Chapter 1 – INTRODUCTION: FINANCIAL MARKETS AND INSTITUTIONS

Central Bank
Monetary Policy
Monetary Theory

Smoothing Business Cycles,
Stability of prices, interest rates, FX rates, and the financial system
Sustaining growth/employment

Excess Funds
(Savings)
-Households
-Firms

Financial Intermediaries
(Banks, Insurance Firms,
Pension Funds, etc.)

Indirect Finance/Intermediation
(95% of the new capital in the US)
Regulated by BRSA (BDDK)

Financial Markets (Bonds, stocks, etc.)

Direct Finance/Securitization
Regulated by CMB (SPK)

Risk-averse households (Consumption
smoothing across time and states):
Consumption/saving/investment decisions
Decision making under uncertainty
Optimal portfolio selection

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Risk-averse households (Consumption
smoothing across time and states):

Theory of Finance/Financial Economics

Profit maximizing firms:
Which projects to invest in?
How to finance?
Public/Private Debt?
Public/Private Equity?

Corporate Finance

-Shortage of Funds
(Investment/consumption
opportunities)
-Firms
-Governments
-Households

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Direct Finance/Securitization
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Well functioning Financial Markets and Institutions are vital to improve

- **Market Efficiency (Allocational/Informational/Operational):** Scarce resources are allocated among available projects optimally → Best projects are financed in the cheapest way, i.e., maximum number of projects (best ones) are financed, so that growth/employment is maximized (Macro objective) (For allocational efficiency, informational and operational efficiencies are prerequisites).

- **Welfare:** Consumption smoothing is enabled. (Micro objective)

### Financial Markets:

Why do we study financial markets?
- Interest rates / stock prices, which are determined in bond/stock markets, affect:
  - Consumers’ consumption and saving decisions
  - Firms’ investment decisions

Why do interest rates / stock prices fluctuate? Which factors affect interest rates / stock prices?
- Interest rate fluctuations: borrowers (-); lenders (+, ?)
- Stock price fluctuations: firms’ investments (+); consumers’ spending (+) → (wealth effect)

Debt vs. Equity markets (bonds, mortgage, stocks, preferred stocks, convertibles)
- Bonds: coupon bonds, discount bonds, FV, c, maturity
- Stocks: residual claimholder (seniority), sensitive to profits, dividends

Primary vs. Secondary Markets
- IPO's (Initial Public Offering), Investment banking, valuation, underwriting
- Firms obtain funds only in primary markets
- Secondary markets are important, because of price determination and liquidity

Brokers (match buyers' and sellers' orders) vs. Dealers (buy and sell securities at stated prices)

Exchanges (e.g., BİST, NYSE, etc.) vs. Over-the-Counter (OTC) Markets (e.g., FX Market)

Money vs. Capital Markets:
- Money Markets (maturity ≤ 1 year): Short Term Bonds, Treasury Bills (TB), Certificates of Deposits (CD), Commercial Papers (CP), Banker's Acceptance (BA), Repurchase Agreements (Repo), Interbank Loans
- Capital Markets (maturity > 1 year): Long Term Bonds, Stocks, Mortgages, Corporate Bonds (CB)
  - Government Securities (GS): TB, GB; Corporate Securities (CS): CP, CB, stocks; Bank Securities (BS): CD, BA, Repo

International Bond Markets:
- Foreign bonds (issuer)
- Eurobonds (currency)
Financial Intermediaries:

Why do we study financial intermediaries?

- 95% of the new capital is raised through intermediaries even in the US

Why intermediation although it is more costly?

- Asymmetric information [esp. important for small savers (consumers) and borrowers (firms)]
- Transaction costs

Functions they perform:

- Reduce transaction costs (Economies of Scale)
- Transformations
  - Size
  - Liquidity (maturity)
  - Risk
- Eliminate/reduce asymmetric information between firms and households
  - Adverse selection (→ screening)
  - Moral hazard (→ monitoring)
  - Costly state verification (→ auditing)

Risks they face; ways to reduce them:

- Credit risk: Screening, specialization, long-term customer relations, etc.
- Interest rate risk: Maturity matching, Derivatives
- FX rate risk: Currency matching, Derivatives
- Portfolio risk: Diversification

Why to regulate financial institutions?

- When to regulate in general (market failures)?
  - Market power (e.g., collusion, product differentiation, bundling, abusive lending)
  - Externalities (bank runs, bank panics, real sector, payment system) → excessive risk taking
  - Asymmetric information (between banks and households) → banks have to be monitored (information is provided to public). By whom? Costly (free-riding problem) →
  - Public good

- All above are relevant for banks
  - To increase the soundness of financial intermediaries
  - To increase information available to investors
  - To protect consumers

- Specifically: Banks are inclined to take excessive risks (due to negative externalities). Households cannot observe the risks taken by banks. Monitoring banks (reducing/eliminating asymmetric information, and preventing their excessive risk taking) is a public good.
How to regulate?

- Entry restrictions (licensing, chartering)
- Disclosure requirements
- Restrictions on assets, activities, capital, competition, interest rates
- Supervision, on/off-site examinations
- Safety net: Deposit insurance, Lender of Last Resort (LLR)

Other Financial Intermediaries:

- Insurance firms, pension funds (assets: bonds, stocks - liabilities: premiums, contributions)
- Finance companies (Tüketici Finansman Şirketleri) (assets: short term credits to clients - liabilities: long term bonds)

Central Banks and Monetary Policy:

- Objectives: Stability and growth (Are they conflicting? They may be in the short run but not in the long run)
  - Smoothing business cycles (booms and recessions)
- How? Monetary Policy (Adjusting the amount of money: M1, M2, M3) Tools
  - Open Market Operations (OMO): Repo, Reverse Repo
  - Reserve requirements
  - Discount Loans
- Counter-Cyclical Monetary Policy:
  - Recessions → expansionary monetary policy (OM purchase)
  - Booms → contractionary monetary policy (OM sale)
- Money growth rate is related with economic growth and inflation (consumption, saving, investment, financing decisions)