

The Financial System.

Notes

“THE FINANCIAL SYSTEM” TARGETS

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BASICS OF THE FINANCIAL SYSTEM

The stock market is just one part of the financial system. The institutions and markets that bring savers and investors together is the **financial system**.

- 1)
- 2)
- 3)
- 4)

FUNCTIONS OF THE FINANCIAL SYSTEM

The purpose of the financial system is to reduce transaction costs, reduce financial risk, and provide liquidity.

- 1) **Reduce Transaction Costs**
- 2) **Reduce Financial Risk**
- 3) **Provide Liquidity**

TYPES OF FINANCIAL ASSETS

Financial assets have value because of a contractual agreement between two parties. (They have no physical value, like physical assets.)

- 1) **Bank Deposits**
- 2) **Loans**
- 3) **Bonds**
- 4) **Stocks**

FINANCIAL INTERMEDIARIES

Financial intermediaries are institutions that gather together money from many people and transform those funds into financial assets.

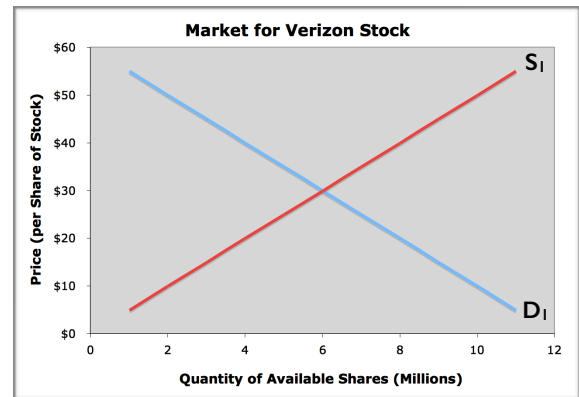
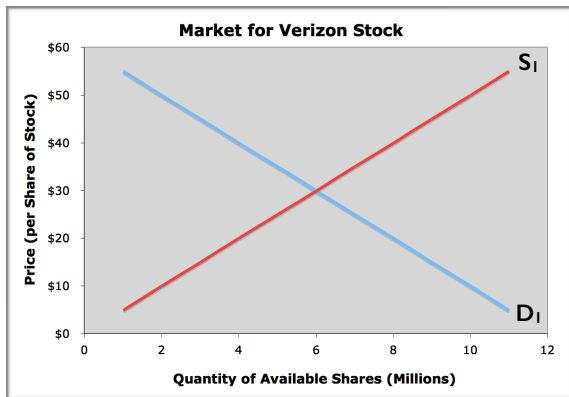
- 1) Mutual Funds
- 2) Pension Funds
- 3) Life Insurance
- 4) Banks

THE STOCK MARKET

Remember that stock is a financial asset. Any owner of stock can hold onto or sell his/her shares of stock at any time.

- 1) A stock has value because of its ability to generate future income.
 - A)
 - B)

- 2) A stock’s price is determined by expectations about the future.
 - A) If expectations are good:
 - i)
 - ii)
 - B) If expectations are bad:
 - i)
 - ii)



STOCK MARKET EXPECTATIONS

Current stock prices are determined by expectations about the future, but how are these expectations formed?

- 1) Efficient Markets Hypothesis
 - A)
 - B)
 - C)
- 2) Irrational Markets
 - A)
 - B)