UNIT 4 OVERVIEW OF THE FINANCIAL SYSTEM

4.1 Getting started.

Suppose that you want to start a business that manufactures a recently invented low-cost robot that cleans the house, mows the lawn, and washes the car, but you have no funds to put this wonderful invention into production. Walter has plenty of savings that he has inherited. If you and Walter could get together so that he could provide you with the funds, your company's robot would see the light of the day, and you, Walter, and the economy would all be better off: Walter could earn a high return on his investment, you would get rich from producing the robot, and we would have cleaner houses, shiner cars, and more beautiful lawns.

Financial markets (bond and stock markets) and financial intermediaries (banks, insurance companies, pension funds) have the basic function of getting people such as you and Walter together by moving funds from those who have a surplus of funds (Walter) to those who have a shortage of funds (you). More realistically, when Apple invents a better iPod, it may need funds to bring it to market. Similarly, when a local government needs to build a road or a school, it may need more funds than local property taxes provide. Well-functioning financial markets and financial intermediaries are crucial to the economic health.

Discuss the following points.

1. Some economists suspect that one of the reasons that economies in developing countries grow so slowly is that they do not have well-developed financial markets. Does this argument make sense?
2. The US economy borrowed heavily from the British in the nineteenth century to build a railroad system. Why did this make both countries better off?

4.2 Look through the following vocabulary notes which will help you understand the text and discuss the topic.

an intermediary intermediation	посредник посредничество
a stake	ставка, доля, интерес
funds (plural) to channel/ transfer/move funds a fund	средства перераспределять, переводить средства фонд
excess syn. surplus	излишек
finance to finance financial a financier	финансы финансировать финансовый финансист
a security syn. a financial instrument	ценная бумага син. финансовый инструмент
to issue securities/debt instruments/equities/stock(s) an issuer	выпустить ценные бумаги, долговые инструменты, акции эмитент
a claim	требование, претензия
efficient efficiency syn. effective effectiveness	эффективный, рентабельный рентабельность эффективный эффективность
wealth well-being welfare	богатство, материальные ценности благополучие, благосостояние обеспечение, благосостояние
to time	распределять по времени
a market a financial market a debt market an equity market a primary (secondary) market an over-the-counter market a money market	рынок финансовый рынок рынок долговых инструментов фондовый рынок первичный (вторичный) рынок внебиржевой рынок денежный рынок

a capital market	фондовый рынок
an exchange a stock exchange a commodity exchange	биржа фондовая биржа товарно-сырьевая биржа
a bond	облигация
a mortgage	закладная
interest payments	выплаты процента
a principal principal payments	основная сумма кредита выплата основной суммы кредита
a maturity date	срок погашения
equity an equity	собственный капитал акция
stock a stock syn. a share, an equity common stocks syn. ordinary shares preferred stocks	капитал компании акция обыкновенные акции привилегированные акции
a dividend	дивиденд
initial	первоначальный
a government agency	государственное учреждение
to conduct trades	проводить торги
an inventory	полный перечень
transaction costs	операционные издержки
to expose risk exposure	подвергать риск потенциальных убытков
depository institutions	депозитарные учреждения
a commercial bank syn. a retail bank	коммерческий банк
a thrift	сберегательное учреждение
contractual savings institutions	договорные сберегательные учреждения
a finance company	финансовая компания
a mutual fund	паевой инвестиционный фонд
a money market mutual fund	паевой инвестиционный фонд по ставкам денежных рынков
an investment bank syn. a merchant bank	инвестиционный банк

a Life Insurance Company	компания по страхованию жизни
a Fire and Casualty Insurance Company	компания по страхованию от пожара и несчастных случаев
a Government Retirement Fund	государственный пенсионный фонд
a Savings and Loan Association	кредитно-сберегательная ассоциация
a Credit Union	кредитный союз
a pool	пул, объединение
insider trading	инсайдерская торговля
bank branching	создание банковских филиалов
to promote	способствовать

4.3 Reading

Functions of Financial Markets and Financial Intermediaries

Financial markets perform the essential economic function of channeling funds from households, firms, and governments that have saved surplus funds by spending less than their income to those that have a shortage of funds because they wish to spend more than their income. This function is shown schematically in Figure 1. Those who have saved and are lending funds, the lender-savers, are at the left, and those who must borrow funds to finance their spending, the borrower-spenders, are at the right. The principal lender-savers are households, but business enterprises and the government, as well as foreigners and their governments, sometimes also find themselves with excess funds and so lend them out. The most important borrower-spenders are businesses and the government, but households and foreigners also borrow to finance their purchases of cars, furniture, and houses. The arrows show that funds flow from lender-savers to borrower-spenders via two routes.

