Chapter 1

1. Because they channel funds from those who do not have a productive use for them to those who do, thereby resulting in higher economic efficiency.

4. No, not everybody is worse off when interest rates rise. People who borrow to purchase a house or a car are worse off because it costs them more to finance their purchase; however, savers benefit because they can earn higher interest rates on their savings. Of course net savers who also have existing portfolios of debt instruments (bonds) will see the current value of their portfolio decrease because when interest rates rise bond prices fall.

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. Also, firms may be reluctant to sell additional new shares when stock prices are low because of the downward pressure increased supply puts on share prices and the impact that would have on existing share holders.

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. So a decrease in the value of the dollar negatively affects financial institutions with long positions in dollars and increases the dollar value of investments held in say the yen or euro. Also changes in foreign exchange rates affect the profits made by traders in foreign exchange who work for financial institutions.

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.
3. Yes, because the absence of financial markets means that funds cannot be channeled to people who have the most productive use for them. Entrepreneurs then cannot acquire funds to set up businesses that would help the economy grow rapidly.

6. You would rather hold bonds, because bondholders are paid off before equity holders, who are the residual claimants.

10. Employees might not work hard enough while you are not looking or may steal or commit fraud.

15. Answers can vary. See Boxes on page 21 and 24 for examples.

Web Exercise 1

a. As of the first quarter of 2011, all Commercial Banks had $14,739.7 billion in total assets (line 1 table L.109), $6,652.0 billion in total loans (add lines 11-14), and $3,550.8 billion in mortgage loans. The percent of assets held in loans is: $6,652.0/$14,739.7 = 45.1%. The percent of assets held in mortgage loans is: $3,550.8/$14,739.7 = 24.1%.

b. Savings institutions (Table L.114) had $1,250.1 billion in total assets in 2011Q1 and $600.3 billion in mortgage loans representing 48.0% of their total assets.

c. Credit Unions had $937.5 billion in total assets in 2011Q1 and $322.3 billion in mortgage loans representing 34.4% of their total assets. Their consumer loans represented $219.7/937.5 = 23.4% of their total assets.