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Role of Financial Markets

GCE A-LEVEL & IB ECONOMICS

Lesson Structure

Role of Financial Markets

- To facilitate saving
- Lending to business & individuals
- Exchange of goods and services
- Forward markets in commodities & currencies
- To provide a market for equities

A World Without Finance

Imagine living in a world without banks, stock markets, currency markets.

What do you think that will be like?
How will the economy be affected?

Discuss with your neighbour (2 min)

A World Without Finance

Some areas that will be affected:

- Mortgages

- Company investment

- Pensions

- Insurance

- International trade & tourism

But What is a Financial Market?

A financial market is an exchange where buyers and sellers trade financial assets (securities), such as shares (equities), currency or bonds.

- Shares/stocks/equities represent owning a % stake in a company, and the owner (shareholder) will receive a portion of the company's profits (dividends). Bonds are loans issued/borrowed by companies/governments from the public. If you own one, the company/government will have to pay back the amount they owed you with interest.

Financial markets are generally regulated to ensure fairness (e.g. asymmetric information) and efficiency. The price of financial assets is dependent on market forces (Demand & Supply).

Types of Financial Markets

Financial markets can take various forms, and includes the following:

- Money markets (for short-term loans e.g. credit cards)
- Capital markets (for exchange of stocks and bonds)
- Currency markets (for foreign exchange of money)
- Forward markets (more on this later)

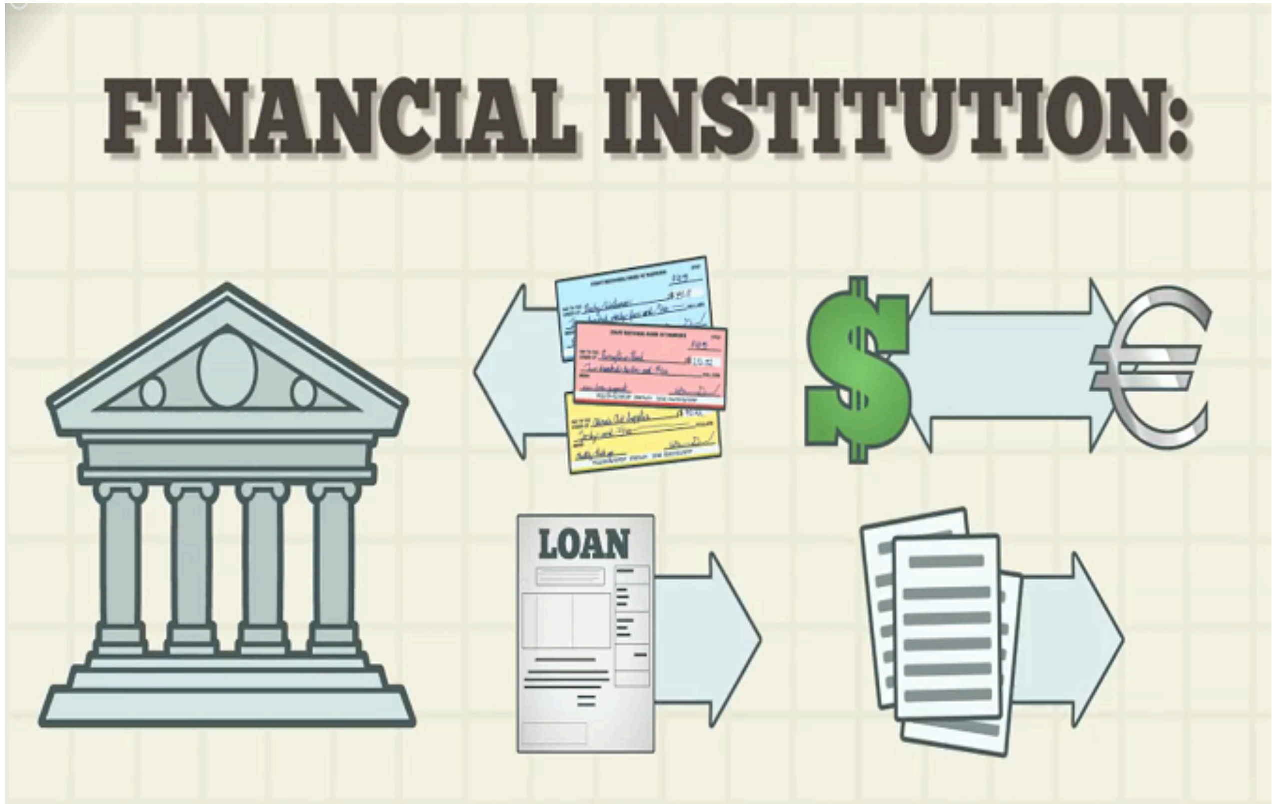
Etc.