In direct finance, borrowers borrow funds directly from lenders in financial markets by selling them securities (also called financial

instruments), which are claims on the borrower's future income or assets. Securities are assets for the person who buys them but they are liabilities for the individual or firm that sells (issues) them. Financial markets are very important to the economy because in the absence of them, borrowers and savers might never get together. Financial markets are essential to promoting economic efficiency because they transfer funds from a person who has no investment opportunities to one who has them. Financial markets are critical for producing an efficient allocation of capital (wealth, either financial or physical, that is employed to produce more wealth), which contributes to higher production and efficiency for the overall economy. Well-functioning financial markets also directly improve the well-being of consumers by allowing them to time their purchases better. Financial markets that are operating efficiently improve the economic welfare of everyone in the society.

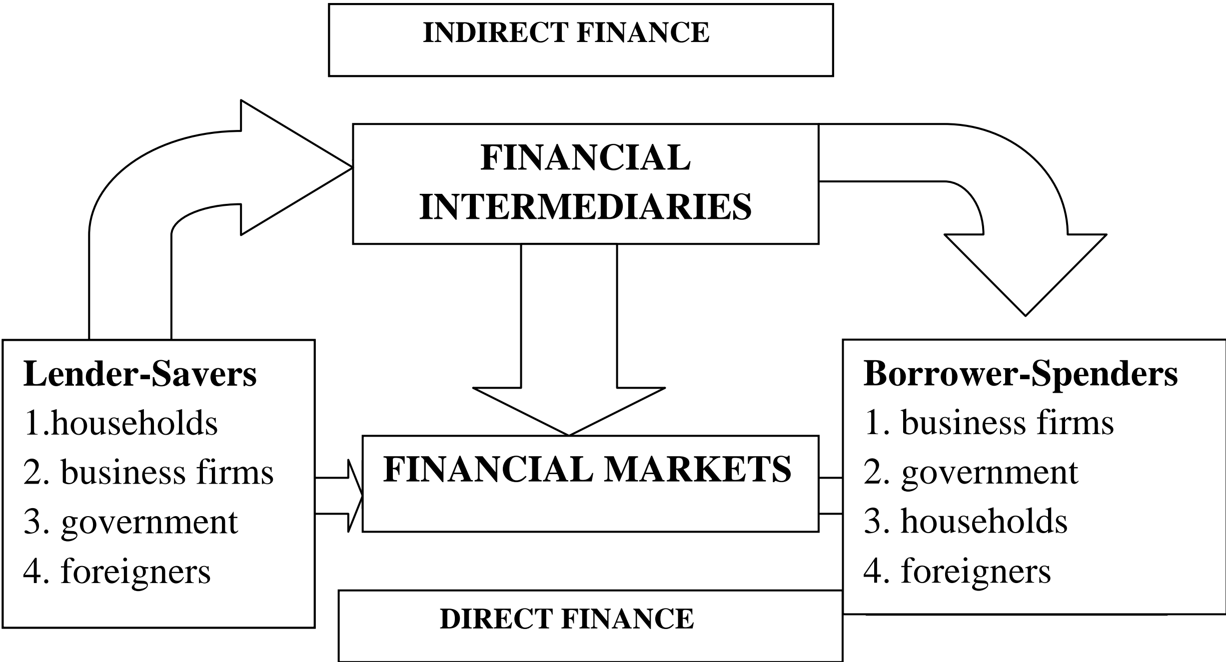

Figure 1. Flows of funds through the financial system

Now that we understand the basic function of financial markets, let's look at their structure. There are several categorizations of financial markets:

- debt and equity markets,
- primary and secondary markets,
- exchanges and over-the-counter markets,
- money and capital markets.

A firm or an individual can obtain funds in a financial market in two ways. The most common method is to issue a debt instrument, such as a bond or a mortgage, which is a contractual agreement by the borrower to pay the holder of the instrument fixed dollar amounts at regular intervals (interest and principal payments) until a specified date (the maturity date), when a final payment is made. The second method of raising funds is by issuing equities, such as common stock, which are claims to share in the net income (income after expenses and taxes) and the assets of the business. Equities often make periodic payments (dividends) to their holders and are considered long-term securities because they have no maturity date. The size of the debt market is often substantially larger than the size of the equity market: The value of debt instruments in the US debt market was $43.4 trillion at the end of 2006, while the value of equities was $19.3 trillion at the end of 2006.

A primary market is a financial market in which new issues of a security, such as a bond or a stock, are sold to initial buyers by the corporation or government agency borrowing funds. A secondary market is a financial market in which securities that have been previously issued can be resold.

Secondary markets can be organized in two ways. One method is to organize exchanges, where buyers and sellers of securities meet in one central location to conduct trades. The New York and American Stock Exchanges for stocks are examples of organized exchanges. The other method is to have an over-the-counter (OTC) market, in which dealers at different locations who have an inventory of securities stand ready to buy and sell securities “over the counter” to anyone who comes to them and is willing to accept their prices. Because over-the-counter dealers are in computer contact and know the prices set by one another, the OTC market is very competitive and not very different from a market with an organized exchange.

