

COURSE TITLE-MONETARY THEORY AND POLICY

WEEK 12- FINANCIAL MARKETS AND MONETARY POLICY

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1.0 OBJECTIVES

At the end of this lecture, you should be able to;

- Understand the functions of the financial markets in the economy.
- Discuss the factors responsible for the slow growth of capital markets in emerging markets.
- Differentiate between financial intermediation and financial mobilization.
- Explain the role of monetary policy in financial markets.
- Evaluate the role of transparency and credibility in monetary policy.

2.0 INTRODUCTION

Financial markets are an important component in the transmission of monetary policy and play a key role in fostering financial stability. Financial market development (FMD) aims at enhancing the capacity of the financial system to pool domestic savings and foreign capital in funding investment and consumption, and at enabling efficient risk-sharing. Deep and liquid markets promote transparent and efficient pricing of assets, attract a diverse investor base, and help transfer risk to parties willing and able to bear them.

A market can be defined as a set of buyers and sellers of clearly identifiable goods or services within a given locality. It can also be seen as an existing arrangement that permits the exchange of goods and services. Financial markets refer to an elaborate system of financial institutions and intermediaries put in place to facilitate the transfer of funds from surplus economic units to deficit economic units.

3.0 MAIN CONTENT

3.1 FUNCTIONS OF FINANCIAL MARKETS IN THE ECONOMY

1. To aid in the distribution of financial resources to the most productive units in the economy.
2. To mobilize capital for investment and hence stimulate economic growth.
3. To enable companies to make short and long-term investments and hence increase the liquidity of shares.
4. To aid in the provision of investment advice to individuals through financial experts.
5. To enable companies to raise short and long-term capital.
6. Financial markets aid in the pricing of securities e.g. the NSE 20 share index indicates changes in share prices.
7. Provide investment opportunities where savers can hold financial instruments for investments made.

Markets in which financial instruments e.g. ordinary shares, preference shares, and debentures are exchanged are known as financial markets. Financial markets can be categorized into the following categories.

- Primary and Secondary markets
- Money and capital markets)

3.2 PRIMARY AND SECONDARY MARKETS

Primary markets are those financial markets in which financial instruments are issued for the first time in the market. E.g., a company that is listed on the stock exchange for the first time will issue its shares in the primary market.

Advantages of primary markets.

1. Firms can raise capital in the primary market.
2. Helps in mobilizing savings.
3. The government can raise funds through the sale of treasury bonds in the primary market.
4. It is a vehicle for direct foreign investment.

On the other hand, a secondary financial market is a market for subsequent selling and purchase of financial securities i.e. for the second or their time, etc.

Advantages or the role of the secondary markets in the economy.

1. It gives investors a chance to buy or dispose of their shares.
2. It increases the diversification of investments where investors can hold several investments to minimize risk.
3. It improves corporate governance through the separation of ownership and management.
4. It gives individuals a chance to own large companies since they can purchase a portion of shares in the companies.

5. It provides investment opportunities for companies and small investors.

Organized exchange and Over-the-counter market (OTC)

Organized exchange is where the trading of securities is done by brokers and buyers and sellers need not be present. Trading is done electronically or via the internet. On the other hand, over the counter market (OTC) is usually organized by dealers or stock brokers who buy the securities themselves and then sell them. They maintain a reasonable balance between demand and supply and observe price movements to determine profit margins on sale. Trading may be done through telephone computer networks fax etc. the dealers or participants set the trading rules. OTC market specializes in securities such as corporate bonds equity securities treasury bonds etc. OTC is however not fully developed in Kenya.

Features of OTC markets

1. Prices are relatively low.
2. It usually deals with new securities of firms.
3. It is composed of small and closely held firms.

3.3 MONEY AND CAPITAL MARKETS

The money market is a market concerned with short-term financial securities. Financial instruments in the money market include commercial paper, treasury bills, bills of exchange, promissory notes, and bank overdrafts. These instruments are sold by commercial banks merchant banks acceptance houses and the government.

The money market offers the following services.

- i) It provides finance to solve the liquidity problems of the company.
- ii) It offers advice to the concerned parties as to which source of finance will meet their financial requirement.
- iii) It offers a medium through which financial securities can be discounted hence making them be highly liquid.

