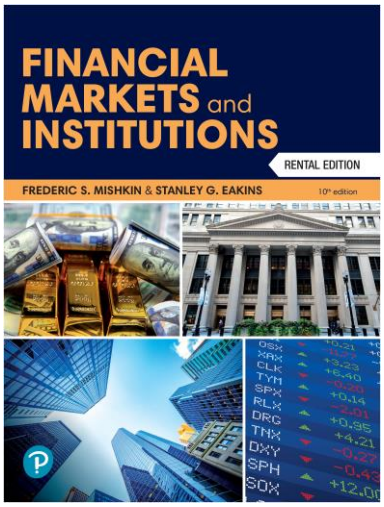
Financial Markets and Institutions

Tenth Edition



Part 1: Introduction
Chapter 1

Why Study Financial Markets and Institutions?

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Chapter Preview (1 of 4)

The evening news features a segment about the bond market and interest rates. What does this mean for your small retail business? Should you borrow money? Issue stock instead of using a bank loan?

What does all this mean? Do I care about interest rates? What about the turmoil in Europe? Are imports more expensive?

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Chapter Preview (2 of 4)

- These are good questions. Of course, the answer to these questions can be found in this book. In fact, this books touches on a variety of topics, including the Fed, stocks markets, bond markets, and banks. We will begin to appreciate many exciting issues related to these topics during the course of this term.

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Chapter Preview (3 of 4)

We preview subjects of interest to anyone who is a part of a productive society. Topics include:

- Why Study Financial Markets?
- Why Study Financial Institutions?
- Applied Managerial Perspective
- How Will We Study Financial Markets and Institutions

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Chapter Preview (4 of 4)

We preview subjects of interest to anyone who is a part of a productive society. Topics include: Web Exercise

- Concluding Remarks

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Why Study Financial Markets? (1 of 2)

Financial markets are crucial in our economy.

1. Channel funds from savers to investors, promoting economic efficiency.
2. Market activity affects: personal wealth, business firms, and economy.

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Why Study Financial Markets? (2 of 2)

- Well functioning financial markets are key factors in producing high economic growth.
- We will briefly examine each of these markets, key statistics, and how we will examine them throughout this course.

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Why Study Financial Markets? Debt Markets & Interest Rates (1 of 4)

- Debt markets allow governments, corporations, and individuals to borrow.
- Borrowers issue a security, called a bond, offering interest and principal over time.
- The interest rate is the cost of borrowing.

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Why Study Financial Markets? Debt Markets & Interest Rates (2 of 4)

- Many types of market interest rates: mortgage rates, car loan rates, credit card rates, etc.
- The level of these rates are important. For example, mortgage rates in the early part of 1983 exceeded 13%.

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Why Study Financial Markets? Debt Markets & Interest Rates (3 of 4)

- Understanding the history of interest rates is beneficial.
- We will study these further in the book: types and characteristics of bonds; theories on how rates are determined.

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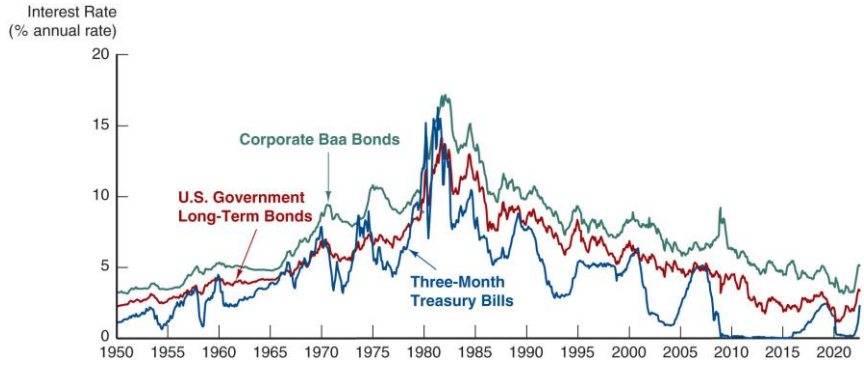
Figure 1.1

Interest Rates on Selected Bonds, 1950–2022



Source: Federal Reserve Bank of St. Louis, FRED database: https://fred.stlouisfed.org/series/TB3MS ; https://fred.stlouisfed.org/series/GS10 ; https://fred.stlouisfed.org/series/BAA .

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Why Study Financial Markets? Debt Markets & Interest Rates (4 of 4)

- For the moment, we will turn to other topics, but revisit these topics.
- In Chapters 2, 11, 12, and 14, we will examine the role of debt markets in the economy.
- In Chapters 3 through 5, we will examine the characteristics of interest rates.

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Why Study Financial Markets? The Stock Market (1 of 3)

- The stock market is the market where common stock (or just stock) are traded.
- Companies initially sell stock (in the primary market) to raise money. After that, the stock is traded among investors.
- The stock market receives the most attention from the media.

