Role of financial markets:
A general overview of functions and benefits

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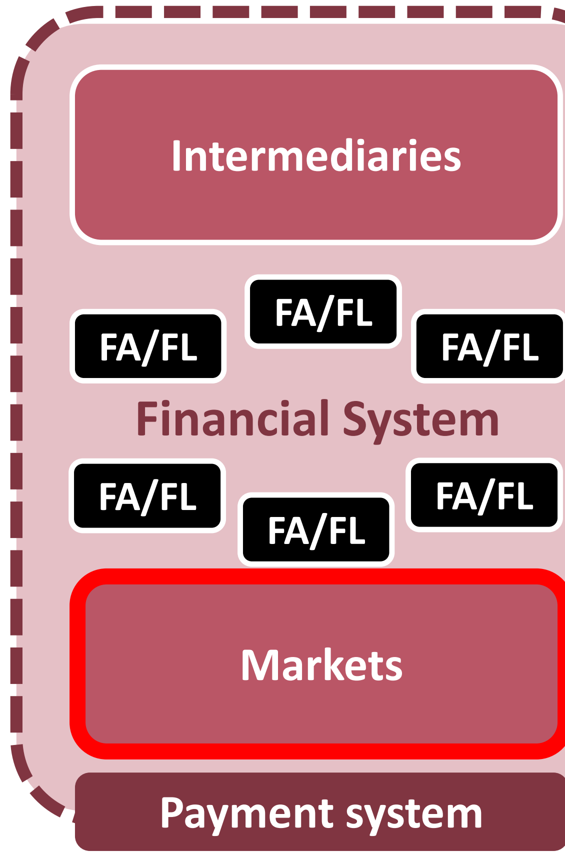
Objective

- Start discussion on financial markets by highlighting the broader context
- Brainstorm on motivation behind financial market development
- Review general function of financial markets as an element of the financial system
- Review function of specific financial market segments

Context of discussion
Financial System: Basic structure

- **Financial markets (and their development) need to be seen in the broader context of the financial system**
- **A financial system consists of**
  - Money (means of payment)
  - Financial instruments
  - Financial markets
  - Financial institutions
  - Financial infrastructure (payment systems)



Questions

(1) Why is it desirable to develop (national) financial markets? What are benefits of (developed) financial markets?

(2) What general functions do financial markets serve?

(3) Why is it desirable to have/develop various financial market segments? How do the functions of financial market segments differ? Which financial market segments cater for what needs?

(4) What characterizes (efficient) functioning financial markets?

Benefits of financial markets

REFLECTION

- **Why is it desirable to have or develop (national) financial markets? What are benefits of (developed) financial markets?**
  - From a general perspective?
  - From the perspective of CBs?

Function of financial markets

REFLECTION

- **What functions do financial markets serve? What distinguishes financial markets from financial intermediaries?**

Benefits of financial markets
The finance-growth nexus

- **Contribute to efficient allocation of economic resources**
- **Support economic growth and resilience**
- **Promote poverty reduction**

How?

… confirmed by research

Function of financial markets
General functions: Financial services

Financial systems provide several services to the economy (economic agents)