- iv) It acts as a channel through which short-term investments e.g. treasury bills and governments bonds are offered to the general public
- v) It acts as a source of finance for small businesses which are unable to raise funds in the capital market.

The capital market on the other hand is a market for long-term sources of finance that are used to acquire fixed assets and for the company's development purposes. Unlike the money market, the capital market plays an important role in the company's development because long-term development loans are normally offered to the country through the capital markets.

The capital market serves as a way of allocating the available capital to the most efficient users. Capital market financial institutions include the stock exchange, hire purchase companies, building societies, and leasing firms.

The major roles of a capital market would include:

- i) To provide long-term finance which is important for the development purpose.
- ii) It acts as a channel through which the necessary finance for the company is provided.
- iii) It acts as a channel through which foreign investment finds its way into the country.
- iv) It facilitates the liquidation of long-term investments.
- v) It provides other services in the form of advice to the investors as to which investments are viable.

Factors contributing to the slow growth of capital markets in many emerging markets

1. Limited number of securities available for investing; only bonds, shares, treasury bills, treasury bonds, and unit trusts are traded in most emerging markets.

Derivatives such as options, swaps, and future, and forward contracts are not traded in most emerging markets.

2. Lack of knowledge or lack of interest by ordinary citizens. Few citizens in a country participate in the stock exchange due to lack of information on how the market operates.
3. Low automation; market operations should be highly computerized and online. Investors should be able to interact online.
4. High taxes on investment income earned in the capital markets thus discouraging these investments.
5. High inflation and poverty levels raise the cost of living leaving less income for investment purposes thereby spending money on basic necessities instead.
6. Low number of quoted companies due to stringent listing requirements.
7. High growth of informal financial schemes as alternative investment avenues.

In order to resolve the above challenges it is necessary to,

1. Implement a computerized stock exchange market through the central depository system-wide area network etc.
2. Seek for integration of stock markets within East African region and beyond.
3. Create awareness on the importance of investing in the capital markets.
4. Increase the number of quoted companies by relaxing listing requirements and give tax incentives to quoted companies.
5. Increase the type of securities that can be traded on the stock exchange such as options and futures.

Financial Intermediaries

These are institutions that link the savers and investors. The main examples of financial intermediaries include.

1. Commercial banks; they act as intermediaries between savers and users of funds.
2. Savings and credit associations; these are firms that take funds from savers and then lends the money to other borrowers.

3. Credit unions; these are cooperative associations whose members have a common bond for example employees of the same company. The savings of members are loaned only to members at low interest rates.

4. Pension funds; these are retirement schemes or plans funded by firms or the government for their workers. s.

5. Life insurance companies; these are firms that take savings in form of annual premium from individuals and then invest these funds in securities such as shares bonds or in the real assets.

6. Brokers; these are agents who facilitate the exchange of securities by linking buyers and sellers. They act on behalf of members of the public who are buying and selling the shares of listed companies.

7. Investment bankers; these are institutions that buy new issue of securities for resale to other investors.

They perform the following functions;

- They give advice to investors
- They give advice to firms that are interested
- They help in the valuation of firms
- They underwrite securities which have not been subscribed to.

Financial mobilization

This is the process of transferring funds from those who have and are not willing to spend (resource abundant sectors) to those who do not have and are willing to spend (resolve deficit sectors).Financial mobilization is carried out by financial intermediaries because in less developed countries individuals tend to hoard money i.e. keeping money in unproductive ventures. Hence in such countries there is need to stimulate the process of financial mobilization.

Financial intermediation is the process which involves an individual or an institution and it revolves around the following:-

- To accept funds from other individuals or institutions
- To lend out these funds to other individuals or institutions.

Therefore, a financial intermediary is an institution that acts as a middleman between those who have funds that they don't intend to spend and those who do not have funds and wish to spend.

Hence, financial intermediaries stimulate the process of financial mobilization.

Advantages / Benefits of financial intermediaries

- a) Financial intermediaries provide a ready source of finance to the borrowers.
- b) It leads to risk reduction i.e. there is the transfer of risk from the savers to the financial intermediary who assumes all the risk involved in lending the money to the borrowers.
- c) They provide a ready market for the savers to deposit their money
- d) It leads to maturity transformation. This is the aspect of borrowing for a short period of time and lending for a long period of time i.e. the financial intermediary borrows for a short period of time from savers and lends to investors for a long period of time. This is because normally there is a conflict of interest between the resource deficit and the resource-abundance sectors of the economy as far as the maturity period of the loan is concerned.
- e) Financial intermediaries package the amounts received from savers and lend them out to the borrowers in different amounts.
- f) They offer advice to borrowers on the available investment opportunities.

