



# ISS3080-Lecture 1

## Why Study Financial Markets and Institutions?

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Sungkyunkwan University



# Agenda

1. Why Study Financial Markets?
2. Why Study Financial Institutions?
3. Applied Managerial Perspective
4. How Will We Study FMI course?



# 1. Why Study Financial Markets?

- UK announced that Britain voted to leave the EU at around 2am on 24 June.
- Brexit vote outcome affects financial markets across the world.
- For example, over 47 trillion won (US\$40 billion) has been erased from the Korean stock market.



# KOSPI in last week





# Value loss in global stock markets





























## Americas >

Name ▲	2 Days	Last	Net Chng	% Chng
 S&P 500		2,037.41	-75.91	-3.59 %
 DJI		17,400.75	-610.32	-3.39 %
 NASDAQ 100		4,285.70	-181.78	-4.07 %
 S&P/TSX		13,891.88	-239.50	-1.69 %
 BOVESPA		50,105.26	-1,454.56	-2.82 %
 MXSE IPC		44,885.82	-1,260.10	-2.73 %

## Europe >

Name ▲	2 Days	Last	Net Chng	% Chng
 STXE 600		321.98	-24.36	-7.03 %
 FTSE 100		6,138.69	-199.41	-3.15 %
 DAX		9,557.16	-699.87	-6.82 %
 CAC 40		4,106.73	-359.17	-8.04 %
 FTSE MIB		15,723.81	-2,242.36	-12.48 %
 SMI		7,747.18	-275.87	-3.44 %
 AEX		424.20	-25.66	-5.70 %
 IBEX		7,787.70	-1,097.60	-12.35 %
 OMXS 30		1,360.73	6.13	0.45 %

## Asia >

Name ▲	2 Days	Last	Net Chng	% Chng
 NIKKEI 225		14,952.02	-1,286.33	-7.92 %
 S&P/ASX 200		5,113.18	-167.50	-3.17 %
 HANG SENG		20,259.13	-609.21	-2.92 %



# 1. Why Study Financial Markets?

Financial markets, such as bond and stock markets, are crucial in our economy.

- These markets channel funds from savers to investors, thereby promoting economic efficiency.
- Market activity affects personal wealth, the behavior of business firms, and economy as a whole



# Function of Financial Markets

- Financial Markets channel funds from person or business without investment opportunities (i.e., “Lender-Savers”) to one who has them (i.e., “Borrower-Spenders”)

## Lender-Savers

1. Households
2. Business firms
3. Government
4. Foreigners

## Borrower-Spenders

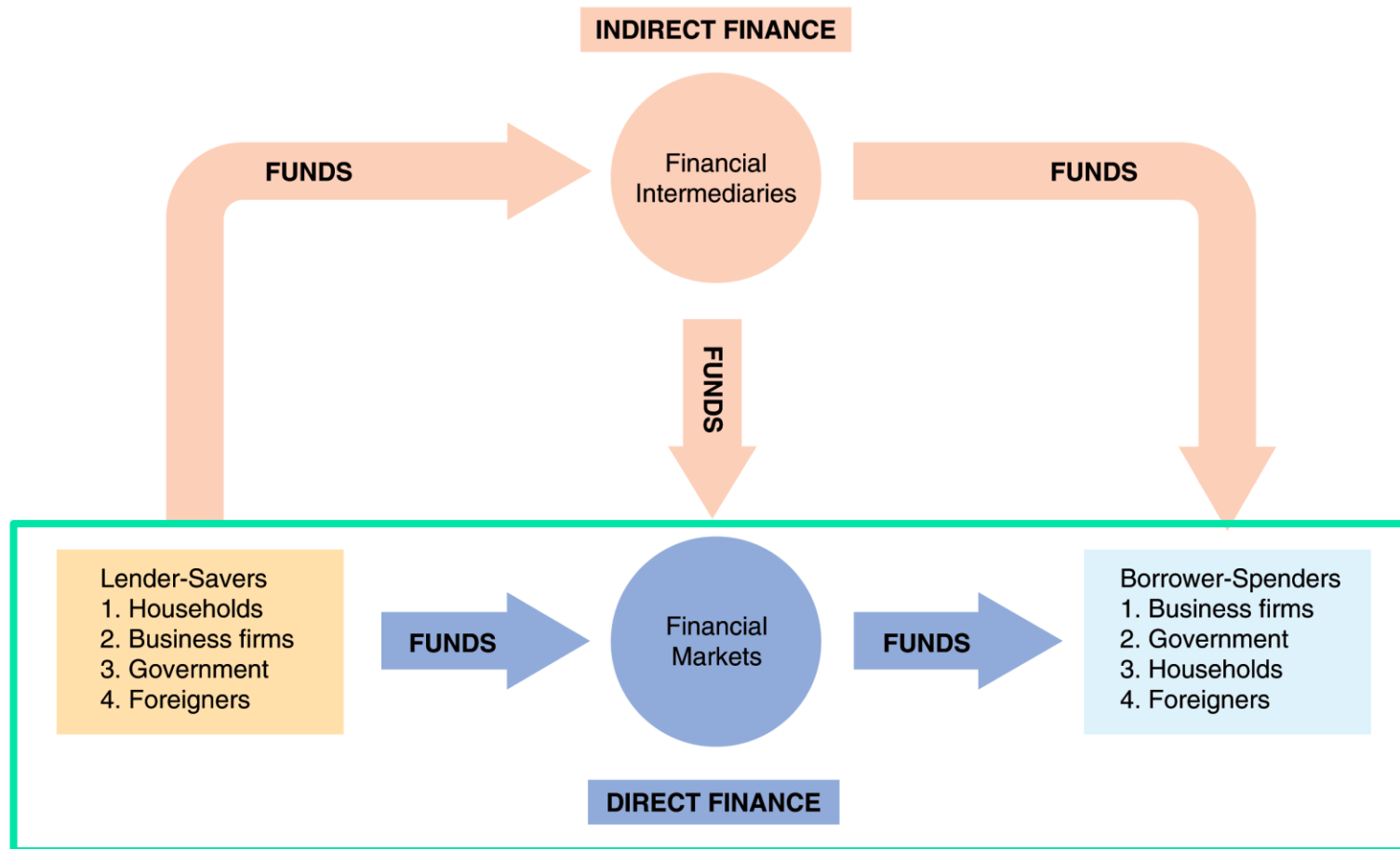
1. Business firms
2. Government
3. Households
4. Foreigners

