ECS307

UNISA

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Introduction

- Introductions and knowing each other
- Expectations about the course;
- Study materials comprise of

1. Recommended Books;
2. Study Guide;
3. Tutorial letter.

Study Content

- **Monetary Policy**: How different is it from **fiscal policy**? Who is the **custodian** of monetary policy & fiscal policy? **Congruence** between monetary and fiscal policy;
- What is monetary policy; **Instruments** of monetary policy; monetary theory; Theory of money demand and money supply; money demand function;
- ISLM model & its use;
- The Role of the central bank? Central Bank Independence; Inflation Policy; Exchange rate policy; Interest rate Policy;
- Financial markets & financial instruments;

FINANCIAL SYSTEM & MARKETS

- The **financial system** consists of institutions in the economy that help to match one person's saving with another person's investment.
- **Financial markets** are the institutions through which economic agents who want to save supply funds for people who want to borrow
- The two most important financial markets in the economy are the bond market and the stock market
- The sale of stock to raise money is called ***equity finance***, whereas the sale of bonds is called ***debt finance***.

The Bond Market

- A **bond** is a certificate of indebtedness that specifies the obligations of the borrower to the holder of the bond
- It identifies the **time** at which the loan will be repaid, called the ***date of maturity***, and the rate of interest that will be paid periodically until the loan matures
- The buyer of a bond gives his or her money in exchange for the promise of interest and eventual repayment of the amount borrowed (called the *principal*).
- The buyer can hold the bond until maturity or can sell the bond at an earlier date to someone else
- **Who can issue bonds?** large corporations, the federal government, or state and local governments
- **For what purpose?** Any purpose for which they require funds they don’t have e.g. financing the purchase of a new factory, or a new school

characteristics of bonds

- Bonds differ in many ways but the following are the main characteristics:

1. The **bond's *term***—the length of time until the bond matures. Some bonds have short terms, such as a few months, while others have long terms e.g. 30 years. Some bonds never mature ***(perpetuities).*** This bond pays interest forever, but the principal is never repaid. Long-term bonds are riskier than short-term bonds because holders of long-term bonds have to wait longer for repayment of principal.
2. The **bond's *credit risk***—the probability that the borrower will fail to pay some of the interest or principal ***(default).*** When bond buyers perceive that the probability of default is high, they demand a higher interest rate to compensate them for this risk. Buyers of bonds can judge credit risk by checking with private agencies which rate the credit risk of different bonds.
3. The **bond's *tax treatment***—the way in which the tax laws treat the interest earned on the bond. The interest on most bonds is taxable income. By contrast, when state and local governments issue bonds, called *municipal bonds,* the bond owners are not required to pay federal income tax on the interest income.

The Stock Market

- **Stock** represents ownership in a firm and is, therefore, a claim to the profits that the firm makes. For e.g. if MTN sells a total of 1,000 shares of stock, then each share represents ownership of 1/1,000 of business.
- After a corporation issues stock by selling shares to the public, the shares trade among stockholders on organized **stock exchanges**. In these transactions, the corporation itself receives no money when its stock changes hands.
- Examples of stock exchanges: **JSE,** New York Stock Exchange, the American Stock Exchange, and NASDAQ (National Association of Securities Dealers Automated Quotation system) all in U.S.
- Most of the world's countries have their own stock exchanges on which the shares of local companies trade.

Stock Market Prices

- Prices at which shares trade on stock exchanges are determined by the Ss & Dd for the stock in the companies
- The demand for a stock (and thus its price) reflects people's perception of the corporation's future profitability
- When people become optimistic about a co.'s future, they raise their demand for its stock and thereby bid up the share price.
- When people expect a company to have little profit or even losses, the price of a share falls.
- Various stock indexes are available to monitor the overall level of stock prices. A *stock index* is computed as an average of a group of stock prices e.g. the JSE index, NASDAQ Composite.
- The most famous stock index is the Dow Jones Industrial Average (USA), computed regularly since 1896.

Stock vs. Bond

- The owner of shares of MTN stock is a part owner of MTN; the owner of an MTN bond is a creditor of MTN
- If MTN is very profitable, the stockholders enjoy the benefits of these profits, whereas the bondholders get only the interest on their bonds
- If MTN runs into financial difficulty, the bondholders are paid what they are due before stockholders receive anything at all
- Compared to bonds, stocks offer the holder both higher risk and potentially higher return.

FINANCIAL INTERMEDIARIES

- **Financial intermediaries** are financial institutions through which savers can indirectly provide funds to borrowers
- The term ***intermediary*** **reflects** the role of these institutions in standing between savers and borrowers
- The most important financial intermediaries are banks and mutual funds.

Banks

- The primary job of banks is to take in deposits from people who want to save and use these deposits to make loans to people who want to borrow
- Banks pay depositors interest on their deposits and charge borrowers slightly higher interest on their loans
- The difference between these rates of interest covers the banks' costs and returns some profit to the banks.
- A second important role for banks in the economy is to facilitate transactions: purchases of goods and services
- In other words, banks help create a special asset that people can use as a ***medium of exchange against their deposits*** *e*.g. checks & electronic systems – internet, mobile

Mutual Funds

- A **mutual fund** is an institution that sells shares to the public and uses the proceeds to buy a selection, or *portfolio,* of various types of stocks, bonds, or both stocks and bonds
- The shareholder of the mutual fund accepts all the risk and return associated with the portfolio
- If the value of the portfolio rises, the shareholder benefits; if the value of the portfolio falls, the shareholder suffers the loss
- Holding a single kind of stock or bond is very risky therefore the primary advantage of mutual funds is that they allow people with small amounts of money to diversify
- With little money, one can buy shares in a mutual fund and, indirectly, become the part owner or creditor of hundreds of major companies.

Mutual Funds

- The company operating the mutual fund charges shareholders a fee proportional to the shares owned by a person each year.
- Another advantage of mutual funds is that they give ordinary people access to the skills of professional money managers who pay close attention to the developments and prospects of the companies in which they buy stock
- The managers buy the stock of those companies perceived to be profitable in the future and sell the less promising stock
- There is scepticism about this second argument.
- With thousands of money managers paying close attention to each company's prospects, it is hard to "beat the market" by buying good stocks and selling bad ones **(Random walk hypothesis).**

Other financial institutions

- Pension funds;
- Credit unions;
- Insurance companies;
- Micro-finances
- Local loan sharks.