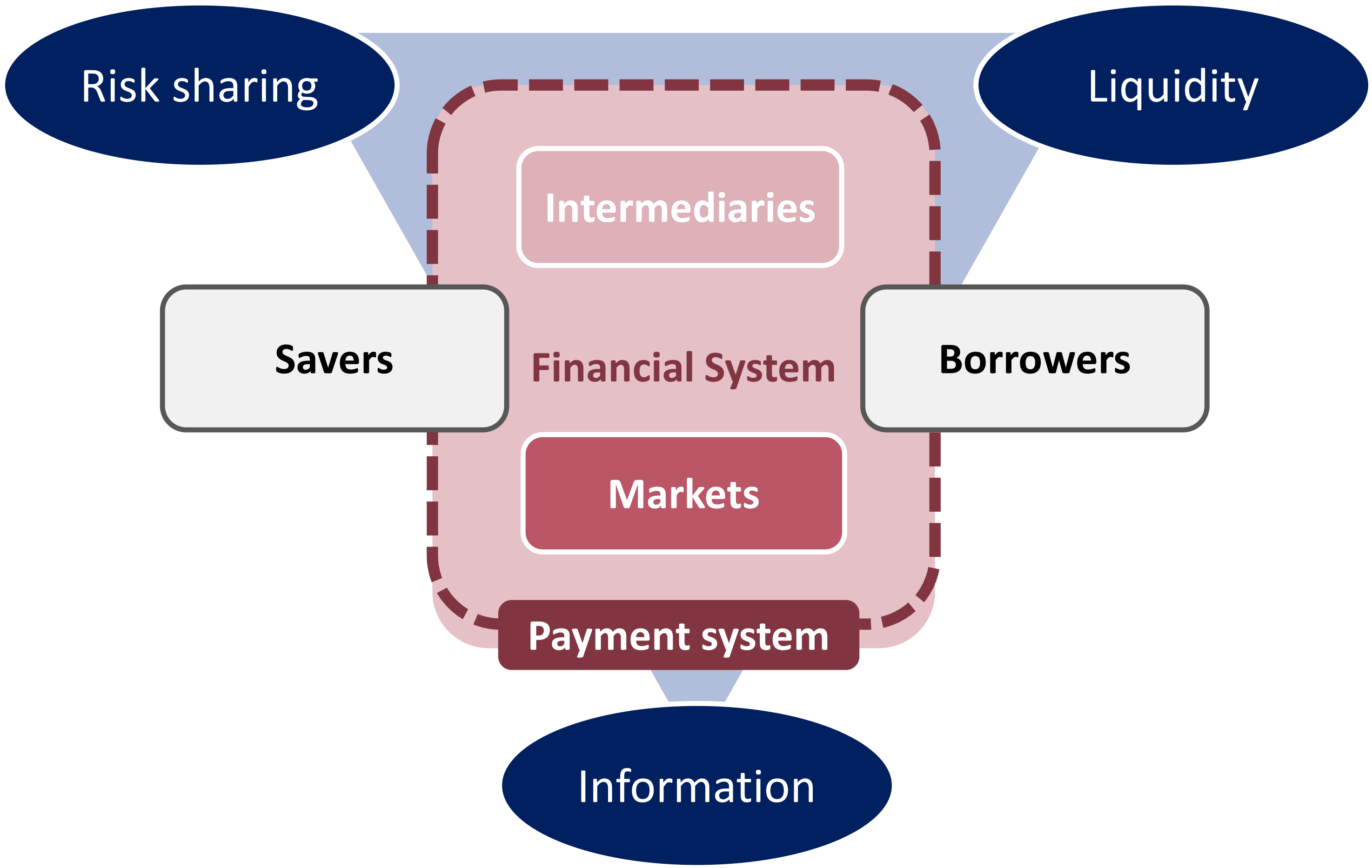
Allocate capital (funds)	• Allows exchange (flow) of funds between lenders, investors, and borrowers • Financial systems provide different channels to allocate funds: directly (via markets) or indirectly (via intermediaries)
Making payments	• Provides transfer mechanisms to channel funds between economic agents • Payment systems and providers of payment system services play crucial role in channeling funds (electronically) by clearing and settling financial transactions
Mobilize savings	• Provides saving instruments • Pooling funds that can be matched with borrower needs
Monitor use of funds	• Funds exchanged take the form of different financial assets and liabilities that can be traced and analyzed
Transform risks	• Provide hedging instruments

Function of financial markets
Distinction between financial markets and intermediaries

- **In contrast to financial intermediaries, financial markets**
- **… match saver and borrower (needs) directly**
  - Example: A company issues a share to raise capital for an investment project. The shares are bought by private households in order to save for retirement
- **… allow financial instruments to be traded**
  - Example: Housholds who own stocks can sell them when to get their invested funds (current market value) back
- **Prices reflect demand and supply (bying & selling) of financial market participants**
- **Financial market transactions take place between a variety of different market participants including households, firms, government, financial intermediaries**

Function of financial markets
Special functions of financial markets

- **In contrast to financial intermediaries, financial markets provide additional services**



Function of financial markets
Special functions of financial markets (cont.)

