THE FINANCIAL SYSTEM

Brief intro

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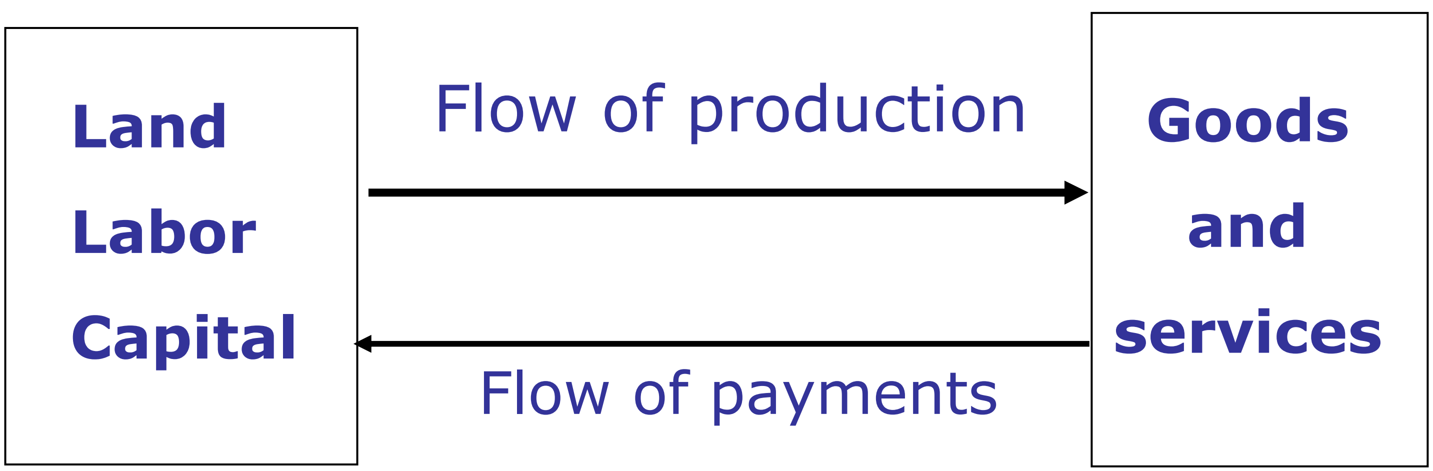
Content