Another way of distinguishing between markets is on the basis of the maturity of securities traded in each market. The money market is a financial market in which only short-term (less than one year maturity) debt instruments are traded. The capital market is the market in which longer-term debt and equity instruments are traded.

As shown in Fig.1, funds also can move from lenders to borrowers by a second route called indirect finance because it involves a financial intermediary that stands between the lender-savers and the borrower-spenders and helps transfer funds from one to the other. A financial intermediary does this by borrowing funds from the lender-savers and then using these funds to make loans to borrower-spenders. Financial intermediation is the primary route for moving funds from lenders to borrowers. Transaction costs, risk sharing, and information costs in financial markets are very important. Financial intermediaries can substantially reduce transaction costs, investors' exposure to risk and eliminate problems caused by asymmetric information which is in fact a lack of information about contracting parties in financial markets. Financial intermediaries can be classified into:

- depositary institutions (banks) which include commercial banks and thrifts;
- contractual savings institutions (insurance companies and pension funds);
- investment intermediaries (finance companies, mutual funds, money market mutual funds, investment banks).

4.4 Comprehension

4.4.1 Answer the questions using the active vocabulary.

1. What is the essential economic function of financial markets?
2. What are the principal lender-savers and borrower-spenders on financial markets?
3. What are the two major routes of funds in the financial system?
4. What is a financial instrument?

5. What are the main reasons for which financial markets are very important?
6. How can financial markets be classified?
7. What is the difference between debt markets and equity markets?
8. What is the difference between primary markets and secondary markets?
9. How can secondary markets be categorized?
10. Why are the over-the-counter markets very competitive and not very different from a market with an organized exchange?
11. What is the difference between money markets and capital markets?
12. Why is the indirect financial route considered the primary route for moving funds from lenders to borrowers?
13. How does a financial intermediary function?
14. What is financial intermediation?
15. What are the advantages of getting funds from a financial intermediary rather than from a financial market?
16. What is asymmetric information? How can it affect the efficiency of financial operations?
17. What are the main categories of financial intermediaries?

4.4.2 Mark these statements T(true) or F(false) according to the information in the text. If they are false say why.

1. Financial markets channel funds from households, firms, and governments that have a shortage of funds because they wish to spend more than their income to those that have saved surplus funds by spending less than their income.
2. Those who have saved and are lending funds, are the lender-savers.
3. Those who must borrow funds to finance their spending, are the lender-spenders.
4. Households, business enterprises and the government, as well as foreigners and their governments can be both lender-savers and borrower-spenders in different occasions on financial markets.

5. Common stocks, which are claims to share in the net income and the assets of the business, often make periodic payments (interest plus principal) to their holders.
6. Debt instruments periodically make payments (dividends) to their holders.
7. Bonds, stocks, and mortgages are both securities and debt instruments.
8. Exchanges and over-the-counter markets have very much in common.
9. There is no difference between exchanges and OTCs.
10. Equity instruments are traded on the money markets.
11. Financial intermediation involves financial intermediaries.
12. Banks, exchanges, insurance companies and pension funds are financial intermediaries.
13. Money markets are the same as money market mutual funds.
14. Life Insurance Companies and Fire and Casualty Insurance Companies, Pension Funds and Government Retirement Funds are the contractual savings institutions.
15. Savings and Loan Associations, Mutual Savings Banks, and Credit Unions are thrift institutions (thrifts).

4.5 Language practice

4.5.1 Match the English terms in the left-hand column with the definition in the right-hand column.

1	Asymmetric information	A	The process of indirect finance whereby financial intermediaries link lender-savers and borrower-spenders.
2	Bond	B	Funds that accumulate investment dollars from a large group of people and then invest in short-term securities such as Treasury bills and commercial paper.
3	Common stock	C	Foreign currencies deposited

			in banks outside the home country.
4	Credit union	D	A financial market in which longer-term debt (maturity of periods greater than one year) and equity instruments are traded.
5	Exchanges	E	A financial institution that provides services such as accepting deposits and giving business loans.
6	Money market	F	Markets in which funds are transferred from people who have a surplus of available funds to people who have a shortage of available funds.
7	Mutual bank	G	A long-term loan secured by real estate.
8	Commercial bank	H	All resources owned by an individual, including all assets.
9	Financial intermediation	I	The inequality of knowledge that each party to a transaction has about the party.
10	Eurocurrencies	J	A secondary market in which dealers at different locations who have an inventory of securities stand ready to buy and sell securities to anyone who comes to them and is willing to accept their prices.
11	Transaction costs	K	A bank owned by depositors.
12	Mortgage	L	A debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate.
13	Security	M	The time and money spent

			trying to exchange financial assets, goods, or services.
14	Wealth	N	Secondary markets in which buyers and sellers of securities (or their agents or brokers) meet in one central location to conduct trades.
15	Financial markets	O	A security that gives the holder an ownership interest in the issuing firm. This ownership interest includes the right to any residual cash flows and the right to vote on major corporate issues.
16	A capital market	P	A claim on the borrower's future income that is sold by the borrower to the lender. Also called a financial instrument.
17	Over-the-counter market	Q	A segment of the financial market in which financial instruments with high liquidity and very short maturities are traded.
18	Money market mutual funds	R	Member-owned financial co-operatives that are created and operated by its members and profits are shared amongst the owners.

