The Business Environment

Chapter II in

Investments: Spot and Derivatives Markets

Flow of Funds

- Saving = Income – Consumption
- Financial Surplus = Saving – Investment

- The Financial Market brings together those with surplus funds with those that have a shortage of funds.

Financial Intermediaries

- Banks, building societies, life assurance and pension funds.
- Advantages:
  - assess creditworthiness
  - Portfolio reduced risk-exposure to idiosyncratic events→ risk-spreading
  - Economies of scale in sale and purchase of financial assets because of transactions, search and information costs
- Asset transformation: hold low-yield short-term liabilities and higher-yield long-term assets.
- Process of Disintermediation

Money Markets & Open Market Operations

- Liabilities of banks constitute main element of money supply, which is a central bank target variable.
- Law of large numbers imply reserve ratios.
- Influenced via Open market operations (OMO): buying and selling of financial assets
  - Purchase of bonds pushes up price→ fall in yield (interest)
  - Also leads to increase in money supply (base money and the multiplier)

Asset Returns

- Nominal Return:

  (Capital Gain + Income)/Investment
- Real Return:

  Nominal Return/Inflation Rate
- Fisher Equation:

  Nominal = Real + Inflation
- HPR:

  Capital gain (loss) + Income

Risk

- General Risks:
  - Market
  - Inflation
  - Default
  - Liquidity
- Other Classification:

Systematic vs. Idiosyncratic Risk

→Risk Premium

- Equity premium puzzle
- Efficient Market Hypothesis: price reflects fundamentals & price changes only on news. But, herding, chartists, excessive price volatility.

Term Structure of Interest Rates

- Central Bank sets short-term rates. How are the rates of longer term investments determined?
  - Average of current and expected future rates
  - Risk premium (inflation for Government backed bonds)
- Ambiguous effect due to inflation expectations.
- Downward sloping yield curve and recessions

MP & Business Environment

- Transmission Mechanism
  – Ripple effect: Eventually all asset prices and rates of return should be affected.
  – First affected by s.r. rate change are close substitutes, similar instruments with similar characteristics, such as risk, liquidity, and length to maturity. This percolates through to all by arbitrage.
  – Long and variable lags
  – Asset prices and incomes adjust

Interest Rate & Real Expenditure

- Real investment responds to real rates
- Internal funds have opportunity cost
- *Income gearing*: if (s.r.) liabilities/income is large, changes in MP may have a large effect on Cash flow and spending, especially if *credit constrained*.
- Fall in Income and asset value may lead to *credit crunch.*
- Exchange rates (overshooting & UIP)

Setting the Official Rate

- CB keeps banks and Money Market short of funds
- Balance daily receipts and spending
- If unbalanced perform OMO with Monetary Policy Committee determined *repo* rate.
- Interbank Market, LIBOR and Fed Funds Rates