

(Please kindly tell me if there is any mistake. Thank you.)

EE431 Economics of Financial Markets and Institutions, 1/2013

Problem Sets 1 : Financial Assets and Overview of Financial Market

Solutions

1. Fill in the blanks.

- (a) Those financial markets that facilitate the flow of short-term funds are known as money market.
- (b) Funds are provided to the initial issuer of securities in the primary market.
- (c) A five year security was purchased two years ago by an investor, who plans to resell it. The security will be sold by the investor in the secondary market.
- (d) Securities are assets for the person who buys them, but are liabilities for the individual or firm that issues them.
- (e) With direct finance , borrowers obtain funds from lenders by selling them securities in the financial markets.
- (f) With direct finance funds are channeled through the financial market from the savers directly to the spenders .
- (g) When I purchase stocks, I own a portion of a firm and have the right to vote on issues important to the firm and to elect its directors.
- (h) Equity holders are a corporation 's residual claimants. That means the corporation must pay all of its debt holders before it pays its equity holders.
- (i) A shareholders benefits directly from any increase in the corporation 's profitability.
- (j) A financial market in which previously issued securities can be resold is called a secondary market.
- (k) A corporation acquires new funds only when its securities are sold in the primary market.
- (l) The higher a security 's price in the secondary market the more funds a firm can raise by selling securities in the primary market.
- (m) A financial market in which only short-term debt instruments are traded is called the money market.
- (n) Equity instruments are traded in the capital market.
- (o) The total collection of pieces of property that serve to store value is a person 's wealth .
- (p) Income is a flow of earnings per unit of time.

2. The following can be described as involving direct finance or indirect finance. Specify.

- (a) You take out a mortgage from your local bank.
Indirect Finance

- (b) You borrow \$2500 from a friend.
Direct Finance
- (c) You buy shares of common stock in the primary market.
Direct Finance
- (d) A corporation takes out loans from a bank.
Indirect Finance
- (e) You make a loan to your neighbor.
Direct Finance
- (f) You buy a U.S. Treasury bill from the U.S. Treasury.
Direct Finance
- (g) You make a deposit at a bank.
Indirect Finance

3. Is the following statement true or false and why?

- (a) Both debt and equity instruments can be short-term financial instruments.
False. Reason. Debt instruments can be long-term (with maturity over one-year) or short-term (with maturity less than one-year). Equity instruments are long-term. Their maturity are over one year.
- (b) Both debt and equity instruments involve a claim on the issuer's income.
True. Reason. Issuers pay debtholders interest and principal and pay equityholders dividends from their income (or from their assets).
- (c) Both debt and equity instruments enable a corporation to raise funds.
True. Reason. A corporation can raise funds by issuing debt instruments or equity instruments.
- (d) The income from bonds is typically more variable than that from equities.
False. Reason. The returns on bonds are predetermined. The returns on equity depends on the issuer's profit. Therefore, the income from bonds is typically less variable than that from equities.
- (e) A bond is a long-term security that promises to make periodic payments called dividends to the firm's residual claimants.
False. Reason: An equity is a long-term security that promises to make periodic payments called dividends to the firm's residual claimants.

4. Corporations receive funds when their stock is sold in the primary market. Why do corporations pay attention to what is happening to their stock in the secondary market?

“The existence of the secondary market makes their stocks more liquid and the price in the secondary market sets the price that the corporation would receive if they choose to sell more stocks in the primary market.”

(Note: You may provide other relevant reasons, which are also correct.)