Liquidity	Risk sharing	Information
• Refers to ease with which assets can be exchanged/sold without loss in value • The higher the liquidity the easier economic agents can (re-) allocate funds at any given time	• Allowing savers to hold a **portfolio** of different assets (→**‚diversification‘**) • The more developped the financial system the more risk can be shared/diversified	• Parts of the financial system specialize in information gathering and monitoring • Special arrangements to solve problem of asymmetric information (→ financial regulation) • The better the available information the lower information (and transaction) costs

- the more willing savers will be to provide funds to potential borrowers
- the greater the ability to raise funds

Special functions of financial markets (cont.)

Reflection

- **How do the scenarios differ with respect to the degree of risk sharing, liquidity and information?**

Imagine your friend's company wants to borrow …	SCENARIO 1: You give your savings to the company of your friend	SCENARIO 2:The company of your friend gets a loan from the same bank where you keep your savings on an account	SCENARIO 3: The company of your friend issues tradable bonds. You purchase some bonds using part of your savings
Risk sharing			
Liquidity			
Information			

Function of financial markets
Role for local financial markets

1	• Local financial markets allow governments to finance fiscal deficit without having to resort to foreign borrowing
2	• Local financial markets support conduct of monetary policy (provide instruments and give information) → arena for action & source of data
3	• Local capital markets improve availability of long term financing
4	• Local financial markets improve access to local currency assets
5	• Local financial markets improve financial deepening and increase efficiency of capital allocation
6	• …

See IMF (2014): The Development of Local Capital Markets: Rationale and Challenges

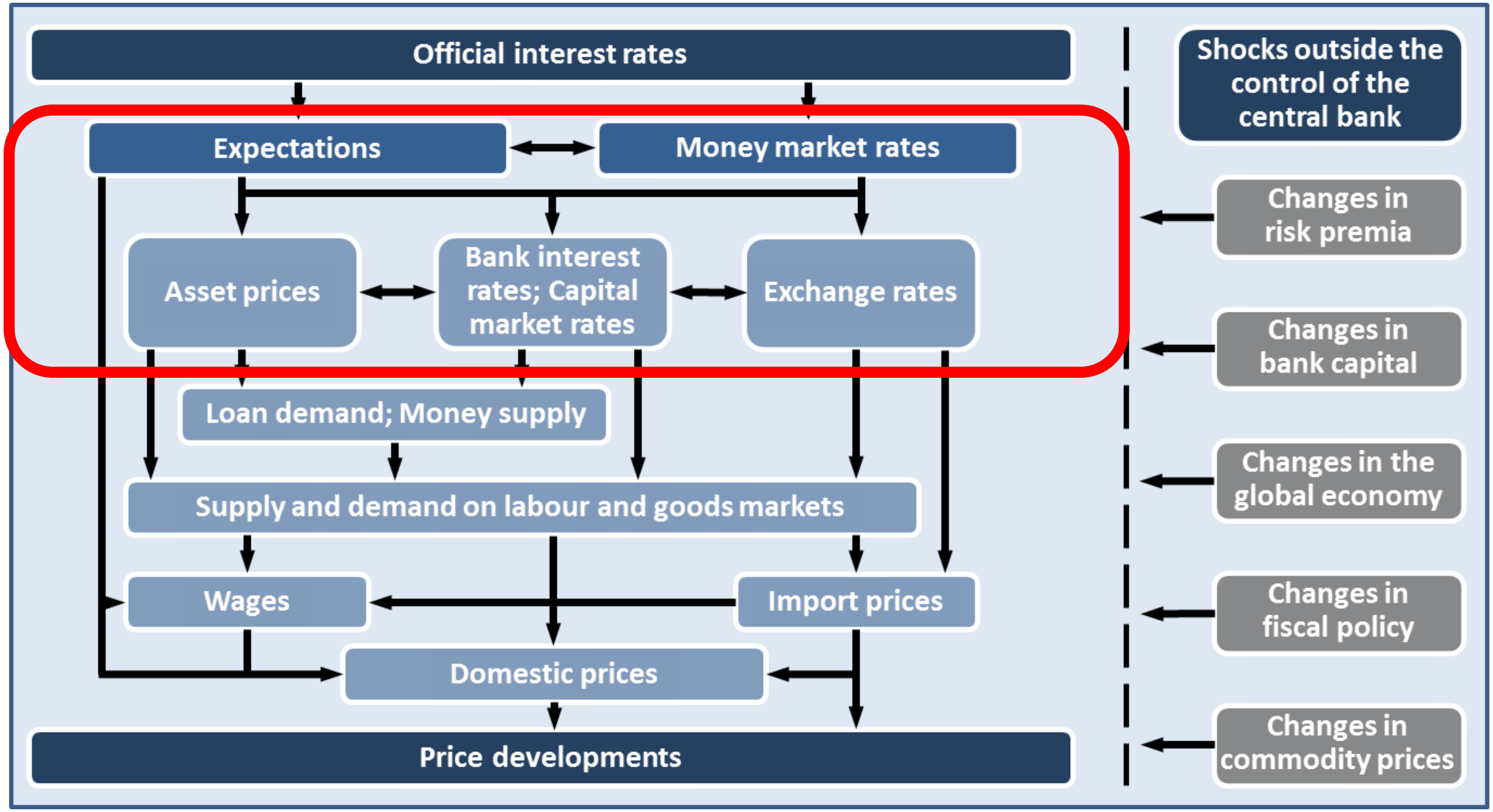
Function of financial markets
General role with a view to different CB functions

