Financial Markets and Institutions 10th edition Mishkin Solutions Manual

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Chapter 1
Why Study Financial Markets and Institutions?

Why Study Financial Markets?

- Debt Markets and Interest Rates
- The Stock Market
- The Foreign Exchange Market

Why Study Financial Institutions?

- Structure of the Financial System
- Financial Crises
- Central Banks and the Conduct of Monetary Policy
- The International Financial System
- Banks and Other Financial Institutions
- Financial Innovation
- Managing Risk in Financial Institutions

Applied Managerial Perspective

How We Will Study Financial Markets and Institutions

- Exploring the Web
- Collecting and Graphing Data

Web Exercise

Concluding Remarks

■ Overview and Teaching Tips

Before embarking on a study of financial markets and institutions, the student must be convinced that this subject is worth studying. Chapter 1 pursues this goal by showing the student that financial markets and institutions is an exciting field because it focuses on phenomena that affect everyday life. An additional purpose of Chapter 1 is to provide an overview for the entire book, previewing the topics that will be covered in later chapters. The chapter also provides the students with a guide as to how they will be studying financial markets and institutions with a unifying, analytic framework and an applied managerial perspective.

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In teaching this chapter, the most important goal should be to get the student excited about the material. I have found that talking about the data presented in the figures helps achieve this goal by showing the students that the subject matter of financial markets and institutions has real-world implications that they should care about. In addition, it is important to emphasize to the students that the course will have an applied managerial perspective, which they will find useful later in their careers. Going through the web exercise is also a way of encouraging the students to use the web to further their understanding of financial markets and institutions.

■ Answers to End-of-Chapter Questions

1. Well-performing financial markets tend to allocate funds to its more efficient use, thereby allowing the best investment opportunities to be undertaken. The improvement in the allocation of funds results in a more efficient economy, which stimulates economic growth (and thereby poverty reduction).

2. Businesses would cut investment spending because the cost of financing this spending is now higher, and consumers would be less likely to purchase a house or a car because the cost of financing their purchase is higher.

3. A change in interest rates affects the cost of acquiring funds for financial institutions, as well as changes the income on assets such as loans, both of which affect profits. In addition, changes in interest rates affect the price of assets such as stocks and bonds that the financial institution owns, which can lead to profits or losses.

4. While it is true that there are many interest rates in the economy, like the interest rate paid by a corporate bond or the interest rate charged to a homeowner, it is also true that all of these interest rates tend to move together. Evidence shows that movements in different interest rates over time are in large part explained by the same events, and thereby allow economists to refer to “the” interest rate when trying to determine its movements.

5. The lower price for a firm’s shares means that it can raise a smaller amount of funds, and so investment in plant and equipment will fall.

6. A bond is a debt instrument, which entitles the owner to receive periodic amounts of money (predetermined by the characteristics of the bond) until its maturity date. A common stock, however, represents a share of ownership in the institution that has issued the stock. In addition to its definition, it is not the same to hold bonds or stock of a given corporation, since regulations state that

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stockholders are residual claimants (i.e., the corporation has to pay all bondholders before paying stockholders).

7. It makes foreign goods more expensive, and so British consumers will buy less foreign goods and more domestic goods.

8. It makes British goods more expensive relative to American goods. American businesses will find it easier to sell their goods in the United States and abroad, and the demand for their products will rise.

9. Changes in foreign exchange rates change the value of assets held by financial institutions and thus lead to gains and losses on these assets. Also, changes in foreign exchange rates affect the profits made by traders in foreign exchange who work for financial institutions.

10. In the mid- to late 1970s, the late 1980s, and the early 1990s, the value of the dollar was low, making travel abroad relatively more expensive; that would have been a good time to vacation in the United States and see the Grand Canyon. As the dollar's value rose in the early 1980s, travel abroad became relatively cheaper, making it a good time to visit the Tower of London.

11. In general, people do not lend large amounts of money to one another because of several information problems. In particular, people do not know about the capacity of other people of repaying their debts, or the effort they will provide to repay their debts. Financial intermediaries, in particular commercial banks, tend to solve these problems by acquiring information about potential borrowers and writing and enforcing contracts that encourage lenders to repay their debt and/or maintain the value of the collateral.

12. Savings and loan associations, mutual savings banks, credit unions, insurance companies, mutual funds, pension funds, and finance companies.

13. The latest financial crisis in the U.S. and Europe occurred in 2007 – 2009. At the beginning it hit mostly the U.S. financial system, but it then quickly moved to Europe, since financial markets are highly interconnected. One specific way in which these markets were related is that some financial intermediaries in Europe held securities backed by mortgages originated in the U.S., and when these securities lost a considerable part of their value, the balance sheet of European financial intermediaries was adversely affected.

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14. The profitability of financial institutions is affected by changes in interest rates, stock prices, and foreign exchange rates; fluctuations in these variables expose these institutions to risk.

15. Because the Federal Reserve affects interest rates, inflation, and business cycles, all of which have an important impact on the profitability of financial institutions.

■ Quantitative Problem

1. The following table lists foreign exchange rates between U.S. dollars and British pounds during April:

Date	U.S. Dollars per GBP	Date	U.S. Dollars per GBP
4/1	1.9564	4/18	1.7504
4/4	1.9293	4/19	1.7255
4/5	1.914	4/20	1.6914
4/6	1.9374	4/21	1.672
4/7	1.961	4/22	1.6684
4/8	1.8925	4/25	1.6674
4/11	1.8822	4/26	1.6857
4/12	1.8558	4/27	1.6925
4/13	1.796	4/28	1.7201
4/14	1.7902	4/29	1.7512
4/15	1.7785		

Which day would have been the best day to convert $200 into British pounds?

Which day would have been the worst day? What would be the difference in pounds?

Solution: The best day is 4/25. At a rate of $1.6674/pound, you would have £119.95. The worst day is 4/7. At $1.961/pound, you would have £101.99, or a difference of £17.96.

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