- Improves economic efficiency





# Function of Financial Markets



**Figure 2.1** Flows of Funds Through the Financial System

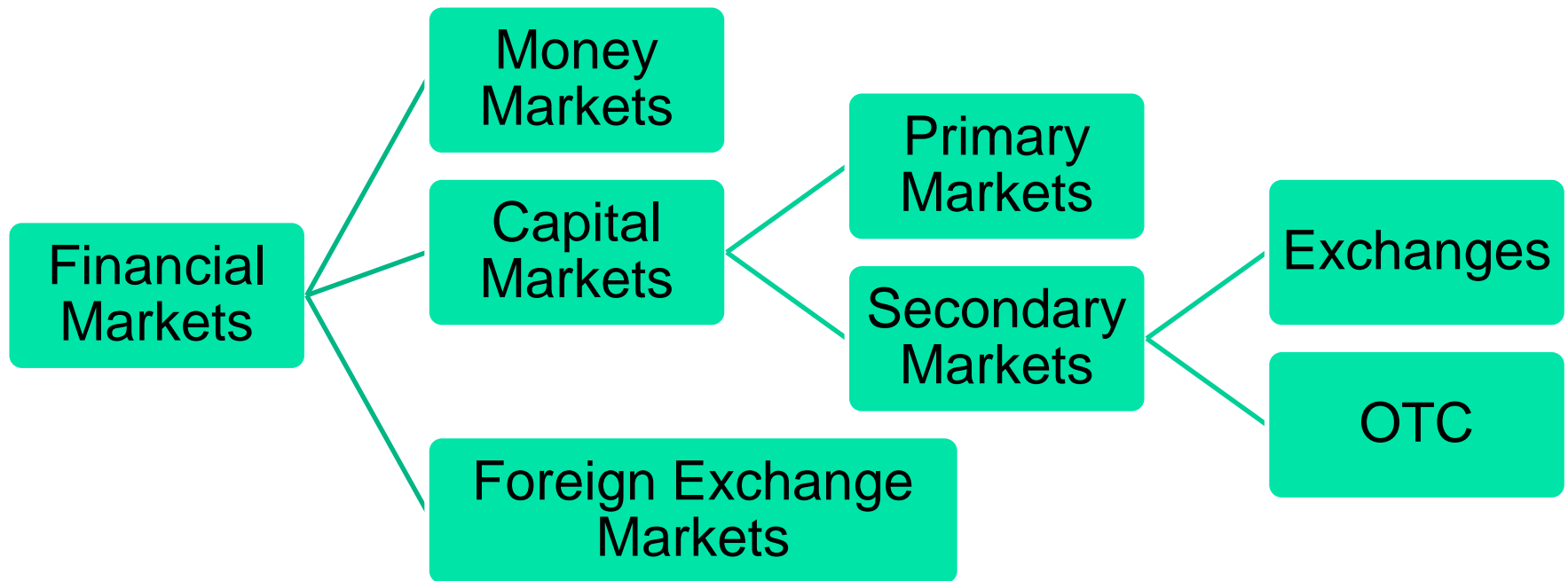


# 1. Why Study Financial Markets?

- Well functioning financial markets, such as the bond market, stock market, and foreign exchange market, 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.



# Categories of Financial Markets





# 1. Why Study Financial Markets?

## Debt Markets & Interest Rates

- Debt markets, or bond markets, allow governments, corporations, and individuals to borrow to finance activities.
- In this market, borrowers issue a security, called a bond, that promises the timely payment of interest and principal over some specific time horizon.
- The interest rate is the cost of borrowing.





