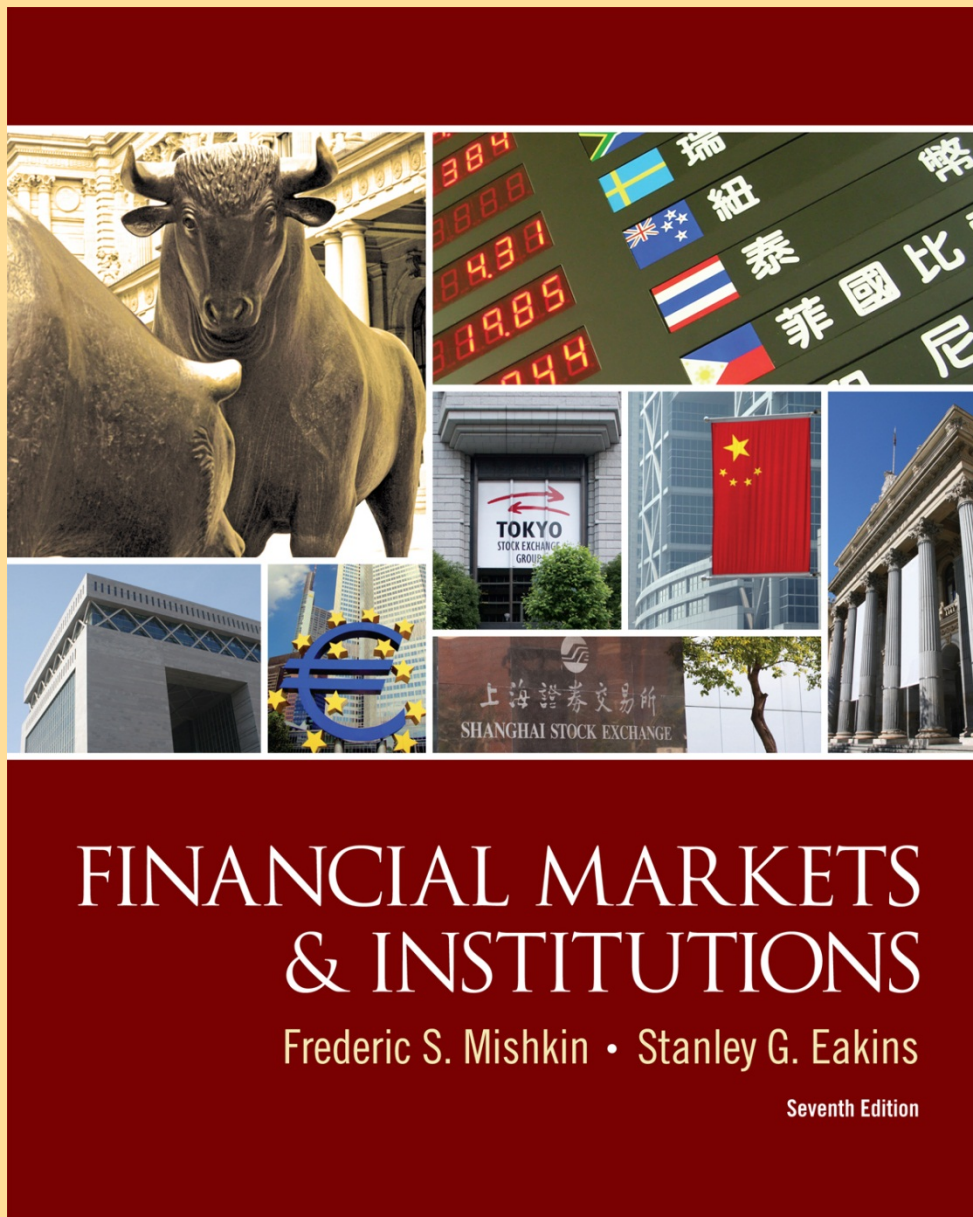


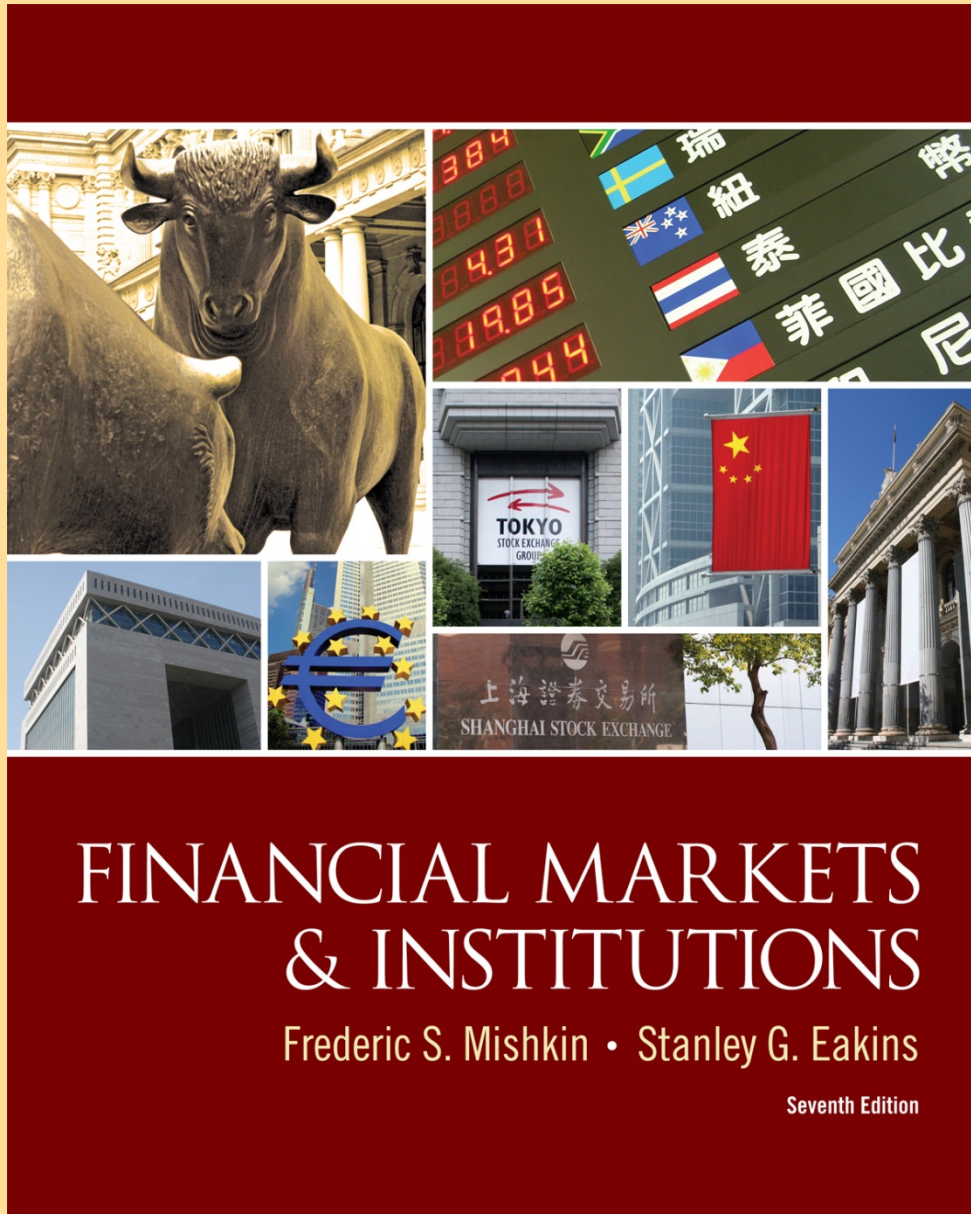
PART ONE

INTRODUCTION



CHAPTER 1

Why Study Financial Markets and Institutions?



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PEARSON



Chapter Preview

The evening news features a segment about interest rates, the Fed Chairman Ben Bernanke, and liquidity in credit markets.

What does all this mean? Do I care about interest rates? What is “the Fed?” Will this impact my firm’s ability to get a bank loan?



Chapter Preview

These are good questions. Of course, the answer to these questions can be found in this book. In fact, this book 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.



Chapter Preview

To start, we preview subjects of interest to anyone who is a part of a productive society. We motivate how financial markets and institutions have significant impact on important questions about our financial well-being.

Topics include:

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



Why Study Financial Markets?

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

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



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.



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.



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 rates in the early part of 1983 exceeded 13%. Financing a house was quite expensive at this time.



