Chapter 2
Overview of the Financial System

■ Answers to End-of-Chapter Questions

1. The share of Microsoft stock is an asset for its owner because it entitles the owner to a share of the earnings and assets of Microsoft. The share is a liability for Microsoft because it is a claim on its earnings and assets by the owner of the share.

2. Yes, I should take out the loan, because I will be better off as a result of doing so. My interest payment will be $4,500 (90% of $5,000), but as a result, I will earn an additional $10,000, so I will be ahead of the game by $5,500. Since Larry's loan-sharking business can make some people better off, as in this example, loan sharking may have social benefits. (One argument against legalizing loan sharking, however, is that it is frequently a violent activity.)

3. The emerging markets of Southeast Asia were not exposed to the economic crisis of 2007 as the exotic financial instruments that were backed by toxic assets were not used in daily transactions within the Asian financial markets. On the other hand, banks in the developed markets of Western Europe were already dealing with the toxic financial instruments on a regular basis that were deemed good on paper, which in turn exposed them much more to the financial crisis. The result was that the Southeast Asian economy was still going strong despite the global scale of the financial crisis that hit Western Europe and the developed economies badly.

4. Debt instruments are important as they are vital for economic activity. It is the market where interest rates are determined. Interest rates are important on a personal level, because they guide our decisions to save and to finance major purchases (such as houses, cars, and appliances, to give a few examples). From a macroeconomic standpoint, interest rates have an impact on consumer spending and on business investment. Furthermore, debt instruments are an alternative way to raise money if the firm is not qualified to raise money through the equity market.

5. This statement is false. Prices in secondary markets determine the prices that firms issuing securities receive in primary markets. In addition, secondary markets make securities more liquid and thus easier to sell in the primary markets. Therefore, secondary markets are, if anything, more important than primary markets.

6. Rewards of investing in the stock market compared to the bond market:

a) The market participants—individual retail investors, institutional investors, and publicly traded corporations—are equity owners as compared to bond holders (bond is a debt in nature).

b) The investor will receive dividend income once or twice a year where the amount can be high based on the performance of the company as compared to bond interest which is fixed in nature.

c) Investors have the opportunity to invest in blue-chip stocks that generate high dividends or capital gains in comparison to bonds which are highly sensitive to the fluctuating interest rates.

Risks of investing in the stock market compared to the bond market:

a) Stocks are volatile financial instruments compared to bonds which are more stable.

b) Sometimes stocks are not able to generate dividends but bonds can generate fixed interest income for the bond holder.

7. Adverse selection can be a problem when there is asymmetric information. For example, this can happen between the seller of insurance and the buyer. Insurance will often not be profitable when buyers have better information about their risk of claiming than does the seller. Ideally, insurance premiums should be set according to the risk of a randomly selected person in the insured slice of the population (55-year-old male smokers, say). In practice, this means the average risk of that group. When there is adverse selection, people who know they have a higher risk of claiming than the average of the group will buy the insurance, whereas those who have a below-average risk may decide it is too expensive to be worth buying. In this case, premiums set according to the average risk will not be sufficient to cover the claims that eventually arise, because among the people who have bought the policy more will have above-average risk than below-average risk. Putting up the premium will not solve this problem, for as the premium rises the insurance policy will become unattractive to more of the people who know they have a lower risk of claiming. One way to reduce adverse selection is to make the purchase of insurance compulsory, so that those for whom insurance priced for average risk is unattractive are not able to opt out.

8. Lisa can seek for a bank that can offer her the lower interest rate but there could be other hidden costs despite the low interest rate and she is not privy to that piece of information. She can hedge against such asymmetric adverse selection situation by surveying all the banks that offers home loans in which she needs to speak to each financial adviser for each bank. In this way, the more banks she surveys, the more information she will absorb before making a final decision of which is the best offer. With the advent of mortgage securitization, the banks may take on more risk by reducing the loan application standards. In this case, risky applicants may be offered loans based on the lowering of standards.

9. I would ask Amelia about her driving behavior. If she is prone to have many accidents, she should buy insurance with lower deductible costs and if she is an excellent driver, she should buy the insurance with lower premium and higher deductible costs.

10. The market is full of businesses selling goods via the direct selling method; consumers do not know if these products are value-for-money, and run the risk of being cheated by the direct sellers. The market is saturated with direct sellers selling their products claiming them to be high quality. Without complete information on the product, buyers are at risk of suffering from asymmetric information. In such cases, consumers tend to take customer feedback, product reviews, surveys, and testimonials seriously—buyers may choose not to purchase a product if it receives negative reviews.

11. Yes, because eliminating moral hazard requires enforcement even if there is no information asymmetry. Even if you know that a borrower is taking actions that might jeopardize paying off the loan, you must still stop the borrower from doing so. Because that may be costly, you may not spend the time and effort to reduce moral hazard, and so moral hazard remains a problem.

12. Economic crisis mainly manifest themselves at the level of financial intermediaries usually. These institutions can be banking institutions, insurance companies, investment companies, financial intermediation companies, or financial conglomerates. Financial intermediaries contribute to the efficient transfer of funds from surplus agents to deficit agents. Financial intermediaries can cause markets to crash as their activities they perform can influence interest rates, the uncertainty in markets, and the price of assets. The collapse of one financial intermediary may also lead to market collapse predominantly through the 'domino effect' as the dealings of financial intermediaries is based on trust between them and the public at large.

    Financial intermediaries can help an economy recover from a crisis if the management of these financial intermediaries be more proactive in retaining and raising capital for financial institutions in distress and also play the role in channeling funds from government assistance provided to financial intermediaries during times of distress to good and profitable investment opportunities that may be starved of capital.

13. Because the costs of making the loan to your neighbor are high (legal fees, fees for a credit check, and so on), you will probably not be able to earn 5% on the loan after your expenses even though it has a 10% interest rate. You are better off depositing your savings with a financial intermediary and earning 5% interest. In addition, you are likely to bear less risk by depositing your savings at the bank rather than lending them to your neighbor.

14. Financial intermediaries can resolve the adverse selection problem in two ways. Firstly, they can require more information from borrowers when they fill their request for funds application form. Secondly, they can source credit history reports of the potential borrower from third party providers of promptness of repayment of previously undertaken loans.