Learning Objectives

Upon completion of this unit, students should be able to:

1. Describe the three major markets: bond, stock, and foreign exchange.
2. Summarize the reasons to study financial institutions.
3. Explain the structure of financial markets.
4. Identify roles of financial intermediaries within financial markets.
5. Describe the key points of risk management and moral hazard.
6. Discuss internationalization of financial markets and their investment opportunities.

Written Lecture

In one form or another, financial markets and institutions are a part of our everyday well-being. While there can be some significant “mystery” as to how such markets function, this course will provide a basis for review and understanding.

Taken at the most basic structure, there are three very important markets to consider: (1) the bond market, where the setting of interest rates occurs; (2) the stock market, where individuals, governments, and corporations trade instruments and create wealth; and (3) the foreign exchange market, where U.S. based initiatives can change due to fluctuations within the foreign exchange.

Along with markets, we need to consider additional factors that can affect the well-being of markets, including central banks (both from the U.S. and abroad), channeling relationships (allocation methods to efficiently transfer wealth), specific intermediaries and their role within the financing arena, and governmental rules and regulations.

Bond Market

When reviewing the interest rate structure, we can see that “generally” interest rates will “move in unison” with each other (Mishkin & Eakins, 2012, p. 2). Figure 1.1 shows that there was a spike around the dates of 1980 to 1985. Why did this occur? Did the Federal Reserve impact rates? Were we in an inflationary period? Go to your favorite search engine, and search for the Federal Reserve Bank of San Francisco. Click on the Education tab. Then, click on Ask Dr. Econ under the Student Activities. Type in the question, “How did the Fed change its approach to monetary policy in the late 1970s and early 1980s?” Click on the Fire Away button. This will give you some information on monetary policy in the late 1970s and early 1980s.

Stock Market

The stock market serves an important role for the allocation of capital necessary for both individual and corporate growth. You can search for more information
about the stock market on the Internet. You can also use the keywords “What are stocks?”

**Foreign Exchange**

Simply put, foreign exchange is where the value of one country’s currency is measured against another. The value of currency has significant impact on both the domestic (internal) value of goods and services and foreign (external) value of goods and services. You can search for more information about foreign exchange market on the Internet.

**Institutions**

There are many different types of financial institutions that assist with financial markets, including depository institutions, contractual savings institutions, and investment intermediaries. Review Table 2.2. You will notice that the value of assets has increased in each category of institution from 1980 to 2009. Also review Table 2.3, which shows the different regulatory bodies that impact these institutions, such as the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and the Federal Reserve System.

In today's environment, there is a specific need to monitor and regulate our financial institutions (and markets). Due to the impact of the Great Recession, there is a continual desire to improve both the operational effectiveness of markets—along with ensuring that fairness and ethics play a key part in the overall approach that financial institutions use when dealing within our society as a whole.

Read the following article: Go to your favorite search engine, and search for VoxEU. Then, search for the article “Financial regulation: Can we avoid another great recession?” It touches on the ideas of moral hazard, liquidity, and risk taking. These concepts will be discussed throughout the course.

**Key Terms from the Article**

**Moral hazard:** When thinking of a moral hazard, we can turn to recent events where borrowers are “walking away” from loans. In some cases, they may be in a position to pay back the loans—but simply choose not to. Since many homes have financially become upside down (today's value vs. the amount still owed on the home), many borrowers are finding that they can purchase similar housing at a fraction of what they had originally paid. Therefore, without regard to the ethical/moral implication, they are consciously choosing to walk away from the financial obligation. Additional examples of moral hazards are provided in the textbook.

**Liquidity:** This idea deals with the overall acceptance of financial products. In other words, the more “liquid” something is, the greater the desire from other investors. For example, if we compare a house vs. a piece of gold—which is more liquid? In this example, a piece of gold would be more liquid simply due to the conditions found within the market. We see a greater desire for gold given its appreciation—vs. housing, which is in a declining state. Both gold and housing are less liquid than certain financial instruments, such as government bonds. Therefore, liquidity is essentially ranked by how valuable (desirable) an asset is vs. the amount of buyers and sellers willing to trade. More information on liquid securities is provided in the textbook.
**Risk:** This concept simply means that the return expected contains some portion of unknowns. In other words, nothing is guaranteed to be 100% risk free. The percentage of expected risk affects the overall cost of the asset/investment. See the section titled “Risk Sharing” in the textbook.

References
