An Overview of the Financial System
ECON 4673
Dr. Keen

Answers

1. *If you suspect that a company will go bankrupt next year, would you rather hold bonds issued by the company or equities issued by the company? Why?*

   You would like to hold bonds because bondholders are paid off before equity holders in bankruptcy.

2. *What is the difference between an investment bank and a commercial bank? Are they involved in direct finance or indirect finance?*

   An investment bank assists in the sale of assets in the primary market by guaranteeing a price for a business' securities (underwriting) and then selling those securities to the public, while a commercial bank receives funds from deposits and uses them to make commercial, consumer, mortgage loans. An investment bank is involved in direct finance since the lending occurs directly between borrower and saver. In contrast, a commercial bank is involved in indirect finance because the commercial bank acts as an intermediary between the borrower and the saver.

3. *Describe who issues each of the following money market instruments: a) Treasury bills; b) Certificates of deposit; c) Commercial paper; and d) Federal funds.*

   Treasury bills are short-term debt instruments issued by the United States government to cover immediate spending obligations, i.e. finance deficit spending. Certificates of deposit (CDs) are issued by banks and sold to depositors. Corporations and large banks issue commercial paper as a method of short-term funding in debt markets. Federal funds are overnight loans from one bank to another.

4. *Briefly explain the difference between money markets and capital markets? Does the U.S. government sell debt in either of those markets? If so, what type(s) of debt do they sell and in what market(s) do they sell it?*

   The money market is a financial market in which short-term debt is traded, while the capital market is a financial market in which equities and longer-term debt are traded. Government participates in both the money and capital markets. It sells T-bills (short-term debt) in the money market, while it sells government bonds (long-term debt) in the capital market.

5. *What is the difference between a mortgage and a mortgage-backed security?*

   Mortgages are loans to households or firms to purchase housing, land, or other real structures, where the structure or land itself serves as collateral for the loans. Mortgage-backed securities are bond-like debt instruments that are backed by a bundle of individual mortgages, whose interest and principal payments are collectively paid to the holders of the security. In other words, when an individual takes out a mortgage, that loan is bundled with other individual mortgages to create a composite debt instrument, which is then sold to investors.

6. *How can the adverse selection problem explain why you are more likely to make a loan to a family member than to a stranger?*

   Since you know your family members better than strangers, you know more about the family borrower's honesty, propensity for risk taking, and other traits. Thus, there is less asymmetric information with a family member than with a stranger which reduces the adverse selection problem. As a result, you are more likely to loan money to a family member.

7. *Why do loan sharks worry less about moral hazard in connection with their borrowers than some other lenders do?*

   Loan sharks can threaten their borrowers with bodily harm if the borrowers take actions that could jeopardize their ability to pay off the loan. Hence, borrowers from a loan shark have a non-monetary incentive that encourage them not increase their moral hazard risk.