Chapter 2: The Financial System

The Financial System supports the economic system. Money (capital) is an important resource needed to bring together the other factors of production to produce the goods and services society needs and wants.

Governments, businesses and individuals can have more money than they currently need (surplus units) or need more money than they currently have (deficit units). The financial systems serve to promote the flow from those who have (but don't currently need) to those who need.

Interest rates are the price of money - the price borrowers pay to get use of other's money, while it is the reward that lenders earn by giving up use of their money for a period of time.

Financial System is composed of:

- Markets
- Institutions
- Instruments (securities)

Transfer or flow of funds

- Direct
- Indirect w/o intermediation
- Indirect with intermediation

Intermediation functions - amount, term, risk
Types of markets

Broker/Dealer
Primary/Secondary
Debt/Equity
Money/Capital

The reward from an investment (or loan) can come in two forms - along the way (while you own/hold the investment) or at the end.

Current income or yield - along the way
Capital gain or loss - received at end (maturity or sale)

Money Market (Discounted securities) - all of the reward is received at maturity

T-bills, Commercial Paper, CDs, Bankers' acceptances, Fed Funds

a) Example: 1-year t-bill has face value of $10,000 and is issued (sold) at a price of $9,500. The purchase price is discounted 5% from the face value and the yield is:

\[ \text{yield} = \frac{10,000 - 9,500}{9,500} = \frac{500}{9,500} = 0.0526 \text{ or } 5.26\% \]

In reality, because of long common practice, the discount rate would actually be quoted differently than 5%. This is because the money market instruments are priced assuming there are only 360 days in a year.
Capital Market Instruments - reward is received both along the way and at the end (maturity or sale).

T-notes, T-bonds, Agencies, Corporate Bonds, Municipals, Stock

There are always exceptions - though all money market instruments are discounted and pay nothing along the way, not all capital market instruments pay reward along the way and at the end. A very few capital market instruments are discounted instruments.

Interest Rates

Determinants - Productivity, Inflation, Risk, Maturity

\[ K = K^* + IP + DP + MP \]

\( K \) = nominal or stated rate of interest
\( K^* \) = most basic rate of interest
\( IP \) = inflation premium
\( DP \) = default premium
\( MP \) = maturity premium

\( K^* + IP \) = risk rate of interest (t-bill rate)
Term Structure (MP) - how rates differ because of the term of the loan

- Liquidity Preference Theory
- Expectations Theory
- Segmentation Theory

Yield Curve - shows relationship between yields and length of term of loan

Yield Spreads (DP) - how rates differ because of varying default risk

Bond ratings: AAA, AA, A, BBB = investment grade
    BB, B, CCC, CC, C, D = high risk