Week 1 Learning Objectives

- Understand the crucial role of the financial services sector in the economy.
- Understand the interrelationships between financial services, markets, and institutions.
- Understand how financial institutions and markets facilitate funds intermediation, payments services, provision of liquidity, and risk transfer.
- Understand how funds intermediation meets the financial objectives of deficit spending units and surplus spending units.
- Distinguish between real assets and financial assets

Week 1 Lecture

Your enrollment in this course is very timely. Periodic financial crises during recent years have raised numerous questions about the operation and regulation of the world financial system. Economists, central bankers, and government officials are busy studying ways of stabilizing financial markets, preventing the spread of financial contagion, improving supervision of banking systems, improving coordination of global economic policies and improving the world economy. International financial institutions, such as the IMF and World Bank, are coming under increased scrutiny. World leaders talk of creating a new "Global Financial Architecture". The global banking system is undergoing rapid consolidation, resulting in all-purpose "mega-banks". The stock exchanges are merging, the fed is tightening, the dollar is falling, real estate is soaring and many other events are shaping our financial markets and our own financial well being.

This course will not resolve the complex problems in global finance. But it should help you understand the nature of modern financial markets, instruments, and institutions; clarifying ongoing debates and providing a basis for you to decide how to handle these events and their impact on you and your own situation. I will put heavy emphasis on interpreting the relationships between key financial market variables. A historical perspective will allow us to analyze what has gone right or wrong, and what lessons we have learned from events such as the U.S. Savings and Loan crisis, the Japanese banking crisis, and recent financial market meltdowns in Asia, Russia, Turkey, and parts of Latin America (most recently Argentina).

With some of these events still playing out and new problems popping up, I will try to bring things up to date in our Current Events and through supplementary lectures in the Lesson. I will also use the Current Events area to assess recent economic data releases and current financial market activity. This class is more than just learning how an investment bank differs from a commercial bank. Its learning how financial markets and institutions influence our lives and how to use the message they send to make better decisions.

First things first. It is important to understand that the financial sector does not stand on its own. Rather, it mirrors events in the real economy. A financial asset is merely a claim against real assets, such as houses or industrial machinery. Every real transaction has a financial transaction behind it. In the simplest case, the exchange of money for goods is an example. A more complex case is a home purchase, where you might purchase the home with a combination of cash and a mortgage, and the bank which provided the loan might package up your mortgage with other mortgages and re-sell it as part of a larger security. These larger securities may, in turn, trade several times over in the secondary mortgage market. So the homeowner really doesn't know where the money goes that is being paid each month. It may sound complicated, and I guess in some ways it is, but financial markets are not hard to understand.

Financial markets can be viewed as the oil that greases the economy. An improperly functioning financial sector can seriously hinder economic development but a well oiled machine can increase output and our well being. Regulators and lawmakers have an impact on this and are therefore rightly included in our work here. But this is not a political class and we need to recognize that it is easy to take a political position here and we need to avoid that temptation. Regardless of your bias, please don't take or defend positions based on political reasons. The current Social Security debate is a good example. It is easy to take partisan sides with this issue. But this is an economics course and the fate of elections isn't relevant. What is relevant is the fate of investors like you and me and the economy as a whole. Objective analysis of even the hottest issues is welcome, but hopefully you will quickly see that being blinded by bias isn't to anyone's advantage, especially yours. Independent thought, logic and reason are hallmarks of good decision making for your company or for yourself. The financial markets hit at our core and therefore can bring out some political and sometimes emotional responses. Please take this class as an opportunity to step back from any of these feelings and gain an independent objective view.

I will leave it to you to read the first couple of chapters of the textbook, which provide a broad overview of financial services. (I will try not to be too repetitive in these lessons.) It should be remembered that both markets and institutions facilitate the provision of financial services, which he defines to include funds intermediation, payments services, provision of liquidity, and risk transfer.

All of these financial services are extremely important, but perhaps the most crucial service is funds intermediation, whereby surplus spending units (SSUs, which are the lenders or suppliers of funds) are hooked up with deficit spending units (DSUs, which are the borrowers or users of funds.) Financial institutions (such as commercial banks)and financial markets act as facilitators of this process. In every transaction, some form of financial instrument (or security) is created. Many of these instruments are traded everyday in the different financial markets. Financial instruments are really just IOUs which enable the issuers (the DSUs) to spend more than their present income, while the purchasers of IOUs (the SSUs) postpone current consumption in return for their expected return on the IOU. The IOU satisfies the financial objectives of both the issuer and the lender, and at the same time leads to a purchase (by the issuer) of real goods and services. As such, these instruments provide a useful economic function, facilitating saving which is in turn used for real investment in the economy. The value of an IOU of course, is only as good as the ability and willingness of the issuer to make good on its obligation to repay the lender. Later in the course we will go into some detail about the characteristics of various types of financial instruments, and how they are priced and traded.