4.5.2 Complete the following text using suitable words or phrases from the box below.

A	investment opportunities	**E**	deregulation
B	pool of savings	**F**	foreign corporations
C	important investors	**G**	financial markets
D	to expand	**H**	funds

Internationalization of financial markets

The growing internationalization of financial markets has become an important trend. Before the 1980s, US ____1____ were much larger than financial markets outside the United States, but in recent years the dominance of US markets has been disappearing. The growth of foreign financial markets has been the result of both large increases in the ____2____ in foreign countries such as Japan and the ____3____ of foreign financial markets, which has enabled them ____4____ their activities. American investors often seek ____5____ abroad. Similarly, ____6____ and banks raise ____7____ from Americans, and foreigners have become ____8____ in the United states.

4.5.3 Complete the text. Replace the Russian words and phrases by English equivalents.

International Bond Market, Eurobonds, and Eurocurrencies

The traditional instruments in the international bond market are known as foreign bonds. ***Иностранные облигации*** are sold in a foreign country and are denominated in that country's ***валюте***.For example, if the German automaker Porsche ***продает облигацию*** in the United States ***деноминированную*** in US dollars, it is classified as a ***иностранная облигация***. Foreign bonds have been an ***важный инструмент*** in the international ***рынке капитала*** for centuries. In fact, a large percentage of US railroads built in the nineteenth century ***были финансированы*** by sales of foreign bonds in Britain.

A more recent ***инновация*** in the international bond market is the Eurobond, a bond denominated ***в валюте*** other than that of the country in which it is sold – ***на пример***, a bond denominated in US dollars sold London. Currently, over 80% of the ***новых выпусков*** in the ***международный рынок облигаций*** are Eurobonds, and the market for these ***ценных бумаг*** has grown very rapidly. As a result, the Eurobond market is now larger than the US ***рынок корпоративных облигаций***.

A variant of the Eurobond is Eurocurrencies, which are ***иностранные валюты*** deposited in banks outside the home country. The most important of the Eurocurrencies are ***евродоллары***, which are US dollars ***задепонированные*** in foreign banks outside the United States or in ***зарубежных филиалах*** of US banks. Because these short-term deposits earn ***процент***, they are similar to ***краткосрочные*** Eurobonds.

4.5.4 Text for discussion.

a. Look up the dictionary for the meaning and pronunciation of the following words and word-combinations and use them to discuss the problems outlined in the text.

Regulation, to issue securities, assets and liabilities, earnings, sales of stock, insider trading, to prohibit, soundness, licensing, financial books, deposit insurance, to subject to restrictions, branching, to abolish, legislation, a stake.

b. Briefly scan the text and outline the list of major points.

c. Read the text more carefully and comment on the following items:

- reporting requirements for financial intermediaries;
- restrictions on assets and activities of financial intermediaries;
- the necessity of deposit insurance.

Financial Regulation

Not surprisingly, given the similarity of the economic system in the USA and in Japan, Canada, and the nations of western Europe, financial regulation in these countries is similar to financial regulation in the United States. The provision of information is improved by requiring corporations issuing securities to report details about assets and liabilities, earnings, and sales of stock, and by prohibiting insider trading. The soundness of intermediaries is ensured by licensing, periodic inspection of financial intermediaries' books, and the provision of deposit insurance.

The major differences between financial regulation in the United States and abroad relate to bank regulation. In the past, the United States was the only industrialized country to subject banks to restrictions on branching, which limited banks' size and restricted them to certain geographic regions. (These restrictions were abolished by legislation in 1994.) US banks are also the most restricted in the range of assets they may hold. Banks abroad frequently hold shares in commercial firms; in Japan and Germany, those stakes can be sizable.

4.6 Render the passage in English using the English equivalents of the italicized phrases given in Russian. Express the main idea of the passage in one sentence.

Основная функция финансовых рынков *состоит в перераспределении* **(is to channel)** средств от сберегателей, которые имеют *излишек средств* **(an excess of funds)**, к расходывателям, которые имеют *дефицит средств* **(a shortage of funds).** Финансовые рынки могут делать это *либо посредством* **(either through)** прямого финансирования, при котором заемщики занимают средства *непосредственно* **(directly)** у *кредиторов* **(lenders)**, *продавая* **(by selling)** им ценные бумаги, или *с помощью* **(through)** *косвенного* **(indirect)** финансирования, которое *включает* **(involves)** финансового посредника, который стоит между кредитором-сберегателем и заемщиком-расходывателем, и помогает *переводить* **(transfer)** средства от одного к другому. Это перераспределение средств *улучшает* **(improves)** экономическое *благосостояние* **(welfare)** каждого в обществе. Так как они *позволяют* **(allow)** средствам *перемещаться* **(to move)** от людей, которые не имеют инвестиционных *возможностей* **(opportunities)**, к тем, которые имеют такие возможности, финансовые рынки *способствуют* **(contribute to)** экономической эффективности. *К тому же* **(in addition)**, перераспределение средств *приносит прямую пользу* **(directly benefits)** потребителям,

позволяя **(by allowing)** им делать покупки, когда они *нуждаются в них больше всего* **(need them most)**.

