Topic 1 : Financial Assets and Overview of Financial Market

EE431

Federic Mishkin, The Economics of Money, Banking and Financial Markets Chapter 1 - 3, HG173 .M57 2007

2015

- Money is not, properly speaking, one of the subjects of commerce; but only the instrument which men have agreed upon to facilitate the exchange of one commodity for another. It is not the wheels of trade: It is the oil which renders the wheels more smooth and easy." David Hume, Of Money , 1752.
- Money is anything that is accepted in payment for goods and services or in the repayments of debts.
- Functions of Money:
    - Medium of exchange
        - This promotes economic efficiency as it reduces transaction costs and it also allows people to specialize in what they do.
    - Unit of account
        - It reduces transaction cost by reducing the number of prices that need to be considered

- Store of value
  - Money is used as a way to store purchasing power over time
    - This function is useful as we do not always want to spend our income immediately upon receiving it
    - It provides more liquidity (the relative ease with which as asset can be converted into a medium of exchange than other assets
  - Standard of deferred payment
- **Money, Wealth and Income**
- **A real asset** is an entity that generates a flow of goods or services over time. Examples, include land, people, factories, inventions, business plans, goodwill with consumers,reputation. Anything that generates a flow of goods or services counts. Key point: realassets need not be tangible.
- **A financial asset** is a legal contract that gives its owner a claim to payments. Examples include currency ($), stocks, bonds, bank deposits,bank loans, etc

- Financial market is a market for financial assets
  - Market is the interaction between buyers and sellers
- Financial markets and financial intermediaries perform the function of channeling funds from agents who have saved funds and want to lend to agents who need funds and want to borrow.
- Financial asset is promise to repay cash (or any valuables) in the future, an asset that derives value because of a contractual claim.
  - Other words, financial products, financial claims, securities
  - Financial asset is a kind of “goods and services”
  - Financial asset is different from general goods and services
  - its price depends on “future return” “risk” and “liquidity
  - “rate of return”, unit = percent
  - Stock A, price = \$100, expected to rise by \$10, Stock B, price = \$10, expected to rise by \$2

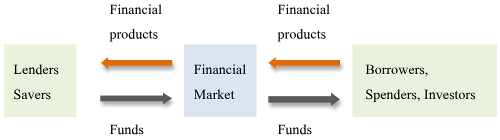
- Information Theory
  - Search goods: their quality is known ex ante
  - Experience goods :their quality is known ex post
  - Credence goods: their quality may never be established, even ex post

- Characteristics of financial assets : Topic 2 - 4
- Financial Institution : Topic 5
- Asymmetric information in the financial market : Topic 6 - 8
- Asymmetric information $\rightarrow$ market failure $\rightarrow$ role of financial intermediation and financial regulations
- Transaction in financial market promotes "saving" and "investment" : flow of funds from savers to investors

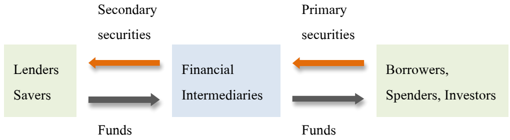
- saving is goods for future consumption
- investment is an increment in the stock of capital goods
- direct investment VS. indirect investment
- economic investment VS financial investment
- We will mention “investment” and “investors” many times in this class. It is your job to identify what type of investment or investors in any context refers to.
- The term “investors” is often used loosely, and we will often use the term loosely in this class.
    - When a firm builds a factory or when a person buys a house, that isinvestment.
    - When a person buys stock, that is, strictly speaking, savings. However, the purchase of a share of stock is commonly called investment, and stockholders are called investor.

