

# The Structure of Financial Markets

# 12

## Multiple Choice

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

## Short Answers

### Question 1

- Financial markets are the factor markets for capital in the Australian economy. They mediate the interactions between savers and borrowers by creating products that provide a return for those who have excess funds, making these funds available to those who need additional money. Examples of financial markets in Australia include the Australian Securities Exchange (an equity market) and the debt market.
- One factor affecting the demand for borrowing by a firm is the level of interest rates on borrowing. A higher interest rate represents a higher cost of borrowing which would reduce the demand for borrowing. A second factor is the firm's expected level of future revenue and profit based on future forecasts of demand for the firm's product. If the firm expects future demand for its product to be high, it is more likely to borrow funds for investment.
- There are three main motives affecting an individual's demand for money. Firstly, the transactions motive. Individuals need to hold a certain quantity of money (either paper currency or electronic money) for carrying out day-to-day transactions for which they require liquid funds. Secondly, the precautionary motive. People often hold money so that they are able to better deal with unpredictable circumstances or emergencies. Thirdly, the speculative motive. As part of their investment portfolio, individuals may hold a certain quantity of funds in the form of money rather than risk making capital losses by investing in financial assets.
- Individual savings make up a part of the total level of national savings in the Australian economy. Individuals with excess funds may place deposits in financial institutions who then lend the money out to businesses for investment purposes. In this way, household saving has a role in supplying funds to financial markets for investment. As can be seen in the graph however, Australia has a low level of national savings compared to the level of investment. For example, in 2008 national savings were equal to about 7 per cent of GDP, while investment was equal to roughly 28 per cent of GDP. This means that Australia is heavily reliant upon overseas savings to finance domestic investment. The international sector supplies funds to Australian financial markets that allow investment to take place that would otherwise be the case if Australia were entirely dependent on its national savings. In this way, both households and overseas savers have a role in supplying funds to financial markets for investment.

## Question 2

- (a). The three main regulators of the Australian financial sector are the Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).
- (b). The Reserve Bank of Australia (RBA) is Australia's central bank. It has responsibility for the conduct of monetary policy, regulation of the payments system and the stability of the financial system. According to the RBA's Charter, its three objectives are the stability of Australia's currency (meaning low inflation), the maintenance of full employment and the economic prosperity and welfare of the people of Australia.
- (c). The Australian Prudential Regulation Authority (APRA) provides prudential regulation and supervision for all authorised deposit-taking institutions including banks, superannuation funds and insurance companies. APRA has a role in encouraging responsible behaviour by financial institutions, as well as having an investigative and recovery role in assisting financial institutions experiencing solvency issues. On the other hand, the Australian Securities and Investments Commission (ASIC) plays a broader consumer protection role in the Australian financial system. ASIC has responsibility for corporate regulation and supervision, oversight of financial service products and regulation of Australia's securities industry. ASIC has the power to monitor, investigate and act in situations where the integrity of the financial system has been undermined by the illegal acts of individuals or companies.
- (d). One of the major regulatory changes to Australia's financial system occurred with the deregulation of the financial sector in the mid-1980s. This included the floating of the Australian dollar in 1983, as well as the replacement of the Reserve Bank's direct controls over banks with broader, indirect controls that affected the system as a whole. A second regulatory change that occurred in more recent years was the slight increase in temporary financial regulation in 2008, in response to the global financial crisis. This included an interim ban (lifted in May 2009) imposed by ASIC on the practice of 'short selling', in which a person sells a share they do not own at the time of the sale and plans to buy it later at a lower price to make a profit. It also included a Government guarantee on deposit accounts in Australian banks in order to sure up confidence in Australian financial institutions. Many of these measures were temporary, though some have suggested that a range of other regulatory changes are likely in the near future.

## Question 3

- (a). Primary financial markets facilitate the creation of new financial assets that can be sold into the economy. Examples of primary financial market transactions are when a business raises funds by issuing debt securities or by selling new shares. Secondary financial markets involve transactions with financial assets that have already been issued on a primary market at some time in the past. For example, buying shares in Telstra from another investor.
- (b). One example of a financial market product is a housing loan. Housing loans are offered by banks and mortgage originators, and are long term loans to purchase property. They require regular repayments of the principal plus interest. A second example of a financial market product is a bond. A bond is a longer-term security for which lenders receive regular fixed payments and receive the principal value of the debt at the end of the bond period from the issuing institution. These are issued by small and large companies, as well as banks and the government.

- (c). Both banks and non-bank financial intermediaries have a role in the financial system of mediating the interactions between net savers and net borrowers in the economy. Historically, banks (for example, the Commonwealth Bank of Australia) have been the largest and most important part of the financial sector. They generally offer a comprehensive range of financial services including accepting deposits, making loans and the issue of credit cards. The last few decades saw the growth of non-bank financial intermediaries who tend to offer more specific financial services. For example, mortgage originators such as Wizard and Aussie Home Loans, credit unions and building societies. However, many small mortgage originators were bought by the traditional banks in the wake of the global financial crisis.
- (d). Financial markets enable investment by providing a bridge between net savers and net borrowers in the economy. Business investment can be financed by either borrowing (debt financing) or issuing shares (equity financing). When a business borrows money from a bank, they are effectively drawing on individual's savings deposited in the bank. In this way, financial markets enable firms to draw on the accumulated savings of individuals in order to purchase capital equipment. A business can also obtain funds for investment by issuing shares to the public. The capital raised can be used by the business to invest in new machinery, plant or equipment.

**Skills Revision**

Scenario	Demand/Supply	Increase/Decrease
BHP Billiton decides to open a new mine in Western Australia.	Demand	Increase
The household savings rate increases by ten per cent.	Supply	Increase
The Commonwealth Government budget deficit increases from zero to \$40 billion.	Demand	Increase
Qantas responds to a downturn in economic activity by cutting back investment in new planes.	Demand	Decrease
The Government increases grants to people buying their first home.	Demand	Increase
A downturn in the global economy reduces foreign investment in Australia.	Supply	Decrease
The Government increases the level of compulsory superannuation contributions by employers.	Supply	Increase
Overseas interest rates increase relative to Australian interest rates.	Supply	Decrease

**Class Activity**

	Regulator
Eastpac Bank...	APRA
A rumour...	APRA
Sawjig...	ASIC
To avoid...	ASIC
A company...	RBA
After several...	RBA