Unit 4 Reading Self – Control Test
Functions of Financial Markets and Financial Intermediaries

1. Which of the following is the main idea of the text?

(A) Financial instruments.
(B) The classification of financial institutions.
(C) The structure of the financial system.
(D) The classification of financial markets.

2. What is most likely the audience the text is addressed to?

(A) bankers
(B) finance students
(C) newspaper readers
(D) financial managers

3. It can be derived from the text that financial markets and financial intermediaries

(A) transfer funds from those who have a surplus of funds to those who have a shortage of funds.
(B) transfer funds from lender-borrowers to savings-spenders.
(C) transfer funds from creditors who have investment opportunities to those who don't.
(D) transfer funds from individuals and institutions in the public and private sectors who sell securities to those who buy them.

4. It can be inferred from the text that direct finance can be defined as

(A) crediting funds by buying financial instruments.

(B) channeling funds from savers to borrowers without any intermediation.
(C) channeling funds from savers to borrowers through intermediation.
(D) borrowing funds by issuing financial instruments.

5. Judging by what you have derived from the text, which do you think of the basic categorizations of financial markets is based on the length of maturity of securities?

(A) primary markets – secondary markets
(B) debt markets – equity markets
(C) money markets – capital markets
(D) exchanges – over-the-counter markets

6. Judging by what you have derived from the text, which do you think of the basic categorizations of financial markets is based on whether the company issues claims to share in the net income and assets or debt instruments?

(A) primary markets – secondary markets
(B) debt markets – equity markets
(C) money markets – capital markets
(D) exchanges – over-the-counter markets

7. It can be derived from the text that

(A) bonds, stocks, and mortgages are both securities and debt instruments.
(B) common stocks often make periodic interest payments to their holders.
(C) common stocks often make periodic dividend payments to their holders.
(D) debt instruments periodically make dividend payments to their holders.

8. It can be derived from the text that

(A) the direct financial route is considered the primary route for moving funds from lenders to borrowers.
(B) exchanges are the most efficient intermediaries.
(C) common stocks are both securities and financial instruments.
(D) financial intermediaries can substantially reduce transaction costs.

9. Which of the following statements would the author most probably disagree with?
(A) Capital markets market are composed of both the primary and secondary markets.
(B) A stock exchange is an exchange where various commodities and derived products are traded.
(C) Maturities on commercial paper rarely range any longer than 270 days.
(D) Common stocks provide ownership interest.

10. What is most likely the subject of the extract which is missing from this text?
(A) Commercial banking.
(B) Basic features of different classes of financial intermediaries.
(C) Central banking.
(D) Remedies to asymmetric information problems.

Unit 4 Glossary

ASYMMETRIC INFORMATION: The inequality of knowledge that each party to a transaction has about the other party. This often happens in transactions where the seller knows more than the buyer, although the reverse can happen as well. Potentially, this could be a harmful situation because one party can take advantage of the other party's lack of knowledge. With increased advancements in technology, asymmetric information has been on the decline as a result of more and more people being able to easily access all types of information.

BANKS: Financial institutions that accept deposits and make loans (such as commercial banks, savings and loan associations, and credit unions).

BOND: A debt security that promises to make payments periodically for a specified period of time. Bonds are used by companies, municipalities, states and U.S. and foreign governments to finance a variety of projects and activities. Bonds are commonly referred to as fixed-income securities and are one of the three main asset classes, along with stocks and cash equivalents. The indebted entity (issuer) issues a bond that states the interest rate (coupon) that will be paid and when the loaned funds (bond principal) are to be returned (maturity date). Interest on bonds is usually paid every six months (semi-annually). The main categories of bonds are corporate bonds, municipal bonds, and U.S. Treasury bonds, notes and bills, which are collectively referred to as simply "Treasuries". Two features of a bond - credit quality and duration - are the principal determinants of a bond's interest rate. Bond maturities range from a 90-day Treasury bill to a 30-year government bond. Corporate and municipals are typically in the three to 10-year range.

BRANCHES: Additional offices of banks that conduct banking operations.

CAPITAL MARKET: A financial market in which longer-term debt (maturity of greater than one year) and equity instruments are traded. Individuals and institutions in the public and private sectors often sell securities on the capital markets in order to raise funds. Thus, this type of market is composed of both the primary and secondary markets.

