Financial markets and institutions of the financial market

FINANCIAL MARKETS

Businesses, individuals, and governments often need to raise capital. On the other hand, some individuals and firms have incomes that are greater than their current expenditures, so they have funds available to invest.

TYPES OF MARKETS

People and organizations wanting to borrow money are brought together with those having surplus funds in the financial markets. Note that “markets” is plural —there are a great many different financial markets in a developed economy such as ours. Each market deals with a somewhat different type of instrument in terms of the instrument’s maturity and the assets backing it. Also, different markets serve different types of customers, or operate in different parts of the country. For these reasons it is often useful to classify markets along various dimensions:

1. **Physical asset vs. Financial asset markets.** Physical asset markets (also called “tangible” or “real” asset markets) are those for such products as wheat, autos, real estate, computers, and machinery. Financial asset markets, on the other hand, deal with stocks, bonds, notes, mortgages, and other claims on real assets, as well as with derivative securities whose values are derived from changes in the prices of other assets.

2. **Spot vs. Futures markets.** Spot markets are markets in which assets are bought or sold for “on-the-spot” delivery (literally, within a few days). Futures markets are markets in which participants agree today to buy or sell an asset at some future date. For example, a farmer may enter into a futures contract in which he agrees today to sell 5,000 bushels of soybeans six months from now at a price of $5 a bushel. In contrast, an international food producer looking to buy soybeans in the future may enter into a futures contract in which it agrees to buy soybeans three months from now.

3. **Money vs. Capital markets.** Money markets are the markets for short-term, highly liquid debt securities. The New York and London Money markets have long been the world’s largest, but Tokyo is rising rapidly. Capital markets are the markets for intermediate- or long-term debt and corporate stocks. The New York Stock Exchange, where the stocks of the largest U.S. corporations are traded, is a prime example of a capital market. There is no hard and fast rule on this, but when describing debt markets, “short term” generally means less than one year, “intermediate term” means one to five years, and “long term” means more than five years.

4. **Primary vs. Secondary markets.** Primary markets are the markets in which corporations raise new capital. If Microsoft were to sell a new issue of common stock to raise capital, this would be a primary market transaction. The corporation selling
the newly created stock receives the proceeds from the sale in a primary market transaction. Secondary markets are markets in which existing, already outstanding, securities are traded among investors. Thus, if Jane Doe decided to buy 1,000 shares of AT&T stock, the purchase would occur in the secondary market. The New York Stock Exchange is a secondary market, since it deals in outstanding, as opposed to newly issued, stocks and bonds. Secondary markets also exist for mortgages, various other types of loans, and other financial assets. The corporation whose securities are being traded is not involved in a secondary market transaction and, thus, does not receive any funds from such a sale. **The initial public offering (IPO) market** is a subset of the primary market. Here firms “go public” by offering shares to the public for the first time. Microsoft had its IPO in 1986. Previously, Bill Gates and other insiders owned all the shares. In many IPOs, the insiders sell some of their shares plus the company sells new shares to raise additional capital.

5. **Private vs. Public markets.** Private markets, where transactions are worked out directly between two parties, are differentiated from public markets, where standardized contracts are traded on organized exchanges. Bank loans and private placements of debt with insurance companies are examples of private market transactions. Since these transactions are private, they may be structured in any manner that appeals to the two parties. By contrast, securities that are issued in public markets (for example, common stock and corporate bonds) are ultimately held by a large number of individuals. Public securities must have fairly standardized contractual features, both to appeal to a broad range of investors and also because public investors cannot afford the time to study unique, nonstandardized contracts. Their diverse ownership also ensures that public securities are relatively liquid. Private market securities are, therefore, more tailor-made but less liquid, whereas public market securities are more liquid but subject to greater standardization.