The stock exchange market

This market came about because of two main reasons; Firstly, the shares of the companies traded in the market are irredeemable meaning once the company has sold shares it can never be repelled by the shareholder to take back the shares and refund the cash unless the company is winding up. Secondly, the shares traded in the

market are freely transferable hence the need to provide a market to facilitate this transferability.

Functions of national stock exchanges

1. To aid in the mobilization of savings for investment in the productive areas of the economy.
2. To check against capital flight which takes place due to inflation and currency depreciation.
3. To assist in the separation of ownership from management thereby improving corporate governance since the investors may not have the expertise to manage their investments.
4. It leads to the encouragement of higher standards of accounting and public disclosure thereby increasing efficiency in the market.
5. To facilitate equity financing as opposed to debt financing since debt financing increases the financial risk of the firm.
6. To enhance easier access to finance by new and smaller companies.
7. To encourage the quotation of private companies which in turn allows greater economic growth.

The role of the stock exchange in economic development

1. Raising capital for businesses; the stock exchange provides companies with facilities to raise capital for expansion purposes.
2. Mobilizing savings for investments; it encourages people to invest surplus funds they have otherwise consumed.
3. Redistribution of wealth; by giving people a chance to buy shares of various companies the stock exchange helps in the redistribution of wealth because people get a chance to share in the profits of businesses that were set up by other people.

4. Improving corporate governance; by having a wide and varied scope of owners public companies tend to have better management records than private companies do.
5. Creates investment opportunities for small investors; as opposed to other businesses that require a huge capital outlay, investing in shares is open to both small and large investors. This is because one buys the number of shares that he can afford.
6. Government source of capital; the government may decide to raise money through the stock exchange through the sale of bonds e.g. government and municipal bonds.
7. Barometer of the economy; share prices may increase or decrease depending on the forces of demand and supply.

Advantages of investing in shares

1. Shares promise a stable income in form of dividends and capital gain due to the appreciation of the share price.
2. The share certificate can act as collateral to obtain loan capital from financial institutions.
3. The shares are freely transferable, and one can easily dispose of the shares when they don't need them.
4. Availability of investment advice; investors can easily obtain expert advice before investing in the shares from investment brokers and investment companies.
5. Participating in company decisions; through the purchase of the shares, one becomes an owner of the company and participates in making key decisions of the firm at the annual general meetings.

Factors to consider when buying shares of a company.

1. The economic conditions of the country such as the inflation rate and interest rates in the country. If the inflation rate is high it may not be advisable to invest in the country and vice versa.
2. Integrity of the management of the company; if their integrity is high then it may be advisable to invest in the shares of the company and vice versa.

3. Nature of the product dealt with; if the product is marketable it may be advisable to buy the shares and vice versa.
4. Variety of operations of the company; if the company has a variety of operations it is likely to be a good investment and vice versa.
5. Companies trading partners; if the company has a broad base of investment partners it may be a good investment and vice versa.
6. Level of competition; if the competition is too stiff buying the shares may not be advisable and vice versa.
7. Prospects of growth; if the prospects of growth are high then it is advisable to buy the shares and vice versa.

The stock market index

An index is a numerical figure which measures the relative change in variables between two periods. A stock index, therefore, measures relative changes in the prices or values of shares. In order to construct the index it is necessary to establish the base year.

Factors to consider in the construction of the index;

1. Need to choose a base year on which to base the price changes.
2. The selection of the companies to be used in constructing the index.
3. Use of suitable weights to be attached to the securities depending on their relative importance.

Difficulties of stock index construction

1. Problems over the selection of securities to be included in the index.
2. Non-inclusion of newly established but important companies.
3. Frequency of stating any changes in the index (usually stated once a year only).

4. There are no clear guidelines on the treatment of bonus and rights issue.
5. The index may only reflect prices at fixed dates.
6. The share price of a company may bear very little relationship to the index. Component shares of the index may reflect price changes out of line with the overall index and their individual share price discrepancies will be left in the total index.

