AQA Economics A-level

Macroeconomics

Topic 4: Financial Markets and Monetary Policy

4.1 The structure of financial markets and financial assets

Notes

The characteristics and functions of money

A medium of exchange: without money, transactions were conducted through bartering. Goods and services were traded with other goods and services, but people did not always get exactly what they wanted or needed. The goods and services exchanged were not always of the same value, which also posed a problem. Exchange could only take place if there was a **double coincidence of wants,** i.e. both parties have to want the good the other party offer. Using money eliminates this problem.

A measure of value (unit of account): Money provides a means to measure the relative values of different goods and services. For example, a piece of jewellery might be considered more valuable than a table because of the relative price, measured by money. Money also puts a value on labour.

A store of value: Money has to hold its value to be used for payment. It can be kept for a long time without expiring. However, the quantity of goods and services that can be bought with money fluctuates slightly with the forces of supply and demand.

A method of deferred payment: Money can allow for debts to be created. People can therefore pay for things without having money in the present, and can pay for it later. This relies on money storing its value.

Definitions of the money supply and the distinction between narrow money and broad money

- The money supply is the stock of currency and liquid assets in an economy. It includes cash and money held in savings accounts.
- Narrow money is physical currency (notes and coins), as well as deposits and liquid assets in the central bank.
- Broad money includes the entire money supply. Cash could be in restricted accounts, which makes it hard to calculate the money supply. It includes liquid and less liquid assets.

The difference between the money market, the capital market and the foreign exchange market

- In the money market, liquid assets are traded. It is used to borrow and lend money in the short term.
- The capital market is where equity and debt instruments are bought and sold. These can then be put to long-term productive use by firms and governments.
- The foreign exchange market is a market where currencies are traded, mainly by international banks. It determines what the relative value of different currencies will be.

The role of financial markets in the wider economy

Financial liquid assets are exchanged in a financial market. For example, the stock market and the bond market are two examples of financial markets.

To facilitate saving

Financial markets provide somewhere for consumers and firms to store their funds. Savings are rewarded with interest payments from the bank.

To lend to businesses and individuals

The transfer of funds between agents is aided by financial markets. The funds can be used for investment or consumption.

To facilitate the exchange of goods and services

The transfer of real economic resources is facilitated in a financial market. Financial markets can make it easier to exchange goods and services from the physical market, by providing a way that buyers and sellers can interact and transfer funds.

To provide forward markets in currencies and commodities

The currency market is another kind of financial market. They are used to trade one currency for another currency. Currencies can have speculative attacks taken on them, which can affect the value of the exchange rate.

In commodity markets, investors trade primary products, such as wheat, gold and oil. Future contracts are a method for investing in commodities. This involves buying or selling an asset with an agreed price in the present, but a delivery and payment in the future.

A forward market is an informal financial market where these contracts for future delivery are made.

- **To provide a market for equities**

  Equity markets involve the trade of shares. It is also called a stock market. Equity markets provide access to capital for firms, and allow investors to own part of a market. Returns on the investment, usually in the form of dividends, are based on future performance. A dividend is a share of the firm's profits.

The difference between debt and equity

Debt is money which has been borrowed from a lender, which is usually a bank. There is little flexibility, and the loan is later repaid with interest.

Equity is a stock or security which represents interest in owning e.g. a firm, a car or a house. It is when there is no outstanding debt, such as when a loan for a car or a mortgage has been fully paid off. The owner's equity is then the car or the house, which can be sold for cash.

Why there is an inverse relationship between market interest rates and bond prices

- There is an inverse relationship between market interest rates and bond prices. When a bond is bought, money is lent to the issuer. The issuer agrees to pay the value of the bond back when it matures, in addition to periodic interest payments. The rate of interest is fixed when the bond is issued.

  New bonds have rates close to the market interest rate. If the market interest rate falls, for example, the bond would be worth more, since it carries a higher interest rate than current market conditions. Similarly, the bond is worth less is the rate increases. This is because the bond has a lower interest rate than the current market.

- Firms can raise finance by issuing shares, issuing corporate bonds and borrowing from a bank. Raising finance through shares is relatively cheap for firms. Although firms are legally obliged to pay their shareholders dividends, a proportion of their profits as a reward for investing in them, they only pay dividends when there are distributable profits and it is voted for by shareholders.

  Borrowing could involve paying back loans with high interest rates, which could be expensive. This might be unaffordable for new, smaller firms. However, it is flexible and the funds can be increased or decreased by borrowing more or paying back the loan.

  Corporate bonds are issued to raise funding for large projects, such as to expand the firm, develop a product, move to a new premise, or takeover another firm. Bonds could be traded in a similar way to shares, and they are partially protected against variable interest rates or economic changes. However, the firm will have to pay the investors who buy the bonds interest.

- In relation to government bonds, the term coupon is an interest payment to the bondholder between the date of issue and the date of maturity. Maturity is the period of time for which the financial asset is outstanding. When it finishes and has been repaid, it has matured.