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Understanding the Financial System

- A well-functioning financial system brings together the funds of investors with those looking to fund investment-spending projects.
- A household's **wealth** is the value of its accumulated savings.
- A **financial asset** is a paper claim that entitles the buyer to future income from the seller.
- A **physical asset** is a claim on a tangible object that gives the owner the right to dispose of the object as he or she wishes.

Understanding the Financial System

- A **liability** is a requirement to pay income in the future.
- **Transaction costs** are the expenses of negotiating and executing a deal.
- **Financial risk** is uncertainty about future outcomes that involve financial losses and gains.

Understanding the Financial System

- The four types of financial assets:
 - Loans
 - Stocks
 - Bonds
 - Bank deposits
- These financial assets exist because the economy has developed specialized markets to facilitate the flow of funds from lenders to borrowers.

Three Tasks of a Financial System

1. Reducing **transaction costs** — the cost of making a deal.
 2. Reducing **financial risk** — uncertainty about future outcomes that involves financial gains and losses.
 3. Providing **liquid** assets — assets that can be quickly converted into cash.
- An individual can **diversify** by investing in several different assets so that the possible losses are independent events.

Types of Financial Assets

- A **loan** is a lending agreement between a particular lender and a particular borrower.
- A **bond** is an IOU issued by the seller in which the seller promises to pay a fixed sum of interest each year and to repay the bond on a particular date.
- A **default** occurs when a borrower fails to make payments as specified by the loan or bond contract.
- A **loan-backed security** is an asset created by pooling individual loans and selling shares in that pool.
- A **stock** is a share in the ownership of a company.

Financial Intermediaries

- A **financial intermediary** is an institution that transforms the funds it gathers from many individuals into financial assets.
- A **mutual fund** is a financial intermediary that creates a stock portfolio and then resells shares of this portfolio to individual investors.
- A **pension fund** is a type of mutual fund that holds assets in order to provide retirement income to its members.

Financial Intermediaries

- A **life insurance company** sells policies that guarantee a payment to a policyholder's beneficiaries when the policyholder dies.
- A **bank deposit** is a claim on a bank that obliges the bank to give the depositor his or her cash when demanded.
- A **bank** is a financial intermediary that provides liquid assets in the form of bank deposits to lenders and uses those funds to finance the investment spending needs of borrowers.

Financial Fluctuations and Macro Policy

- The financial market can cause instability in the economy.
- In general, policymakers are reluctant to assume that markets are wrong (i.e., inefficient).
- In the past 15 years, however, there have been two huge asset bubbles, each of which created major economic problems when it burst.