Finance 312
Money, Banking and Financial Markets
Key Concepts (Unit III)

(By the end of Unit III, you should know/be able to:)

Distinguish between money markets and capital markets –know what instruments are traded in each; be able to identify various money/capital market instruments by characteristics.

Distinguish between primary and secondary markets – know what types of instruments are traded in each

Money Markets: Know the major characteristics of money markets. Know the function/role of money markets. Who are the major participants in money markets? Know the instruments traded in money markets and be able to identify the various instruments by characteristic. Know the major money (market) rates [i.e., prime rate versus discount rate versus fed funds rate versus LIBOR, etc] and be able to distinguish between same based on description. Know the relative liquidity of various money market securities

Money Market Mutual Funds: Know the major factors/forces contributing to the development of the MMMF. Know (generally) the major asset holdings of the typical MMMF.

T-Bill Rates – given the price of a T-bill, be able to calculate its rate on a discount basis and also the actual return to investors (for 3, 6, 12 month bills).

Repurchase Agreements – What is the nature of a financial transaction involving a repurchase agreement? Major characteristics? Why are "repos" used in financial transactions?

Capital Markets: Know the major components (sub-categories) of capital markets (i.e., bond market, stock market, mortgage market, etc.) characteristics of capital markets. Know what types of instruments are traded in capital markets. Be able to distinguish between organized securities exchanges and over-the-counter markets (and be able to cite/identify examples of each).

What are the specific rights accruing to the holder of a U.S. Treasury bond? What is the difference between a Treasury note and Treasury bond?

What is a Treasury Inflation Protected Security? How does it work? (That is, what are the mechanics involved?)

What is a Treasury STRIP? Where would it most likely be traded?

What is an agency security? Who issues them? Characteristics?

How does U.S. business finance itself—in terms of debt versus equity funding? Why?

Debt Instruments and Stuff:

What is a "junk" bond? Why would anyone buy junk?

What is the function of a Moody's or a Standards and Poor's? How do they likely affect interest rates? market efficiency?

What are the general categories of municipal bonds? Be able to distinguish between types/degrees of risk of each type. What is the primary advantage of municipal bonds to the holder?

Know the major characteristics of corporate bonds, as well as the basic types of corporate bonds.

Some more stuff about bonds—

Revenue *v* general obligation (municipal)

Bearer *v* registered

Convertible *v* non-convertible

Callable *v* non-callable

Secured *v* unsecured

How would each characteristic, other factors equal, affect the price of a bond? Also, be able to calculate the taxable equivalent of a tax-free bond, and vice versa.

AND YOU STILL MUST BE ABLE TO – calculate the present value of a bond (as in Unit I, Chapter 3). This time note explicitly the effects of semiannual interest payments.

Stocks: be able to distinguish between common and preferred stock—by characteristic. What are the rights associated with stock ownership? Be familiar with the relative importance over time of stocks versus bonds as sources for business finance.

Are there notable, significant trends that have occurred in money or capital markets over the last 10 – 20 years—either in terms of level of activity involving various instruments, relative importance of groups of players, etc.?

What is an IPO? How does it work? Who are the participants?

Differentiate (in general) between the NYSE, the American Stock Exchange and NASDAQ. What determines on which a firm's stock is traded?

What is an investment bank *vis-à-vis* a commercial bank?

What is meant by underwriting? Who does it? How? Why?

Note: You do NOT need to be concerned with calculations under the various stock evaluation models. Just know generally the nature of a one-period valuation model, the generalized dividend valuation model, the Gordon growth model, and price earnings.

Mortgage Markets: Know the major types of mortgage loans and be able to distinguish between same based on characteristics.

What is meant by the term "points"? effect?

Be familiar with the general nature of mortgage amortization. Note: you will not be required calculate/figure loan payments or amortization.

Be familiar with the different intermediaries that operate in mortgage markets and the primary role of each.

How/why does a secondary market exist for mortgages? Who are the major participants in such a market?

What is a reverse (annuity) mortgage? When, why and how did such develop? Who is/was Robert Wagner?

Is it safer for a child to hold a lit match or a portfolio of mortgage-backed securities? Explain!

What's a pass-through security?

The Foreign Exchange Market

Currency Appreciation/Depreciation: be able to distinguish between appreciation and depreciation of a currency given a change in exchange rates (expressed in terms of either currency)

Exchange Rates: Given the exchange rate of currency A relative to currency B, be able to calculate the value of currency B relative to currency A. Distinguish between spot (exchange) rate and forward rate.

Be able to analyze the effects of various factors that affect exchange rates—both in the short run and long run.

Law of One Price: Know what accounts for this law. What are the implications of the law? How does this law relate to exchange markets? How does this law relate to the theory of purchasing power parity?

The International Financial System-

Chapter 12 deals with exchange rate determination under a system of freely fluctuating exchange rates, i.e., a pure market determined rate. This chapter introduces government intervention into the process.

What is meant by the term “dirty float” ?

Why do governments intervene in foreign exchange markets?

If a central bank buys its domestic currency while selling foreign assets in the foreign exchange market, what will be the effect on:

a) that country’s international reserves?
b) that country’s monetary base?

Distinguish between a sterilized and an unsterilized foreign exchange intervention. How is each accomplished?

We read periodically that a country has a “balance of payments deficit.” What does that phrase mean?

Distinguish between “current account” and “capital account” in balance of payments accounting. What are the major components of each?

Can a country have a deficit in its trade balance without having a deficit in its “balance of payments” ? Conversely, can a country that has a “balance of payments deficit” have a surplus in its trade balance?

What was the general nature of the Bretton Woods agreement? What sparked world support for the agreement? What happened to the agreement? When? Why?

How would a country, or group of countries, go about the process of “fixing” exchange rates and maintaining that fix over time? Be able to explain what would have to happen if a currency began to experience unexpected weakness (or strength).

What is a “currency board” (in the context of Argentina’s Currency Board). What would be the advantage of a currency board?

What is “dollarization?” Factors favoring? Drawbacks?

What is meant by the term “special drawing rights” ?
Where would SDRs appear on the Fed’s balance sheet?

What are three international considerations that affect the conduct of monetary policy? Be able to explain each.

What does it mean when it is said that the U.S. dollar is an international reserve currency?

What is the Exchange Stabilization Fund of the U.S. Treasury? What is the purpose of the ESF? What are its assets?

In the context of foreign exchange markets, what is meant by the phrase “disorderly market conditions” ? How could Fed intervention affect such market conditions?