CB functions

(e.g. monetary policy, FX reserve management, financial stability etc.)

Data source	• Data collection and analysis of monetary and financial developments provides basis for policy formulation (i.e. decisions) and implementation (i.e. operations)
Source of risk	• Monetary & financial developments may undermine achieving the policy objectives or may call for particular CB actions
Arena for action	• Monetary operations take place within the monetary and financial system
Venue for policy transmission	• Monetary policy stance is transmitted through the monetary and financial sector

Function of financial markets
Special role for monetary policy transmission



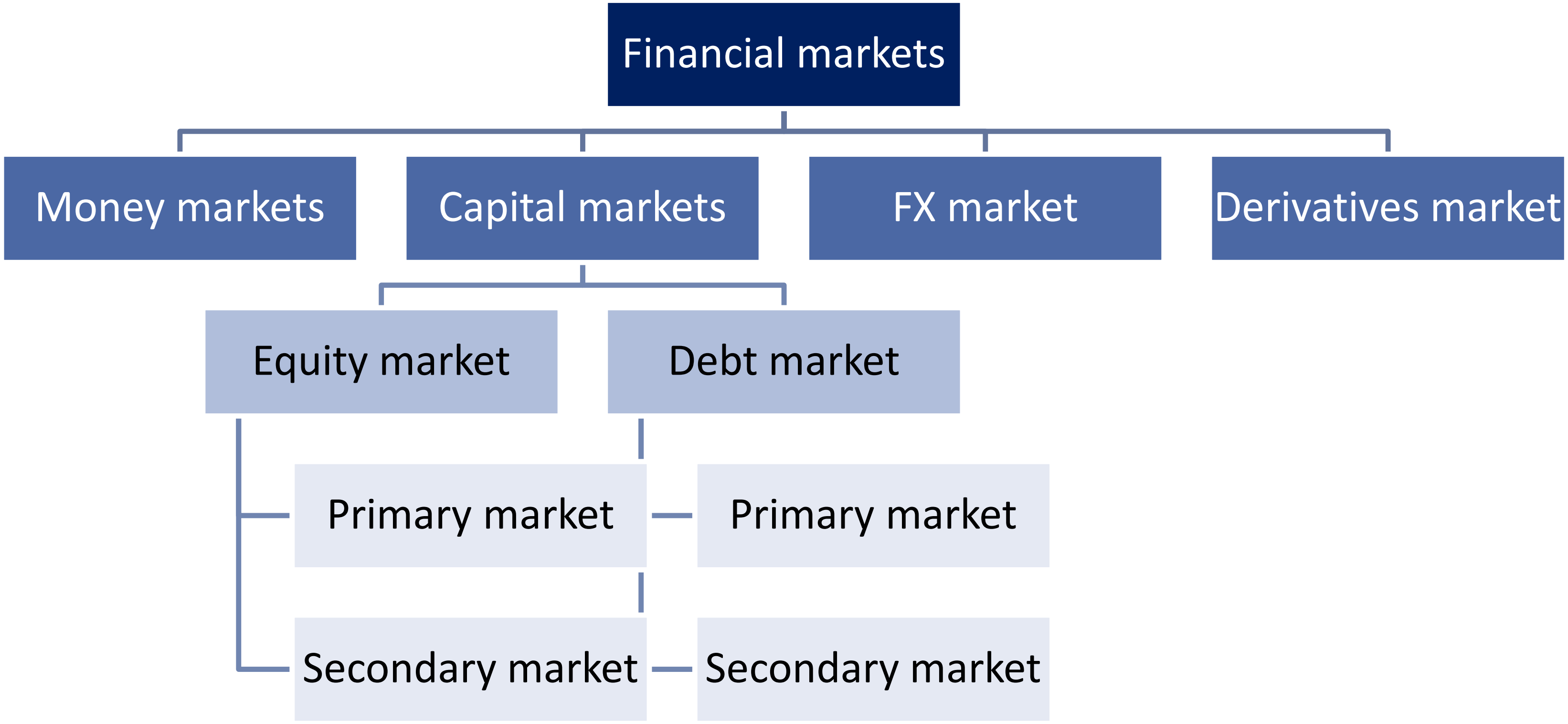
Function of financial markets: Specific market segments