Why Study Financial Markets? Debt Markets & Interest Rates

- Because interest rates are important to individuals and business, understanding the history of interest rates is beneficial.
- The next slide shows historical interest rates in various sectors of the bond market: Long-Term U.S. Government rates, Short-Term U.S. Government rates, and corporate rates.
- We will study these further in several chapters, examining the types and characteristics of bonds, as well as theories on how rates are determined.



Bond Market and Interest Rates

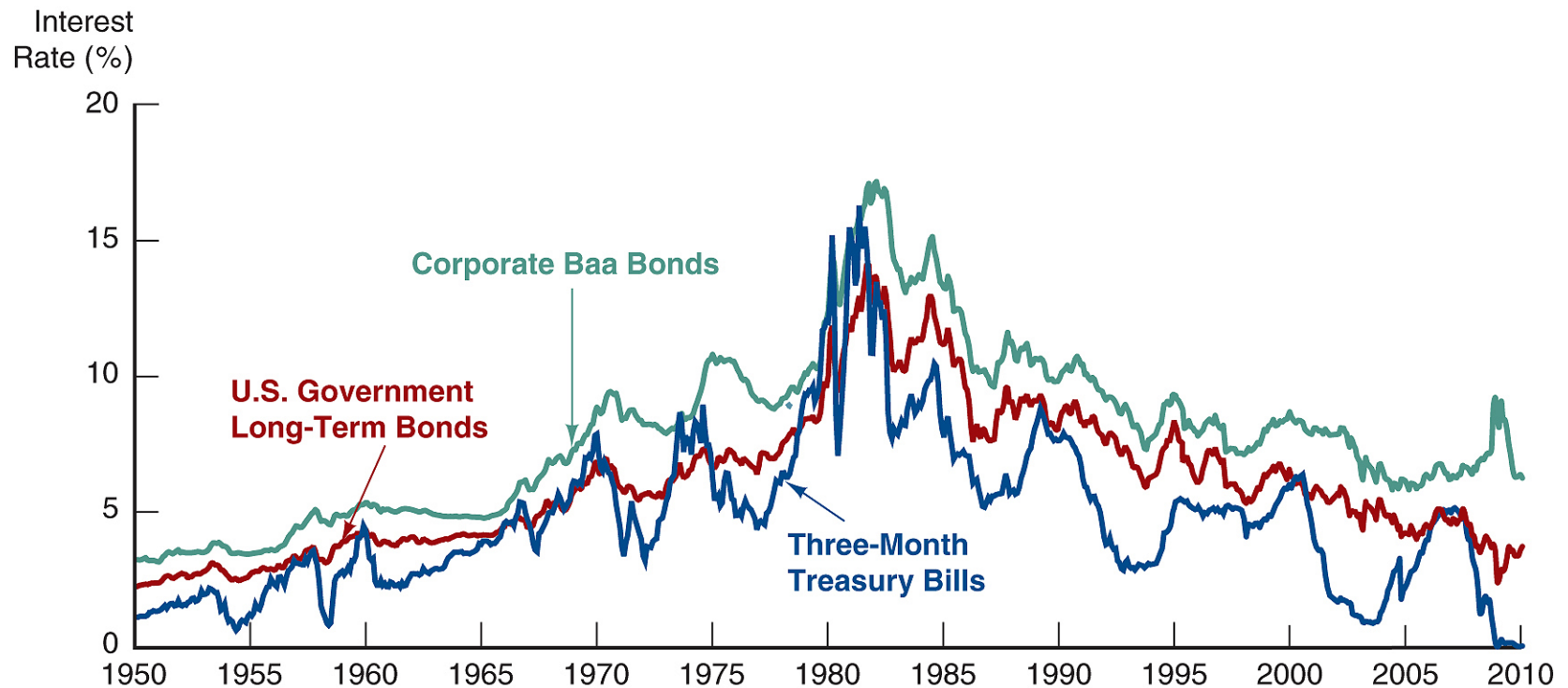


FIGURE 1.1 Interest Rates on Selected Bonds, 1950–2010

Sources: Federal Reserve Bulletin; www.federalreserve.gov/releases/H15/data.htm.



Why Study Financial Markets?

Debt Markets & Interest Rates

- For the moment, we will turn to other topics, but revisit these topics.
- In chapters 2, 9, 10, and 12, we will examine the role of debt markets in the economy.
- In chapters 3 through 5, we will examine the characteristics of interest rates.