Financial Institutions

Can each person name a financial institution that they have heard of?

E.g. a company operating in the finance industry

What do you think they do?



Financial Institutions - Banks

Banks are important financial intermediaries that allow smooth running of the financial markets. They are classified into two basic types.

Commercial Banks:

They provide everyday banking services to individuals and businesses including

- Lending (for credit cards, mortgages, business investment, overdrafts, personal loans etc.)

- Saving (to accept deposits in bank accounts so they can lend it out and pay you an interest)

- Financial transactions/payments (bank transfers, bill payments, salary payment etc.)

Financial Institutions - Banks

Investment Banks:

- Help companies raise money to invest in business projects and expand their operations (i.e. to finance business ventures)

- This is done by selling stocks (parts of the company to the public) and or issuing bonds (borrowing money from the public) in capital markets

- Selling stocks is called equity financing where the buyer becomes a shareholder and receives a dividend (profits) from the company

- Issuing bonds is called debt financing where the buyer will be loaning money to the company and will be repaid that amount with interest

Financial Institutions - Banks

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Banks are private firms that aim to maximise profits, but they are regulated as they can significantly affect the economy when they fail.

Another reason for regulation is the amount of risk they take, which is an essential component when running a bank.

Remember the financial crisis bailout?

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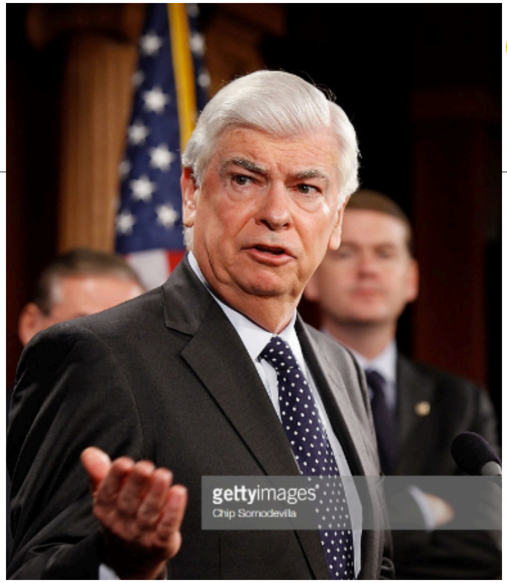
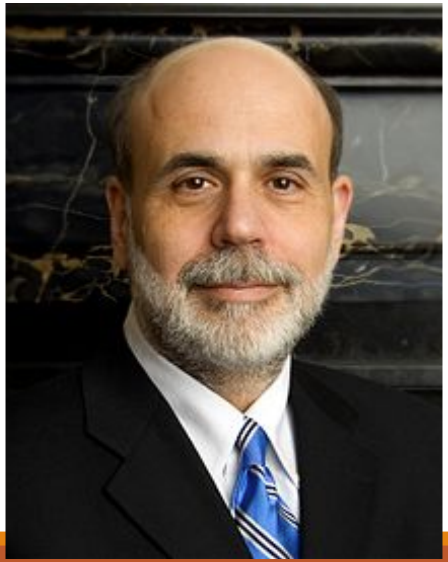
Bailout… Justified?



"Was this a justified rescue to prevent a systemic collapse of financial markets or a $30 billion taxpayer bailout for a Wall Street firm while people on Main Street struggle to pay their mortgages?" Senate Banking Committee Chairman Christopher Dodd asked at the beginning of the hearing.



If Bear Stearns had been allowed to fail, it would have led to a "chaotic unwinding" of Bear Stearns investments held by individuals and other financial institutions.

"Moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability," Bernanke said.

Why Are Banks Important?

- Financial markets facilitate saving and lending through commercial banks. Savings allow a store of value, and provides funds for banks to lend.

- Commercial Banks provide credit to the economy when they lend to businesses and individuals, and can boost consumption and investment in an economy.

- The money supply will fall significantly when banks fail, which will push up cost of borrowing as money becomes less available. This a similar effect to increasing interest rates.

Why Are Banks Important?

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- Commercial banks help make exchange of goods and services easier by providing efficient methods of payment/transactions (e.g. cash, credit/debit cards, overdrafts, bank transfers) and liquidity.

- Banks provide security for buyers and sellers in a transaction due to the confidence it will be carried out successfully.

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Why Are Banks Important?

- Investment banks connects investors with firms and help finance business projects. This increases the output of firms and the economy.

