

Finance 4000

Money and Capital Markets

Ninth class

- Financial Structure of Economies
  - Why are financial contracts written as they are?
  - Why do more funds flow to borrowers from financial intermediaries than from financial markets?
  - Why do financial crises occur and why do they matter?

- Basic Aspects of Financial Markets
  - Transactions costs
    - Transactions costs are costs of buying or selling something or assessing the quality of the good
  - Risk
    - Risk is the chance of danger, loss or injury or other adverse consequences
  - Asymmetric information
    - Asymmetric information is an inequality of information in which one party to a transaction has information about himself or herself that the other party does not have
    - Adverse selection occurs when those least desirable from the point of view of party making loan or insurance are the ones attracted by the offered contract
    - Moral hazard is the set of actions taken because a person has a loan, contract or insurance

- Observations about financial aspects of economies
  - Loans from financial intermediaries are the most important source of external financing for businesses
    - Issuing stock is not the most important source of external financing for businesses
    - Issuing marketable debt and equity securities is not the most important source of external financing for businesses
    - Direct finance, in which borrowers deal directly with savers, is relatively unimportant
    - Banks are the largest single source of external financing for businesses
    - Only relatively large, established firms obtain external financing through financial markets
  - Financial markets and intermediaries are heavily regulated
  - Debt contracts often involve collateral and restrictive covenants

- Transactions costs
  - explain why savers use financial intermediaries to allocate their saving
    - Actual payments necessary to buy and sell
    - Economies of scale in payments and diversifying
  
- Tools to help reduce costs associated with adverse selection
  - Government regulation
  - Private production and sale of information
  - Financial intermediation
  - Restrictions on behavior of recipient of funds
    - Collateral
    - Restrictive covenants

- Tools to reduce costs associated with moral hazard
  - Government regulation to increase information
  - Contractual restrictions
  - Monitoring
    - Financial intermediaries

- Financial crises
  - Large decreases in the prices of assets associated with failures of nonfinancial and financial firms
  - Causes of financial crises
    - Increases in interest rates
    - Increases in uncertainty
    - Asset market effects on balance sheets
      - Really effect of decrease in asset values

- Banking panics
  - Run on banking system
  - Sudden withdrawal of a substantial amount of deposits by many depositors
  - If worried that a bank will not be able to pay everyone, get there first
  - Not necessarily *panic* in the sense of unreasoning fear
  - If worried that others will run on the bank, get there first
  - Problem of liquidity versus solvency
  - Disruption of financial arrangements
  - Decrease in the money supply
    - Spending
    - Employment and output

- Banking panics are part of the reason that banks are heavily regulated
  - Depression
  - Historically, many different rules applied to banks
    - Asymmetric information between depositors and banks