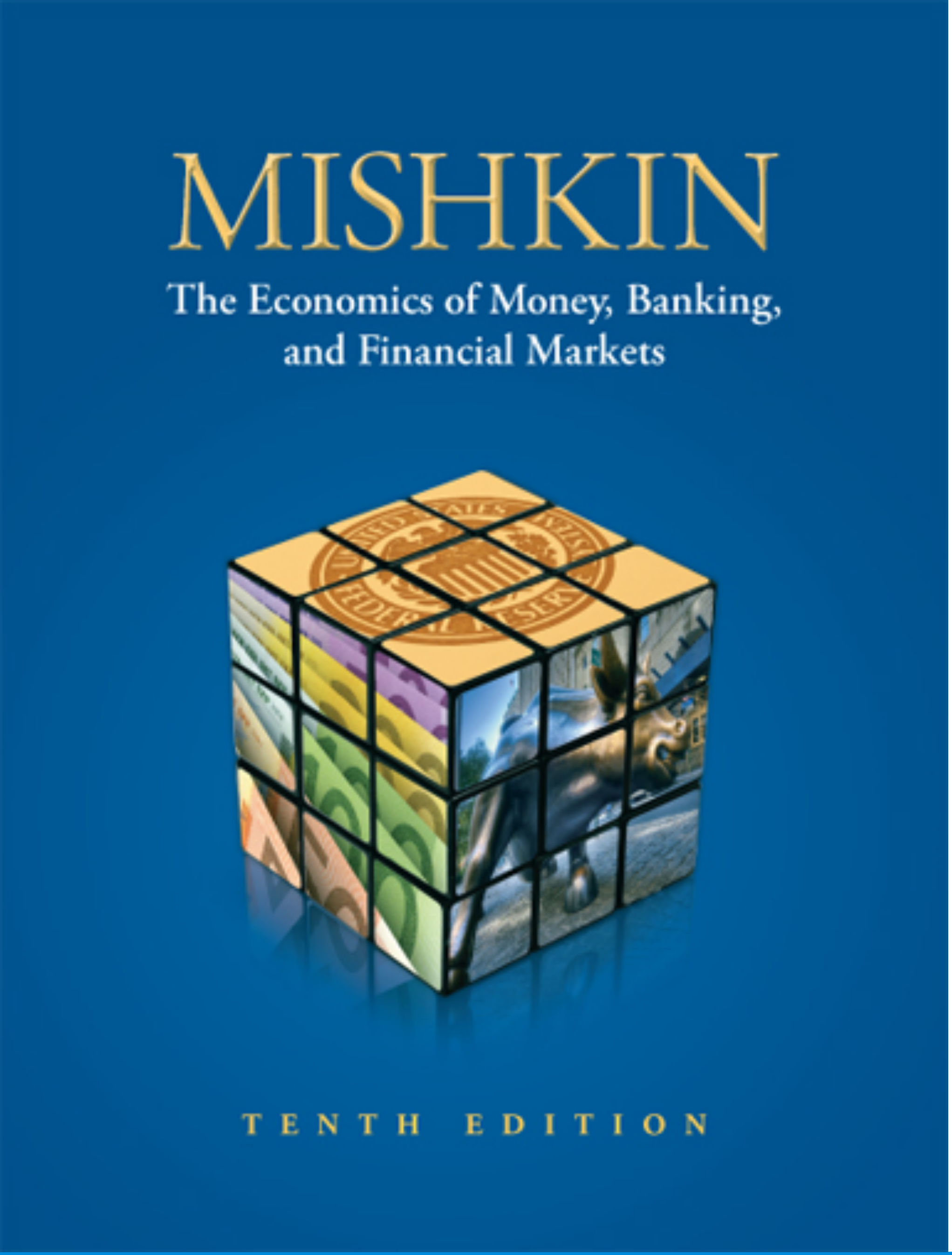


Chapter 2

An Overview of the Financial System

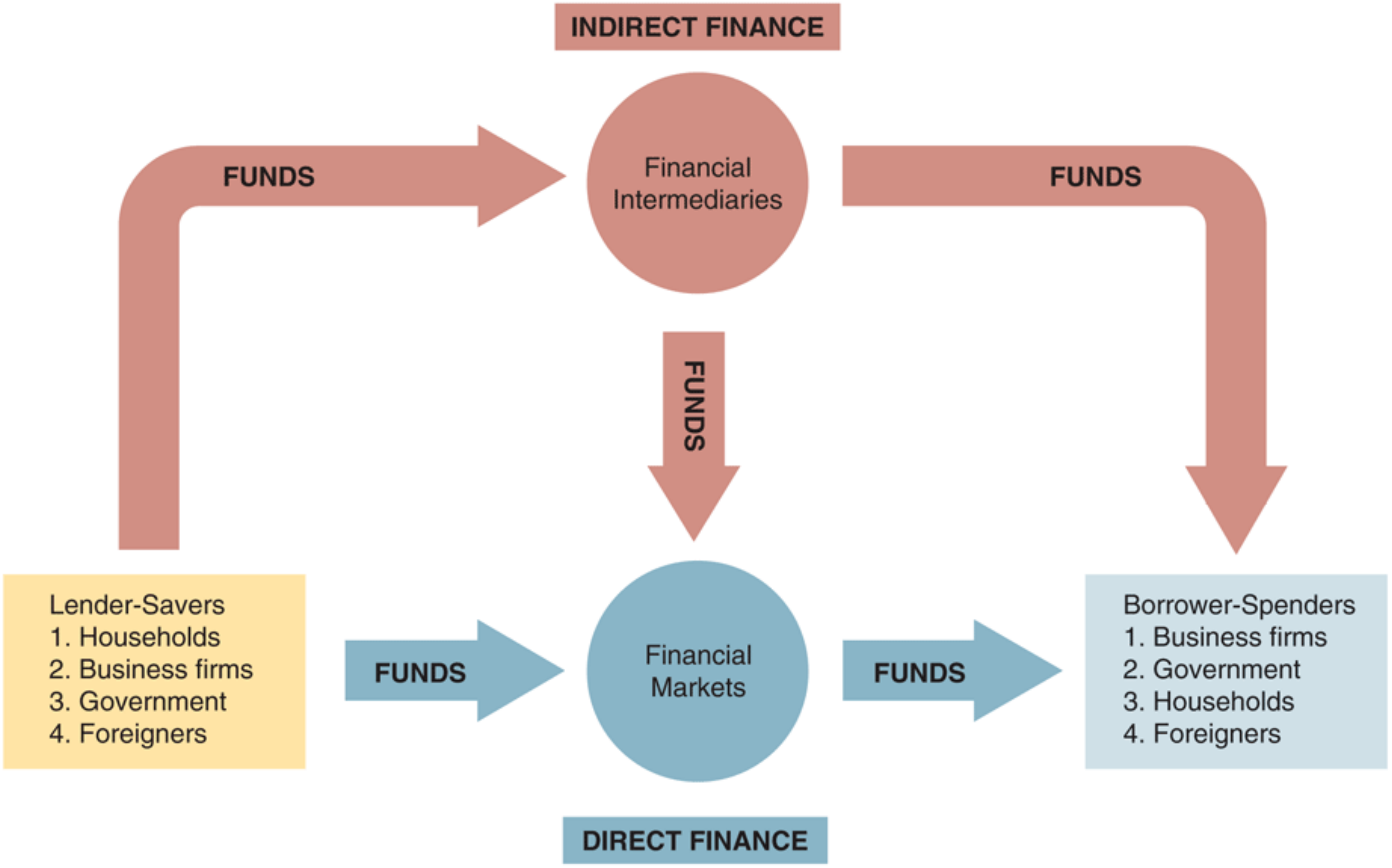
Function of Financial Markets

- Perform the essential function of channeling funds from economic players that have saved surplus funds to those that have a shortage of funds
- Direct finance: borrowers borrow funds directly from lenders in financial markets by selling them securities

Function of Financial Markets (cont'd)

- Promotes economic efficiency by producing an efficient allocation of capital, which increases production
- Directly improve the well-being of consumers by allowing them to time purchases better

Figure 1 Flows of Funds Through the Financial System



Structure of Financial Markets

- Debt and Equity Markets
  - Debt instruments (maturity)
  - Equities (dividends)
- Primary and Secondary Markets
  - Investment Banks *underwrite* securities in primary markets
  - Brokers and dealers work in secondary markets

Structure of Financial Markets (cont'd)

- Exchanges and Over-the-Counter (OTC) Markets
  - Exchanges: NYSE, Chicago Board of Trade
  - OTC Markets: Foreign exchange, Federal funds
- Money and Capital Markets
  - Money markets deal in short-term debt instruments