Why Study Financial Markets?

The Stock Market

- The stock market is the market where common stock (or just stock), 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.



Why Study Financial Markets?

The Stock Market

- The next slide shows the level of the Dow Jones Industrial Average over the last 55 years. Note how volatile stock prices have been, especially over the last five years.
- In future chapters, we will examine the role of the stock market, as well as how prices react to information in the marketplace.

Stock Market

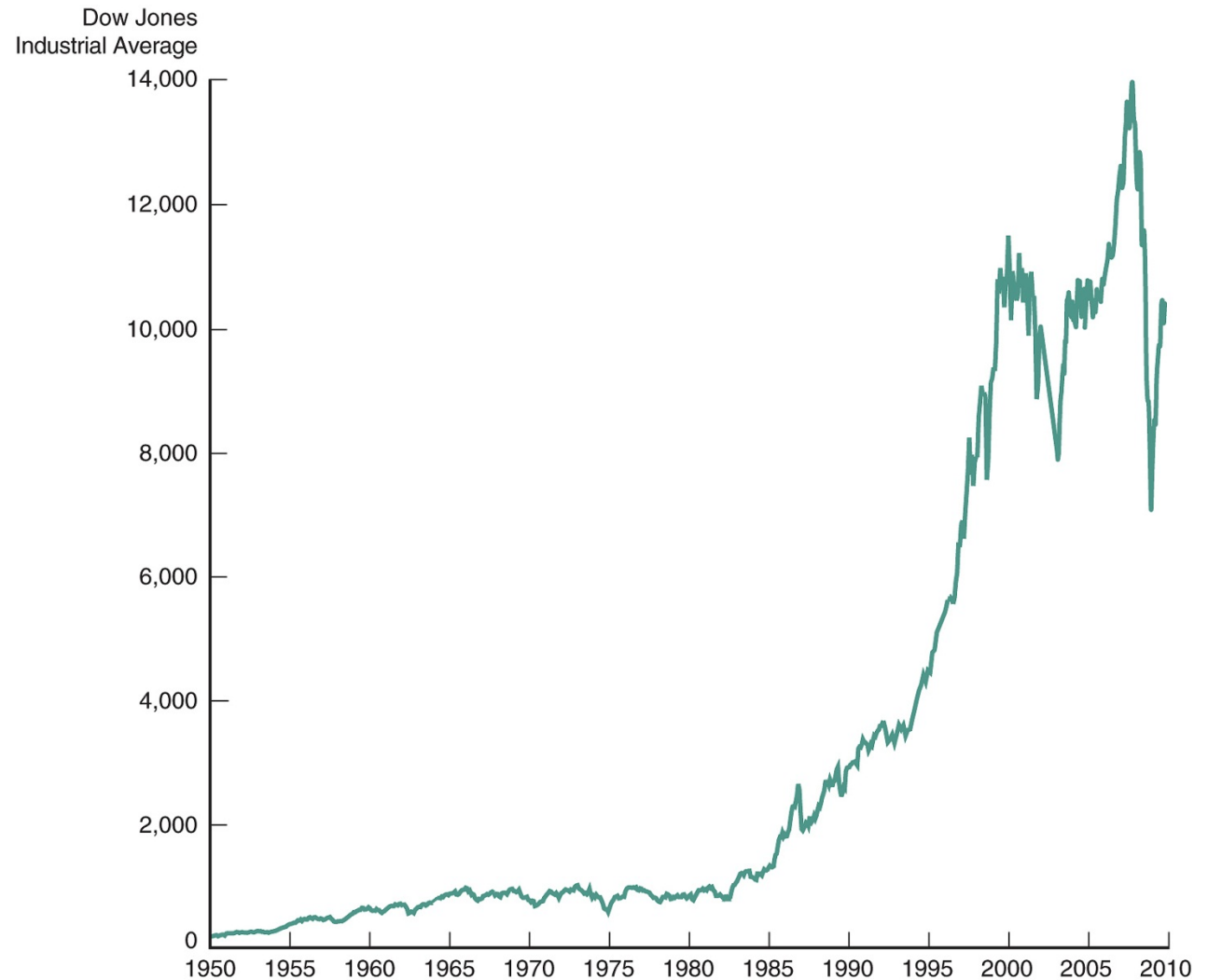


FIGURE 1.2 Stock Prices as Measured by the Dow Jones Industrial Average, 1950–2010

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



Why Study Financial Markets?

