Financial Markets

Chapter One

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Table of content

Introduction to Financial Markets

- Overview of financial markets
- How do financial markets help businesses?
- Role of financial markets in the global economy
- The functions of financial markets
- Types of financial markets
- Financial markets' failures and their types

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Overview of Financial Markets

The financial market refers to the market where the sale and purchase of financial products occurs. Such products include stocks, bonds, currencies, derivatives, commodities, cryptocurrencies, etc. It acts as a platform for sellers and buyers to connect and deal in their desired financial assets at a price determined by market forces.

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Overview of Financial Markets

- Financial markets can give an opportunity for you to invest money in shares (also known as equities) to build up money for the future.
- Over a long period of time, this can often provide a better return than opening a savings account at your bank. But buying shares can be risky. It is important to remember that the value of any investment can go down as well as up, and getting good returns in the past does not always mean they'll be good in the future.
- Financial markets also allow people to take out insurance. Insurance companies need to use financial markets to make sure you will receive a pay-out if you have an accident, such as losing or damaging your mobile phone.
- Financial markets enable lenders such as banks to borrow money. They make loans to people who want to borrow – whether that's attending university with a student loan or buying a house with a mortgage.

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How do financial markets help businesses?

- Financial markets provide finance for companies so they can hire, invest and grow.
- For example, Apple started in a garage in California. While it had some great ideas, it needed money to make them happen.
- In 1977, it persuaded a single investor to loan the company $250,000. Over time, the company grew and less than five years later it was able to borrow over $100 million from financial markets by selling shares in the company.
- Apple is now worth hundreds of billions of dollars and employs over 100,000 people.

So, when they work well, financial markets can make the country much better off.

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Role of financial markets in the global economy

- The financial market plays a significant role in the growth of an economy, as it provides a platform for individuals, businesses, and governments to invest, borrow, and raise capital. Thus, it results in the subsequent rise in efficiency, new businesses, and employment.
- Through its complex web of operations, the financial market has a major bearing(direction-orientation) on economic expansion. Capital formation, resource allocation(division), risk management, and liquidity provision are just a few areas in which it contributes to the economy's growth.

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The functions of financial markets

The financial market has many roles in an economy and operates about six main functions, including:

1. Facilitating savings
2. Providing loans
3. Facilitating transactions
4. Allocating capital to more productive use
5. Providing a market for equity
6. Providing forward markets

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The functions of financial markets

1. **Facilitating savings:** financial markets provide a means for people to transfer their money power from the present to the future. For example, you can put aside some money for savings or invest in bonds and shares to earn future interest.
2. **Providing loans:** in the capital market, corporations or the government can issue loans and bonds in exchange for public money. Bonds, in the case of a corporation, are loans made by an investor to a business in need of cash for operations and growth.
3. **Allocating capital to more productive use:** people can invest their extra cash in a business function to collect interests instead of sitting idle in a bank account.

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The functions of financial markets

4. **Facilitating transactions:** financial markets provide a way for buyers and sellers to interact and exchange funds for their transactions.
5. **Providing forward markets:** in forward markets, you can offer to buy a product in the future at a pre-determined price to avoid price volatility(التقلب).
6. **Providing a market for equities:** an equity market is a market of shares. A company can sell shares to the public in exchange for capital to grow. An individual investing in the company's shares can also earn a return on investment, usually in the form of dividends - a fixed amount of money paid at a certain period provided the business performs well.

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Types of financial markets

Financial markets are categorized into various types based on the assets traded and the structure of the market. Here are some of the primary types of financial markets:

1. **Stock Market (Equity Market)**
2. **Bond Market (Debt Market)**
3. **Foreign Exchange (Forex) Market**
4. **Commodity Market**
5. **Derivatives Market**
6. **Money Market**

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Types of financial markets

7. Real Estate Market
8. Private Equity and Venture Capital Markets
9. Cryptocurrency Market
10. Alternative Investment Markets
11. Over-the-Counter (OTC) Market
12. Primary Market
13. Secondary Market

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Types of financial markets

1. **Stock Market (Equity Market):** In this market, shares of publicly-traded companies are bought and sold. It's a place where investors can acquire ownership stakes in businesses. Stock markets are often divided into primary markets (where new securities are issued) and secondary markets (where existing securities are traded among investors).

2. **Bond Market (Debt Market):** Bond markets deal with debt securities. Bonds are essentially loans made by investors to governments, municipalities, or corporations in exchange for periodic interest payments and the return of the bond's face value at maturity. This market provides a means for entities to raise capital.

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Types of financial markets

3. **Foreign Exchange (Forex) Market:** The forex market is where currencies are traded. It's crucial for international trade and investment, as it allows for the exchange of one currency for another. Exchange rates in this market are influenced by various economic factors.