# 1. Why Study Financial Markets?

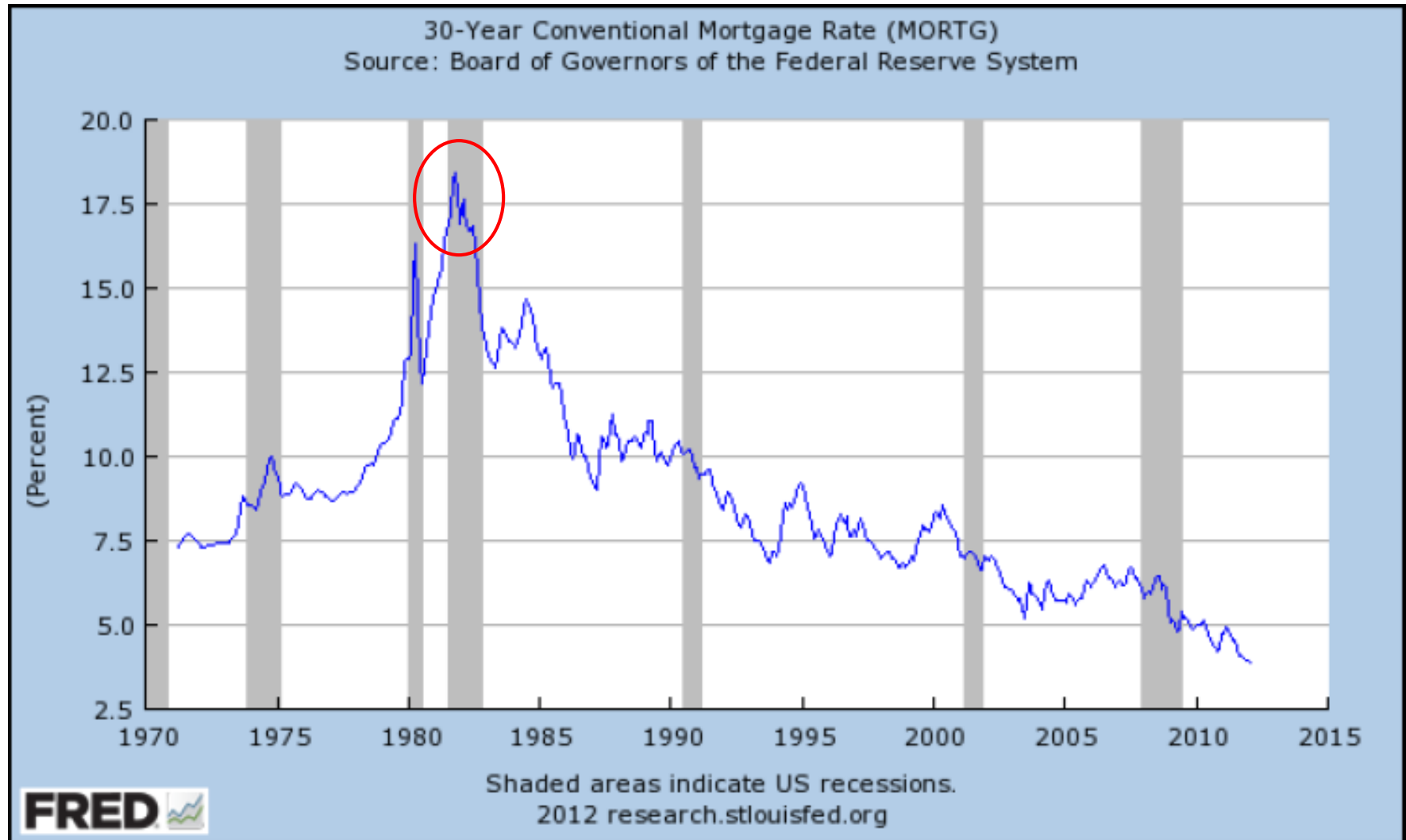
## Debt Markets & Interest Rates

- There are many different types of market interest rates, including mortgage rates, car loan rates, credit card rates, etc.
- The level of these rates are important. For example, mortgage rate exceeded 17% in the UK in November 1979 and soon afterwards in the US in early 1983. Financing a house was quite expensive then.





