8/8 - Lecture 2 - A Modern Financial System

Financial System

→ There is an inherent connection between the 'real economy' where G/S are traded and the financial markets where financial securities are traded

→ **Financial system:** a range of financial institutions, financial instruments, and financial markets facilitating the flow of funds between lenders/savers and borrowers

- ↳ Essential in facilitating economic growth and future productive capacity in a country
- ↳ A modern, sound financial system will encourage the accumulation of savings that are available for investment in productive capacity in an economy
- ↳ The provision of finance to business will increase economic growth, productivity, employment and living standards

→ There are 2 broad categories of economic agents

- ↳ **Surplus units** (savers)
  - ⇢ Provider of funds; lenders - have excess funds
  - ⇢ Invest savings via purchase of financial instruments
- ↳ **Deficit units** (borrowers)
  - ⇢ Users of funds - have shortage of funds (but expect to have surplus in future)
  - ⇢ Borrow funds via sale/issuance of financial instruments

→ The use of monetary value in modern market economies makes it easier for surplus units to save their excess funds, and easier for borrowers to gain access to these

→ Financial institutions, instruments and markets facilitate financial transactions between providers of funds and users of funds

→ The principle role of financial institutions and markets is to "bring together providers of funds with users of funds"

→ **Flow of funds:** movement of funds through the financial system between savers and borrowers, giving rise to financial instruments

→ 4 main attributes of financial assets

1. Return or yield: the total financial benefit received (interest and capital gain) from an investment; expressed as a percentage of amount initially invested
2. Risk: the possibility or probability that an actual outcome will vary from the expected outcome; uncertainty
3. Liquidity: ability to sell an asset within a reasonable time at current market prices and for reasonable transaction costs; access to cash and other sources of funds to meet day-to-day expenses and commitments
4. Time-pattern of cash flows: the frequency of periodic cash flows (interest and principal) associated with a financial instrument

- ↳ Financial institutions & markets provide an enormous range of investment opportunities that have different levels of these four attributes

→ **Portfolio restructuring:** the buying and selling of a wide range of financial investments assets in order to best meet current savings, investment and funding needs

→ Monetary policy is another function of the financial system

↳ Actions of the central bank taken to influence interest rate levels to achieve certain economic outcomes → primary target is <u>inflation</u>

→ An efficient financial system:

↳ Generates a range of financial instruments that possess the desired combination of the four attributes valued by savers

↳ Encourages accumulation of savings and directs these to the most efficient users, increasing investment in productive capital in an economy

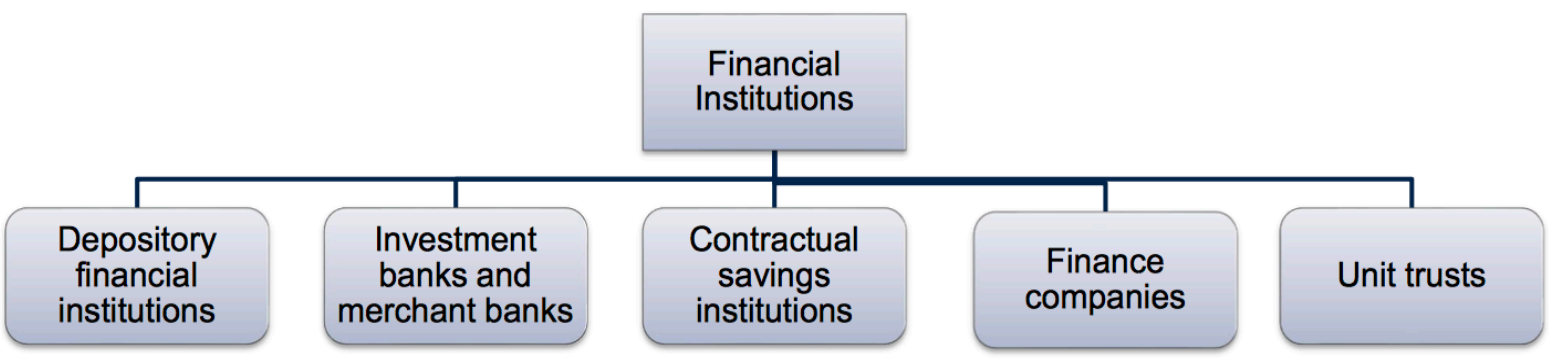
↳ Implements monetary policy of governments by influencing interest rates

→ The GFC and its aftermath have placed greater emphasis on the "soundness and stability" of the financial system → through financial regulation

→ GFC demonstrated the resultant large social and economic costs of instability in financial systems, and the intrinsic link between the real economy and the financial markets

Financial Institutions

→ Financial institutions vary widely - categorised by differences in sources and users of funds



→ Depository financial institutions

↳ Called "Authorised Deposit-taking Institutions (ADI's)" in Australia

↳ Mainly attract the savings of depositors through on-demand deposit and term deposits accounts

↳ eg. Commercial banks, building societies and credit unions/cooperatives

↳ Mainly provide loans to borrowers in household and business sectors

↳ Have around 58% of total financial system assets

→ Investment banks and merchant banks

↳ In Australia, also called "Money market corporations"

↳ Mainly provide off-balance-sheet (OBS) advisory services to support corporate and government clients

↳ eg. advice on mergers and acquisitions, portfolio restructuring, finance and risk management

↳ May also provide some loans to clients, but are more likely to advise on raising funds directly in capital markets