- Flow of funds : borrowers (deficit spending unit), lenders (surplus spending unit)

1. Direct Finance : borrowers borrow funds directly from the lenders by selling them securities



2. Indirect Finance : Financial intermediary stands between the lenders and the borrowers and help transfer funds from one to the other



Example : Direct (D) or Indirect (I) finance

- deposit money into a bank
- buy a newly issued bond from PTT PLC. at Kasikorn Bank
- buy a government bond at BOT
- buy an insurance plan from an insurance company
- give your friend a loan
- your friends put money into your business and both of you share in the profits (or losses) of the business

Note : Different roles of financial institutions.

- Primary and secondary market(classified by seasoning of the claims) :
- .... market = market in which newly-issued securities are sold to initial buyers by the corporation or government borrowing the funds.
- .... market = market in which previously-issued securities are traded.
- Note that the originally issuer or borrower receives funds only when its securities are first sold in the .... market; the issuer does not receive funds when its securities are traded in the .... market.
- In Economics, is primary market more important than secondary market?

- Importance of secondary market: promote liquidity, provide information necessary for the financial asset price determination in the primary market.
  - They allow the original buyers of securities to sell them before the maturity date, if necessary. That is, they make the securities more liquid.
  - They allow participants in the primary markets to make judgements about the value of newly-issued securities by looking at the prices of similar, existing securities that are traded in the secondary markets.
- Notice that most financial economics theories focus on activities in the secondary market.

- Money and capital market (classified by maturity)
  - Short-Term (maturity < 1 year) Money Market
  - LongTerm (maturity > 1 year) Capital Market
- Debt and equity market (classified by the nature of the claims)
  - Debt instrument = a contractual agreement by the issuer of the instrument (the borrower) to pay the holder of the instrument (the lender) fixed dollar amounts (interest and principal payments) at regular intervals until a specified date (maturity date) when a final payment is made.
  - Equity = a contractual agreement representing claims to a share in the income and assets of a business
  - A key feature distinguishing equity from debt is that the equity holders are the residual claimants: the firm must make payments to its debt holders before making payments to its equity holders.

- Derivative market
    - A derivative is a financial instrument whose value depends on (or derives from) the value of other, more basic underlying assets.
    - for example;
        - Forward contract : a contract to buy or sell a specified amount of a designated asset at a date known in the future, is not traded on organised exchanges
        - Futures contract : a contract to buy or sell a specified amount of a designated asset at a date known in the future, is traded on organised exchanges
        - Option: contract that gives the owner the right but not obligation to buy or sell a specified asset at a stipulated price

- Throughout this course, we'll be considering various aspects of the role that these various financial instruments and financial intermediaries play in the economy as a whole.
- With all of these definitions in hand and collected in one place, we'll always be able to refer back to this overview if we need to remember how a particular type of financial instrument works or what a particular role of financial intermediary play.

Example

"IF THE banks won't lend you money, might a stranger? Probably not, to judge by recent data from Prosper, an American peer-to-peer lending marketplace (a place where people can lend their own money to other people).
Peer-to-peer lending, the website, which lets lenders bid against each other on the interest rates they are prepared to offer to specific borrowers, has seen an increase in demand from subprime borrowers as access to bank credit has tightened."
Source: Economist (2007)
Explain the difference between direct finance and indirect finance.
What is the method for direct financing mentioned in the news: bank lending, peer-to-peer financing or none?

Example

News 1. “The Stock Exchange of Thailand Index hit a new 18-year high, ahead of the Bank of Thailand’s policy rate meeting today. The Thai bourse ended the morning session at 1,540.12 points, gaining 8.05 from the previous closing. The index further rallied in the afternoon, despite foreign net-sells this month, to end the day at 1,546.64 points on turnover of Bt63 billion.”
Source: The Nation)
News 2. “Supalai Public Company Limited (SPALI) is offering a 5-year unsecured debentures with the issue size of THB 745 million. The coupon rate has been determined at 3.73 per cent per annum. The interest is payable semi-annually.”
Source: ThaiBMA

- Specify which piece of news talks about primary market and which piece of news talks about secondary market.
- Specify which piece of news talks about debt market and which piece of news talks about equity market.