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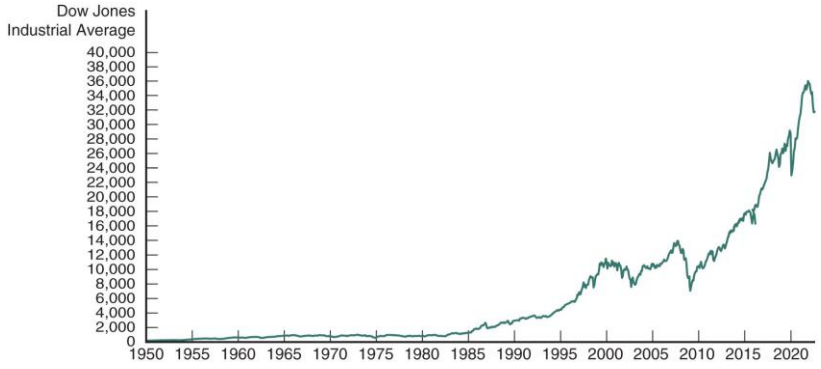
Figure 1.2

Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2022



Source: Federal Reserve Bank of St. Louis, FRED database: https://fred.stlouisfed.org/series/DJIA .

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Why Study Financial Markets? The Stock Market (2 of 3)

Companies, not just individuals, also watch the market.

- Often seeking additional funding
- The success of SEOs is dependent on the company's stock

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Why Study Financial Markets? The Stock Market (3 of 3)

- In Chapter 2, we will examine the role of the stock market in the financial system.
- In Chapters 6 and 13, we will further look at how stock prices behave to information in the marketplace.

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Why Study Financial Markets? The Foreign Exchange Market (1 of 3)

- The foreign exchange market is where international currencies trade and exchange rates are set.
- Although most people know little about this market, it has a **daily** volume around $5 trillion!

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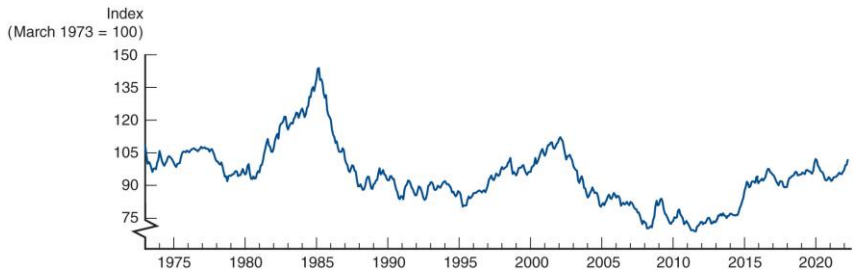
Figure 1.3

Exchange Rate of the U.S. Dollar, 1970–2022



Source: Federal Reserve Bank of St. Louis, FRED database:
https://fred.stlouisfed.org/series/TWEXMMTH

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Why Study Financial Markets? The Foreign Exchange Market (2 of 3)

- These fluctuations matter!
  - In recent years, consumers have found that vacationing in Europe is expensive, due to a weakening dollar relative to the Euro.
  - When the dollar strengthens, foreign purchase of domestic goods falls.

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Why Study Financial Markets? The Foreign Exchange Market (3 of 3)

In Chapter 15, we will examine how exchange rates are determined in both the short- and long-run.

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Why Study Financial Institutions? (1 of 3)

We will also spend considerable time discussing financial institutions—the corporations, organizations, and networks that operate the so-called "marketplaces." We will look at:

1. Structure of the Financial System
   - Helps funds move from savers to investors, typically through financial intermediaries
2. Financial Crises
   - The "Great Recession" of 2007–2009 was the worst financial crisis since the Great Depression. Why did it happen?

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Why Study Financial Institutions? (2 of 3)

3. Central Banks and the Conduit of Monetary Policy
   - The role of the Fed, and foreign counterparts, in the management of interest rates and the money supply
4. The International Financial System
   - Capital flows between countries impacts domestic economies
   - Need to understand exchange rates, capital controls, and the role of agencies such as the IMF

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Why Study Financial Institutions? (3 of 3)

5. Banks and Other Financial Institutions
   - Includes the role of insurance companies, mutual funds, pension funds, etc.
6. Financial Innovation
   - Focusing on improvements in technology and the impact on financial product delivery
7. Managing Risk in Financial Institutions
   - Focusing on risk management in the financial institution

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Applied Managerial Perspective

- Financial institutions are among the largest employers in the U.S. and often pay high salaries.
- Knowing how financial institutions are managed may help you better deal with them.

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How We Study Financial Markets and Institutions (1 of 2)

Basic Analytic Framework

1. Simplified models are constructed, explained, and then manipulated to illustrate various phenomena.
2. "Practicing Manager" cases are used to tie theoretical and empirical aspects.

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How We Study Financial Markets and Institutions (2 of 2)

Other features

1. Case Studies
2. Applications and Numerical Examples
3. Special Interest Boxes
4. Hundred of Analytical End-of-Chapter Problems
5. Predicting the Future Problems

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Exploring the Web (1 of 2)

Web Exercise

The World Wide Web is an enormous resource for present and historical information. We will periodically present **Web exercises** to introduce some of the important locations for information, and how to use it.

