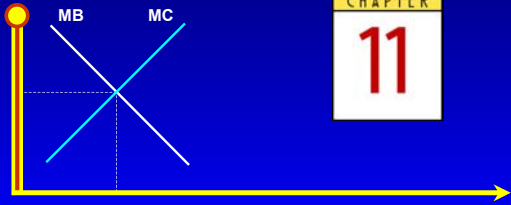


Financial Markets and International Capital Flows




CHAPTER
11

PLAN

- Financial markets and their role in directing savings to productive uses.
- Banking system, bond market, stock market.
- International capital flows and International financial markets
- Influence on the balance of trade.


Introduction

- The stock market boom included sound investment decisions and speculation (gambling).
- The role of financial markets is to ensure national saving is allocated to the most productive uses.

 **The Financial System and the Allocation of Saving to Productive Uses**


- Key Components of Economic Growth
 - High rates of saving
 - An efficient financial system that distributes national savings to the most productive investments

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 **The Financial System and the Allocation of Saving to Productive Uses**


- The U.S. financial system:
 - Is a decentralized market oriented system.
 - Includes financial institutions and financial markets.

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 **The Financial System and the Allocation of Saving to Productive Uses**


- The financial system in the U.S. improves the allocation of savings in two ways:
 - Provides information
 - Helps savers share the risk

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 The Financial System and the Allocation of Saving to Productive Uses


- The Banking System
 - Banks are a *financial intermediary* between savers and borrowers.

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 The Financial System and the Allocation of Saving to Productive Uses


- The Banking System
 - By acting as a financial intermediary, banks can increase the efficiency of the capital market in several ways:
 - ◆ Banks specialize in evaluating the quality of a borrower and perform the task at a lower cost.

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 The Financial System and the Allocation of Saving to Productive Uses


- The Banking System
 - By acting as a financial intermediary, banks can increase the efficiency of the capital market in several ways:
 - ◆ Banks pool savings, which increases the efficiency of making large loans.

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 **The Financial System and the Allocation of Saving to Productive Uses**


- **The Banking System**
 - By acting as a financial intermediary, banks can increase the efficiency of the capital market in several ways:
 - ◆ Banks develop expertise in making small business and consumer loans.
 - ◆ Banks offer services to savers which attract their deposits.

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 **The Financial System and the Allocation of Saving to Productive Uses**


- **Bond**
 - A legal promise to repay a debt, usually including both the principal amount and regular interest payments

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 **The Financial System and the Allocation of Saving to Productive Uses**


- **Principal Amount**
 - The amount originally lent
- **Coupon Rate**
 - The interest rate promised when a bond is issued

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 The Financial System and the Allocation of Saving to Productive Uses


- Coupon Payments
 - Regular interest payments made to the bondholder

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 The Financial System and the Allocation of Saving to Productive Uses


- Bonds -- An Example
 - Principle amount of a bond = \$1,000,000
 - Coupon rate = 5%
 - Annual coupon payment = $(0.05)(\$1,000,000) = \$50,000$

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 The Financial System and the Allocation of Saving to Productive Uses


- Bonds
 - Corporations and governments sell bonds to raise funds.
 - The longer the *term* of the bond the higher the coupon rate.

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 **The Financial System and the Allocation of Saving to Productive Uses**


- **Bonds**
 - The greater the risk of default, the higher the coupon rate.
 - Municipal bonds are exempt from federal taxes and have a lower coupon rate.
 - Bondholders may sell their bonds at any time in the *bond market* at their market price.

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 **The Financial System and the Allocation of Saving to Productive Uses**


- **Stock (or equity)**
 - A claim to partial ownership of a firm

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 **The Financial System and the Allocation of Saving to Productive Uses**


- **Two sources of return to stockholders**
 - **Dividend**
 - ◆ A regular payment received by stockholders for each share that they own
 - **Capital gain**
 - ◆ The difference between the purchase price and selling price, when the selling price is higher

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 **The Financial System and the Allocation of Saving to Productive Uses**

- Observations
 - An increase in future dividends or future stock prices will raise the price of the stock today.
 - An increase in required rate of return will lower today's stock price.