# Historical Mortgage Rate in the US



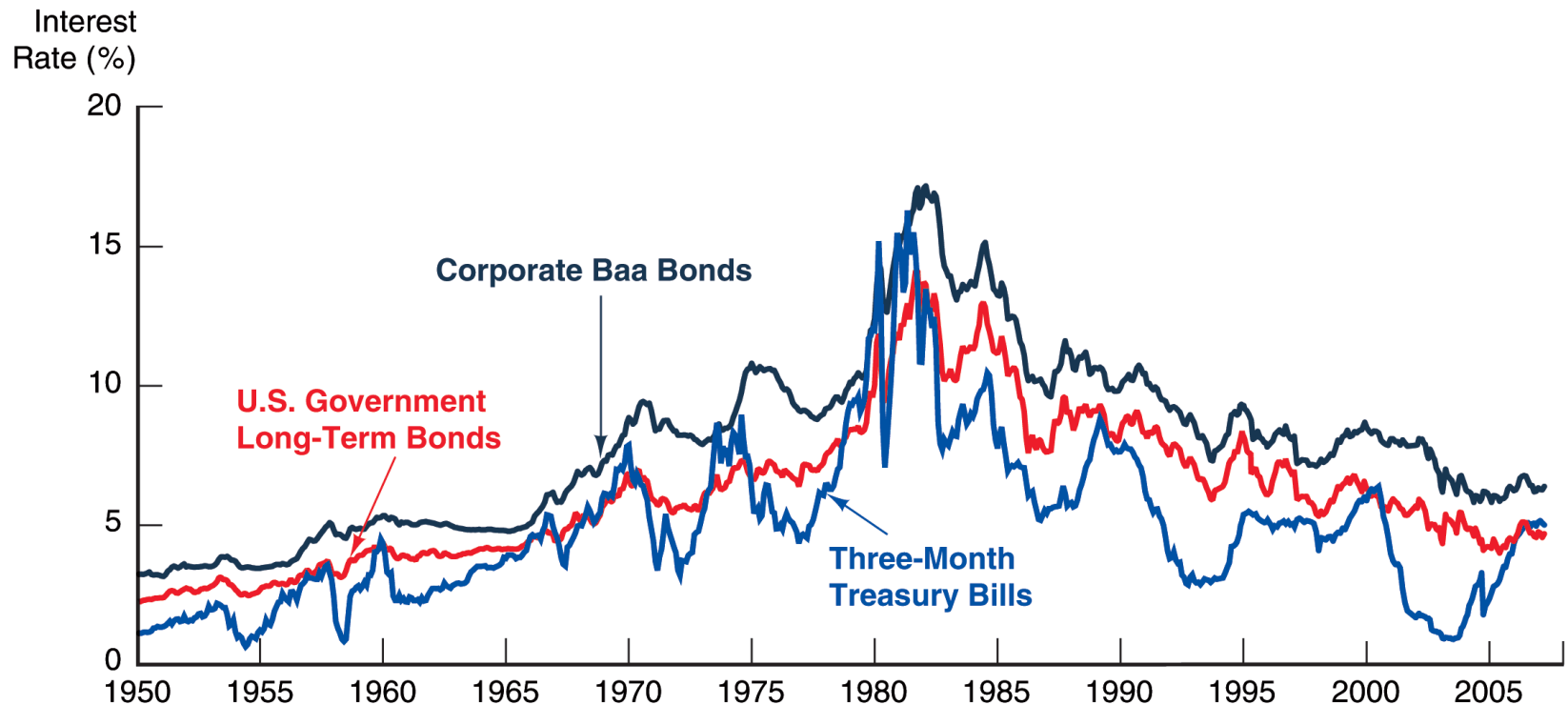


# 1. Why Study Financial Markets? Interest Rates

- Types of Bonds and Interest Rate
  - Long-term Bond v.s. Short-term Bond (e.g. three-month treasurer bills in the US)
  - Government Bond v.s. Corporate Bond
- Because interest rates are important to individuals and business, understanding the history of interest rates is beneficial.



# Bond Market and Interest Rates



**Figure 1.1** Interest Rates on Selected Bonds, 1950–2007

Sources: Federal Reserve *Bulletin*; [www.federalreserve.gov/releases/H15/data.htm](http://www.federalreserve.gov/releases/H15/data.htm).

Complete list of interest rates <http://www.federalreserve.gov/releases>



# International Bond Market

- The internationalization of financial markets is an important trend.