REFLECTION

- **Why is it desirable to have/develop various financial market segments?**
  - From a general perspective?
  - From the perspective of CBs? (Which financial market segments are of particular relevance with regards to your tasks at the CB?)
- **What are functions of specific financial market segments? How do the functions of financial market segments differ? Which financial market segments cater for what needs?**
  - Money vs capital market
  - Equity vs debt market
  - Cash vs derivative market

Function of financial markets: Specific market segments
Overview of financial market segments

- **Different financial market segments cater for different needs/serve different purposes**



Function of financial markets: Specific market segments
Distinction of financial market segments

Primary vs Secondary markets

- Dinstinguishing characteristic: **Purpose** for savers and borrowers
- **Primary markets** are markets in which financial market products are initially sold. Their main purpose is to **raise funds**.
- **Secondary markets** are markets in which financial market products are bought and sold among investors. They **provide liquidity and facilitate risk and maturity management**

Equity vs Debt markets

- Distinguishing characteristic: **Legal rights and obligations** attached
- **Equity** instruments provide a claim to profits and assets of a firm. Investors become (partial) owner of the company and are involved in the governance of the firm
- **Debt** market instruments are claims which requires the borrower to repay the borrowed amount (the principal) plus a rental fee (the interest) either at once or periodically over a fxed period of time (maturity)

Money vs Capital markets

- Distinguishing characteristic: **maturity** of the traded financial instruments
- Maturities of less than a year (short term) are issued and traded on the **money market**
- Instruments with a maturity greater than a year (longer term)are issued and traded on the **capital market**

Function of financial markets: Specific market segments

Distinction of financial market segments: Bond & credit market

- **Bond and credit market are terms often used interchangeably**
  - Bond market is actually only a segment of the credit market
  - Credit market refer to a market segment through which economic agents (companies and governments) issue debt such as bonds, short-term commercial paper
  - Instruments are primarily issued to cover an entity's financing needs
- **In the broader sense, the credit market also includes derivative markets**
  - designed primarily to transfer risk
  - traded instruments: futures, options and swaps

Function of financial markets: Specific market segments
Distinction of financial market segments (cont.)

Financial markets can be distinguished further

Settlement of financial transactions	• **Cash market:** Settlement takes place „immediately“ (accord. to market convention eg t+2) • **Derivatives market**: Settlement takes place at prespecified future date (‚Future‘) or within a prespecified time period (‚Option‘) → *not the only distinction of derivative markets! Main characteristic:* ***risk transfer***
Currency/Unit of payment	• **FX market**
Issuer	• **Public issuer** e.g. government bond market, municipal bond market • **Private issuer:** Corporate bond market, stock market