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 **The Financial System and the Allocation of Saving to Productive Uses**

- Observations
 - The uncertainty of future earnings and dividends increases the risk of purchasing a stock.
 - Stock market investors account for this risk by requiring a higher rate of return or *risk premium*.

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 **International Capital Flows**

- Two Macroeconomic Roles for International Capital Flows
 - A country with greater investment opportunities than savings can fill the savings gap by borrowing from abroad.
 - International capital flows allow countries to run trade imbalances.

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International Capital Flows

- International financial markets allocate savings to productive capital in different countries.
- International financial markets are subject to the laws of at least two countries.



International Capital Flows

- International Capital Flows
 - Purchases or sales of real and financial assets across international borders



International Capital Flows

- Capital Inflows
 - Purchases of domestic assets by foreign households and firms
- Capital Outflows
 - Purchases of foreign assets by domestic households and firms



International Capital Flows

- Trade Balance (or net exports)
 - The value of a country's exports less the value of its imports in a particular period (quarter or year)



International Capital Flows

- Trade Surplus
 - When exports exceed imports, the difference between the value of a country's exports and the value of its imports in a given period



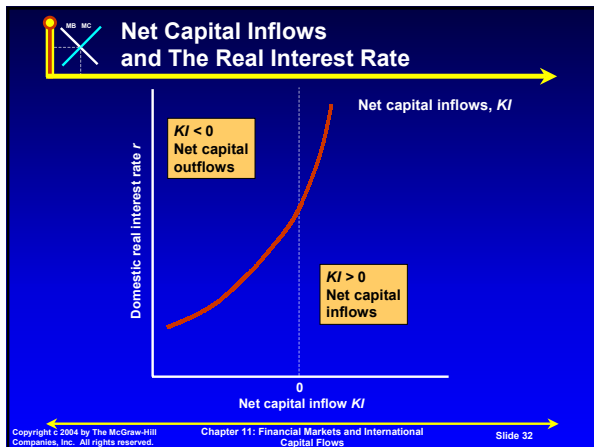
International Capital Flows

- Trade Deficit
 - When imports exceed exports, the difference between the value of a country's imports and the value of its exports in a given period

International Capital Flows

- The Determinants of International Capital Flows
 - Real interest rate
 - ◆ High domestic real interest rates will cause net capital inflows.
 - ◆ Low domestic real interest rates will cause net capital outflows.

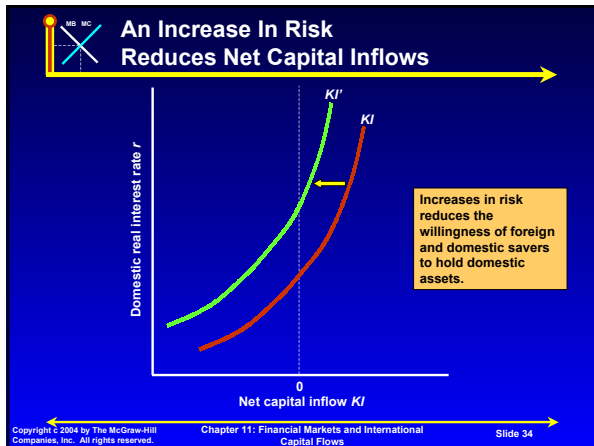
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International Capital Flows

- Risk
 - For a given real interest rate, an increase in riskiness in domestic assets will reduce net capital inflows and vice versa