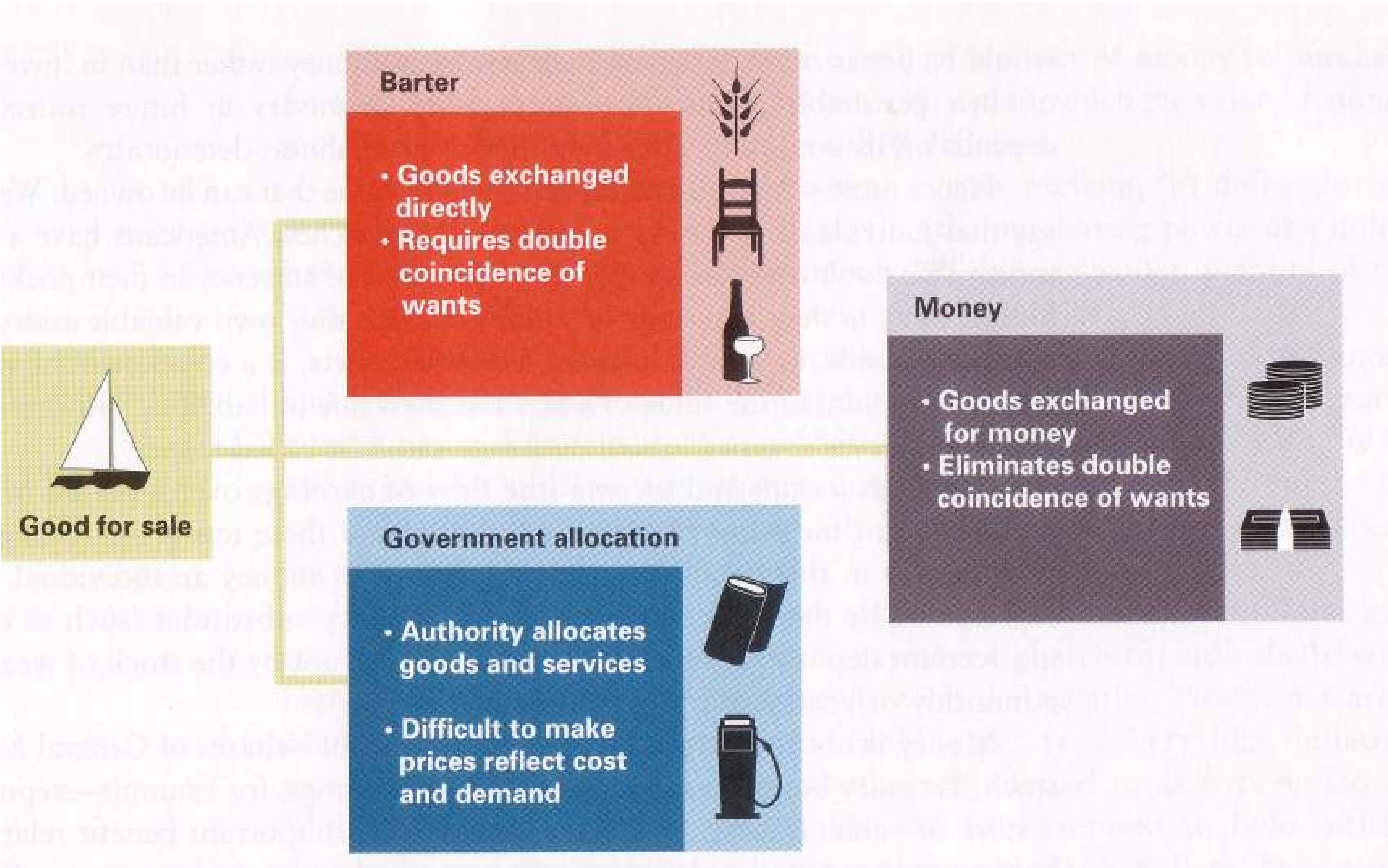
1.The Economy System

The basic function of any economy is to allocate scarce resources. The Economic System must combine inputs - land and other natural resources, labor and capital equipment - in order to produce outputs – in the form of goods and services.

The Economic System
The economy generates a flow of production in return for a flow of payments.



Methods of Exchange



Money

- Money is anything that someone is willing to accept in payment for goods and services or to pay off debts.