Listing or quotation of companies

Listing involves making the company to go public. When a company goes public it's able to issue shares to the public through the stock exchange.

Advantages of stock exchange quotation

- i) The quoted company will be able to raise funds from the public.
- ii) A company that is quoted can obtain underwriting facilities
- iii) A listed company will enjoy material and information prestige through positive goodwill from the public.
- iv) A listed company can raise permanent funds in the stock exchange
- v) A listed company will be viewed by the public to be more creditworthy hence creditors will be willing to grant credit to the public at more affordable rates.
- vi) A listed company can compare its performance with other similar companies which are also listed (cross-sectional analysis)
- vii) A listed company able to obtain some privileges from the government as an incentive by the government for companies to be listed e.g., tax allowances and protection from competitors.

Disadvantages of being listed

- i) It leads to the loss of confidential information to the public
- ii) There are certain regulations and rules which govern the quotation of a company. If the company does not meet these rules or regulations then it's likely to be quoted.

- iii)* Quotation involves several formalities such as getting permission from the capital market authority (CMA).
- iv)* The existing shareholders may lose control of the company as a result of the quotation
- v)* The company whose profit records are not promising may be deregistered from the stock exchange and this will impact negatively on the company.
- vi)* In case the company's profits decrease, then this will be reflected to the public and is likely to lead to a reduction in the share price and subsequent reduction in goodwill hence making it difficult for the company to raise funds from the public.

MONETARY POLICY AND FINANCIAL MARKETS

Overview

Monetary policy and financial markets are intrinsically linked. Central banks conduct monetary policy by directly and indirectly influencing financial market prices. Since financial market participants seek to extract profits from buying and selling securities, markets inevitably pay close attention to both words and deeds of central banks. The relationship between monetary policy and financial markets is by no means a one-way street.

Financial market prices reflect the expectations of market participants about future economic and monetary developments. These expectations, in turn, provide valuable information for central banks in determining the optimal future course of monetary policy. This subtopic focuses on how monetary policy influences various financial market prices. The monetary policy instrument of emphasis here is typically the short-term interest rate.

3.4 MONETARY POLICY EFFECT ON FINANCIAL MARKETS

How does monetary policy affect financial markets?

Monetary policy is aimed at preserving price stability. In some countries, central banks operate under mandates that refer to additional objectives such as full employment, maximum sustainable growth, stable interest rates, or stable exchange rates. To meet their objectives, central banks intervene in financial markets. It is through the financial markets that monetary policy affects the real economy.

Financial markets are the connecting link in the transmission mechanism between monetary policy and the real economy. Monetary policy affects financial markets through various channels.

However, the transmission process from monetary policy to financial markets and finally to the real economy has a single source: the monetary policy instrument.

Typically, the monetary policy instrument is a financial market price that is directly set or closely controlled by the central bank. For most central banks with floating exchange rates today, the monetary policy instrument is a short-term interest rate.

Under fixed exchange rate regimes, a particular exchange rate serves as the instrument. Under monetary targeting regimes, the instrument is typically the quantity of central bank money in the banking system. The precise sequence of the monetary transmission mechanism depends on the instrument which is used. We assume that the monetary policy instrument is a short-term interest rate. This reflects common practice for central banks with floating exchange rates.

Bond prices and the exchange rate

Short-term interest rates alone have only limited direct effects on the economy. Interest rates that determine savings and investment decisions and therefore have a stronger impact on the economy typically have longer maturities. To impact the economy, monetary policy impulses must therefore first be transmitted from the money market to the capital market. In practice, due to uncertainty about the future evolution of short-term interest rates and due to time-varying risk premiums, the longer the maturity, the weaker the link between current short-term rates and long-term rates.

Central bank would often find it difficult to guide longer-term interest rates to a level commensurate with what it considers to be the optimal monetary policy stance. Assuming a flexible exchange rate regime, the exchange rate is arguably the quickest transmission channel for monetary policy, particularly in open economies. Monetary policy impacts exchange rates via the yield curve and from there via interest rate parity relations. It is the yield curve of both the home and the foreign country, and thus the monetary policies of both the home and the foreign country which affect the exchange rate between two currencies.