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International Capital Flows

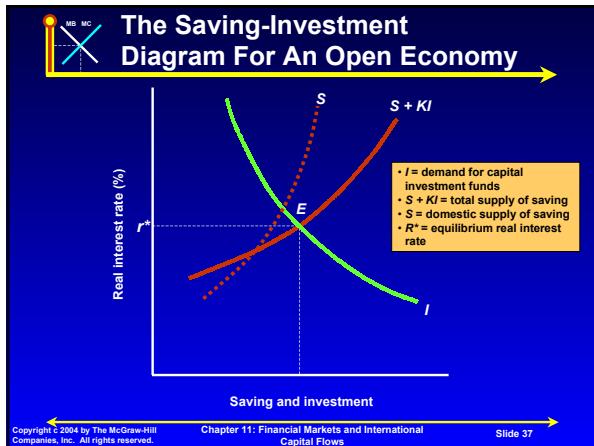
- Saving, Investment, and Capital Inflows
 - $Y = C + I + G + NX$
 - ◆ Subtract $C + G + NX$ from both sides
 - $Y - C - G - NX = I$
 - National saving (S) = $Y - C - G$
 - $NX + KI = 0$; so, $KI = -NX$
 - ◆ Substitute S for $Y - C - G$ & KI for $-NX$
 - $S + KI = I$

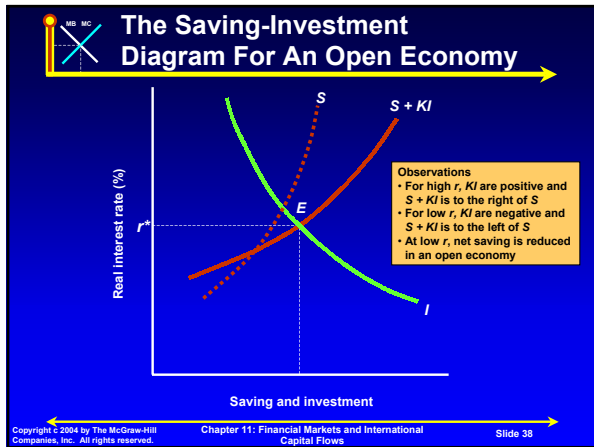
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International Capital Flows

- Observation
 - The pool of saving available for domestic investment includes national savings and the funds from savers abroad.

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International Capital Flows

- The Saving Rate and the Trade Deficit
 - A low rate of national saving is the primary cause of trade deficits.



International Capital Flows

- The Saving Rate and the Trade Deficit
 - $Y = C + I + G + NX$
 - ◆ Subtracting $C + I + G$ from both sides
 - $Y - C - I - G = NX$
 - $S = Y - C - G$
 - $S - I = NX$
 - ◆ Assuming I is constant
 - If S increases, NX increases, and vice versa.



International Capital Flows

- The Saving Rate and the Trade Deficit
 - Low national saving implies high consumer and government spending
 - High rates of spending will:
 - ◆ Increase imports.
 - ◆ Decrease exports.

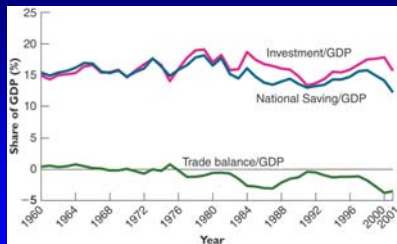


International Capital Flows

- The Saving Rate and the Trade Deficit
 - Low national saving will also increase capital inflows.
 - ◆ High spending creates investment opportunities
 - ◆ Shortage of domestic saving will occur
 - ◆ Real interest rates will rise
 - ◆ Capital inflows will occur



National Saving, Investment, and the Trade Balance in the U.S., 1960 - 2001

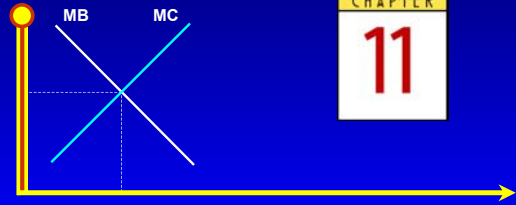




International Capital Flows

- What Do You Think?
 - Is the U.S. trade deficit a problem?

End of
Chapter



CHAPTER
11