1.The Economy System

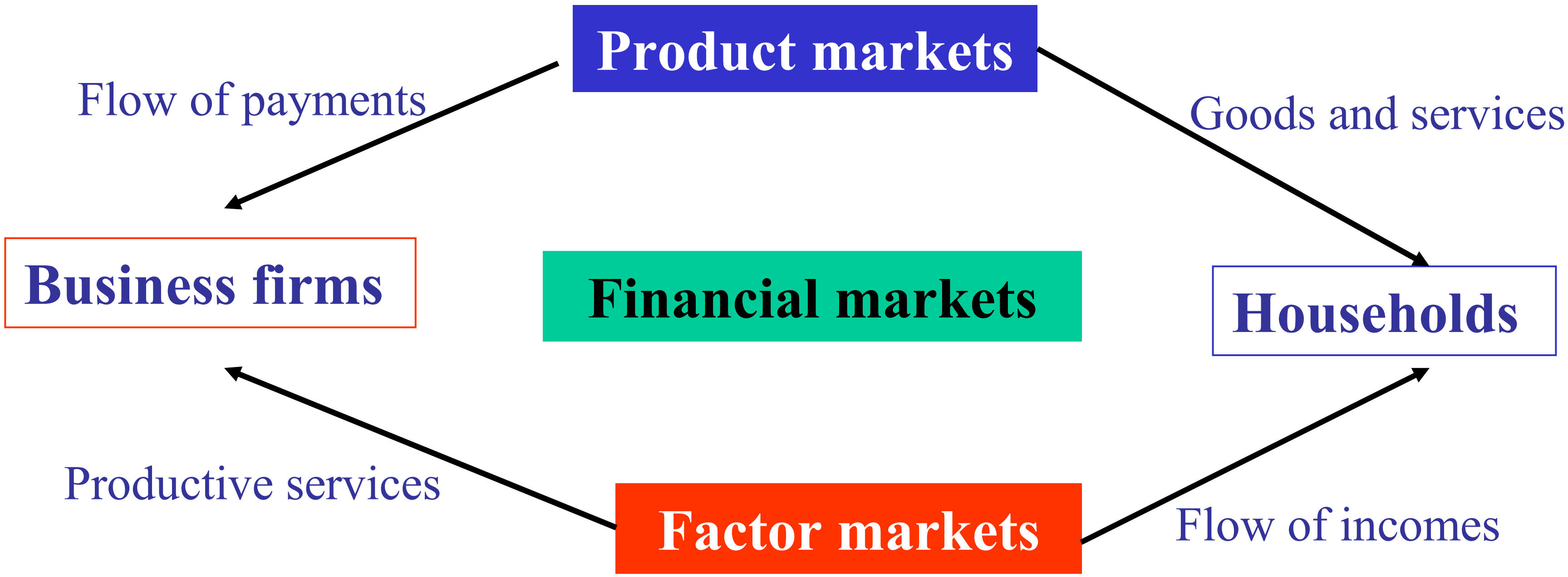
- The Czech Economy system :

- Economic growth is above average,
- Inflation is low,
- The Czech currency is stable,
- Investments are flowing into the country,
- Low unemployment,
- Public sector debts.

Role of Markets in the Economic System

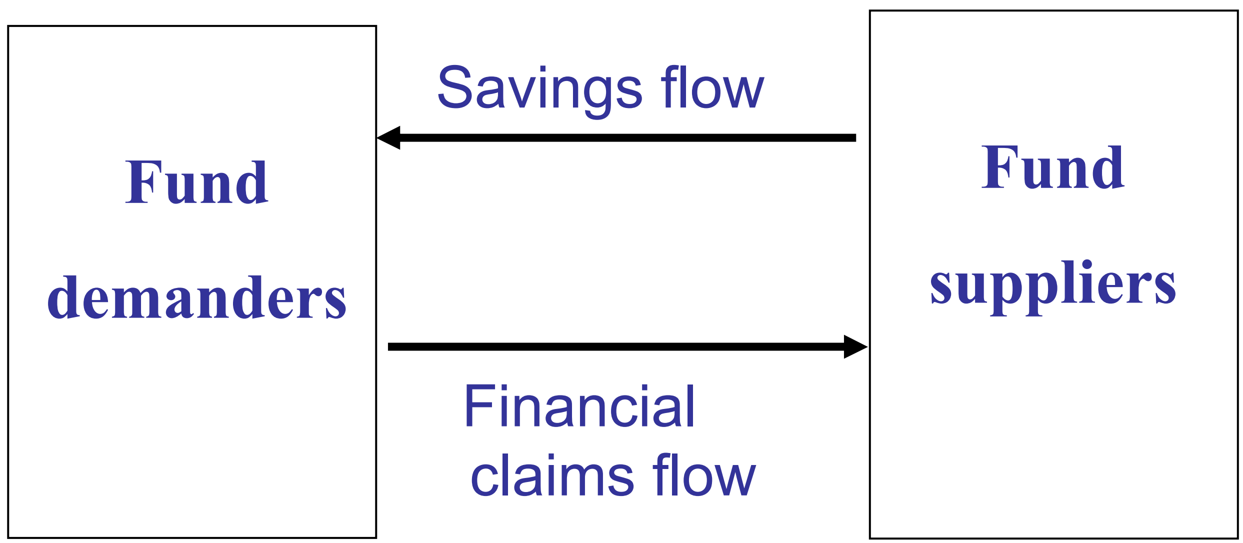
- The marketplace determines what goods and services will be produced and in what quantity.
- There are essentially types of markets at work within the economic system:
    - Product market
    - Factory market
    - Financial market
- **The financial markets channel savings**.

Role of Markets in the Economic System



2. The Financial System

- The financial markets operating within the financial system make possible the exchange of current income for future income and the transformation of savings.



2. The Financial System

- Flows of financial claims are packaged in the form of attractive financial services, such as stocks, bonds, deposits and insurance policies.
- The Czech financial sector has stabilised as regards shareholders, economics, technology and human capital.

Financial system

- The three groups of potential savers and borrowers in an economy are:
  - households,
  - businesses,
  - governments.
- The financial system brings together savers and borrowers by channeling funds from savers to borrowers while giving savers claims on borrowers´ future income.
- The financial system achieves this transfer by creating financial instruments, which are assets for savers and liabilities for borrowers.

Financial system

- The financial system also provides three key services for the benefit of savers and borrowers:
  - 1. risk sharing,
  - 2. liquidity,
  - 3. information.
- These services are provided through two channels:
  - financial markets,
  - financial institutions.

Risk sharing & Liquidity

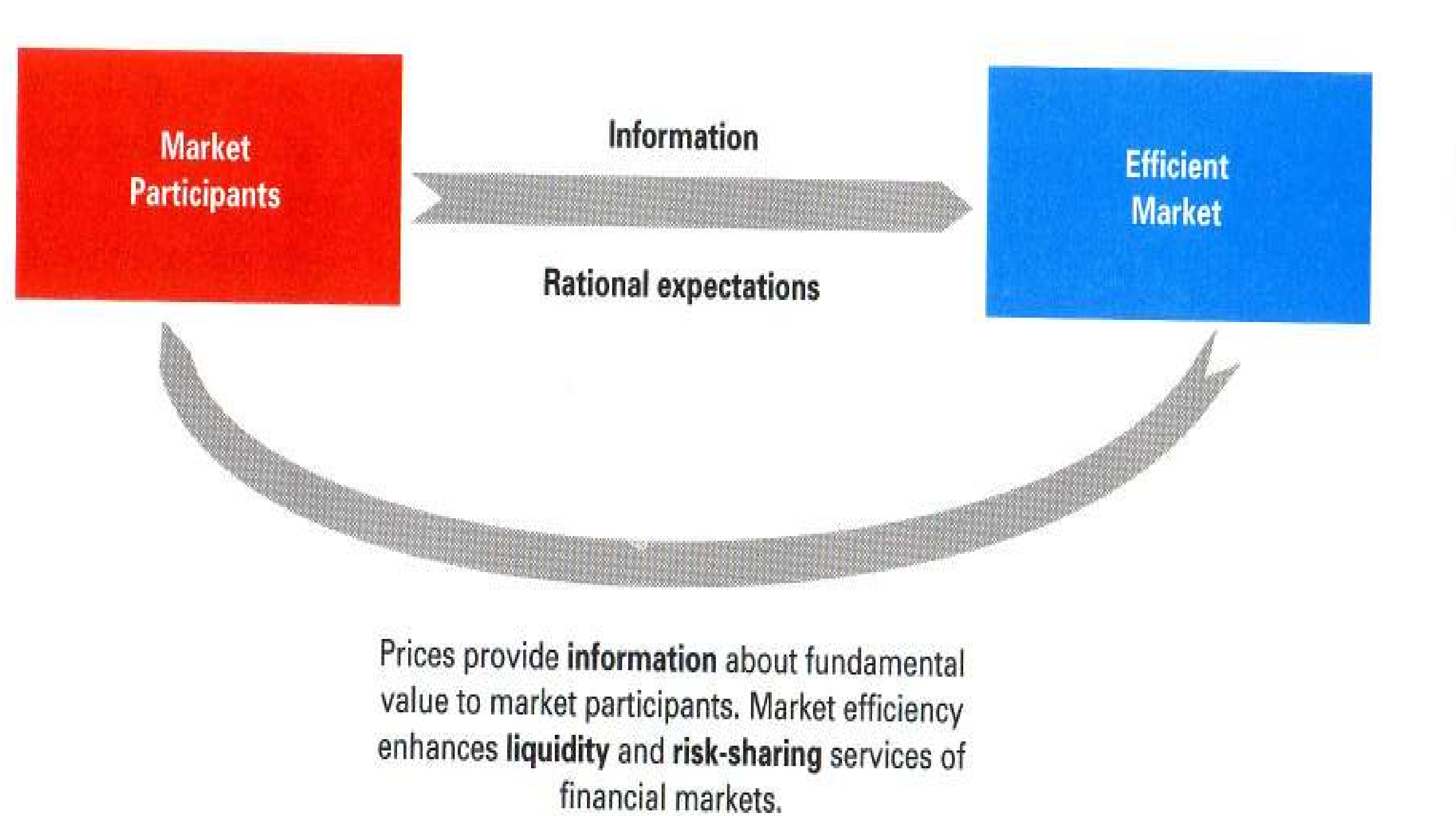
- **Risk** is the degree of uncertainty of an asset´s return.
- The financial system provides risk sharing by giving savers and borrowers ways to reduce the uncertainty to which they are exposed.

- **Liquidity**
- Liquidity is a measure of how readily one asset can be converted to cash.

Information

- The financial system gathers and communicates information about borrowers´circumstances so that individual savers do not have to search out prospective borrowers.
- The financial system allocates funds efficiently because it reduces the cost of information in matching savers with borrowers.

Flow of Information in the Efficient FM



Financial markets

- Financial markets match savers and borrowers and prices of financial assets in those markets affect the financial and spending decisions of individuals and businesses.
- The international capital market
  - is the market for lending and borrowing across national boundaries,
  - grew rapidly during the past 20 years.
- Financial markets communicate important information through the prices of financial assets.

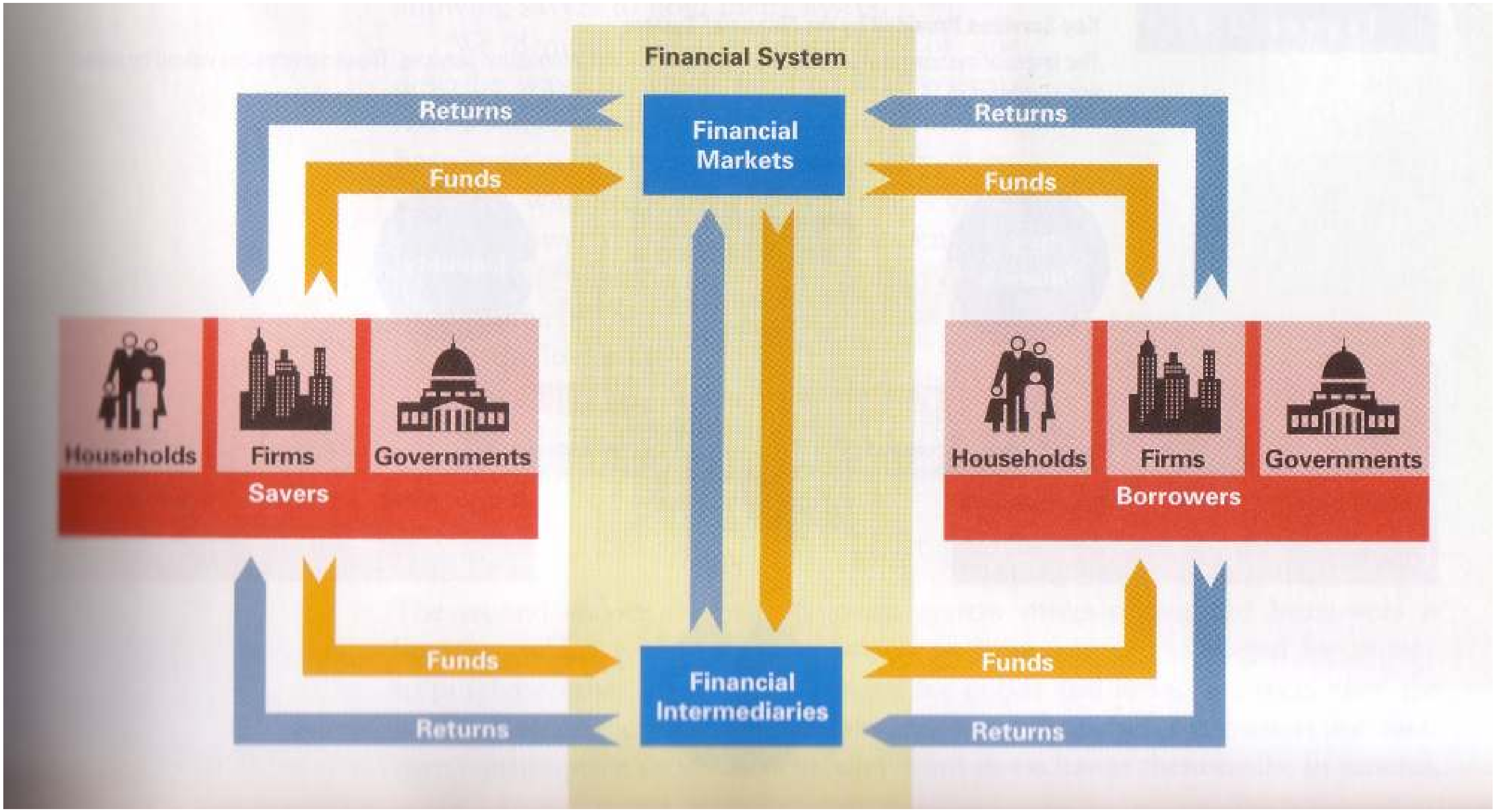
Financial system

- The financial system provides channels to transfer funds from individuals and groups who have saved money to individuals and groups who want to borrow money.
- SAVERS (lenders) are suppliers of funds, providing funds to borrowers in return for promises of repayment of even more funds in the future.
- BORROWERS are demanders of funds for consumer durables, houses, or business plant and equipment, promising to repay borrowed funds based on their expectation of having higher incomes in the future.

