Financial markets

Chapter 77 – April, 2017

Financial markets

- *Financial markets* are different from *product markets* and *factor markets*
  - product markets: buying and selling of *physical goods*
  - factor markets: buying and selling of *land, labour and capital*
- 2 purposes of financial markets:
  1. provide *services* demanded by households, firms, and governments
  2. allow participants to *speculate* and realise financial gains
- *crises* in the financial markets will cause damage in the *real economy*

The role of financial markets

- *saving*: transferring spending power from the present into the future
- *lending*: households, firms and governments borrow money
- *facilitating the exchange of goods and services*: creating payment systems for goods and services
- *providing forward markets*: buying and selling forward in order to even out price fluctuations
- *providing a market for equities*: shares (or stocks) can be bought and sold in financial markets, which creates liquidity
- *providing insurance*: insurance companies pay out the costs of the damages in return for a *premium*

DIFFERENT TYPES OF FINANCIAL INSTITUTIONS

- *retail banks*:
    - make a profit by borrowing money at low rates and lending it out at higher rates (i.e., overdrafts, loans, mortgages),
    - provides other services (i.e., bank account, savings account, insurance)
- *commercial banks*:
    - borrow from businesses that have excess (safe place to store funds)
    - lend to firms that need capital (i.e., overdraft, loan)
- *investment banks*:
    - trade in foreign exchange, commodities, bonds and shares
    - trade in *derivatives* (i.e., 2007-08 financial crisis)
    - advise companies how to raise money

Different types of financial institutions

- *saving vehicles*:
  - *pension funds*:
  - *assurance companies*:
  - *unit trusts* and *investment trust companies*: invest savers' money in shares
  - *private equity and hedge funds*: specialize in *riskier* investments
- *speculators* (i.e., hedgers, day traders, margin traders, arbitrageurs, ...)
- *insurance companies*: provide insurance against risks by charing a *premium*

Different types of markets

- *money markets*: short-term borrowing/lending in general up to one year (i.e., Treasury Bills, Bills of exchange, interbank market)
- *capital markets*: provide longer-term financing in general more than one year (i.e., bonds, shares)
    - *bonds*: long-term loans issued by firms and governments (up to 25 years), can be sold before maturity
    - majority of transactions of bonds and shares in markets is made by speculators
- *foreign exchange markets*: where different currencies are traded
    - *spot markets*: currency is traded now
    - *forward markets*: currency contracts are made for the future (i.e., 3 months)

Different types of markets

- *commodity markets* (i.e., London Metal Exchange, Chicago Mercantile Exchange):
  - comodities are traded (i.e., nickel, gold, silver, copper, corn, wheat; cocoa, cotton, ...)
  - spot or future contracts
  - most contracts are speculative
- *derivatives markets*: trade in financial instruments
  - in theory reduces financial risk in markets
  - however in 2007-08, they were the main cause for the crisis
- *insurance markets* (also *reinsurance*):

Market failure

Reasons why market failure occurs in financial markets

- *asymmetric information*:
  - financial institutions have more knowledge than their customers
  - securitisation in the USA of mortgages (see 2007-08 financial crisis page 494!)
  - asymmetric information between financial institutions and regulators
- *moral hazard*: occurs when an economic agent makes decisions in their own best interest knowing that there are potential adverse risks, and that if problems result, the cost will be partly borne by other economic agents (i.e., bonuses, financial crisis)

Market failure

Reasons why market failure occurs in financial markets

Market failure

Reasons why market failure occurs in financial markets

- *speculation and market bubbles*:
  - market bubble: price of asset rises excessively then collapses
  - caused by *herding behaviour* (see page 495 for explanation)
  - collapse of housing prices due to a large rise in interest rates (mechanism?): example Japan in the 1980's, or US in 2009
  - collapse in stock market valuations: dot-com bubble
- *market rigging*: through collusion or price fixing
  - *insider trading*
  - individuals or institutions fixing the price of a commodity, a currency or an asset (i.e., libor scandal)
- *externalities*: finaancial markets create negative externalities
  - costs carried by other firms, individuals, governments but not the financial markets themselves
  - example: 2007-08 crisis $\rightarrow$ bail-out (i.e., nationalisation of banks)

KEYTERMS

- capital markets:
- commercial banks:
- derivatives:
- equity:
- financial markets:
- investment banks:
- money market:
- retail banks:

Keyterms

Revision (Chapter 55)

- creative destruction:
- multi-plant monopolist:

Keyterms

Revision (Chapter 56)

- competitive tendering:
- contracting out:
- deregulation:
- regulatory capture:
- nationalisation:
- privatisation:

KEYTERMS

REVISION (CHAPTER 57)

- elasticity of demand for labour:
- marginal physical product:
- marginal revenue product:
- total physical product:
- unit labour cost:

Keyterms

Revision (Chapter 58)

- activity or participation rates:
- economically active:
- net migration:
- population of working age:
- workforce or labour force or working population:
- workforce jobs:

KEYTERMS

- bilateral monopoly: