Monetary Economics
Financial Markets

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Readings

- Chapter 1
- Next set of notes, Chapter 2

Broad Overview

- Give you an overall impression of financial markets

Financial Markets

- Financial markets trade financial instruments
  - Instruments also are called securities
  - Securities represent claims to something now or in the future
  - Examples
    - Stocks
    - Bonds
    - Foreign exchange, which trades money, not securities
    - Derivative securities

Trading on Financial Markets

- How do financial markets work?
  - Buying and selling securities on trading floor
  - Trades arranged by telephone
  - Computer bids by buyers and offers by sellers

What Do Financial Markets Accomplish?

- Financial markets trade securities
- Those securities, when created, move funds from some people to other people

Stock Issuance

Investor

Funds

Stock

Firm building structure

Stock Trading After Issuance

- Trading stock after it is issued allows people to buy or sell claims to the future income of the firm which issued the stock
- Trading on “secondary” market

Liquid and Illiquid Instruments

- Not all financial instruments are tradeable
  - Non-marketable financial instruments
    - Deposits in financial institutions
- Not all financial instruments are liquid
  - Liquidity is the ability to quickly and inexpensively turn an asset (such as a financial instrument) into cash
    - Bonds issued by states and local governments are relatively illiquid compared to stocks
    - Houses are relatively illiquid compared to state and local governments’ bonds

Players in Financial Markets

- Individuals
- Non-financial firms
- Government
- Investment banks
- Mutual funds
- Hedge funds
- Commercial banks
- Insurance companies
- Regulators

Securitization

- Transformation of one set of financial instruments into another set of instruments
  - Example – Treasury strips
    - Income to holder comes periodically with a big payment at the end
    - Separate into securities for each periodic payment and the payment at the end
  - Example – Students loans are combined and converted into SLABS (Student Loan Asset Backed Securities)

Derivatives

- Derivatives are securities whose value is based on (derived from) other assets
  - Example – Contracts for which payments are determined by the future value of commodities, such as oil or wheat – Called futures contract
  - Example – Contracts for which payments are determined by mortgage payments made by mortgage borrowers

Summary

- Financial markets play an important role in the economy
  - Finance activities of firms
  - Investors trade risk and return of existing securities
- Financial markets
  - Trades can be accomplished many different ways
  - Almost everyone participates one way or another
- Derivative instruments have become increasingly important