Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: International Trade
Level: Third year Bachelor

Lecture 06: Financial Markets (Definition. Function. Organization. Instruments).

Learning Objectives

After teaching this Lecture the Students should be able to:

- *Define the* Financial Markets

- Discuss the Function of Financial Markets

-*Elucidate the Organization of the* Financial Markets

- Distinguish the Primary and secondary Markets

- Define the Money and Capital Markets

- List and describe the different used instruments in financial Markets

The Lecture is about the Financial Markets**.** Here we examine the securities (instruments) traded in financial markets. We first focus on the instruments traded in the money market and then turn to those traded in the capital market.

1- Defining the financial Markets

The financial Markets are simply the mechanisms and conventions that exist for the transfer of funds and their counterparts (i.e. the financial instruments) between the various participants. In fact, all the ultimate saver-lenders and borrower-spenders (Household, Businesses, Government and Foreigners) and all the financial Intermediaries are participants in the financial Markets. It refers to *direct finance,* borrowers borrow funds directly from lenders in financial markets by selling them *securities* (also called *financial instruments*).

2- The Function of financial Markets

In fact, it is hard Without financial markets to transfer funds from a person or firm who has no investment opportunities to one who has them. Financial markets are thus essential to promoting economic efficiency.

The existence of financial markets is also beneficial even if someone borrows for a purpose other than increasing production in a business. Say that you are recently married, have a good job, and need to buy a house. You get a good salary, but because you have just started to work, you have not yet saved much. Over time, you would have no problem saving enough to buy the house of your dreams, but by then you would be too old to get full enjoyment from it. Without financial markets, you are stuck; you cannot buy the house and must continue to live in your tiny apartment. They allow funds to move from people who lack productive investment opportunities to people who have such opportunities. Thus financial markets are critical for producing an efficient allocation of capital, which contributes to higher production and efficiency for the overall economy

3- Structure of Financial Markets

The following descriptions of several categorizations of financial markets elucidate essential features of these markets.

- Primary and secondary financial Markets

A **primary market** is a financial market in which new issues of a security, such as a bond or a stock, are sold to initial buyers by the corporation or government agency borrowing the funds.

The primary markets for securities are not well known to the public because the selling of securities to initial buyers often takes place behind closed doors. An important financial institution that assists in the initial sale of securities in the primary market is the investment bank. It does this by underwriting securities: It guarantees a price for a corporation's securities and then sells them to the public.

A **secondary market** is a financial market in which securities that have been previously issued (and are thus secondhand) can be resold. Securities brokers and dealers are crucial to a well-functioning secondary market. Brokers are agents of investors who match buyers with sellers of securities; dealers link buyers and sellers by buying and selling securities at stated prices. When an individual buys a security in the secondary market, the person who has sold the security receives money in exchange for the security, but the corporation that issued the security acquires no new funds. Secondary markets serve two important functions. First, they make it easier and quicker to sell these financial instruments to raise cash; that is, they make the financial instruments more liquid. The increased liquidity of these instruments then makes them more desirable and thus easier for the issuing firm to sell in the primary market. Second, they determine the price of the security that the issuing firm sells in the primary market.

- **Money and capital Markets**: it is another way of distinguishing between financial Markets

Money Markets: it is a financial market in which only short-term debt instruments (less than one year) are traded. Money market securities are usually more widely traded than longer-term securities and so tend to be more liquid. Firms and banks actively use the money market to earn interest on surplus funds that they expect to have only temporarily. In this market, short-term securities have smaller fluctuations in prices than long-term securities, making them safer investments. That is why money market securities are usually more widely traded than longer-term securities and so tend to be more liquid.

Capital Markets: is the market in which longer-term debt (generally those with original maturity of one year or greater) and equity instruments are traded.

4- Instruments traded in financial markets.

- Money Market Instruments: the debt instruments traded in the money market are short terms to maturity that is why, they undergo the least price fluctuations and so are the least risky investments.

Treasury Bills: They are short-term debt instruments and are issued to finance the government. They pay a set amount at maturity and have no interest payments, but they effectively pay interest by initially selling at a discount, that is, at a price lower than the set amount paid at maturity. For instance, you might pay $10,000 in May 2021 for a one year Treasury Bill that can be redeemed in May 2022 for $11,000. Furthermore, They are the most liquid of all the money market instruments, because they are the most actively traded. They are also the safest of all money market instruments, because there is almost no possibility of *default*, a situation in which the party issuing the debt instrument is unable to make interest payments or pay off the amount owed when the instrument matures. The government is always able to meet its debt obligations, because it can raise taxes or issue *currency* (paper money or coins) to pay off its debts. Treasury bills are held mainly by banks, although small amounts are held by households, corporations, and other financial intermediaries.

Negotiable Bank Certificates of Deposit: A *certificate of deposit* (*CD*) is a debt instrument, sold by a bank to depositors, that pays annual interest of a given amount and at maturity, pays back the original purchase price. They are an extremely important source of funds for commercial banks, from Firms, and government agencies.

Banker's Acceptances: A *banker's acceptance* is a bank draft as a promise of payment similar to a check, issued by a firm, payable at some future date, and guaranteed for a fee by the bank that stamps it "accepted."In fact, this instrument is created in the course of carrying out international trade and has been in use for hundreds of years. These "accepted" drafts are often resold in a secondary market at a discount and are therefore similar in function to Treasury bills. Furthermore, the firm issuing the instrument is required to deposit the required funds into its account to cover the draft. If the firm fails to do so, the bank's guarantee means that it is obligated to make good on the draft. The advantage to the firm is that the draft is more likely to be accepted when purchasing goods abroad, because the foreign exporter knows that even if the company purchasing the goods goes bankrupt, the bank draft will still be paid off.

Repurchase Agreements: are short-term loans (usually with a maturity of less than two weeks) in which Treasury bills serve as *collateral*, an asset that the lender receives if the borrower does not pay back the loan. The most important lenders in this market are large corporations.

- Instruments traded in Money markets:

These instruments are debt and equity instruments with maturities of greater than one year.

Equity: it is Stock claims on the net income and assets of a firm.

Mortgages: are loans to households or institutions to purchase housing, land, or other real structures, where the structure or land itself serves as collateral for the loans.

Government Securities: These long-term debt instruments are issued by the country Treasury to finance the deficits of the government. Because they are the most widely traded bonds in any country, they are the most liquid security traded in the capital market. They are held by the banks, households, and foreigners.

5- Key Terms to learn

-Securities: The term "security" refers to a fungible, negotiable financial instrument that holds some type of monetary value.

-Efficiency: signifies a peak level of performance that uses the least amount of inputs to achieve the highest amount of output.

-Increasing: rising in number, amount or level of something.

-Saving: is an interest-bearing deposit account held at a bank or other financial institution

-Efficient allocation of capital:

-Issue: An issue is a process of offering securities in order to raise funds from investors. Companies may issue bonds or stocks to investors as a method of financing the business.

-Liquid: A liquid asset is an asset that can easily be converted into cash in a short amount of time

-Fluctuations: to change frequently from one thing to another (used about prices….).

-Maturity: Maturity is the date on which the life of a transaction or financial instrument ends,

-Default: Default is the failure to repay a debt, including interest or principal, on a loan or security. A default can occur when a borrower is unable to make timely payments, misses payments, or avoids or stops making payments. Individuals, businesses, and even countries can default if they cannot keep up their debt obligations. Default risks are often calculated well in advance by creditors.

-Owe: to have to pay money for something they have done

-Pay off: to pay all the money that you owe for something.