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The Structure of Financial Markets

Multiple Choice Answers

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|---|---|----|---|----|---|
| 1 | C | 6 | C | 11 | B |
| 2 | C | 7 | B | 12 | A |
| 3 | B | 8 | D | 13 | B |
| 4 | D | 9 | B | 14 | D |
| 5 | A | 10 | B | 15 | A |

Short Answer Questions

Question 1

- (a) Primary financial markets involve a first-time issue of a financial asset sold directly by the company, bank or government to the buyer. Secondary financial markets involve the purchase and sale of second-hand financial assets (which were previously issued in the primary market).
- (b) The primary financial institutions in the Australian economy are banks. Other financial institutions include finance companies, merchant banks, credit unions, permanent building societies, mortgage originators, life insurance companies and superannuation funds.
- (c) Shares are a form of equity finance that provides the holder with part ownership of a company and entitles them to a share of the profits (paid as dividends). Futures and options are agreements to trade in financial instruments in the future. A bond is a form of debt finance which is given in return for lending a company, bank or government a sum of money. The owner of the bond is entitled to regular interest payments and a repayment of the original loan at the end of the period.
- (d) Financial markets take deposits from savers and make those funds available to investors within the economy, allowing investment to occur within the economy. Financial markets provide a single market for investors to obtain funds, increasing the ease of funding investment, which could not otherwise occur without financial markets. Financial markets also make it possible to finance investment with different financial arrangement, for example equity markets allow a company to sell its ownership in return for funds, without having to repay the funds. However financial institutions will usually charge a slightly higher interest rate to investors than it pays to borrowers (the interest differential) which means less investment and saving will occur than if the interest rate stayed at the market equilibrium.

Question 2

- (a) The Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investment Commission (ASIC).
- (b) The RBA is the banker to the banks by allowing banks to hold a level of reserve funds in Exchange Settlement Accounts in the RBA (to provide a minimum level of liquidity to meet withdrawals and settle transactions between banks). The RBA will also provide loans to banks in the short term money market to cover shortfalls in their exchange settlement accounts.
- (c) In recent years the RBA's primary objective has been to maintain an environment of low inflation through its administration of monetary policy. The goals of the RBA as stated in the RBA charter are to maintain stability of the currency, full employment and economic prosperity.
- (d) The RBA is responsible for the regulation of the payment system. The payment systems board within the RBA monitors the efficiency and stability of payment methods including credit cards, electronic cash, travellers cheques and stored value cards. Additionally, the RBA supervises procedures in the foreign exchange market and is responsible for holding Australia's gold and foreign exchange reserves.
- (e) APRA's first regulatory role is to ensure deposit-taking institutions can meet their obligations to the individuals who save money with them. This includes ensuring deposits can be repaid, insurance entitlements can be paid and superannuation funds are available to individuals when required. APRA also intervenes where institutions are unable to meet their obligations by providing emergency funds to the institution, or compensating savers – this is known as the “lender of last resort” function.

Question 3

- (a) A business may borrow to fund investment – a purchase of capital goods used in production. Businesses may also need to borrow in the short term (through an overdraft) to make up for shortfalls in revenue and pay their regular expenses (such as wages), particularly if the sales of their product are highly volatile or seasonal in nature.
- (b) In recent years, Australia's household debt has increased considerably, at an average rate of fifteen per cent per year. This is largely due to the growth in mortgage debt, as lower interest rates and booming housing prices have increased the amount borrowed as mortgages. There has also been an increase in other forms of borrowing such as personal loans and credit cards.
- (c) The transactions motive describes the demand for money required to ensure that everyday transactions and purchases can be carried out by individuals and businesses. The precautionary motive is when money is demanded to provide for unexpected or emergency circumstances, acting as a personal method of insurance. The speculative motive is when money is demanded as a financial asset to make a profit, usually due to the fact that money has virtually no risk, and can earn a stable interest rate.
- (d) Individuals make their money available as savings ready for borrowing in financial markets. The role of individuals as savers in the Australian economy has decreased dramatically in recent years as high debt levels have meant that most individuals tend to be borrowers rather than savers. With a low level of national savings in Australia, the overseas sector provides a large amount of funds for Australian investment to occur. Excess savings in overseas economies (with low investment levels) are deposited in Australian financial market. In return for providing funds for investment, interest and dividend payments must be paid to the overseas savers.