Financial markets

Financial markets are the other important component of investment environment.

Financial markets are designed to allow corporations and governments to raise new funds and to allow investors to execute their buying and selling orders. In financial markets funds are channeled from those with the surplus, who buy securities, to those, with shortage, who issue new securities or sell existing securities. A financial market can be seen as a set of arrangements that allows trading among its participants.

Financial market provides three important economic functions

1. Financial market determines the prices of assets traded through the interactions between buyers and sellers;

2. Financial market provides a liquidity of the financial assets;

3. Financial market reduces the cost of transactions by reducing explicit costs, such as money spent to advertise the desire to buy or to sell a financial asset.

Financial markets could be classified on the bases of those characteristics:

• Sequence of transactions for selling and buying securities;

• Term of circulation of financial assets traded in the market;

• Economic nature of securities traded in the market;

• From the perspective of a given country.

By sequence of transactions for selling and buying securities:

- Primary market
- Secondary market

All securities are first traded in the primary market, and the secondary market provides liquidity for these securities.

✓ **Primary market**: is where corporate and government entities can raise capital and where the first transactions with the new issued securities are performed. If a company's share is traded in the primary market for the first time this is referred to as an initial public offering (IPO).

Investment banks play an important role in the primary market:

• Usually handle issues in the primary market;

• Among other things, act as underwriter of a new issue, guaranteeing the proceeds to the issuer.

✓ **Secondary market**: - Where previously issued securities are traded among investors. Generally, individual investors do not have access to secondary markets. They use security brokers to act as intermediaries for them. The broker delivers orders received from investors in securities to a market place, where these orders are executed. Finally, clearing and settlement processes ensure that both sides to these transactions honor their commitment. Types of brokers:

• Discount broker, who executes only trades in the secondary market;

• Full service broker, who provides a wide range of additional services to

Clients (ex., advice to buy or sell);

• Online broker is a brokerage firm that allows investors to execute trades electronically using Internet.

Types of secondary market places:

• Organized security exchanges;

• Over-the-counter markets;

• Alternative trading system.

An organized security exchange: Provides the facility for the members to trade securities, and only exchange members may trade there. The members include brokerage firms, which offer their services to individual investors, charging commissions for executing trades on their behalf. Other exchange members buy or sell. For their own account, functioning as dealers or market makers who set prices at which they are willing to buy and sell for their own account. Exchanges play very important role in the modern economies by performing the following tasks:

• Supervision of trading to ensure fairness and efficiency;

• The authorization and regulation of market participants such as brokers and market makers;

• Creation of an environment in which securities' prices are formed efficiently and without distortion. This requires not only regulation of an orders and transaction costs but also a liquid market in which there are many buyers and sellers, allowing investors to buy or to sell their securities quickly;

• Organization of the clearing and settlement of transactions;

• The regulation of the admission of companies to be listed on the exchange and the regulation of companies who are listed on the exchange;

The over-the-counter (OTC) market: Is not a formal exchange. It is organized network of brokers and dealers who negotiate sales of securities. There are no membership requirements and many brokers register as dealers on the OTC. At the same time there are no listing requirements and thousands of securities are traded in the OTC market. OTC stocks are usually considered as very risky because they are the stocks that are not considered large or stable enough to trade on the major exchange.

An alternative trading system (ATS) Is an electronic trading mechanism developed independently from the established market places – security exchanges – and designed to match buyers and sellers of securities on an agency basis. The brokers who use ATS are acting on behalf of their clients and do not trade on their own account. The distinct advantages of ATS in comparison with traditional markets are cost savings of transactions, the short time of execution of transactions for liquid securities, extended hours for trading and anonymity, often important for investors, trading large amounts.

By term of circulation of financial assets traded in the market:

- Money market;
- Capital market

Money market - in which only short-term financial instruments are traded.

Capital market - in which only long-term financial instruments are traded. The capital markets allow firms, governments to finance spending in excess of their current incomes.

By economic nature of securities, traded in the market:

- Equity market or stock market;
- Common stock market;
- Fixed-income market;
- Debt market;
- Derivatives market

From the perspective of a given country financial markets are:

- **Internal or national market**; The internal market can be split into two fractions: domestic market and foreign market. Domestic market is where the securities issued by domestic issuers (companies, Government) are traded. A country's foreign market is where the securities issued by foreign entities are traded.

- **External or international market**. The external market also is called the international market includes the securities which are issued at the same time to the investors in several countries and they are issued outside the jurisdiction of any single country (for example, offshore market).

The comparison of money market and capital market

Features	Money market	Capital market
Term of circulation of securities traded	Short-term, less than 1 year	Long-term, more than 1 year
Level of risk	Low, because of trading short-term securities which have lower level of risk and high liquidity	Long-term securities, traded in this market, is more risky
Fund suppliers	Commercial banks, nonfinancial business institutions with the excess funds	Banks, insurance companies, pension funds, lending the large amounts of funds for a long-term period; investment funds with big pools of funds for investing
Financial instruments	Certificates of deposit; Treasury bills; Commercial paper; Bankers' acceptances; Repurchase agreements, other short-term investment vehicles	Common stocks; Preferred stocks; Treasury bonds; Municipal bonds; Corporate bonds; other long-term investment vehicles
Aims for raising money	For financing of working capital and current needs	For financing of further business development and investment projects