- International Bond Market
  - Eurobond
    - Denominated in one currency, but sold in a different market
    - now larger than U.S. corporate bond market
    - Over 80% of new bonds are Eurobonds.



# 1. Why Study Financial Markets?

## The Stock Market

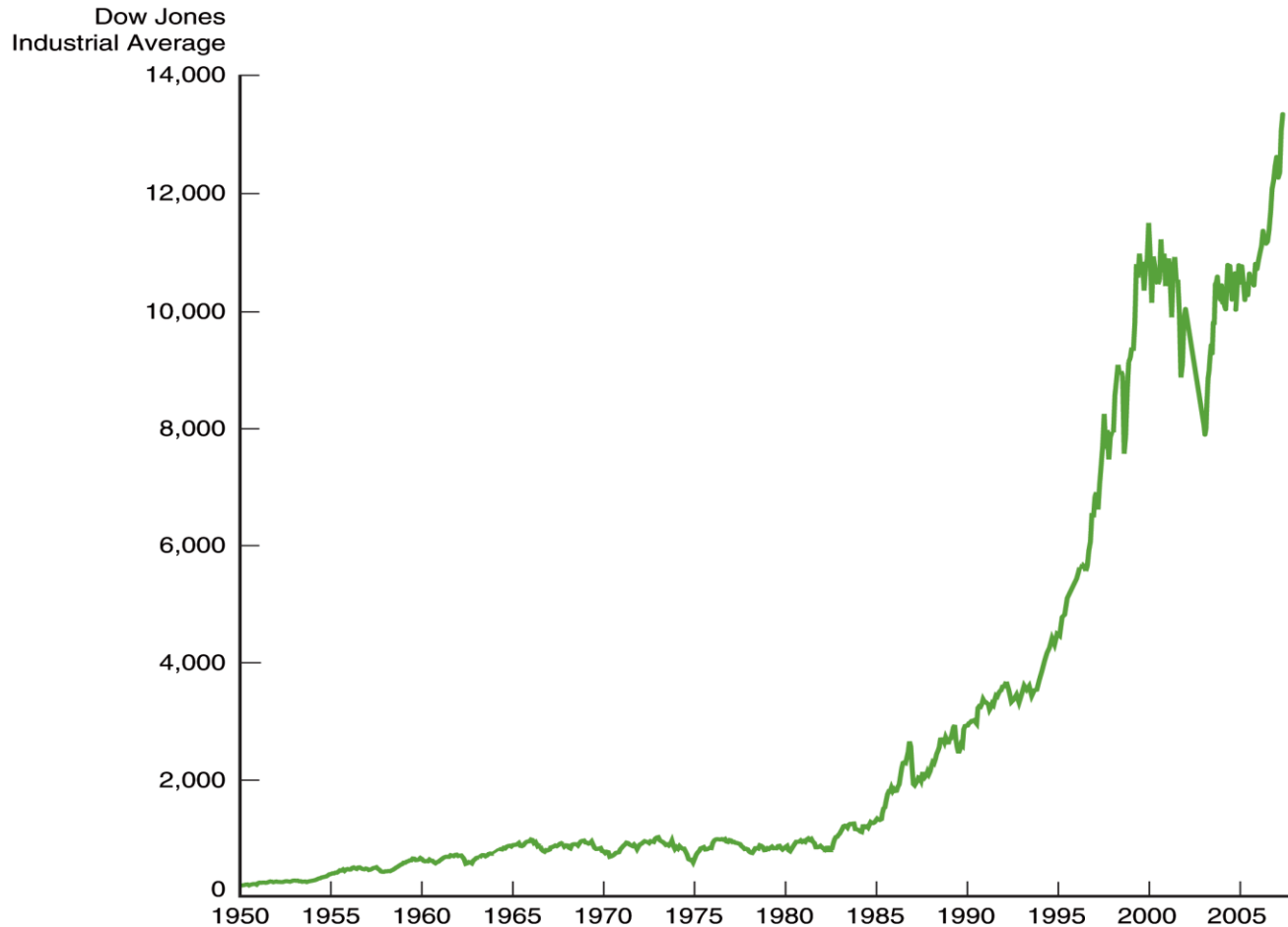
- The stock market is the market where (common) stock or (ordinary) shares, representing ownership in a company, are traded.
- Companies initially sell stock (in the primary market) to raise money. But after that, the stock is traded among investors (secondary market).
- Of all the active markets, the stock market receives the most attention from the media, probably because it is the place where people get rich (and poor) quickly.







