Chapter 2
Overview of the Financial System

Function of Financial Markets

Structure of Financial Markets

- Debt and Equity Markets
- Primary and Secondary Markets
- Exchanges and Over-the-Counter Markets
- Money and Capital Markets

Internationalization of Financial Markets

- International Bond Market, Eurobonds, and Eurocurrencies
  - Global Box: Are U.S. Capital Markets Losing Their Edge?
- World Stock Markets

Function of Financial Intermediaries: Indirect Finance

- Transaction Costs
  - *Following the Financial News*: Foreign Stock Market Indexes
  - Global Box: The Importance of Financial Intermediaries Relative to Securities Markets: An International Comparison
- Risk Sharing
- Asymmetric Information: Adverse Selection and Moral Hazard
- Economies of Scope and Conflicts of Interest

Types of Financial Intermediaries

- Depository Institutions
- Contractual Savings Institutions
- Investment Intermediaries

Regulation of the Financial System

- Increasing Information Available to Investors
- Ensuring the Soundness of Financial Intermediaries
- Financial Regulation Abroad

■ Overview and Teaching Tips

Chapter 2 is an introductory chapter that contains the background information on the structure and operation of financial markets that is needed in later chapters of the book. This chapter allows the instructor to branch out to various choices of later chapters, thus allowing different degrees of coverage of financial markets and institutions.

The most important point to transmit to the student is that financial markets and financial intermediaries are crucial to a well-functioning economy because they channel funds from those who do not have a productive use for them to those who do. Some instructors will want to teach this chapter in detail, and those who focus on international issues will want to spend some time on the section "Internationalization of Financial Markets." However, those who slant their course to public policy issues may want to give this chapter a more cursory treatment. No matter how much class time is devoted to this chapter, We have found that it is a good reference chapter for students. You might want to tell them that if in later chapters they do not recall what particular financial intermediaries do and who regulates them, they can refer back to this chapter, especially to tables, such as Tables 2.1 and 2.3.

■ Answers to End-of-Chapter Questions

1. Examples of how financial markets allow consumers to better time their purchases include:

   - The purchase of a durable good, like a car or furniture.
   - Paying for tuition.
   - Paying the cost of repairing a flooded basement.

   In all three cases, consumers were able to pay for a good or service (education or the reparation of a flooded basement) without having to wait to save enough and only then being able to afford such goods and services.

2. Yes, I should take out the loan, because I will be better off as a result of doing so. My interest payment will be $4,500 (90% of $5,000), but as a result, I will earn an additional $10,000, so I will be ahead of the game by $5,500. Since Larry's loan-sharking business can make some people better off, as in this example, loan sharking may have social benefits. (One argument against legalizing loan sharking, however, is that it is frequently a violent activity.)

3. Yes, because the absence of financial markets means that funds cannot be channeled to people who have the most productive use for them. Entrepreneurs then cannot acquire funds to set up businesses that would help the economy grow rapidly.

4. The principal debt instruments used were foreign bonds which were sold in Britain and denominated in pounds. The British gained because they were able to earn higher interest rates as a result of lending to Americans, while the Americans gained because they now had access to capital to start up profitable businesses such as railroads.

5. If the Yen denominated bond is sold in Tokyo, then it is not considered a Eurobond. If the bond is sold in New York, then it is considered a Eurobond.

6. You would rather hold bonds, because bondholders are paid off before equity holders, who are the residual claimants.

7. Because you know your family member better than a stranger, you know more about the borrower's honesty, propensity for risk taking, and other traits. There is less asymmetric information than with a stranger and less likelihood of an adverse selection problem, with the result that you are more likely to lend to the family member.

8. Maria cannot participate in a hedge fund since this type of mutual fund requires minimum contributions of $100.000 and sometimes more. This type of financial intermediary is targeted to specific savers that have a less cautious perception of risks, using the collected funds to buy assets that are earn high returns, but are quite risky.

9. Loan sharks can threaten their borrowers with bodily harm if borrowers take actions that might jeopardize paying off the loan. Hence borrowers from a loan shark are less likely to engage in moral hazard.

10. They might not work hard enough while you are not looking or may steal or commit fraud.

11. Yes, because eliminating moral hazard requires enforcement even if there is no information asymmetry. Even if you know that a borrower is taking actions that might jeopardize paying off the loan, you must still stop the borrower from doing so. Because that may be costly, you may not spend the time and effort to reduce moral hazard, and so moral hazard remains a problem.

12. True. If there are no information or transaction costs, people could make loans to each other at no cost and would thus have no need for financial intermediaries.

13. Because the costs of making the loan to your neighbor are high (legal fees, fees for a credit check, and so on), you will probably not be able to earn 5% on the loan after your expenses even though it has a 10% interest rate. You are better off depositing your savings with a financial intermediary and earning 5% interest. In addition, you are likely to bear less risk by depositing your savings at the bank rather than lending them to your neighbor.

14. Financial intermediaries benefit because they can earn profits on the spreads between the returns they earn on risky assets and they payments they make on the assets they have sold. Households and firms benefit because they can now own assets that have lower risk.

15. This is a topic for which there is no clear answer. On one side, it would be beneficial to have financial regulations that are identical in all countries to avoid financial markets participants to migrate their business to countries with fewer regulations. On the other side, all countries are different and designing a common set of financial regulations seems to be a rather difficult task. Most countries would want to maintain at least part of their regulations, so consensus is difficult to reach.