  - Capital markets deal in longer-term debt and equity instruments

Table 1 Principal Money Market Instruments

Principal Money Market Instruments

Type of Instrument	Amount Outstanding ($ billions, end of year) 1980	1990	2000	2010
U.S. Treasury bills	216	527	647	1,773
Negotiable bank certificates of deposit (large denominations)	317	543	1,053	1,833
Commercial paper	122	557	1,619	1,057
Federal funds and security repurchase agreements	64	388	768	1,234

Source: Federal Reserve Flow of Funds Accounts; www.federalreserve.gov.

Table 2 Principal Capital Market Instruments

Principal Capital Market Instruments

Type of Instrument	Amount Outstanding ($ billions, end of year) 1980	1990	2000	2010
Corporate stocks (market value)	1,601	4,146	17,627	17,189
Residential mortgages	1,106	2,886	5,463	9,436
Corporate bonds	366	1,008	2,230	2,983
U.S. government securities (marketable long-term)	407	1,653	2,184	2,803
U.S. government agency securities	193	435	1,616	6,158
State and local government bonds	310	870	1,192	1,807
Bank commercial loans	459	818	1,091	1,031
Consumer loans	355	813	536	710
Commercial and farm mortgages	352	829	1,214	1,919

Source: Federal Reserve Flow of Funds Accounts; www.federalreserve.gov.