- Hence, a healthy banking/financial system is beneficial in growing the economy, and an imperfect one tend to hold back developing countries as firms lack the necessary funds/investment to grow.

Bailout... Justified?

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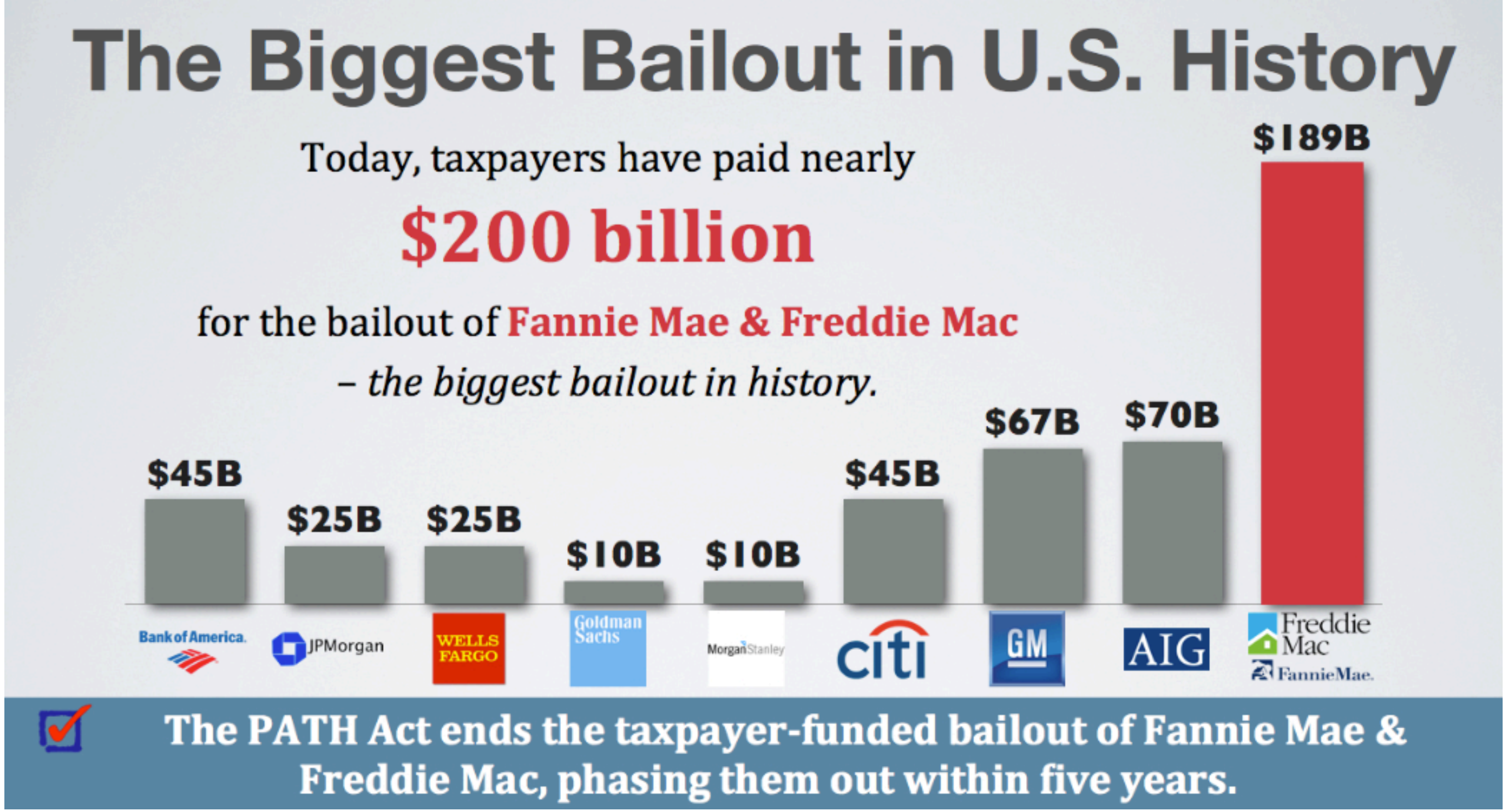
However... Bailouts may not be the best idea? https://www.youtube.com/watch?v=2GSffFgPE1E