COMMERCIAL BANK: A financial institution that provides services such as a accepting deposits and giving business loans. Commercial banking activities are different than those of investment banking, which include underwriting, acting as an intermediary between an issuer of securities and the investing public, facilitating mergers and

other corporate reorganizations, and also acting as a broker for institutional clients.

COMMERCIAL PAPER: An unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days. The debt is usually issued at a discount, reflecting prevailing market interest rates. The maturity length of commercial paper is less than a year, often 30, 60 or 90 days. The corporations who issue commercial paper are usually the largest, most stable, and most profitable businesses in the country.

COMMODITIES EXCHANGE: A commodities exchange is an exchange where various commodities and derivatives products are traded. Most commodity markets across the world trade in agricultural products and other raw materials (like wheat, barley, sugar, maize, cotton, cocoa, coffee, milk products, pork bellies, oil, metals, etc.) and contracts based on them. These contracts can include spot prices, forwards, futures and options on futures. Other sophisticated products may include interest rates, environmental instruments, swaps, or ocean freight contracts. The two biggest commodity exchanges in good old U. S. of A. are the Chicago Board of Trade and the Chicago Mercantile Exchange. Unlike, let's say a grocery store where commodities physically trade hands, commodity exchanges trade only legal ownership. This is much like a stock market, which trades the ownership of a corporation, but leaves the factory at home. Commodity markets offer two basic sorts of trading -- spot (immediate delivery of a commodity) and futures (delivery of a commodity at a future date).

COMMON STOCK: A security that gives the holder an ownership interest in the issuing firm. This ownership interest includes the right to any residual cash flows and the right to vote on major corporate issues.

CREDIT UNION: A financial institution that focuses on servicing the banking and lending needs of its members, who must be linked by a

common bond. These are member-owned financial co-operatives. These institutions are created and operated by its members and profits are shared amongst the owners. As soon as you deposit funds into a credit union account, you become a partial owner and participate in the union's profitability. Credit unions are formed by large corporations and organizations for their employees and members.

DEPOSIT INSURANCE: A program of guaranteeing, or insuring, customers' deposits at a bank or similar institution. Since the 1930s bank deposits have been insured by the Federal Deposit Insurance Corporation (FDIC). Other programs have insured deposits at credit unions and savings and loan associations. The FDIC works like this -- If a bank is unable to pay back all or part of its customers' deposits because it has done something like go out of business, then the FDIC steps in to make up the difference--up to a pretty hefty limit.

DIVIDEND: The portion of a corporation's after-tax accounting profit that's paid to shareholders or owners. Corporate managers usually try to pay the shareholders some minimum dividend that's comparable to returns from other financial markets--such as the interest on government securities or corporate bonds--to keep the owners from selling off the company's stock. That portion of after-tax accounting profit that's not paid out as dividends is typically invested in capital.

EFFICIENCY: Obtaining the most possible satisfaction from a given amount of resources. Efficiency for our economy is achieved when we cannot increase our satisfaction of wants and needs by producing more of one good and less of another. This is one of the five economic goals, specifically one of the two micro goals (the other being equity).

EQUITY: This has two, not totally unrelated, uses in our wonderful world of economics. The first is as one of the two micro goals (the other being efficiency) of a mixed economy. This use relates to the "fairness" of our income or wealth distributions. The second use of the term equity means ownership, especially the ownership of a business or corporation.

EUROBONDS: Bonds denominated in a currency other than that of the country in which they are sold.

EUROCURRENCIES: Foreign currencies deposited in banks outside the home country.

EURODOLLARS: U.S. dollars that are deposited in foreign banks outside of the United States or in foreign branches of U.S. banks.

EXCHANGES: Secondary markets in which buyers and sellers of securities (or their agents or brokers) meet in one central location to conduct trades. An exchange is a marketplace in which securities, commodities, derivatives and other financial instruments are traded. The core function of an exchange - such as a stock exchange - is to ensure fair and orderly trading, as well as efficient dissemination of price information for any securities trading on that exchange. Exchanges give companies, governments and other groups a platform to sell securities to the investing public. An exchange may be a physical location where traders meet to conduct business or an electronic platform.

ECONOMIC EXPOSURE: An exposure to fluctuating exchange rates, which affects a company's earnings, cash flow and foreign investments. The extent to which a company is affected by economic exposure depends on the specific characteristics of the company and its industry.

FINANCIAL INTERMEDIARIES: Institutions (such as banks, insurance companies, mutual funds, pension funds, and finance companies) that borrow funds from people who have saved and then make loans to others.

FINANCIAL INTERMEDIATION: The process of indirect finance whereby financial intermediaries link lender-savers and borrower-spenders.

FINANCIAL MARKETS: Markets in which funds are transferred from people who have a surplus of available funds to people who have a shortage of available funds.