A healthy economy is dependent on efficient transfers of funds from people who are net savers to firms and individuals who need capital. Without efficient transfers, the economy simply could not function: Carolina Power & Light could not raise capital, so Raleigh’s citizens would have no electricity; the Johnson family would not have adequate housing; Carol Hawk would have no place to invest her savings; and so on. Obviously, the level of employment and productivity, hence our standard of living, would be much lower. Therefore, it is absolutely essential that our financial markets function efficiently—not only quickly, but also at a low cost.

**RECENT TRENDS**

Financial markets have experienced many changes during the last two decades. **Technological advances** in computers and telecommunications, along with the **globalization of banking and commerce**, have led to **deregulation**, and this has **increased competition** throughout the world. The result is a much more efficient, internationally linked market, but one that is far more complex than existed a few years ago. While these developments have been largely positive, they have also created problems for policy makers. At a recent conference, Federal Reserve Board Chairman Alan Greenspan stated that modern financial
markets “expose national economies to shocks from new and unexpected sources, and with little if any lag.” He went on to say that central banks must develop new ways to evaluate and limit risks to the financial system. Large amounts of capital move quickly around the world in response to changes in interest and exchange rates, and these movements can disrupt local institutions and economies.

With globalization has come the need for greater cooperation among regulators at the international level. Various committees are currently working to improve coordination, but the task is not easy. Factors that complicate coordination include (1) the differing structures among nations’ banking and securities industries, (2) the trend in Europe toward financial service conglomerates, and (3) a reluctance on the part of individual countries to give up control over their national monetary policies. Still, regulators are unanimous about the need to close the gaps in the supervision of worldwide markets.

Another important trend in recent years has been the increased use of derivatives. A derivative is any security whose value is derived from the price of some other “underlying” asset. An option to buy IBM stock is a derivative, as is a contract to buy Japanese yen six months from now. The value of the IBM option depends on the price of IBM’s stock, and the value of the Japanese yen “future” depends on the exchange rate between yen and dollars. The market for derivatives has grown faster than any other market in recent years, providing corporations with new opportunities but also exposing them to new risks.

**Derivatives can be used either to reduce risks or to speculate.** Suppose an importer’s net income tends to fall whenever the dollar falls relative to the yen. That company could reduce its risk by purchasing derivatives that increase in value whenever the dollar declines. This would be called a **hedging operation**, and its purpose is to reduce risk exposure. Speculation, on the other hand, is done in the hope of high returns, but it raises risk exposure. For example, Procter & Gamble recently disclosed that it lost $150 million on derivative investments, and Orange County (California) went bankrupt as a result of its treasurer’s speculation in derivatives.

The size and complexity of derivatives transactions concern regulators, academics, and members of Congress. Fed Chairman Greenspan noted that, in theory, derivatives should allow companies to manage risk better, but that it is not clear whether recent innovations have “increased or decreased the inherent stability of the financial system.”
FINANCIAL INSTITUTIONS

Transfers of capital between savers and those who need capital take place in the three different ways diagrammed in Figure 1:

1. **Direct transfers** of money and securities, as shown in the top section, occur when a business sells its stocks or bonds directly to savers, without going through any type of financial institution. The business delivers its securities to savers, who in turn give the firm the money it needs.

2. As shown in the middle section, transfers may also go through an **investment banking house** such as Merrill Lynch, which underwrites the issue. An underwriter serves as a middleman and facilitates the issuance of securities. The company sells its stocks or bonds to the investment bank, which in turn sells these same securities to savers. The businesses’ securities and the savers’ money merely “pass through” the investment banking house. However, the investment bank does buy and hold the securities for a period of time, so it is taking a risk—it may not be able to resell them to savers for as much as it paid. Because new securities are involved and the corporation receives the proceeds of the sale, this is a primary market transaction.

3. Transfers can also be made through a **financial intermediary** such as a bank or mutual fund. Here the intermediary obtains funds from savers in exchange for its own securities. The intermediary then uses this money to purchase and then hold businesses’ securities. For example, a saver might give dollars to a bank, receiving from it a certificate of deposit, and then the bank might lend the money to a small business in the form of a mortgage loan. Thus, intermediaries literally create new forms of capital—in this case, certificates of deposit, which are both safer and more liquid than mortgages and thus are better securities for most savers to hold. The existence of intermediaries greatly increases the efficiency of money and capital markets.