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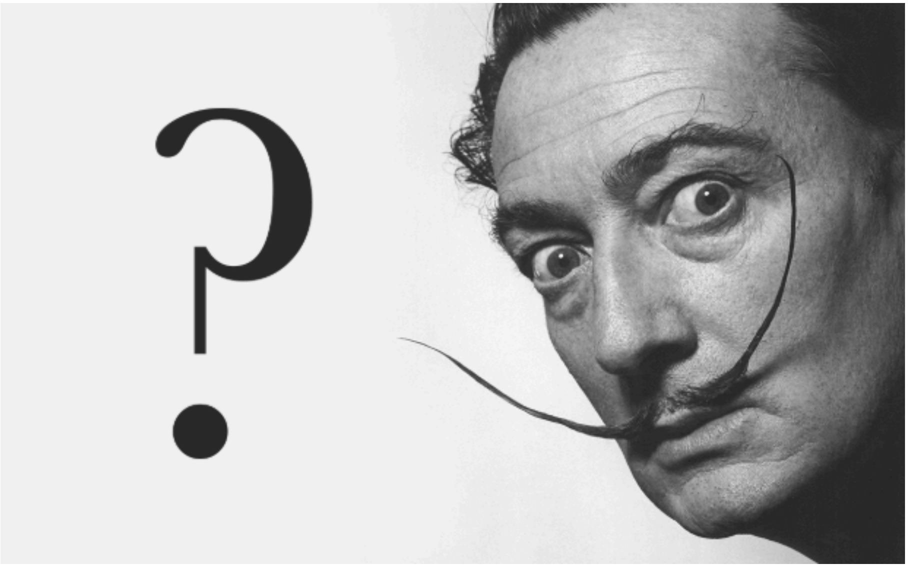
Which Are The Functions of a Commercial Bank?



- Provide loans to businesses and individuals using the bank's deposits

- Get the public to buy some of the company's shares to raise money

- Generate a return on savings deposited in the bank

- Help process financial transactions and payments for trade of goods and services

- Provide a place for businesses to save their profits

- Help issue and sell company/government bonds to the public

- Help wealthy individuals with their investment plans

Forward Markets

A forward contract allows buyers and sellers to set the price of a transaction to be made on a later date.

E.g. if you are a coffee farmer, you may agree at the start of the season to sell coffee beans to Nespresso at a fixed price at the time of harvest. This reduces the risk of price fluctuations in coffee beans, which can adversely affect your income.

Hence, forward contracts obligates buyers/sellers to buy or sell the product at a certain price in the future.

Forward Markets

Similar to stabilizing the price of commodities (hedging commodity risk), forwards can also reduce risk of exchange rate fluctuations.

It is possible to buy a forward contract to buy or sell pounds at a specific rate in the future for USD (or other currencies). This is useful for exporters and importers to protect themselves, against a fall in the value of the currency which they receive their income.

Forward Markets

E.g. You export cotton candy to US and expect to earn \$150 USD You want to exchange that back to £100 pounds (assume \$1.5 to £1) for spending in the UK. One day, exchange rate of USD to GBP falls to \$2 to £1. You will then only earn £75!

To avoid this, you will buy a forward contract in advance, stating that you can exchange \$150 USD to GBP at the rate of \$1.5 to £1, at the time when you sell the cotton candy. Hence, your revenue in pounds is ensured.

Forward Markets

Note that hedging means to mitigate the risk of something using a financial instrument (usually a derivative).

Forward contracts can be traded in the forwards markets, and can be enforced by the owner of the contract, whoever they may be.

Hence, forward markets are important in ensuring business certainty & confidence, reducing business risk, and promotes trade. This again is important to growing the economy.

How will you hedge against this?

Assume that you are a UK exporter to the US. You expect to pay your workers in pounds but earns US dollars. You will need to pay your workers £200 by the end of the month using $300 you earned, but you expect the value of the USD to fall by 20% which will increase your labour costs down the line.

What type of forward contract will you buy to hedge against this situation? Discuss with your neighbour.

Equity Markets

Equity markets are financial markets where company stocks and shares are traded.

The value of companies, and price of their stocks (value of owning a % of the company) tend to rise/fall over time, and is determined by market forces (supply and demand).

In general, the most accessible stocks that can be bought by the public are listed on the stock exchange. However, newer types of equity financing such as crowdfunding platforms, makes ownership in a private limited company much easier.

By providing a market for equities, financial markets make credit (money supply) more accessible for firms and allow them to invest in new/existing business projects to achieve higher output and economic growth.

Financial Markets and the Economy

To summarize, financial markets are important because:

- Financial markets (through financial intermediaries e.g. banks) can severely affect money supply in an economy for individuals and firms. This in turn affects the level of consumption and investment, as well as economic growth.

- The liquidity of credit, and ease of transactions provided by financial markets promotes trade and investment, and allows it to operate much more efficiently.

- Business confidence/certainty gained by hedging in forward markets encourages trade and investment, which is associated with economic growth.