

## FINANCIAL SYSTEMS AND THE GLOBAL ECONOMY (322-1)

*[The financial system is the collection of markets, institutions, laws, regulations, and techniques through which*

1. *securities are traded,*
2. *interest rates are determined, and*
3. *financial services are produced and distributed.*

*The financial system's main function is to redistribute loanable funds from savers to borrowers.]*

Obj 1. **THE CIRCULAR FLOW OF PAYMENTS AND PRODUCTION IN THE ECONOMIC SYSTEM:** **The economic system** allocates resources to produce the goods and services needed by society.

The economic system creates a circular flow of production between producing units and consuming units: **The producing units (businesses firms and governments) produce goods and services that are bought by the consuming units (households), while the consuming units provide resources (land, labor, capital, and management skill) that are used by the producing units.**

The economic system also creates a circular flow of payments between the same producing and consuming units:

**The consuming units pay the producing units for goods and services, while the producing units pay the consuming units for resources.**

The flows of production and payment move in *opposite* directions. [See Exhibit 1-1.]

Objs 2 + 3. A **market** is a mechanism for trading goods and services.

**THE GLOBAL ECONOMIC SYSTEM CONTAINS THREE TYPES OF MARKETS:**

1. **Factor markets**--distribute **resources (aka the factors of production)** from the consuming units to the producing units.
2. **Product markets**--distribute goods and services from the producing units to the consuming units.
3. **Financial markets**--distribute funds from those who save to those who borrow.

**Savings** is the amount of funds a household, business, or government retains after it has made all its current expenditures. If income exceeds expenditures, there will be savings.

**Investment** is expenditure on capital goods and inventories for the purpose of increasing *future* production and income.

**Businesses invest in** capital goods and inventories.

**Households invest in** durable goods (homes, automobiles, furniture).

**Governments invest in** public facilities (buildings, highways).

Those who want to invest do *not* always have sufficient savings to do so.

**The financial market transforms savings into investment by** letting investors borrow savings. Investors get funds to invest, and savers receive financial claims (promises of interest, dividends, rents and royalties) on the funds they loan.

Obj 4. **THE FINANCIAL SYSTEM'S SEVEN BASIC FUNCTIONS:**

1. **Savings function**--The financial system puts savings to work with little risk but with potential profit to savers.
2. **Wealth function**--The financial system stores wealth as financial instruments (stocks, bonds) until they are needed for consumption.

**Wealth** is the sum of all assets held by an economic unit.

**Net financial wealth** is the sum of all assets held by an economic unit minus all debts owed.

Savings add to an economic unit's wealth.

3. **Liquidity function**--The financial system allows investors to raise investment funds by converting financial assets (stocks, bonds) into cash. **Liquidity** expresses how easily an asset may be converted into cash within a short time period and a small price range.
4. **Credit function**--The financial system supplies credit to support both consumption and investment spending.  
**Credit** is the loan of funds in exchange for the promise of future repayment.
5. **Payments function**--The financial system allows consumers to buy goods and services from around the world. Credit cards and electronic payments are common methods of making payments to distant producing units.
6. **Risk function**--The financial system produces and sells risk-protection services to households, businesses, and governments. The main risk-protection service is insurance, but the financial system also allows economic units to self-insure by storing wealth against future losses.
7. **Policy function**--The financial system provides a means for government policy to achieve high employment, low inflation, and controlled economic growth.  
The government manipulates interest rates and credit availability to stabilize the economy.

Objs 5 + 6. **NINE TYPES OF FINANCIAL MARKETS IN THE GLOBAL FINANCIAL SYSTEM:**

1. **Money market**--facilitates short-term loans between those with temporary savings and those with temporary shortages or funds. Money market loans and securities mature within one year.  
**THE MOST COMMON LENDERS** are commercial banks and nonfinancial businesses with temporary savings.  
**THE LARGEST BORROWER** is the US Treasury Department. Other major borrowers include other governments (within their own domestic markets), large corporations, and securities dealers. Subdivisions of the money market specialize in different money market instruments, including the Treasury bill market, the **CD** (certificate of deposit) market (the largest segment), the bankers' acceptances market, the commercial paper market, the federal funds market, and the Eurocurrency market.
2. **Capital market**--facilitates long-term loans between those with long-term savings and those wishing to make long-term investments. Capital loans mature after at least one year.  
**THE MOST COMMON LENDERS** are financial institutions (insurers, mutual funds, securities dealers, and pension funds).  
**THE MOST COMMON BORROWERS** are businesses, which borrow funds to buy equipment and build facilities, but households and governments also tap the capital market. Subdivisions of the capital market specialize in mortgage loans, tax-exempt (municipal) bonds, consumer loans, Eurobonds, Euronotes, corporate stock, corporate notes, and corporate bonds.
3. **Open market**--makes loans and trades securities to any individual or institution.
4. **Negotiated market**--makes loans and trades securities through direct bargaining and private contracts.
5. **Primary market**--trades newly issued loans and securities. Economic units use the primary market to raise money for investment in buildings, equipment, and inventories: Businesses sell newly issued stocks; households take out mortgages to buy homes.
6. **Secondary market**--trades or exchanges loans and securities that have already been issued. Economic units use the secondary market to increase liquidity: Stockholders sell their stocks for cash; savers convert their cash into previously issued bonds.
7. **Spot market**--trades securities and financial services for immediate delivery (1 - 2 business days).
8. **Futures or forwards market**--trades contracts calling for future delivery of financial instruments at currently agreed-upon prices.
9. **Option market**--trades contracts that give investors the right to buy or sell designated securities to option writers at guaranteed prices at any time during the lives of those contracts.

*[The US savings rate is currently -- and has been over the past few decades -- one of the lowest in the world.*

**Three reasons for our low savings rate:**

1. ***the rising number of young workers in the US--Young workers spend more, borrow more, and save less.***
2. ***changing public attitudes toward savings--Younger generations expect prosperity and low unemployment.***
3. ***availability of retirement income--Social Security and Medicare promise a minimum level of retirement income and services, which encourages wage-earners to spend rather than save.]***

***[The US government can encourage a higher national savings rate by***

1. *reducing taxes on personal income and business profit,*
2. *stabilizing the economy,*
3. *avoiding inflation, and*
4. *establishing regulations that promote safer financial institutions.]*

Obj 7. **THREE FACTORS TIE ALL FINANCIAL MARKETS TOGETHER:**

1. **Credit**--Almost all financial markets trade credit. Borrowers constantly seek lower interest rates, helping to bring credit costs in different markets into balance.
2. **Speculation**--Speculators try to outguess the market by forecasting future market developments and then buying what they believe are underpriced securities and selling what they believe are overpriced securities.  
By constantly seeking to maximize profit, speculators level out the prices of securities.
3. **Arbitrage--Arbitrageurs** transfer funds from one market to another whenever securities prices between markets are out of line.  
By constantly seeking better prices in other markets, arbitrageurs help to maintain consistent prices among markets.