ECS307

UNISA

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Chapter 1

1. Why study money, banking and financial markets;
2. Do activities in the financial markets have direct effects on personal wealth, the behaviour of businesses and consumers, and the cyclical performance of the economy?

Interest rates

- It is the cost of borrowing or the price paid for rental of funds
- It is usually expressed as a percentage of the rental of $100 per year
- Examples of interest rates in the economy: mortgage interest rates, car loan rates, bond rates
- “r” have a tendency to move in unison, as a result they are just lumped up as “r”
- What is the importance of interest rates: on a personal level (dual effect depending on whether you want to save or borrow), on a more general level

Money and Business cycles

- What is money? In South Africa, can money be classified as rand only? What else is money?
- Money is anything that is generally accepted in payment for goods and services or in the repayment of debts
- What is a business cycle: fluctuations in the output of the economy/activities in the economy from slump to boom ....
- Money plays an important role in generating business cycles
- What characterise the level MS during recession & boom

Money and inflation, interest rate

- Inflation is the continual increase in the price level
- What is the relationship between MS, inflation and business cycles? Inflation = f(MS, ...)
- What is the role of the central bank in terms of MS, interest rate and inflation?
- Interest rate is a positive function of money supply;
- However the relationship has been less clear-cut since 1980
- **NB: money affects many critical economic variables in the economy hence the importance of monetary policy.**
- **Who is the custodian of monetary policy**
- MP is the management of money and interest rates

Fiscal Policy and monetary policy

- What is fiscal policy?
- Decisions about government spending and revenue collection (taxation)
- Budget deficit vs. budget surplus
- Which one is better between a deficit & surplus?
- How is a budget deficit financed?

The Foreign Exchange Market

- It is where funds are converted from one currency to the other
- It is important in determining the foreign exchange rate
- The exchange rate is the price of one currency in terms of the other
- Exchange rate volatilities (depreciation/appreciation vs. revaluation/devaluation) affects the prices of imports and exports

Chapter 2: Financial System

- Direct finance vs. indirect finance
- **Direct finance:** borrowers borrow funds directly from lenders in financial mkts by selling them securities (financial instruments) e.g. bond or stock.
- **Indirect finance:** borrowers borrow from lenders through financial intermediaries e.g. banks. Financial intermediaries can substantially reduce transaction costs coz they have developed the expertise and coz they take advantage of **economies of scale**. They also offer other **liquidity services** e.g. payment systems. They provide **risk-sharing** through a process called **asset transformation** whereby risky assets are turned into safer assets for investors. They also promote risk sharing through **portfolio diversification.**

Debt & Equity Markets:

- A firm/indiv. obtain funds thru 2 main ways i.e. Debt & Equity methods
- Common debt instruments are bond or mortgage, whereby the borrower pays the holder of the instrument fixed amts regularly (interest + principal) until the maturity
- Debt instrument can be short term (less than 1 yr), intermediate (btwn. 1 & 10 yrs) & long term (more than 10 yrs)
- Equities e.g. common stock pay out **dividends** (periodic payments)
- Equity holders are **residual claimants** since they are part owners. They benefit from profitability increases

Primary & Secondary Markets

Primary mkt is where new securities (bond or stock) are sold.

- This is usually not well known & done behind closed doors
- Investment bank does the underwriting of securities i.e. guarantees prices of securities and sell them to the public

Secondary mkt is where previously issued securities are resold e.g. bond, stock, foreign exchange, futures & options

- **Brokers** (matchers only) & **dealers** (buy & sell) are important

- **Important functions of secondary mkts:**

1. Making securities more desirable by ensuring their liquidity
2. determine the prices of the securities in the primary mkt. Price offered in the secondary mkt determines what investors pay in the primary mkt

Two ways of organising secondary mkts

1. **Exchanges mkt** where buyers and sellers of securities meet in one central location to trade
2. **Over-the-counter (OTC) mkt** is a computer contact trading where dealers at different locations with inventories of securities are ready to buy & sell at set prices

Money & Capital markets

- **Money mkt** is a fin mkt where short-term debt instruments are traded
- **Capital mkt** is the mkt where longer term debt instruments and equity instruments are traded
- Money markets are more liquid compared to capital mkts coz money mkt instruments are more traded
- Shorter term instruments are less fluctuating in terms of prices making them safer investments

Money Market Instruments

- **Treasury Bills**: they have no interest payments but effectively pay interest by initially selling at a discount e.g. buy at R5000 and redeem on maturity at R5,500. Also MP instruments
- **Negotiable bank certificates of deposits (CDs):** instruments sold by banks to depositors that pay annual interest and on maturity pay back the purchase price.
- **Commercial Paper:** is a short-term debt instrument issued by large banks and well known corporations.
- **Repurchase Agreements (Repos):** Short term loans with a maturity of less than 2 weeks, for which TBs act as collateral. Standard bank borrows R1billion loan from Mercedes & promises to repay in a weeks time. Mercedes buys from standard bank an equivalent of R1 billion in TBs. The bank repurchases the R1 billion after a week at a price slightly higher than the purchase price
- **Federal (fed) funds:** borrowing overnight between banks to finance shortfalls in the required reserve ratios by the central bank (**overnight accommodation**) at a sensitive interest rate called **federal funds rate**

Capital Market Instruments

Stocks

Mortgages: loans to purchase housing, land & other real structures, with structures serving as collateral

Corporate bonds: issued by corporations with strong credit ratings. Some are called **convertible bonds** giving the holder the option to convert the bond into a specified no. of shares at any time up to maturity

Government securities: issued by treasury department on behalf of government to finance the deficit

- **Government Agency securities**: issued by various government agencies to finance critical services e.g. electricity, water, transport
- **Local government bonds (municipal bonds)**
- **Consumer & bank commercial loans:** loans to consumers and businesses made by banks and finance companies

Internationalisation of Financial Mkts

- Deregulation of financial mkts promoted the internationalisation
- Increase in pools of savings in foreign countries
- **Foreign bonds**: bonds sold in a foreign country in that country's currency
- **Eurobond:** bond denominated in the currency other than that of the country in which it is sold e.g. a bond denominated in Rand sold in Egypt
- **Eurocurrencies:** foreign currencies deposited in banks outside the home country e.g. Eurodollars which are US4s deposited in foreign banks outside USA.
- **Is a bond denominated in Euros a Eurobond?** No unless it is sold outside Euro-zone

Asymmetric information: Adverse selection & moral hazard

- In financial mkts, information flow is not balanced/unequal (**asymmetric**) e.g. btwn a borrower and lender
- Asymmetric information cause the problem before transaction (adverse selection) and problem after transaction (moral hazard)
- The risky borrowers are the most active in seeking loans and would most likely get (**adverse selection**)
- Lenders may decide not to make any loans even though are good credit risks in the marketplace
- **Moral hazard** is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) and make it less likely to repay the loan. As a result lenders may decide not to make a loan.
- Both problems impede well functioning of the system.

- How do financial markets solve the problems of adverse selection and moral hazard?
- What are the major effects of adverse selection and moral hazard to the financial system and the economy?