Financial Institutions and Financial Markets

Lecture Slides (English)

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Agenda

Financial system: meaning and capital flows (direct vs. indirect financing)
Importance of the financial system to the economy
Components: surplus units, deficit units, markets, intermediaries
Financial markets: money market vs. capital market
Key instruments and participants
Summary

Financial System

Meaning & channels of fund flows

Financial System: Definition

A financial system is the movement of funds from surplus units to deficit units.
Funds flow through financial markets and financial institutions.
Direct financing: funds flow via financial markets.
Indirect financing: funds flow via financial institutions (financial intermediaries).

Importance to the Economy

Improves the efficiency of fund allocation in the economy.
Surplus units can invest to earn returns through markets or institutions.
Deficit units can raise funds to invest in productive projects.
Investment supports employment, income, and government tax revenues for development.

Key Economic Units

Surplus Units (Lenders)

Households: many small savers but significant overall
Businesses: profits but limited immediate projects
Government: budget surplus in some periods
Foreign sector: overseas investors with excess funds

Deficit Units (Borrowers)

Businesses: main borrowers for investment and growth
Government: borrowing for development spending
Households: consumption and small business needs
Foreign sector: investment in domestic projects

Financial Markets (Direct Financing)

A channel where deficit units raise funds directly from surplus units.
Deficit units issue securities/financial instruments to obtain funds.
Supports efficient use of funds and overall economic growth through investment and production.

Financial Institutions (Indirect Financing)

Financial institutions act as intermediaries to channel funds indirectly.
They mobilize funds from surplus units and lend to deficit units.
Examples: commercial banks, finance companies, credit foncier, specialized financial institutions.

Why Financial Institutions Matter

Reduce transaction costs (time and monetary costs of financial transactions).

Reduce information asymmetry, which can cause:

- Adverse selection (before a transaction)
- Moral hazard (after a transaction)

Institutions specialize in screening borrowers and monitoring the use of funds.

Financial Markets

Money market vs. capital market

Financial Market: Definition

A financial market facilitates the transfer (trading) of financial assets.
It channels savings from surplus units to deficit units through direct financing.
Instruments may be issued by businesses, financial institutions, and government.

Money Market vs. Capital Market

Money Market

Short-term funding (maturity ≤ 1 year)
High liquidity, lower risk, typically lower return
Supports liquidity management and short-term financing

Capital Market

Long-term funding (maturity > 1 year)
Lower liquidity, higher risk, typically higher return
Supports long-term investment and economic development

Why the Money Market Is Important

Provides a place to invest short-term surplus funds rather than holding idle cash.

Supplies short-term funding at lower cost than long-term capital market funding.

Allows surplus units to park funds while waiting for future opportunities.

Money Market Instruments (Examples)

Treasury Bills (T-Bills): government-issued; sold at a discount; very low credit risk.
Commercial Paper (CP): issued by large, creditworthy corporations.
Promissory Note (P/N), Bill of Exchange (B/E), Post-dated Cheque: short-term trade instruments.
Bankers' Acceptance: bills guaranteed by a commercial bank.
Negotiable Certificate of Deposit (NCD): tradable time deposit certificate.
Interbank borrowings and repurchase agreements (repo).

Money Market Participants

Ministry of Finance
Bank of Thailand (central bank)
Commercial banks and other financial institutions
Businesses/corporates

Why the Capital Market Is Important

Provides long-term funding essential for economic development.
Promotes investment, employment, and production of goods and services.
Offers higher expected returns than deposits/money market instruments, but with higher risk.

Capital Market Securities

Debt instruments: issuer promises interest payments and principal repayment at maturity.

- Government bonds: Treasury bonds, state enterprise bonds, central bank bonds
- Corporate bonds (debentures): higher yields to compensate for credit and interest-rate risk

Equity instruments: represent ownership; returns come from dividends and price appreciation.

- Common stock: voting rights; residual claim
- Preferred stock: dividend preference; limited/no voting rights

Capital Market Participants

Ministry of Finance
Securities companies (brokers/dealers)
Listed companies
Investors (individual and institutional)

Key Takeaways

Financial system connects surplus and deficit units through direct and indirect financing.
Financial institutions reduce transaction costs and information problems.
Money market supports short-term funding and liquidity; capital market supports long-term investment.
Understanding instruments and participants explains how funds flow through the economy.