Chapter 1
Why Study Financial Markets and Institutions?

■ Answers to End-of-Chapter Questions

1. Because they channel funds from those who do not have a productive use for them to those who do, thereby resulting in higher economic efficiency.

2. In a market economy, resources tend to flow to activities that provide the greatest returns for the risks the lender bears. When economic activity weakens, monetary policymakers can push interest rate target (adjusted for inflation) temporarily below the economy's natural rate, which lowers the real cost of borrowing. This improves bank balance sheets and the banks' capacity to lend. During a financial crisis, many banks may have too little capital, which limits their ability to make loans during the initial stages of an economic recovery. By keeping short-term interest rates low, a central bank helps recapitalize the banking system by helping to raise the industry's net interest margin (NIM), which boosts banks' retained earnings, and thus, its capital. However, if interest rates are already at near zero, other solutions maybe necessary. For example, increased government spending through fiscal policy may be an alternative solution.

3. German consumers will most likely to travel to the U.K. and spend their money in the hotels and tourist attractions as the pound sterling is considered low compared to the euro. Additionally, all the British goods in the Eurozone will sell quickly due to the lowered value of the pound sterling as compared to the euro. German consumers would also buy more British-made products compared to same products made in Germany as British-made goods will be relatively cheaper compared to similar goods made in Germany.

4. Eurozone businesses will benefit from the increase in value of the U.S. dollar as they will be able to price products more competitively against American goods. U.S. importers of foreign-made goods like French wine and German appliances might "experience a windfall" as their products become cheaper.

5. The lower price for a firm's shares means that it can raise a smaller amount of funds, and so investment in plant and equipment will fall.

6. Higher stock prices mean that consumers' wealth is higher and so they will be more likely to increase their spending.

7. A central bank is a governmental body which is responsible for the conduct of monetary policy. Part of its functions include regulating the entire commercial, retail, and merchant investment and foreign banks in a country, and involves the management of interest rates and the quantity of money. The central bank also has the power to set and change the monetary policy of a country should the country suffer from an economic crisis or have excess money supply.

   The Federal Reserve System in the U.S. is more of a quasi-institution where the legislation that governs it originates from the legislative assemblies but the funding does not originate from the legislature. Funding for the Federal Reserve is derived from its own investments. The national central banks in the Eurozone operate much like the regional Federal Reserve Banks. The European Central Bank (ECB) sets common monetary policy for the entire Eurozone area. National central banks in the Eurozone area form the Eurosystem. The task of the Eurosystem is three-fold:-

   (i) To define and implement the common monetary policy of the Union.

   (ii) To conduct foreign exchange operations.

   (iii) To hold and manage the official foreign reserves of the Euro member states.

   Students can access all countries' central bank websites using the following URL https://www.bis.org/cbanks.htm.

8. Banks play a key role as the most important financial intermediary in fuelling the economic growth process by allowing the expansion of physical and human capital and the creation of new ideas (the three key factors of economic growth). Roads, dams, ports, etc. can be built since banks channel funds from savers into these projects.

9. Changes in foreign exchange rates change the value of assets held by financial institutions and thus lead to gains and losses on these assets. Also changes in foreign exchange rates affect the profits made by traders in foreign exchange who work for financial institutions.

10. In the mid to late 1970s and the late 1980s and early 1990s, the value of the dollar was low, making travel abroad relatively more expensive; that would have been a good time to vacation in the United States and see the Grand Canyon. As the dollar's value rose in the early 1980s, travel abroad became relatively cheaper, making it a good time to visit the Tower of London.

11. A robust financial market creates conditions for economic growth and financial stability by ensuring a constant (uninterrupted) flow of funds between savers and borrowers based on credible information flows for the best possible uses of these funds. When the information flow is not credible (i.e. lacks transparency), then the system is prone to crises and the proper channeling of funds is interrupted, thereby removing the pillars of economic growth.

12. Savings and loan associations, mutual savings banks, credit unions, insurance companies, mutual funds, pension funds, and finance companies.

13. Generally, interest rates are prices. They are the price paid for the use of money for a period of time and are expressed as a percentage of the total outstanding balance that is either fixed or variable. There are two ways in which interest rates can be defined: first, from the borrower's point of view, it is the cost of borrowing money (borrowing rate); and second, from a lender's point of view, it is the fee charged for lending money (lending rate).

The central bank makes decisions on monetary policy. This is done through the regulation of interest rates which influences the availability of money in order to provide economic growth and prevent downturns. Regulation of interest rates helps ensure stable prices and liquidity for the country. This policy is routinely checked to ensure that the supply of money within the economy is neither too large (causing prices to increase) nor too small (causing prices to decrease).

Because retail banks are usually the first financial institutions to expose money to the economy, they are the principal instruments used by the central bank to manipulate the money supply. By adjusting the interest rates on the money it lends to or borrows from the retail banks, the central bank is able to regulate the supply of money to the end user (individuals and companies).

14. Debt market, or bond market, is crucial to any economic activity as it enables corporations and governments to borrow in order to finance their activities; it is also where interest rates are determined. Other than borrowing funds from banks, a company can also issue bonds to the public in order to raise money to finance their activities. How it works is that the company issues bonds for the general public to buy, and the bond buyer pays the company cash in return for the bonds on paper. The company will then pay interest on an annual basis to the buyer who has bought their bonds. This transaction is operated within the debt market, which is different from issuing of shares by companies to the general public operating in the equity market.

15. Because the Federal Reserve affects interest rates, inflation, and business cycles, all of which have an important impact on the profitability of financial institutions.

■ Quantitative Problems

1. The following table lists foreign exchange rates between U.S. dollars and euro (EUR) during February, 2014.

Date	**U.S. Dollars per EUR**	**Date**	**U.S. Dollars per EUR**
2014		**2014**	
2/1	1.348781	2/16	1.369300
2/2	1.328781	2/17	1.370679

2/3	1.352399	2/18	1.375730
2/4	1.350628	2/19	1.376089
2/5	1.351799	2/20	1.368862
2/6	1.360180	2/21	1.372465
2/7	1.361194	2/22	1.373730
2/8	1.363577	2/23	1.373741
2/9	1.363577	2/24	1.374172
2/10	1.364353	2/25	1.374726
2/11	1.365278	2/26	1.367002
2/12	1.359235	2/27	1.371264
2/13	1.366882	2/28	1.380712
2/14	1.369081		
2/15	1.369300		

Which day would have been the best day to convert $300 into euro? Which day would have been the worst day? What would be the difference in euro?

Solution:

2-Feb 1.328781 225.77
Euro 225.77 is the highest for February 2014

28-Feb 1.380712 217.28
Euro 219.09 is the lowest for February 2014.

Euro 225.77 – Euro 217.28 = Euro 8.49