The Stock Market

Companies, not just individuals, also watch the market. Although 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.



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*** volume around \$1 trillion!



Why Study Financial Markets?

The Stock Market

- The next slide shows how the U.S. dollar has fluctuated in price against a basket of foreign currencies.
- 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, and US manufacturers experience a decreased demand for their goods.



Foreign Exchange Market

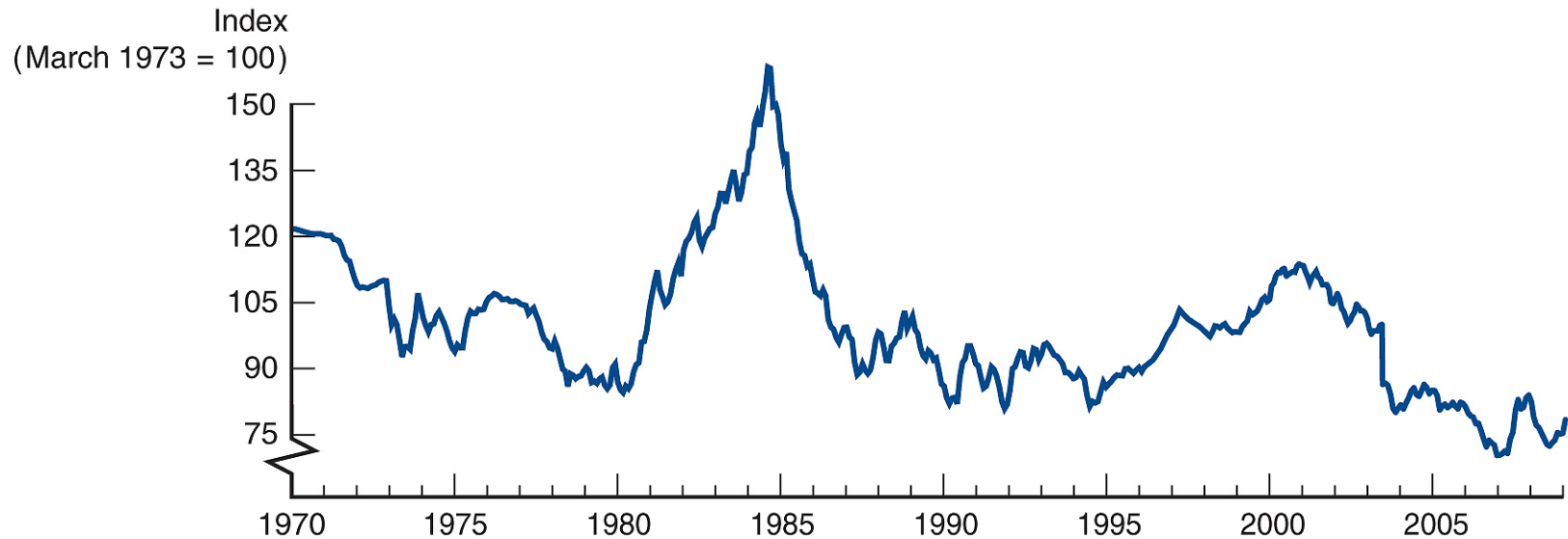


FIGURE 1.3 Exchange Rate of the U.S. Dollar, 1970–2010

Source: www.federalreserve.gov/releases/H10/summary/indexbc_m.txt.



Why Study Financial Markets?

The Stock Market

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



Why Study Financial Institutions?

We will also spend considerable time discussing financial institutions—the corporations, organizations, and networks that operate the so-called “marketplaces.” These institutions play a crucial role in improving the efficiency of the economy. We will look at:

1. Structure of the Financial System

- Helps get funds from savers to investors

2. Financial Crises

- The financial crises of 2007–2009 was the worst financial crisis since the Great Depression. Why did it happen?



Why Study Financial Institutions?

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



Why Study Financial Institutions?

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



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.



How We Study Financial Markets and Institutions

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.



How We Study Financial Markets and Institutions

Basic Analytic Framework

3. Actual articles from the *Wall Street Journal* reinforcing the concepts from the book, and explanations of articles, helping you develop critical skills to identify key concepts from the day's news.