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Exploring the Web (2 of 2)

Web Exercise

The next three slides (starting on page 11 in the text) show you how to (1) find historical interest rates from the Fed and save the information, (2) how to import the data into Excel, and (3) how to examine the information using an Excel chart.

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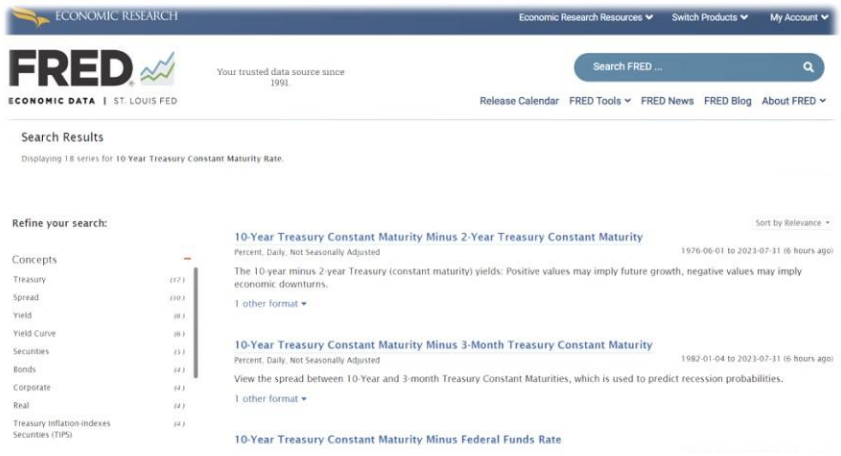
Figure 1.4

Federal Reserve Bank of St. Louis, FRED Database



Source: https://fred.stlouisfed.org/series/GS10 .

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Figure 1.5

Excel Spreadsheet with Interest-Rate Data

FRED Graph Observations						
Federal Reserve Economic Data						
Link: https://fred.stlouisfed.org						
Help: https://fredhelp.stlouisfed.org						
Economic Research Division						
Federal Reserve Bank of St. Louis						
DGS10	Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis, Percent, Monthly, Not Seasonally Adjusted					
DGS1	Market Yield on U.S. Treasury Securities at 1-Year Constant Maturity, Quoted on an Investment Basis, Percent, Monthly, Not Seasonally Adjusted					
Frequency: Monthly						
observation_date	DGS10	DGS1				
2022-01-01	1.76	0.55				
2022-02-01	1.93	1.00				
2022-03-01	2.13	1.34				
2022-04-01	2.75	1.89				
2022-05-01	2.90	2.06				
2022-06-01	3.14	2.65				
2022-07-01	2.90	3.02				

Source: Used with permission from Microsoft Corporation;
https://fred.stlouisfed.org/series/GS1 ; https://fred.stlouisfed.org/series/GS10 .

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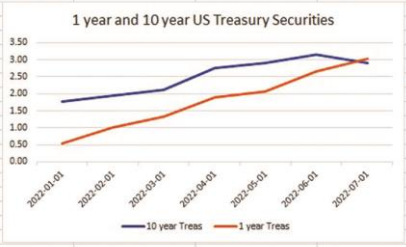
Figure 1.6

Excel Graph of Interest-Data

FRED Graph Observations		
Federal Reserve Economic Data		
Link: https://fred.stlouisfed.org		
Help: https://fredhelp.stlouisfed.org		
Economic Research Division		
Federal Reserve Bank of St. Louis		
DGS10	Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis, Percent, Monthly, Not Seasonally Adjusted	
DGS1	Market Yield on U.S. Treasury Securities at 1-Year Constant Maturity, Quoted on an Investment Basis, Percent, Monthly, Not Seasonally Adjusted	
Frequency: Monthly		
observation_date	10 year Treas	1 year Treas
2022-01-01	1.76	0.55
2022-02-01	1.93	1.00
2022-03-01	2.13	1.34
2022-04-01	2.75	1.89
2022-05-01	2.90	2.06
2022-06-01	3.14	2.65
2022-07-01	2.90	3.02
Average	2.44	1.58
Standard Deviation	0.55	0.88



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Concluding Remarks

- This field is an exciting one, and this book will help you develop skills to further your career and your understanding of financial events.
- You will also have a better understanding of the controversies to hotly debated in the political arena.

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Chapter Summary (1 of 2)

- Why Study Financial Markets?: The three primary markets (bond, stock, and foreign exchange) were briefly introduced.
- Why Study Financial Institutions?: The market, institutions, and key changes affecting these were outlined.

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Chapter Summary (2 of 2)

- Applied Managerial Perspective: The book will often present material to better understand how actual managers use the information in daily operations.
- How We Will Study Financial Markets and Institutions: We outlines the three key components: analytical framework, features, and web exercises.

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