# Dow Jones Industrial Average (1950-2007)

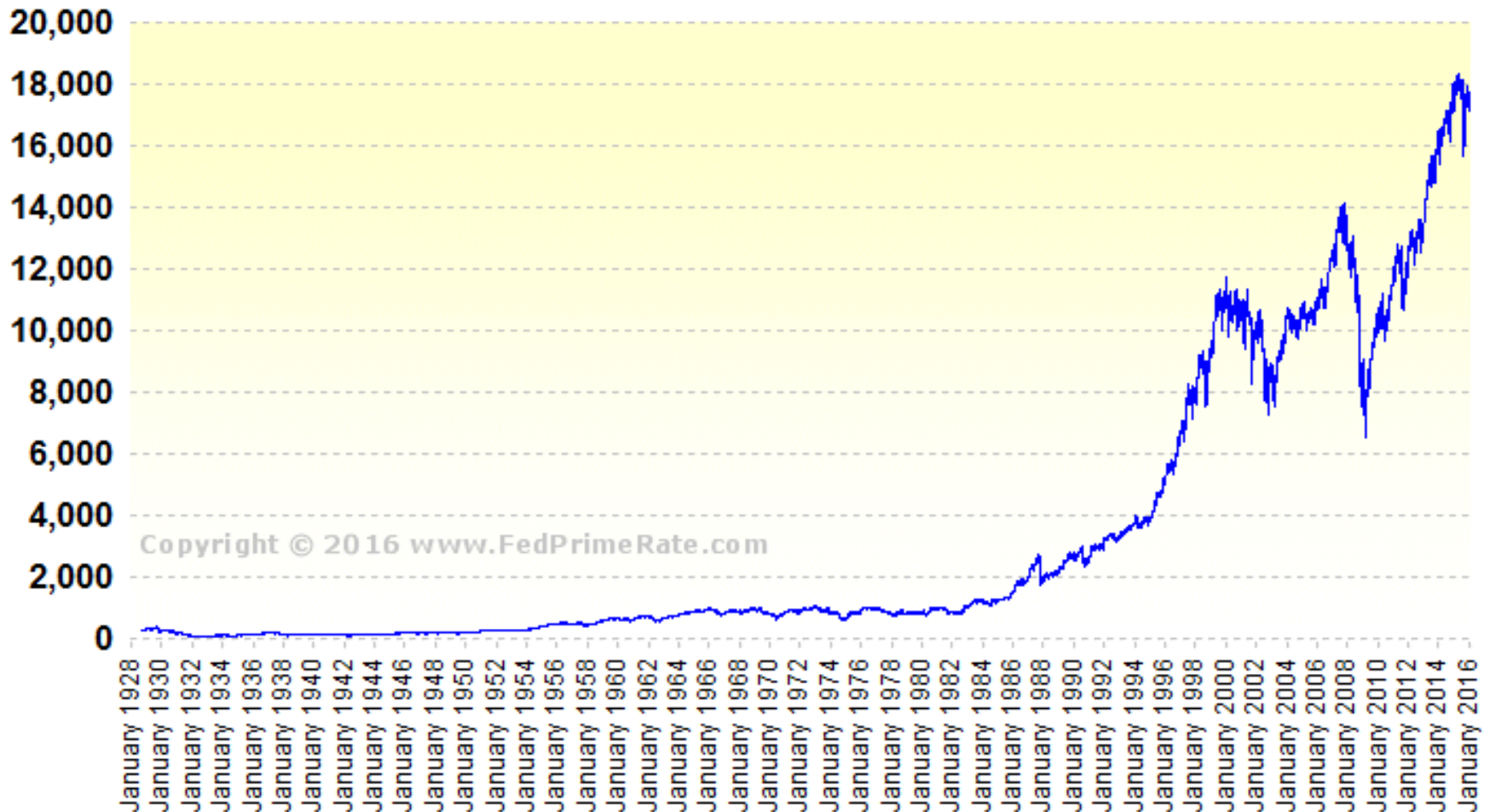


**Figure 1.2** Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2007

Source: Dow Jones Indexes: <http://finance.yahoo.com/?u>.



**October 1, 1928 Through January 5, 2016**



Source: [www.FedPrimeRate.com](http://www.FedPrimeRate.com)



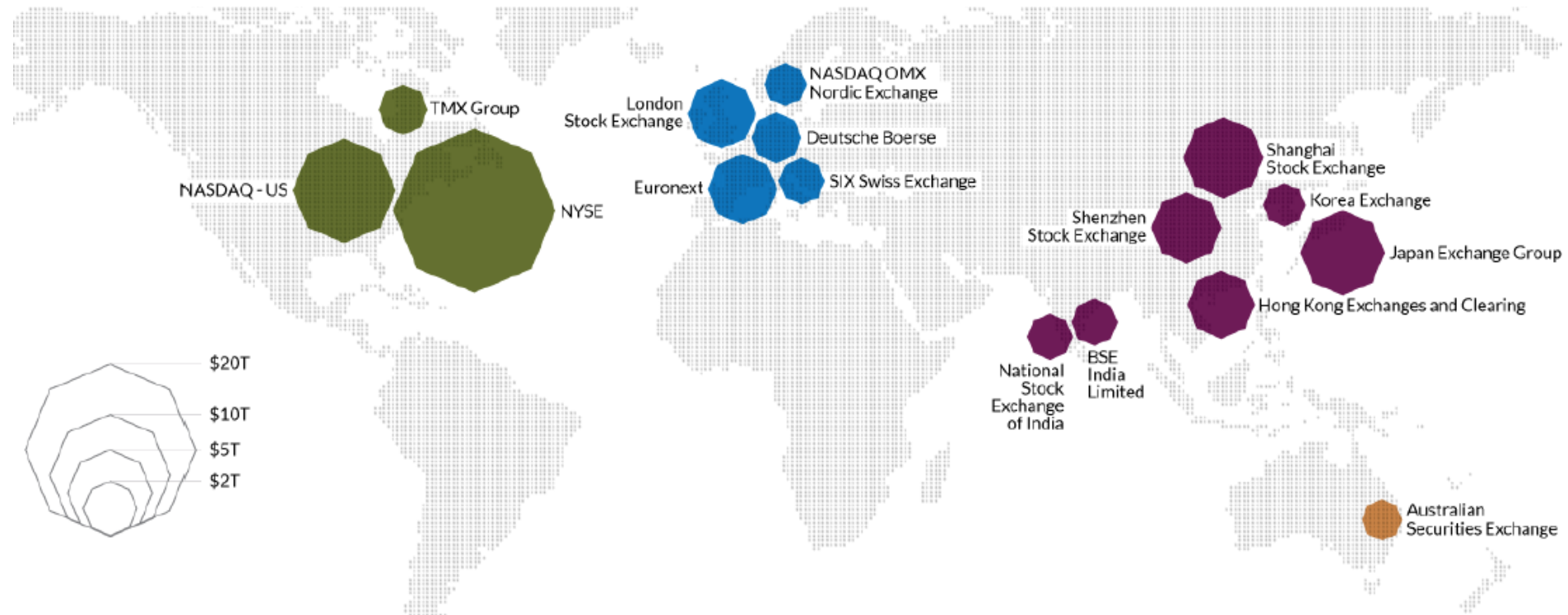
# 1. Why Study Financial Markets?

## The Stock Market

- Companies, not just individuals, also watch the market. Although non-financial corporations don't typically "invest" in the market, they often seek additional funding in equity markets after going public. The success of these seasoned-equity offerings (SEOs) is very dependent on the current price of the company's stock.



# World's Stock Exchanges by Size



Source: <http://www.visualcapitalist.com/all-of-the-worlds-stock-exchanges-by-size/>



# 1. Why Study Financial Markets?

## The Foreign Exchange Market

- 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*** trading volume around \$1 trillion!