4. **Commodity Market:** In commodity markets, raw materials such as oil, gold, agricultural products, and metals are bought and sold. These markets facilitate price discovery for essential goods and materials.

5. **Derivatives Market:** Derivatives are financial contracts whose value is derived from an underlying asset, index, or interest rate. This market includes options, futures, swaps, and forwards. Derivatives can be used for hedging or speculative purposes.

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Types of financial markets

6. **Money Market:** The money market deals with short-term debt securities, such as Treasury bills, certificates of deposit (CDs), and commercial paper. It provides a platform for governments and institutions to manage their short-term cash needs.

7. **Real Estate Market:** Real estate markets involve the buying and selling of real property, including land and buildings. Real estate can be purchased for investment, development, or personal use.

8. **Private Equity and Venture Capital Markets:** These markets involve investments in privately-held companies. Private equity typically focuses on mature companies, while venture capital targets startups and early-stage businesses.

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Types of financial markets

9. **Cryptocurrency Market:** This relatively new market involves digital or virtual currencies like Bitcoin and Ethereum. Cryptocurrencies are decentralized and operate on blockchain technology.

10. **Alternative Investment Markets:** These markets encompass a wide range of non-traditional assets, including hedge funds, art, collectibles, and even intellectual property.

11. **Over-the-Counter (OTC) Market:** In OTC markets, securities are traded directly between parties without the involvement of a centralized exchange. It's common for bonds and certain types of derivatives.

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Types of financial markets

12. **Primary Market:** This is where new securities are issued and sold to the public for the first time. Companies raise capital by issuing stocks or bonds in the primary market.

13. **Secondary Market:** In contrast to the primary market, the secondary market involves the trading of existing securities among investors. Stock exchanges like the NYSE and NASDAQ are examples of secondary markets.

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Financial markets' failures

- **Financial market failures** happen when the market fails to operate efficiently. This results in a significant loss in economic output.

- Like many types of markets, the financial market is largely influenced by a **price mechanism**. That is, the system through which the prices of goods and services are determined based on the market **demand** and **supply**. When the price of a financial asset deviates too far from its actual value, financial market failures will occur.

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Types of Financial market failures

Financial market failures are grouped into four main types:

1. Financial crisis
2. Market bubbles (market crash)
3. Asymmetric information
4. Market rigging

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Financial crisis

- A **financial crisis** happens when the prices of financial assets reduce sharply, leaving businesses and consumers alike unable to pay off their debts. During a financial crisis, banks and other financial institutions may experience liquidity shortages. Financial crises can be triggered by systemic failures, uncontrollable human behaviours, or the lack of governmental regulations.
- Some examples include the **Argentine Great Depression** and **the Lebanese Currency Crisis**.

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Market bubble

- A **market bubble** happens when a financial asset is overvalued due to overly optimistic projections about the future, followed by a drastic drop in the price.
- The **Dot-com Bubble** is a famous example of a market bubble. In the 1990s, there was a surge in investment in technology-based companies and the Internet, which quickly drove up the price of the stock in this sector. However, after the market peaked, the price nosedived, sparking a panic among investors and up to 10% of loss in the stock market.

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What is Market Bubble?

- Bubble is an economic cycle that is characterized by the rapid escalation of market value, particularly in the price of assets.
- This fast inflation is followed by a quick decrease in value, or a contraction that is sometimes referred to as a “crash” or a “bubble” burst.

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Asymmetric information

- **Asymmetric information** is the state where one party has information that the other does not have.
- In a transaction, when either the buyer or seller has asymmetric information, they can use this to drive more benefits for themselves.
- For example, an owner of a used laptop doesn't reveal to their buyer its defects. As a result, the buyer may pay a higher price than they should.

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What is asymmetric information?

- Financial markets exhibit asymmetric information in any transaction in which one of the two parties involved has more information than the other and thus has the ability to make a more informed decision.
- Economists say that asymmetric information leads to market failure. That is, the law of supply and demand that regulates the pricing of goods and services is skewed.

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Market rigging

- **Market rigging** happens as firms raise or fix prices to generate higher profits for themselves.
- The practices of market rigging are often referred to as price-fixing or collusion.
- In the case of price-fixing, a market leader can increase the price of a product, which allows smaller firms to raise the price as well, causing customers to pay a higher price for the commodity.

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What is market rigging?

- Market rigging refers to the illegal practice of manipulating financial markets for personal gain. It can take various forms, such as insider trading, price manipulation, and collusion among market participants.
- Market rigging can occur in any financial market, including stocks, bonds, commodities, and currencies.

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Thank you!

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