Lecture 1: Introduction

ECON435: Financial Markets and the Macroeconomy

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Saving and Investment

Macroeconomic Definitions:

Saving:
- consume less than your current resources
- so as to have more resources in the future

Investment:
- put current resources to a productive use (e.g. build factories, …)
- produce more resources in the future

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Financial Autarky

Autarky = self-sufficiency (no market access)

For an individual (or an economy) in autarky:

saving = investment

Example: a castaway on a tropical island

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Roles of Financial Markets

Financial markets **allow for a separation of**:
- savings decisions
- investment decisions

Financial markets **distribute resources** (money) from savers to entrepreneurs

- *if you want to save:* you don't need to create an enterprise and invest on your own
- *if you want to invest:* you don't need to come up with all the money on your own

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Roles of Financial Markets (ctd.)

- Consumption timing
- Information role of market prices
- Risk allocation
- Separation of ownership and management
  → does not always work well

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Real Assets and Financial Assets

- **Entrepreneurs:** use current resources to create productive capital, which will produce resources in the future

→ **invest in real assets**, e.g. factories etc.

- **Savers:** buy claims on these future resources (securities) from entrepreneurs

→ **invest in financial assets**, e.g. stocks, bonds etc.

= central focus of finance

→ Financial markets create financial assets = claims on real assets

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Classes of Financial Assets

- Fixed income securities (or debt):
  - Money market: maturity up to 1 year, e.g. certificates of deposit
  - Bond market: maturity > 1 year
- Stocks (or equity)
- Derivatives

Financial Intermediaries

Difficult for small households to interact with large corporations that need finance

→ **Financial Intermediaries:**
bring borrowers (businesses) and lenders (households) together:

1) pool savings from households (deposits)
2) diversify risk by lending to many businesses
3) have expertise in screening, monitoring

The Investment Process

Portfolio: collection of all assets of an investor

Asset allocation: decision of what asset classes to invest in (debt, equity etc.)

Security selection: choice of what individual securities to pick within these asset classes (e.g. Google, Microsoft, etc.)

Players in Financial Markets

- Business Firms – borrow
- Households – save
- Government
- Financial Intermediaries:
  - Banks
  - Investment Companies
  - Insurance Companies
  - ...