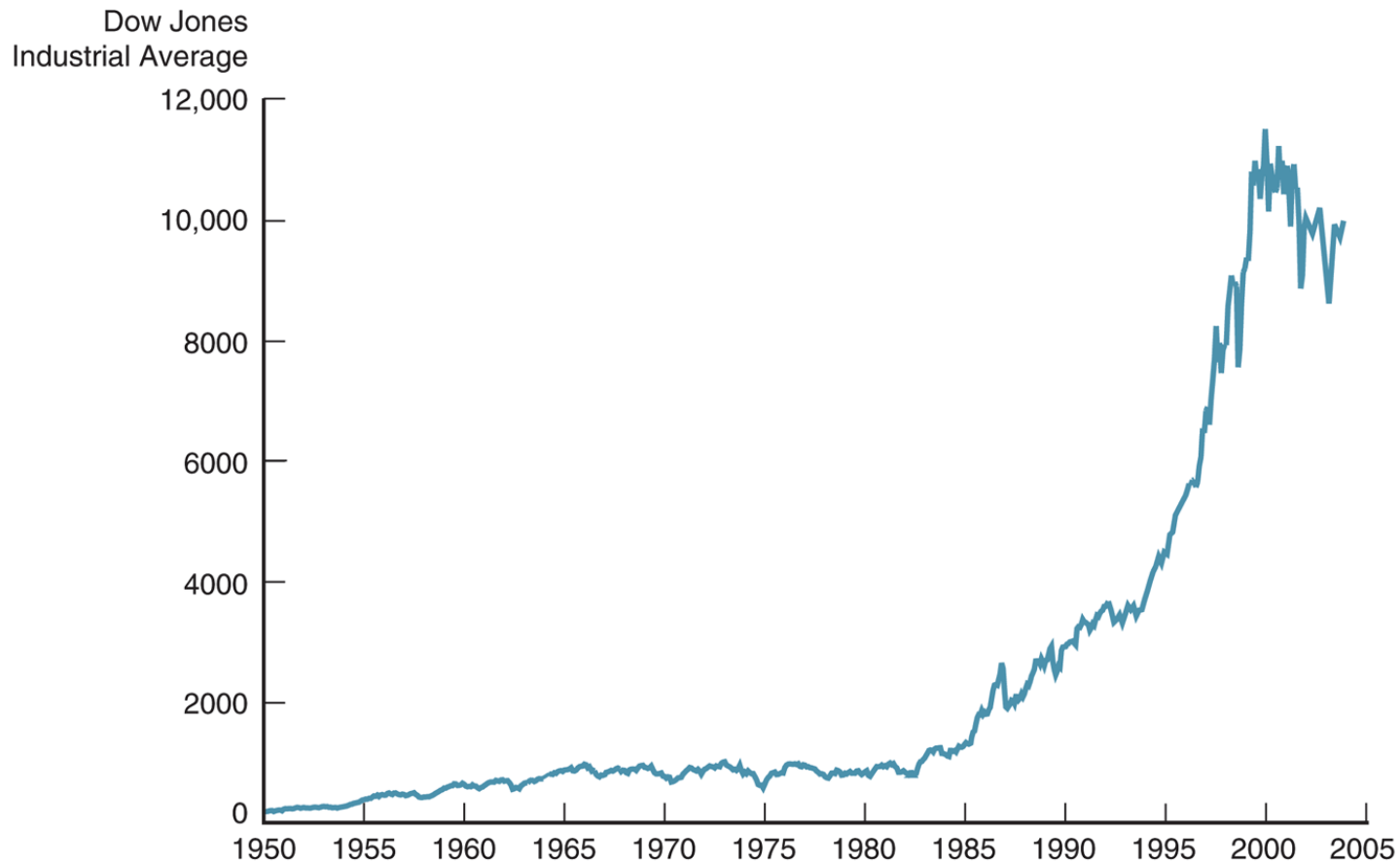


Figure 1.2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2005

Foreign Exchange Market

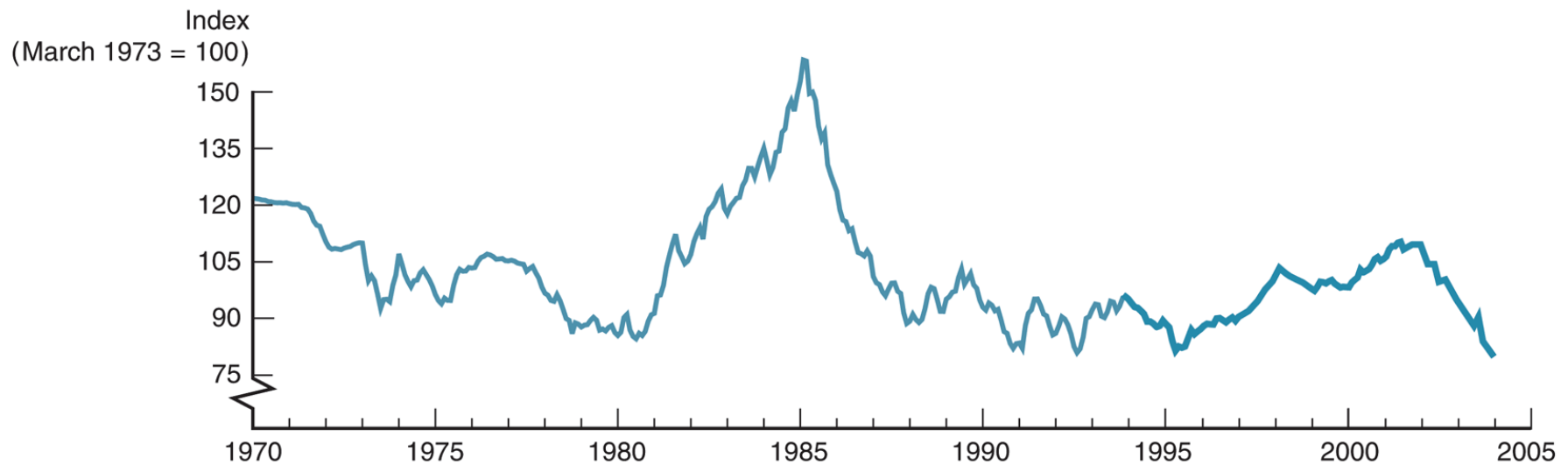


Figure 1.3 Exchange Rate of the U.S. Dollar for a Basket of Foreign Currencies, 1970–2004



Classification of financial markets

- Primary Market
 - New security issues sold to initial buyers
- Secondary Market
 - Securities previously issued are bought and sold



Classification of financial markets

- Exchanges
 - Trades conducted in central locations (e.g., New York Stock Exchange)
- Over-the-Counter (OTC) Markets
 - Dealers at different locations buy and sell



Classification of financial markets

- International Bond Market
 - Foreign bonds
 - Eurobonds (now larger than U.S. corporate bond market)
- World Stock Markets
 - U.S. stock markets are no longer always the largest—
at one point, Japan's was larger



Functions of Financial Intermediaries (FIs)

- Engage in process of indirect finance
- Reduce transactions costs
 - Developing expertise
 - Taking advantage of economies of scale
- Provide liquidity
 - E.g., depositors can earn interest on the accounts and yet still convert them into goods whenever necessary



Functions of Financial Intermediaries (FIs)

- Reduce the exposure of investors to risk
 - Risk sharing: create and sell assets with lesser risk to one party in order to buy assets with greater risk from another party
- Mitigate asymmetric information problems
 - Adverse Selection (before transaction occurs): potential borrowers most likely to produce adverse outcome are ones most likely to seek loan and be selected
 - Moral Hazard (after transaction occurs): the borrower has incentives to engage in undesirable activities making it more likely that he won't pay the loan back



Types of Financial Intermediaries

- Depository Institutions
 - Commercial banks
- Contractual Savings Institutions
 - Insurance companies
 - Pension funds
- Investment Intermediaries
 - Mutual funds



Regulation of Financial Markets

- Increase Information to Investors: SEC
- Ensure the Soundness of Financial Intermediaries
 - Disclosure
 - Deposit Insurance: FDIC
- Improve Monetary Control
 - Reserve requirements: FRS