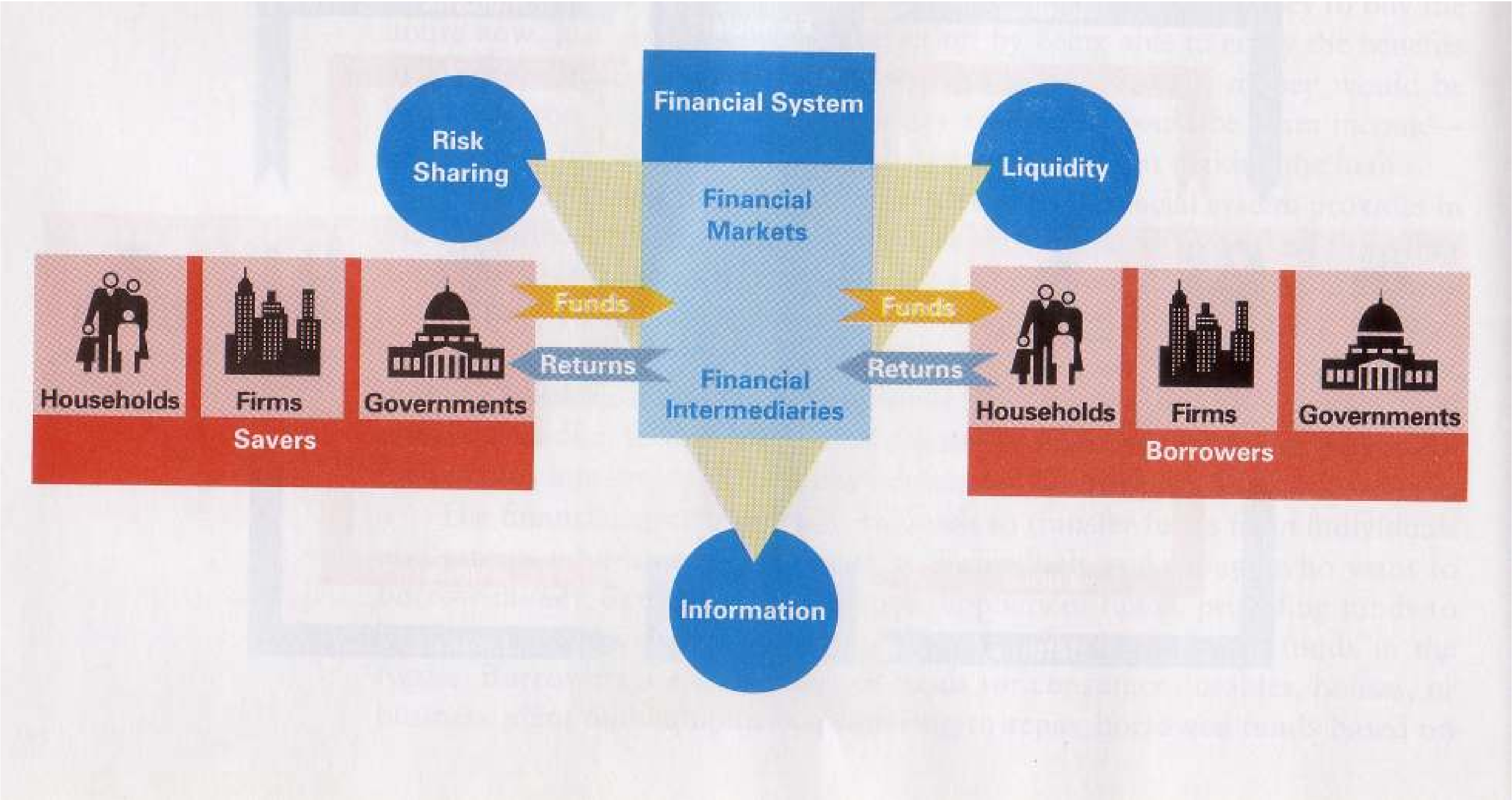
Financial system

- These promises are FINANCIAL LIABILITIES for the borrower – that is, both a source of funds and a claim on the borrower´s future income.
- For example, your car loan is an asset (use of funds) for the bank and a liability (source of funds) for you.
- Savers and borrowers can be households, businesses, or governments, both domestic and foreign.
- Financial markets issue claims on individual borrowers directly to savers.
- Financial institutions or intermediaries act as go-betweens by holding a portfolio of assets and issuing claims based on that portfolio to savers.

Moving Funds Through the FS



Key Services Provided by the FS



Risk Sharing

- Risk is the chance that the value of financial assets will change relative to what you expect.
- Individuals prefer stable returns on the collection of assets they hold.
- A collection of assets is called a PORTFOLIO.
- Splitting of wealth into many assets is known as DIVERSIFICATION.
- As long as the individual returns do not vary in the same way, the risk of severe fluctuations in a portfolio´s value will be reduced.
- The financial system provides risk sharing by allowing savers to hold many assets.

Risk Sharing

- Financial markets can create instruments to transfer risk form savers or borrowers who do not like uncertainty in returns or payments to savers or investors who are willing to bear risk.
- The ability of the financial system to provide risk sharing makes savers more willing to buy borrowers.
- This willingness, in turn, increases borrowers´ ability to raise funds in the financial system.

Liquidity

- Liquidity is the ease with which an asset can be exchanged for money to purchase other assets or exchanged for goods and services.
- The more liquid an asset, the easier it is to exchange the asset for something else.
- Financial markets and intermediaries provide trading systems for making financial assets more liquid.

Information

- The last service of the financial system is the collection and communication of information, or facts about borrowers and expectations about returns on financial assets.
- Gathering informations includes finding out about prospective borrowers and what they will do with borrowed funds.
- A problem that exists in most transactions is asymmetric information »» borrowers possess information about their opportunities or activities that they don´t disclose to lenders or creditors and can take advantage of this information.