Other assets

Monetary policy also affects the stock market. The relationship between monetary policy and stock prices is complex because stocks are influenced by monetary policy through several channels-

- i) If stocks are priced using the dividend discount model, then monetary policy affects stock prices via the interest rate which is used to discount future dividends.
- ii) Interest rates may also affect the value of the domestic assets of a company, and the exchange rate affects the value of its foreign assets and foreign profits.
- iii) Monetary policy influences the financing cost of a company as well as the availability of
loans
- (iv) The medium-term effects of monetary policy on the real economy can influence a firm's profits.

Monetary policy can also affect commodity prices. The expansionary or restrictive monetary policy supports or weakens real activity in the medium run and can thus influence the demand and the price for commodities.

Monetary policy affects housing prices. The transmission from monetary policy to housing prices tends to be stickier than is the case for other financial market prices. Real estate is not a standardized good that is traded on organized markets. Monetary

policy affects the discount rate which must be used to discount future yields. Apart from that, the medium-term real effects of monetary policy may affect demand, rental prices and thus house prices. An important determinant for the price of all long-dated assets is the risk premium. Purchasing power risk is one of the risks compensated for by the risk premium is. Monetary policy which ultimately determines the purchasing power of money; therefore, monetary policy affects the perceived purchasing power risk. A further risk compensated by the risk premium derives from the expected volatility of an asset price during its lifespan. As monetary policy affects asset prices, it can also impact the expected volatility of asset prices and, in turn, again affect the risk premium.

The link between the monetary policy instrument and any one financial market price is subtle and variable. Central banks would face an exceedingly difficult task if they had to rely on a single price to transmit monetary policy impulses to the real economy. The fact that monetary policy works simultaneously through several financial market prices reinforces the precision and the impact of monetary policy.

3.5 THE ROLE OF TRANSPARENCY AND CREDIBILITY IN MONETARY POLICY.

Why is central bank's transparency pertinent?

Transparency is a crucial element of a successful monetary policy strategy.

If a central bank wants to implement its monetary policy strategy efficiently, it should communicate its intentions and expectations to financial markets and to the public as clearly as possible.

- i) Central bank transparency then allows markets to better anticipate the future path of short-term rates, the effect of this path on other financial market prices, and ultimately the impact on the real economy. The monetary policy transmission process is thus rendered more efficient.
 - (ii) It reduces uncertainty and may therefore lead to lower volatility in various financial markets. Less volatility should translate into a lower risk premium and may

thus promote investment and positively affect economic growth. Lower risk premiums also lead to higher asset prices.

(iii) The increasing importance of asset prices. A sudden increase in asset price volatility could have more adverse consequences for the real economy than what we might infer from experience. Central banks clearly have the incentive to avoid becoming the source of unnecessary asset price volatility. The growing importance of balance sheet considerations in monetary policy only reinforces the importance of transparency in central bank communication.

(iv) Transparency is a crucial element in creating democratic legitimacy for politically independent institutions. The institution's actions can have wide-ranging consequences for a country's citizens and its elected government.

3.6 FINANCIAL MARKETS EFFECT ON MONETARY POLICY

How do financial markets affect monetary policy?

Financial market prices reflect market expectations about future economic developments, such as inflation, output, and the likely course of monetary policy. It is therefore natural and appropriate for central banks to evaluate closely the information contained in market prices. Market expectations can and should influence the setting of monetary policy. Central banks must exercise caution in using the information extracted from market expectations as an input to formulating monetary policy.

4.0 CONCLUSION

Financial markets look for guidance from the central bank, the central bank looks for guidance from financial markets. The two parties temporarily lose sight of the underlying factors determining inflation, namely the output gap in the short to medium-run, and money growth in the long run. To avoid this trap, central banks should exercise due caution when making use of financial market expectations. Financial markets provide useful information for a central bank in search of the optimal monetary policy path. Central banks must ensure that they do not end up

merely executing the expectations developed in the market. The information about expected future developments reflected in market prices must be continuously cross-checked against a wide range of monetary and economic indicators in what amounts to a “checks and balances” approach to monetary policy.

5.0 SELF-ASSESSMENT EXERCISE

1. Discuss the function of financial markets in the economy.
2. Differentiate the roles of the following financial markets
 - (a) Primary and Secondary
 - (b) Money and Capital Markets.
3. Monetary policy and financial markets are intrinsically linked. Discuss.
4. Evaluate the effect of monetary policy on commodity prices.
5. Examine the role of transparency and credibility in monetary policy.

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