INSIDER TRADING: It is the trading of a corporation's stock or other securities (e.g. bonds or stock options) by individuals with potential access to non-public information about the company. In most countries, trading by corporate insiders such as officers, key employees, directors, and large shareholders may be legal, if this trading is done in a way that does not take advantage of non-public information. However, the term is frequently used to refer to a practice in which an insider or a related party trades based on material non-public information obtained during the performance of the insider's duties at the corporation, or otherwise in breach of a fiduciary or other relationship of trust and confidence or where the non-public information was misappropriated from the company.

INSURANCE: Transferring risk to others. The need for insurance occurs because people tend to be risk averse in many circumstances. As such, most of us are willing to pay for certainty. Those who satisfy this need for insurance, insurance companies for example, do so because they can pool risk. If insurance companies know the chance of some loss (an accident, illness, or whatever) and its cost, then they can divide this cost among a large group of risk averse types. The insurance company agrees to pay the cost of the loss and each of the risk averse types pay a risk premium, but get the peace of mind that goes with certainty.

INVESTMENT BANKS: Firms that assist in the initial sale of securities in the primary market (underwriting). Financial intermediaries that perform a variety of services. This includes

underwriting, acting as an intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and also acting as a broker for institutional clients. The role of the investment bank begins with pre-underwriting counseling and continues after the distribution of securities in the form of advice.

MONEY MARKET: A financial market in which only short-term debt instruments (maturity of less than one year) are traded. A segment of the financial market in which financial instruments with high liquidity and very short maturities are traded. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. Money market securities consist of negotiable certificates of deposit (CDs), bankers acceptances, U.S. Treasury bills, commercial paper, municipal notes, federal funds and repurchase agreements (repos).The money market is used by a wide array of participants, from a company raising money by selling commercial paper into the market to an investor purchasing CDs as a safe place to park money in the short term.

MONEY MARKET MUTUAL FUNDS: Funds that accumulate investment dollars from a large group of people and then invest in short-term securities such as Treasury bills and commercial paper.

MORTGAGE: A long-term loan secured by real estate.

MUTUAL BANK: A bank owned by depositors.

MUTUAL SAVINGS BANK: A type of thrift institution, originally designed to serve low-income individuals, that historically invested in long-term, fixed-rate assets such as mortgages. Initiated in 1816, the first mutual savings banks (MSBs) were the Philadelphia Saving Society and Boston's Provident Institution for Saving. Most MSBs were located in the Mid-Atlantic and industrial Northeast regions of

the United States. By 1910, there were 637 of these institutions. MSBs were generally very successful until the 1970s. During the 1980s, regulations governing what they could invest in and what rate of interest they could pay to customers combined with rising interest rates to cause massive losses for MSBs. Consequently, many MSBs failed in the 1980s; others merged, became commercial banks or converted to stock form.

NEW YORK STOCK EXCHANGE: The largest stock market in the United States, located on the famous Wall Street in New York City. This is the big daddy of all stock markets in the country, often referred to as the "big board." It was begun in the 1790s to help fledgling corporations in our fledgling country raise the funds needed for capital investment. All stock transactions (millions each day) are conducted by its members, making membership a very valuable commodity. It currently has slightly over a 1,000 members or "seats," with the only way to get a seat on the exchange from a retiring or deceased member.

OVER-THE-COUNTER MARKET: A secondary market in which dealers at different locations who have an inventory of securities stand ready to buy and sell securities to anyone who comes to them and is willing to accept their prices. A decentralized market of securities not listed on an exchange where market participants trade over the telephone, facsimile or electronic network instead of a physical trading floor. There is no central exchange or meeting place for this market. Also referred to as the "OTC market". In the OTC market, trading occurs via a network of middlemen, called dealers, who carry inventories of securities to facilitate the buy and sell orders of investors, rather than providing the order matchmaking service seen in specialist exchanges such as the NYSE.

PREFERRED STOCK: Stock on which a fixed dividend must be paid before common dividends are distributed. It often does not mature and usually does not give the holder voting rights in the company.

PRIMARY MARKET: A financial market in which new issues of a security are sold to initial buyers. A market that issues new securities on an exchange. Companies, governments and other groups obtain financing through debt or equity based securities. Primary markets are facilitated by underwriting groups, which consist of investment banks that will set a beginning price range for a given security and then oversee its sale directly to investors. Also known as "new issue market" (NIM).

REGULATION: Government rules or laws that control the activities of businesses and consumers. The motivation for regulation is that businesses are inclined to do things that are harmful to the public--actions which need to be prevented or otherwise controlled. Regulation is essentially an extension of government's authority to protect one member of society from another. It tends to take one of two forms--(1) industry regulation that's intended to prevent firms from gaining and abusing excessive market control and (2) social regulation that seeks to protect consumers for problems caused by pollution, unsafe products, and the lack of information (market failure).

RISK SHARING: The process by which financial intermediaries create and sell assets with risk characteristics that people are comfortable with and then use the funds they aquire by selling these assets to purchase other assets that may have far more risk.