3. Functions of the FS

- **Savings Function -** providing profit for the public savings
- **Wealth Function -** providing a means to store purchasing power until a final usage (and minimize infation effect)
- **Liquidity Function -** providing a means of raising funds by converting securities and other fin. assets into cash balances
- **Credit Function -** providing a continuing supply of credit by businesses, consumers and governments
- **Payments Function -** providing a mechanism for making payments to purchase goods and services

3. Functions of the FS

- **Risk Function -** providing a continuing supply of credit by businesses, consumers and governments
- **Policy Function -** providing a channel for government policy to achieve society´s goals of high employment, low inflation and sustainable economic growth

- **Financial systems are never static.**
- They change constantly in response to shifting demands, the development of new technology, changes in laws and regulation.

4. Financial Institutions

- **Financial intermediaries** are institutions that borrow funds from savers and lend them to borrowers, providing risk-sharing, liquidity, and information services in the process.
- The principal types of financial intermediaries are commercial banks, credit unions, savings and loan associations, mutual savings banks, mutual funds, finance companies, insurance companies, and pensions funds.
- Banks are the largest financial intermediaries, and they lend to many sectors of the economy, including households and small and medium-sized businesses.

Financial Intermediaries in the FS

- The FS also channels fund from savers to borrowers indirectly through intermediaries.
- These institutions facilitate financial trade by raising funds from savers and investing in the debt or equity claims of borrowers.
- This indirect form of finance is known as financial intermediation.
- Financial intermediaries have two tasks:
  - 1) matching savers and borrowers,
  - 2) providing risk-sharing, liquidity, and information services.

Financial Intermediaries

- **The Other Services**
- **Assets transformations**
  - Special risk assets into secure assets primary borrowers
  - Long-term passive into active
- **Risk transformations**
  - Spreading – risks to more subjects
  - Pooling – aggregating risks – built asset portfolios
- **Liquidity transformations**
- **Transactions cost transformations**

Financial Intermediaries

A) Universal

- Broker
- Dealer
- Financial agency
- Trading with financial assets on own or foreign account

- **Depository institutions**
  - (commercial banks, savings banks, credit unions…)
- **Contractual institutions**
  - (insurance companies, pension funds…)
- **Investment institutions**
  - (investment companies…)

Financial Intermediaries

B) Specialist

- **Market makers**
  - Buying and selling FA on own account
  - Quotations bid-ask (bid-offer) spread
- **Arbitrageurs**
  - Different markets same time
  - One market different time
- **Hedgers**
  - Decline prices FA
  - Interest rates
  - Currency prices
  - Open position A≠P
  - Closed position A=P
- **Speculators**
  - Open /closed positions against hedgers
  - Short selling

Financial Intermediaries in the US

FINANCIAL INTERMEDIARIES IN THE UNITED STATES†

Class of institution	Assets ($ billions) 2000	% of total assets of intermediaries 1960	1970	1980	1990	2000
Mutual funds						
Money market mutual funds	1698	0.0	0.0	1.8	4.4	5.7
Other mutual funds	4988	2.9	3.5	1.6	5.7	16.6
Finance companies	1071	4.7	4.7	4.9	5.4	3.6
Insurance companies						
Life insurance companies	3199	19.4	14.8	11.0	12.1	10.7
Property and casualty companies	895	4.4	3.7	4.3	4.7	3.0
Pension funds						
Private pension funds	5129	6.3	8.1	12.0	14.4	17.1
State and local government retirement funds	3034	3.3	4.4	4.7	6.5	10.1
Depository institutions						
Commercial banks	6344	38.2	37.2	35.7	29.3	21.2
Savings institutions	1303	18.8	18.8	18.8	12.1	4.3
Credit unions	435	1.1	1.4	1.5	1.9	1.5
Government financial institutions	1883	1.0	3.4	4.2	3.7	6.3
	Total: $30.0 trillion					

† Data are as of September 30, 2000.

- First question, please?