View historical financial data and forecasts at <http://www.forecasts.org/data/index.htm>



# Foreign Exchange Rate

## Sterling Pound Against US Dollar (1970-2015)







# Brexit Vote's Effect on Exchange Rate

19 Jun 2016 08:15 UTC - 26 Jun 2016 08:23 UTC

**GBP/USD** close:1.36754 low:1.34101 high:1.50056





# 1. Why Study Financial Markets?

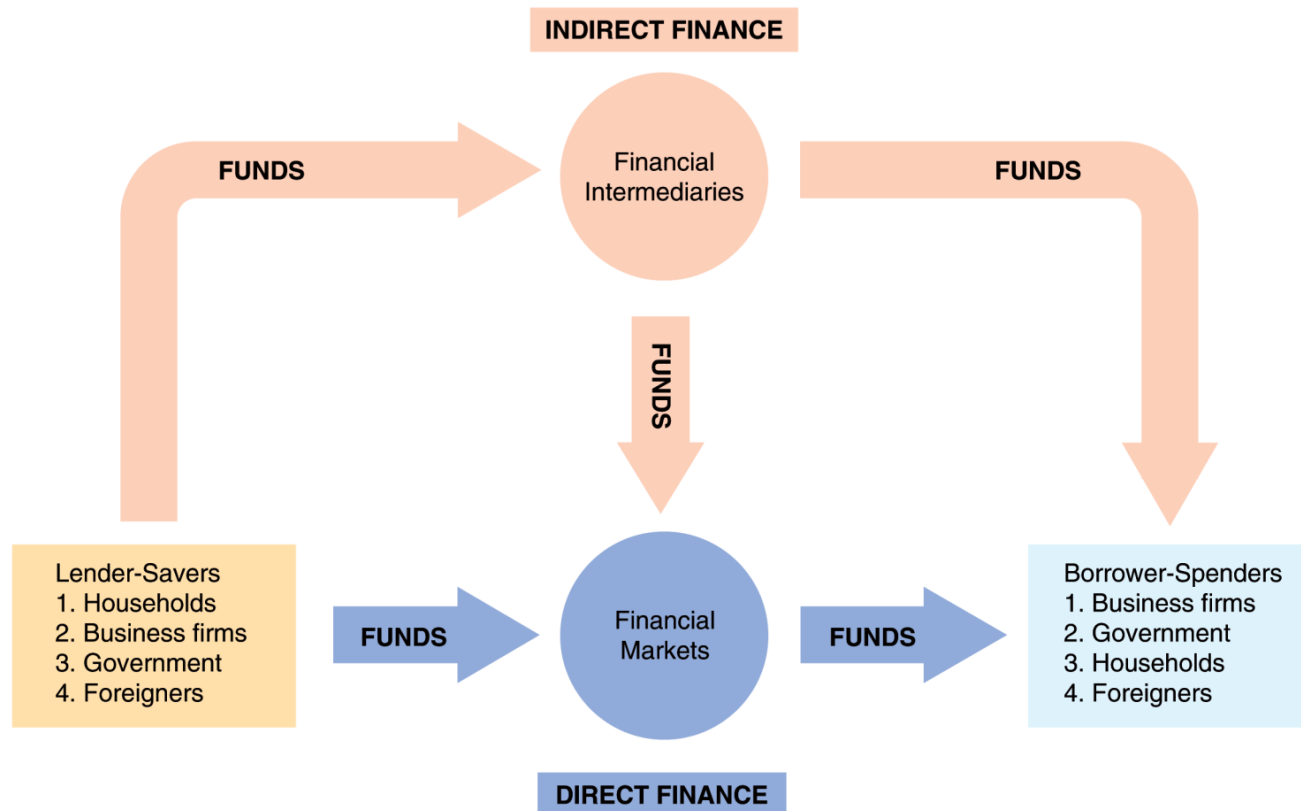
## The Foreign Exchange Market

- These fluctuations matter!
  - Now, foreign consumers will find that vacationing in the UK will be more economic, due to a strengthening dollar relative to the pound sterling.
  - When the dollar strengthens, purchase of domestic goods in the US falls, and US manufacturers experience a decreased demand for their goods.



## 2. Why Study Financial Institutions? Function of Financial Intermediaries

We now turn our attention to the top part of Figure 2.1 – indirect finance.



