The Financial System

- The financial system consists of institutions that help to match one person’s saving with another person’s investment.
- It moves the economy’s scarce resources from savers to borrowers.
- The financial system is made up of institutions (Markets and Intermediaries)

Financial Institutions in the U.S. Economy

- Financial Markets
  - Stock Market
  - Bond Market
- Financial Intermediaries
  - Banks
  - Mutual Funds
Other Financial Institutions

- Credit unions
- Pension funds
- Insurance companies
- Loan sharks

The Bond Market

A bond is a certificate of indebtedness that specifies obligations of the borrower to the holder of the bond.

Characteristics of a Bond

- **Term:** The length of time until the bond matures.
- **Credit Risk:** The probability that the borrower will fail to pay some of the interest or principal.
- **Tax Treatment:** The way in which the tax laws treat the interest on the bond.
  - Municipal bonds are federal tax exempt.
**Stock Market Basics**

- **What is Stock?**
  - A stock is a tradable security that a firm issues to certify that the stockholder owns a share of the firm.
  - Figure 19.1 shows an example of a stock certificate.

**The Stock Market**

- **Stock** represents ownership in a firm and is therefore, a claim to the profits that the firm makes.
- The sale of stock to raise money is called **equity financing**.
  - Compared to bonds, stocks offer both higher risk and potentially higher returns.

**The Stock Market**

The most important stock exchanges in the United States are the New York Stock Exchange, the American Stock Exchange, and NASDAQ.
The Stock Market

Most newspaper stock tables provide the following information:
- Price (of a share)
- Volume (number of shares sold)
- Dividend (profits paid to stockholders)
- Price-earnings ratio

Stock Market Basics

- Reading the Stock Market Report
  - Figure 19.2 in the textbook shows a part of a page from the Wall Street Journal.

The Market for Loanable Funds

Loanable funds refers to all income that people have chosen to save and lend out, rather than use for their own consumption.
An Increase in the Supply of Loanable Funds...

1. Tax incentives for saving increase the supply of loanable funds...
2. ...which reduces the equilibrium interest rate...
3. ...and raises the equilibrium quantity of loanable funds.

Market for Loanable Funds...

Government Policies That Affect Saving and Investment

- Taxes and saving
- Taxes and investment
- Government budget deficits
An Increase in the Demand for Loanable Funds...

1. An investment tax credit increases the demand for loanable funds...

2. ...which raises the equilibrium interest rate...

3. ...and raises the equilibrium quantity of loanable funds.

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Government Budget Deficits and Surpluses

- When the government spends more than it receives in tax revenues, the short fall is called the budget deficit.
  - For 2003, the budget deficit is $307 billion
- The accumulation of past budget deficits is called the government debt.
  - For 2003, the total debt is 6.7 trillion.

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Government Budget Deficits and Surpluses

- Government borrowing to finance its budget deficit reduces the supply of loanable funds available to finance investment by households and firms.
- This fall in investment is referred to as crowding out.
  - The deficit borrowing crowds out private borrowers who are trying to finance investments.
1. A budget deficit decreases the supply of loanable funds... and reduces the equilibrium quantity of loanable funds.

2. ...which raises the equilibrium interest rate...

The Effect of a Government Budget Deficit...