How We Study Financial Markets and Institutions

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



Exploring the Web

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.



Exploring the Web

Web Exercise

The next three slides (starting on page 10 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.

Exploring the Web



FIGURE 1.4 Federal Reserve Web Site for Selected Interest Rates

Source: www.federalreserve.gov.

Exploring the Web

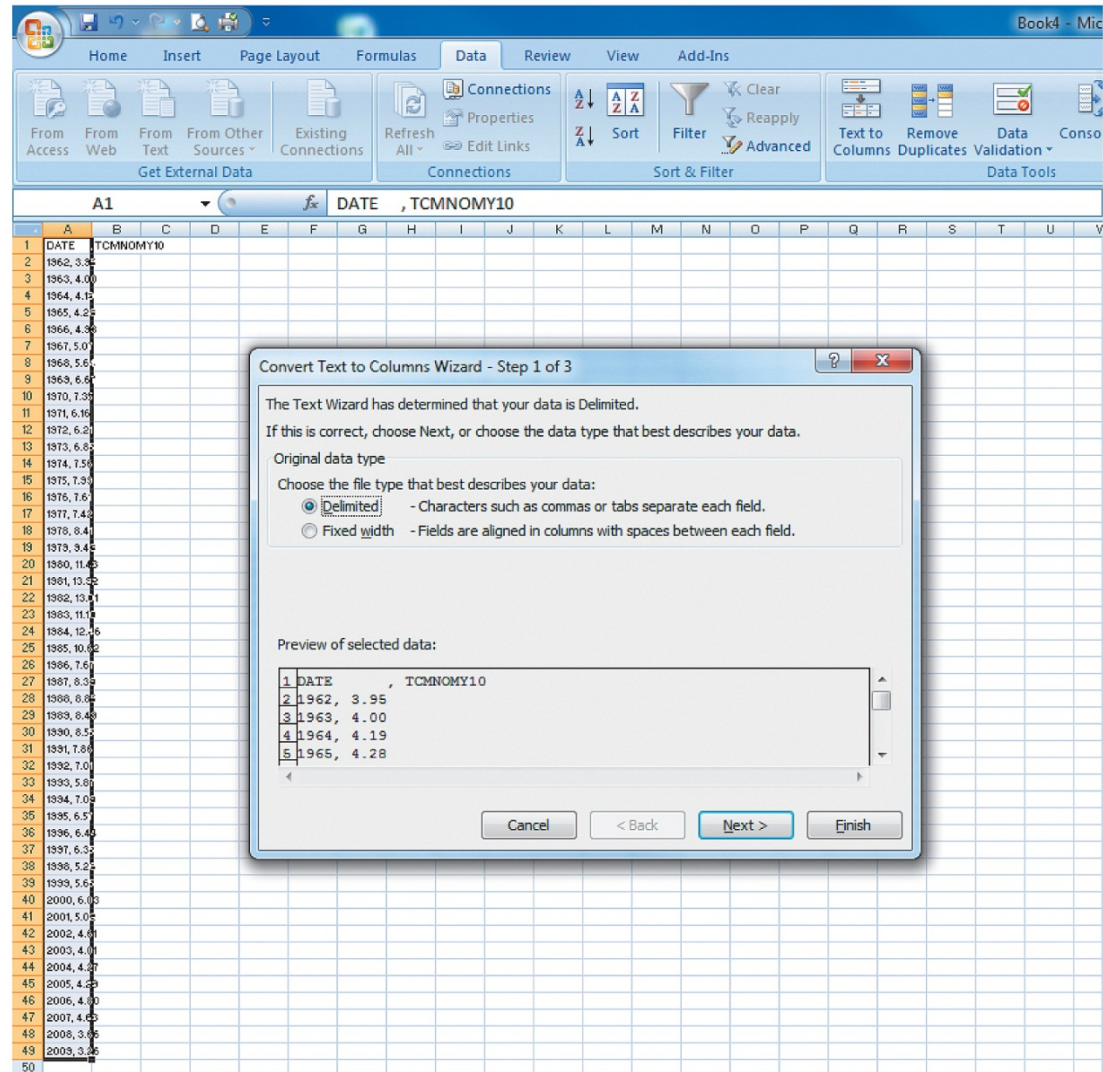


FIGURE 1.5 Excel Spreadsheet with Interest-Rate Data

Source: Used with permission from Microsoft

Exploring the Web

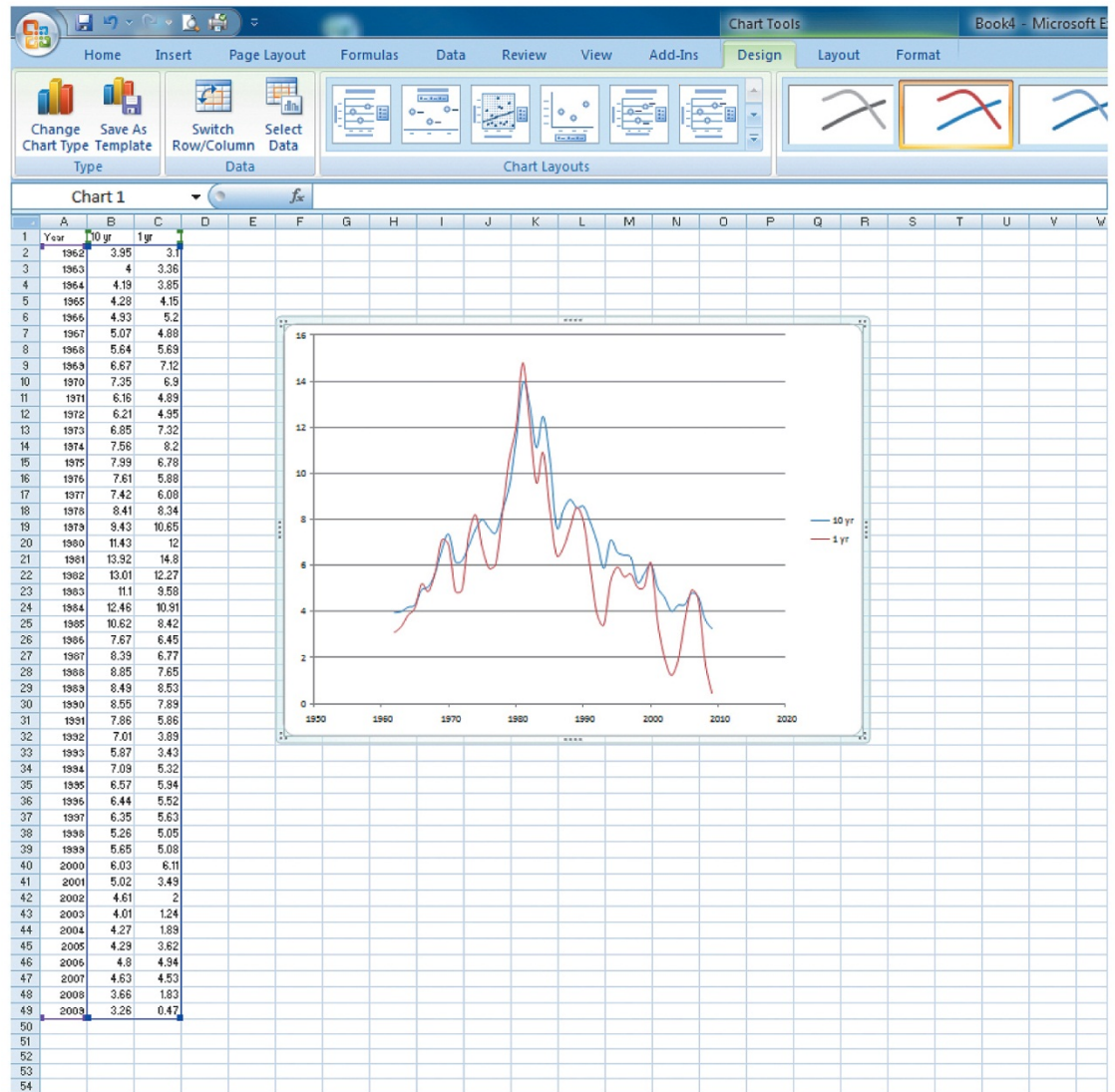


FIGURE 1.6 Excel Graph of Interest-Data

Source: Used with permission from Microsoft



Chapter 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.



Chapter Summary (cont.)

- 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.