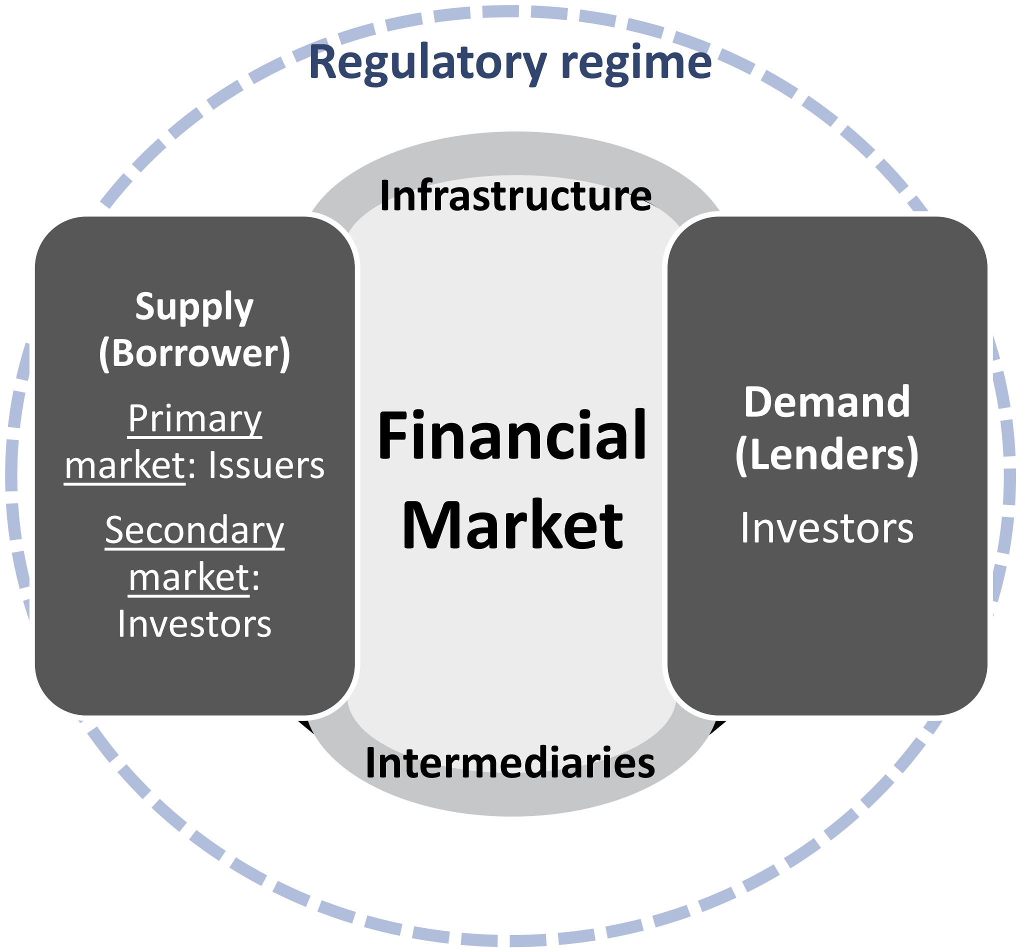
Characteristics of efficient functioning financial markets

Reflection

- **What are basic characteristics of efficient functioning financial markets?**

Characteristics of efficient functioning financial markets
General considerations (1)

- **Functioning financial markets build on „the four Is“**
  - **Issuers** with short, medium and longer-term financing needs (→ supply)
  - **Investors** with a need to place savings (→ demand)
  - **Intermediaries** bringing issuers and investors together
  - **Infrastructure** providing conducive environment for transactions, settlement and price discovery
- **… in the context of a regulatory regime providing the basic framework**



Characteristics of efficient functioning financial markets
General considerations (2)

(1) Competitive market structure

(2) Low transaction costs

– incl. search/information costs, legal costs, transaction & settlement costs, etc.)

(3) Accurate, widely available information

– in particular, accurate pricing of financial assets

(4) Investor protection

(5) Robust/safe market infrastructure

(6) Heterogeneity among market participants

(7) (Low level of fragmentation)

Key takeaways

- Financial markets (and their development) need to be seen in the broader context of the financial system
- Financial markets provide special services to the functioning of a market-based economy, promoting the general economic development (→ finance-growth-nexus)
- Specific financial market segments serve different functions and cater for different needs of economic agents
- Efficiently functioning financial markets build on a diverse issuers and investor base which deal with each other with the support of various financial intermediaries via a range of infrastructures on the basis of a regulatory framework

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