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**Figure 1: Diagram of the Capital Formation Process**
Notes:

Investment Banking House - An organization that underwrites and distributes new investment securities and helps businesses obtain financing.

Financial Intermediaries - Specialized financial firms that facilitate the transfer of funds from savers to demanders of capital.

In the United States and other developed nations, a set of specialized, highly efficient financial intermediaries has evolved. The situation is changing rapidly, however, and different types of institutions are performing services that were formerly reserved for others, causing institutional distinctions to become blurred. Still, there is a degree of institutional identity, and here are the major classes of intermediaries:

1. **Commercial banks**, the traditional “department stores of finance,” serve a wide variety of savers and borrowers. Historically, commercial banks were the major institutions that handled checking accounts and through which the Federal Reserve System expanded or contracted the money supply. Today, however, several other institutions also provide checking services and significantly influence the money supply. Conversely, commercial banks are providing an ever-widening range of services, including stock brokerage services and insurance.

2. **Savings and loan associations (S&Ls)**, which have traditionally served individual savers and residential and commercial mortgage borrowers, take the funds of many small savers and then lend this money to home buyers and other types of borrowers. In the 1980s, the S&L industry experienced severe problems when short-term interest rates paid on savings accounts rose well above the returns being earned on the existing mortgages held by S&Ls and (2) commercial real estate suffered a severe slump, resulting in high mortgage default rates. Together, these events forced many S&Ls to either merge with stronger institutions or close their doors.

3. **Mutual savings banks**, which are similar to S&Ls, operate primarily in the northeastern states, accept savings primarily from individuals, and lend mainly on a long-term basis to home buyers and consumers.

4. **Credit unions** are cooperative associations whose members are supposed to have a common bond, such as being employees of the same firm. Members’ savings are loaned only to other members, generally for auto purchases, home improvement loans, and home mortgages. Credit unions are often the cheapest source of funds available to individual borrowers.

5. Pension funds are retirement plans funded by corporations or government agencies for their workers and administered primarily by the trust departments of commercial banks or by life insurance companies. Pension funds invest primarily in bonds, stocks, mortgages, and real estate.

6. Life insurance companies take savings in the form of annual premiums; invest these funds in stocks, bonds, real estate, and mortgages; and finally make payments to the beneficiaries of the insured parties. In recent years, life insurance companies have also offered a variety of tax-deferred savings plans designed to provide benefits to the participants when they retire.

7. Mutual funds are corporations that accept money from savers and then use these funds to buy stocks, long-term bonds, or short-term debt instruments issued by businesses or government units. These organizations pool funds and thus reduce risks by diversification.
They also achieve economies of scale in analyzing securities, managing portfolios, and buying and selling securities. Different funds are designed to meet the objectives of different types of savers. Hence, there are bond funds for those who desire safety, stock funds for savers who are willing to accept significant risks in the hope of higher returns, and still other funds that are used as interest-bearing checking accounts (the money market funds). There are literally thousands of different mutual funds with dozens of different goals and purposes.

**Money Market Fund** - A mutual fund that invests in short-term, low-risk securities and allows investors to write checks against their accounts.

Mutual funds have grown more rapidly than any other institution in recent years, in large part because of a change in the way corporations provide for employees’ retirement. Most workers know they don’t know how to invest wisely, so they turn their retirement funds over to a mutual fund. Hence, mutual funds are growing rapidly. Excellent information on the objectives and past performances of the various funds are provided in publications such as *Value Line Investment Survey* and *Morningstar Mutual Funds*, which are available in most libraries.

The result of the ongoing regulatory changes has been a blurring of the distinctions between the different types of institutions. Indeed, the trend in the United States today is toward huge **financial service corporations**

**Financial Service Corporation** - A firm that offers a wide range of financial services, including investment banking, brokerage operations, insurance, and commercial banking.

Literature: