Financial markets notes BAFI1002 RMIT

TOPIC 1: Introduction to Financial Markets

TOPIC 2: The Flow of Funds and Determination of Interest Rates

TOPIC 3: The Money Market

TOPIC 4: The Debt-Capital Market

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TOPIC 7: The Derivatives Markets

TOPIC 8: The Changing Financial System and Role of Financial Institutions

TOPIC 1: Introduction to Financial Markets

What is a financial system?

- Made up of financial institutions, instruments, markets that facilitate transactions for goods and services and financial transactions
    - **Elements**
    - Financial instruments
    - Financial markets
    - Financial institutions
    - **Function**
    - Facilitate the transfer of funds from surplus economic units to deficit economic units by creating new financial assets
    - Facilitate the trade of existing financial assets
    - **Components**
    - Surplus economic units
        - Individuals, households and companies with more funds than required for immediate expenditure
        - Savers and potential lenders
    - Deficit economic units
        - Those who require funds to meet expenditure plans
        - Borrowers
    - Financial institutions
    - Financial assets
    - Financial markets
        - Equity markets
        - Bond markets
        - Swaps
        - Forex

Types of financial assets

- Debt
    - Represents the obligation to repay the lender principal and interest payments
- Equity
    - Represents an ownership claim over the profits of a business
- Hybrid
    - Both debt and equity
    - Preference shares
        -

    - Convertible notes (bonds)
- Derivatives
    - Forwards
    - Futures
    - Options
    - Swaps

Attributes of financial assets

- Return vs. risk
- Liquidity
    - The ability to buy or sell the asset without financial loss
    - The ability to turn asset to cash quickly "**Marketability"**
- Time pattern of the cash flows
    - When, how much, and how often do cash flows come in
- Portfolio structuring

How to borrow or invest?

- **Direct finance**
- Banks, investment banks, brokers, dealers
- Money moves straight from supplier to receiver and bank just facilitates
- Buying shares during IPO,
- **Indirect**
- For example term deposits, you lend money to bank, bank lends that money on at higher rate, banks pays you for loan, and bank gets paid by other lender

Avantages of financial intermediation

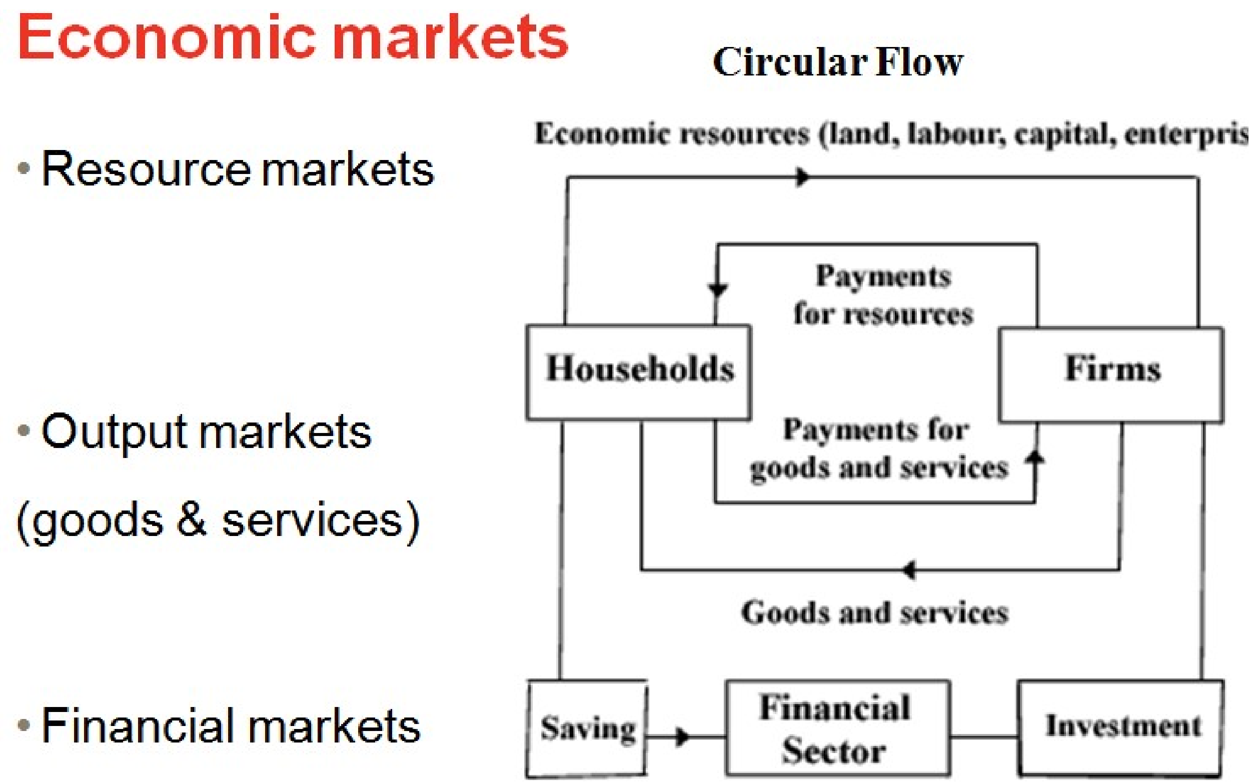
- Asset value transformation
    - Small savings from large pool of people can allow large borrows
- Maturity transformation
    - Match maturity preference as they have large pool of different financial assets
- Credit risk reduction and diversification
    - Banks have professionals who manage risk and decide if investors investment is risk adverse
    - Also bank diversifies investment for you
- Liquidity provision

   - Savings increases, investment increases, economy grows and people can access money easier

Disadvantages of financial intermediation

- Increased cost of funds for borrowers
- Reduced return from lending for savers
- **Why**
- Institution take net interest margin
- Also charge for service

Economic circular flow model



- The money we save goes to financial services
- These financial services might be banks or superannuation funds that make investments
- These investments go to firms and these firms pay employers and the cycle continues

Benefits of strong economic financial flow

- Economic growth

- Full employment as money is going to firms and firms pay more workers
- Price stability, as inflation is determined by AD, hence cost availability of funds will impact inflation, easier to control when constant flow
- External balances, if there is lots of money in the economy then the supply is high which lowers exchange rate and increases exports which boosts economy
- Efficient allocation of resources, if financial system works well, people who are good with money will get to borrow money, if not working well then government will intervene, however intervention is inefficient

Forms of government regulations

- Fiscal budget
- RBA
- ACC