Fin-Ed Centre

MASSEY UNIVERSITY
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FINANCIAL EDUCATION AND RESEARCH CENTRE

Understanding your financial world

Financial Markets

The discussion of fiscal policy highlighted the need for governments to borrow to fund deficits and the discussion of monetary policies highlighted the use of interest rates to influence economic growth, inflation and exchange rates. The mechanism for enabling fiscal and monetary policies to be enacted is the financial market.

Financial markets operate within a financial system which facilitates the creation, holding and transfer of financial assets (e.g. shares).

Financial Market Defined

A financial market is a market that trades in financial assets. It is not essential for a financial market to exist in order for financial assets to be created and exchanged, but in most economies financial assets are created and then traded in some type of financial market. The existence of financial markets improves the attractiveness of financial assets, both for prospective buyers and for sellers. The market that deals with the immediate delivery of financial instruments is called the spot (or cash) market, for example the stock market. The markets that deal with financial instruments for delivery at some future date are called the derivative markets.

(Parry, Wirth, and Bennett, 2009, p85.)

In the discussion of exchange rates the concept of the foreign exchange market was introduced. Foreign exchange markets are one of the financial markets in the financial system. This summary introduces other financial markets and describes their role.

The Roles of Financial Markets

Reduction of costs

Financial markets reduce the transaction costs for participants because the existence of markets reduces the amount of time and effort required to search for buyers/sellers of securities or find information about whether they can be trusted. There are economies of scale from an organised exchange and an organised exchange has rules of participation that offer some protection for participants.

Establishing prices

Markets help with **price discovery** because they establish prices for securities. This happens when a large number of similar securities are traded at the same time and buyers and sellers compare prices to establish a fair market price. **Deep markets** exist when a large number of securities are traded at the same time and **thin markets** when low numbers are traded.

Maintaining liquidity

Liquidity is the ease of converting a security into cash, so a liquid asset can be easily bought and sold while the converse is true for an illiquid asset. This does not mean that an illiquid asset cannot be sold; the seller might have wait for a long time or sell at a discount to turn the asset into cash.

Transfer of risk

Some securities are riskier than others. Financial markets allow those wanting to reduce risk to transfer the risk to those who are more willing to accept the risk. These transactions are done through the markets using specialised financial products.

Securities

The type of financial instruments used to finance an organisation's operations.

Financial instruments are instruments that allow funds to be transferred between investors and borrowers.

(Parry, Wirth, and Bennett, 2009, p85.)

Types of Financial Market

The types of financial market are distinguished by a number of characteristics:

- Time frame
  The market for short-term debt of less than one year is called the **money market**. The market for longer term instruments (of one year or more) is called the **capital market**.

- Type of financial claim
  Debts are traded in **debt markets** and shares (also known as stocks and equities) are traded in the **share market** (also known as the stock market or equities market).

- Newly issued or existing claims
  New securities (such as Mighty River Power shares) are distributed through **primary markets**. The subsequent trading of securities takes place through **secondary markets**. Secondary markets allow investors to buy or sell existing securities. Secondary markets are also a good way to find out about the price of securities because they are traded continuously and prices are published.

- Cash or derivatives
  See box above.

- Organisational structure
  Securities can be traded by auction, through dealers (such as stockbrokers) or through intermediaries in an **intermediated market**.

Money market

This market deals with the trade of short-term debt securities that are usually shorter than one year in duration and are highly liquid. This market is an important one for short-term funding for companies as well governments. The 90-day bank bill which is frequently mentioned in the news is an example of the type of security used by companies for short term funding.

Money markets operate through telephones and electronic screens. This type of market does not have a formal structure or physical location (unlike, for instance, a stock yard or fruit and vegetable market) and is known as an **over-the-counter** (OTC) market. Because there is no physical market the market operates on trust and participants are mainly financial institutions, governments and large companies.

Types of securities traded in the money market include:

- Treasury bill – for funding government expenditure
- Bank bill – for short-term borrowing and investing
- Certificate of deposit – a source of short term funding for banks
- Promissory note – a source of funding for companies with a good credit rating.

Capital market

The capital market is for financial instruments with maturities longer than one year and consists mainly of the equities market (also known as the share market or the stock market) and bond markets (also known as debt markets).

- Equity market

  This market involves the trading of mainly shares, but can also involve the trading of debt. Markets include the New York Stock Exchange (NYSE), Australian Stock Exchange (ASX) and New Zealand Exchange (NZX). Shares (also known as common stock or equities) are a common, but expensive, way for companies to raise funds. When a company wants to raise funds it can issue new share capital (such as Z and Might River Power), but because of the expense a company does not do this often. The company receives the proceeds of the issue and the shares are subsequently traded on the secondary market but the company does not benefit financially if the price of the shares goes up.

  Individuals, companies and institutional investors (such as Kiwisaver or the Cullen fund) participate in the share market. There has been a trend away from individuals directly participating in the share market to more indirect participation through Kiwisaver and other funds.

- Debt markets

  Debt (or bond) markets are similar to the money market; they are operated by telephone and electronic screen but for longer-term debt instruments. As note in the discussion of equity markets some share markets (like the NZX) also operate a debt market, NZDX). The main participants are the New Zealand Reserve Bank, the government, financial institutions and overseas investors.

  The instruments traded on debt markets are Crown or non-Crown instruments. Crown instruments are government bonds (usually three- and ten-year maturity), inflation indexed and Kiwi bonds. The minimum value for a government bond is $1 million so these are usually purchased by financial institutions and broken down into smaller parcels for small investors and sold in the secondary market. The majority of securities traded are government bonds, with a good proportion held by overseas investors.

  Corporate, local government and SOE (State-owned enterprises) issue bonds in this market to meet the need for long term funding. In addition, companies issue capital notes which are similar to bonds but fall between other forms of debt and equity in ranking.