**Figure 2.1** Flows of Funds Through the Financial System



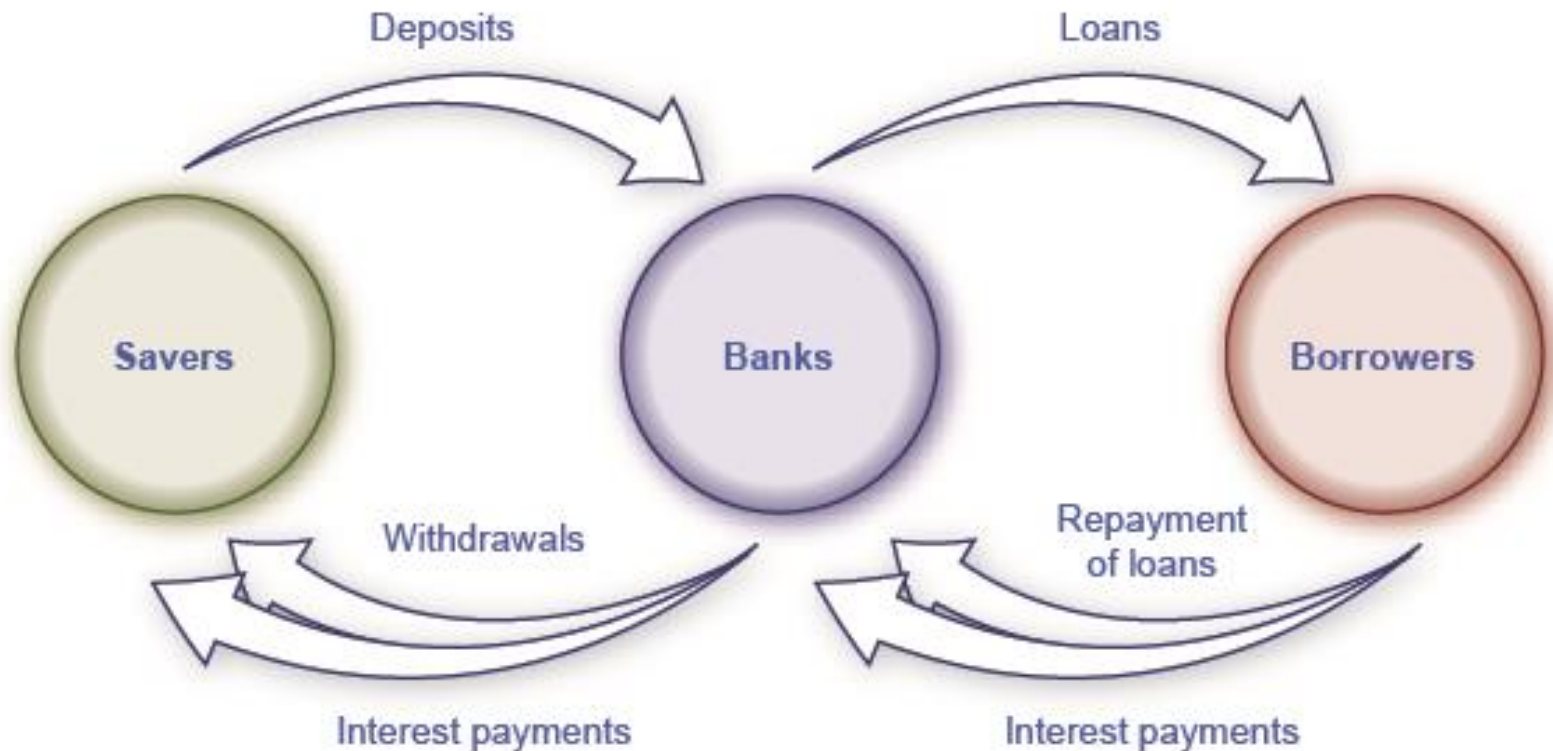
## 2. Why Study Financial Institutions?

- Central Banks and the Conduct of Monetary Policy
- Structure of the Financial System
  - Helps get funds from savers to investors
- Banks and Other Financial Institutions
  - Includes the role of insurance companies, mutual funds, pension funds, etc.



## 2. Why Study Financial Institutions? Role of Financial Institutions

### Financial Intermediaries





## 2. Why Study Financial Institutions? Financial Intermediation

- The indirect finance process is called financial intermediation, which is actually the primary means of moving funds from lenders to borrowers.
  - More important source of finance than securities markets (such as stocks)
  - Needed because of transactions costs, risk sharing, and asymmetric information





## 2. Why Study Financial Institutions? Benefits of Financial Intermediaries

- Transactions Costs
  - Financial intermediaries make profits by developing expertise and taking advantage of economies of scale to reduce **transactions costs**.
  - Low transaction costs enable a financial intermediary to provide its customers with **liquidity** services.
  - Low transaction costs help reduce the exposure of investors to risk through **risk sharing**.
- Financial intermediaries also help individuals and businesses to **diversify** their asset holdings.



## 2. Why Study Financial Institutions? Global Perspective

- Studies show that firms in the U.S., Canada, the U.K., and other developed nations usually obtain funds from financial intermediaries, not directly from capital markets.
- In Germany and Japan, financing from financial intermediaries exceeds capital market financing 10-fold.
- However, the relative use of bonds versus equity does differ by country.



### 3. Applied Managerial Perspective

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



## 4. How We Study FMI course

- Engage in discussions during lectures
- Practice the end of chapter questions after each lecture
- Read the relevant chapters of the book
- Explore the internet that provides an enormous resource for present and historical information on financial markets and institutions.



## 4. How FMI Course is Assessed

- Assessment criteria:
  - *Attendance:* (Total 15%)  
1% mark for each daily attendance of the course.
  - *Group Project Presentations:* (Total 20%)  
Each group gives a 20 minutes' presentation on the last Friday (15 July).
  - *Weekly review exams:* (Total 60%)  
Three one-hour weekly review exams on Fridays. Each accounts for 20% towards your final result for the course.



# Summary

- 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.
- Applied Managerial Perspective
- How to learn the course efficiently.



# Group Project Topics

- An investigation to financial markets in your home country and how they are affected by global economy.
- A historic review to the interest rate and mortgage rate in your home country from 2005 to 2015. Explain the causes and consequences of the major fluctuations during the period.
- Does Market Efficiency Hypothesis hold in the stock market in your home country?
- An Investigation to foreign financial institutions (commercial banks, insurance companies, pension funds, investment banks, etc.) operating in a chosen country. (You can either focus on one type of financial institutions or look at a range of them).



# Group Project

- Please form groups of 3-5 students
- Choose one topic to prepare your group project.
- The presentation will last for 15-18 minutes followed by a few minutes questioning time with the audience.





# Next Topic

- What Do Interest Rates Mean and What Is Their Role in Valuation?
- Readings:
  - Mishkin and Eakins (2009) Chapters 3-4
  - Mishkin and Eakins (2015) Chapter 4