Internationalization of Financial Markets

- **Foreign Bonds**: sold in a foreign country and denominated in that country's currency
- **Eurobond**: bond denominated in a currency other than that of the country in which it is sold
- **Eurocurrencies**: foreign currencies deposited in banks outside the home country
  - Eurodollars: U.S. dollars deposited in foreign banks outside the U.S. or in foreign branches of U.S. banks
- World Stock Markets
  - Also help finance the federal government

PEARSON

Function of Financial Intermediaries: Indirect Finance

- Lower transaction costs (time and money spent in carrying out financial transactions)
  - Economies of scale
  - Liquidity services
- Reduce the exposure of investors to risk
  - Risk Sharing (Asset Transformation)
  - Diversification

Function of Financial Intermediaries: Indirect Finance (cont'd)

- Deal with asymmetric information problems
  - (before the transaction) Adverse Selection: try to avoid selecting the risky borrower.
    - Gather information about potential borrower.
  - (after the transaction) Moral Hazard: ensure borrower will not engage in activities that will prevent him/her to repay the loan.
    - Sign a contract with restrictive covenants.

PEARSON

Function of Financial Intermediaries: Indirect Finance (cont'd)

- Conclusion:
  - Financial intermediaries allow "small" savers and borrowers to benefit from the existence of financial markets.

Table 3 Primary Assets and Liabilities of Financial Intermediaries

Primary Assets and Liabilities of Financial Intermediaries

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository institutions (banks)		
Commercial banks	Deposits	Business and consumer loans, mortgages, U.S. government securities, and municipal bonds
Savings and loan associations	Deposits	Mortgages
Mutual savings banks	Deposits	Mortgages
Credit unions	Deposits	Consumer loans
Contractual savings institutions		
Life insurance companies	Premiums from policies	Corporate bonds and mortgages
Fire and casualty insurance companies	Premiums from policies	Municipal bonds, corporate bonds and stock, and U.S. government securities
Pension funds, government retirement funds	Employer and employee contributions	Corporate bonds and stock
Investment intermediaries		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

Table 4 Principal Financial Intermediaries and Value of Their Assets

Primary Financial Intermediaries and Value of Their Assets

Type of Intermediary	1980	1990	2000	2010
	Value of Assets ($ billions, end of year)			
Depository institutions (banks)				
Commercial banks	1,481	3,334	6,469	14,336
Savings and loan associations and mutual savings banks	792	1,365	1,218	1,244
Credit unions	67	215	441	912
Contractual savings institutions				
Life insurance companies	464	1,367	3,136	5,176
Fire and casualty insurance companies	182	533	862	1,242
Pension funds (private)	504	1,629	4,355	4,527
State and local government retirement funds	197	737	2,293	2,661
Investment intermediaries				
Finance companies	205	610	1,140	1,439
Mutual funds	70	654	4,435	7,935
Money market mutual funds	76	498	1,812	2,755

Source: Federal Reserve Flow of Funds Accounts; www.federalreserve.gov/releases/Z1/.

PEARSON

Regulation of the Financial System

- To increase the information available to investors:
  - Reduce adverse selection and moral hazard problems
  - Reduce insider trading (SEC).

Regulation of the Financial System (cont'd)

- To ensure the soundness of financial intermediaries:
  - Restrictions on entry (chartering process).
  - Disclosure of information.
  - Restrictions on Assets and Activities (control holding of risky assets).
  - Deposit Insurance (avoid bank runs).
  - Limits on Competition (mostly in the past):
    - Branching
    - Restrictions on Interest Rates

Table 5 Principal Regulatory Agencies of the U.S. Financial System

Principal Regulatory Agencies of the U.S. Financial System

Regulatory Agency	Subject of Regulation	Nature of Regulations
Securities and Exchange Commission (SEC)	Organized exchanges and financial markets	Requires disclosure of information, restricts insider trading
Commodities Futures Trading Commission (CFTC)	Futures market exchanges	Regulates procedures for trading in futures markets
Office of the Comptroller of the Currency	Federally chartered commercial banks	Charters and examines the books of federally chartered commercial banks and imposes restrictions on assets they can hold
National Credit Union Administration (NCUA)	Federally chartered credit unions	Charters and examines the books of federally chartered credit unions and imposes restrictions on assets they can hold
State banking and insurance commissions	State-chartered depository institutions	Charter and examine the books of state-chartered banks and insurance companies, impose restrictions on assets they can hold, and impose restrictions on branching
Federal Deposit Insurance Corporation (FDIC)	Commercial banks, mutual savings banks, savings and loan associations	Provides insurance of up to $250,000 for each depositor at a bank, examines the books of insured banks, and imposes restrictions on assets they can hold
Federal Reserve System	All depository institutions	Examines the books of commercial banks that are members of the system, sets reserve requirements for all banks
Office of Thrift Supervision	Savings and loan associations	Examines the books of savings and loan associations, imposes restrictions on assets they can hold

PEARSON