SAVINGS AND LOAN ASSOCIATION: A depository institution chartered by the Federal Home Loan Bank that was established to assist home owners with low-cost mortgage loans using savings deposits. However, S&Ls have expanded their activities and now provide most of the services of traditional banks, including checkable deposits.

SECONDARY MARKET: A financial market in which securities that have previously been issued can be resold. A market where

investors purchase securities or assets from other investors, rather than from issuing companies themselves. The national exchanges - such as the New York Stock Exchange and the NASDAQ are secondary markets. Secondary markets exist for other securities as well, such as when funds, investment banks, or entities such as Fannie Mae purchase mortgages from issuing lenders. In any secondary market trade, the cash proceeds go to an investor rather than to the underlying company/entity directly.

SECURITY: A claim on the borrower's future income that is sold by the borrower to the lender. Also called a financial instrument.

SECURITIES AND EXCHANGE COMMISSION: (SEC) A federal government agency that regulates the trading of corporate stock to protect investors against unscrupulous practices. Like a number of other federal regulatory agencies, the SEC was established in the 1930s--1934 to be exact. The impetus for its formation was to prevent investors from manipulating the stock market and to prevent other practices that contributed to the 1929 stock market crash. The SEC has all sorts of rules governing the stock market, including information disclosure, insider trading, speculation, and use of credit.

STOCK MARKET: A financial market that trades ownership shares in corporations--corporate stock. The three best known, national stock markets in the United States are the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers. There are also a few regional markets--the Chicago, Philadelphia, and Pacific exchanges are the most notable that trade stock on a smaller scale. Other countries that use corporations to produce stuff, all of the industrialized ones, also have stock markets. The biggest and most worthy of attention are in Tokyo, London, Toronto, Frankfurt, and Paris. Stock markets play a vital role in our economy, making it possible for businesses to raise the large sums of money needed for investment.

STOCK: A variable or measurement that is defined for an instant in time (as opposed to a period of time). A stock can only be measured at

a specific point in time. For example, money is the stock of production that exists right now. Other important stock measures are population, employment, capital, and business inventories.

T-BOND: The abbreviation for Treasury bond, which is one kind of government security issued by the U. S. Treasury to obtain the funds used to finance the federal budget deficit. A Treasury bond (or T-bond) has a maturity length of over 10 years, with 15 and 30 years common maturities. T-bonds, together with other long-term bonds issued by state and local governments and businesses, are traded in capital markets. The interest rate on T-bonds is a key long-run interest rate.

T-NOTE: The abbreviation for Treasury note, which is one kind of government security issued by the U. S. Treasury to obtain the funds used to finance the federal budget deficit. A Treasury note (or T-note) has a maturity length of between one and 10 years.

THRIFT INSTITUTIONS (THRIFTS): Savings and loan associations, mutual savings banks, and credit unions. Non-profit depository financial institutions that were originally established to provide limited banking services, often to specific groups, that were not adequately offered by traditional banks. The three primary thrift institutions are credit unions, savings and loan associations, and mutual savings banks. In recent decades these thrift institutions have broaden the range of financial services, especially offering checkable deposits, and thus operate as banks. In particular, they come under the same monetary policy regulation as traditional banks.

TRANSACTION COSTS: The time and money spent trying to exchange financial assets, goods, or services. Costs incurred when buying or selling securities. These include brokers' commissions and spreads (the difference between the price the dealer paid for a security and the price at which it can be sold). Also referred to as "transaction fees."

TREASURY BILLS (T-bills): Securities sold by the federal government with initial maturities of less than one year. They are often considered the lowest-risk security available.

UNDERWRITING: Guaranteeing prices on securities to corporations and then selling the securities to the public. 1. The process by which investment bankers raise investment capital from investors on behalf of corporations and governments that are issuing securities (both equity and debt). 2. The process of issuing insurance policies. The word "underwriter" is said to have come from the practice of having each risk-taker write his or her name under the total amount of risk that he or she was willing to accept at a specified premium. In a way, this is still true today, as new issues are usually brought to market by an underwriting syndicate in which each firm takes the responsibility (and risk) of selling its specific allotment.

WEALTH: All resources owned by an individual, including all assets.

WELFARE: An assortment of programs that provide assistance to the poor. The cornerstone of our welfare system is Aid to Families with Dependent Children (AFDC), which was created by the Social Security Act (1935). It provides cash benefits to assist needy families with children under the age of 18. Funding comes partly from the federal government and partly from states. Because states also administer their own programs, benefits and qualification criteria differ from state to state. A second part of the welfare system, one that's run entirely by the federal government, is Supplemental Security Income (SSI). This program provides cash benefits to elderly, blind, and disabled in addition to any benefits received through the Social Security system. Our welfare system includes a whole bunch of additional benefits, including Medicaid, food stamps, low-cost housing, school lunches, job training, day care, and earned-income tax credits.