

CHAPTER 2:

THE ECONOMIC ENVIRONMENT

1. MACROECONOMIC POLICY

- Macroeconomic policy is the management of the economy by government in such a way as to influence the performance and behaviour of the economy as a whole.
- The main objective of macroeconomic policy is to achieve the following:
 - Economic growth
 - Control of inflation (price stability)
 - High level of employment
 - Balance of payments (levels of imports and exports)
 - An appropriate distribution of income and wealth
- Economic objectives may **conflict** with one another. For example:
 - Full employment can increase inflation as the demand for goods and services will increase
- The government may achieve the macroeconomic objectives through the following tools:
 - **Fiscal policy:** This involves the use of taxation. Is government spending money or collecting taxes? A **public sector budget deficit** arises when government spending exceeds the amount of money raised through taxes.
 - **Monetary policy:** This is the regulation of the economy through control of money supply/interest rates
 - **Exchange rate policy:** involves change the value of the currency in order to change the prices of imports and exports.

- **Regulation:** this is any form of government interference with the operation of the free market. Examples: (a) **Competition policy:** - to reduce a company's domination of a market, controls on prices, investigating acquisitions & mergers, (b) **Green policies:** - polluter pays or clean up contamination, subsidies to environmental friendly companies (c) **Assistance:** regional development grants

- Regulation may be required where there is market failure. **Market failure** is when market mechanism fails to result in market efficiency (an optimal allocation of resources)

- Important types of market failure are:
 - Imperfect competition (e.g. monopolies)
 - Social costs (externalities such as pollution)
 - Imperfect information (e.g. where fees charged for services are not transparent)
 - Inequality (government may act to improve social justice. E.g. by funding a health service or controlling certain prices)

2. IMPACT OF ECONOMIC VARIABLES ON SHAREHOLDER WEALTH

- The Board of Directors **cannot influence all** decisions that will affect the value of the business (equity value) and the share price (Po). One of the major factors is macroeconomic variables.
- **Interest rates** if they fall:-
 - More people will borrow and increase demand as they spend the money. business revenue will increase
 - Lower the cost of debt and improve profits
- **Inflation rates** if it raises:-
 - Costs rise causing a drop in profits
 - Causes interest rates to rise
 - The home currency weakens (good for exports, bad for imports)
- **Taxes**
 - Lower taxes may stimulate demand for business as individuals spend.
 - Higher taxes will damage company profits.

3. FINANCIAL INTERMEDIARIES

- **Intermediation** refers to the process whereby potential borrowers are brought together with potential lenders by a third party, the intermediary.
- Examples of financial intermediaries include: Commercial banks, building societies, finance houses, insurance companies, institutional investors etc.
- The benefits of financial intermediaries are:
 - Opportunities for diversification
 - Investors can access bank expertise in assessing corporate risk, thus obtaining the best return for a particular level of risk
 - Legislation that provides for investor protection should a bank fail (in terms of central bank support) further reduces the risk investors' face.
 - Provide hedging opportunities e.g. through a forward contract
 - Provide a simple way for the lender to invest, without him having personally to find a suitable buyer.

4. FINANCIAL MARKETS

Financial markets can be classified as primary and secondary, capital market and money markets, exchange-traded and over-the-counter markets.

Primary and Secondary Markets

- **Primary markets:** allows organisations to raise new finance. This can be done by issuing shares and bonds.

- **Secondary markets:** allow investors to trade (buy and sell) in already issued investments. No finance is raised by the company in this market.

Money Markets, Capital Markets and Euromarkets

- Money markets are operated by banks/financial institutions and provide means of trading lending and borrowing in the **short-term**. Short-term securities include: **Treasury bills** (risk free government securities), **Certificates of Deposits** (CD's – securities issued by the bank and can be sold at *any time*), **Commercial paper** (*unsecured* corporate debt with maturity up to 270 days).
- Capital markets are markets for trading in **long-term** financial instruments, equities and debentures. They enable organisations to raise new finance and investors to realise investments. Main UK markets are the Stock Exchange and Alternative Investment Market (AIM).
- Euromarkets are **international** markets for larger companies to raise finance in a **foreign currency**.

Exchange and Over the Counter Exchanges

An Exchange provides a market place in which investors can buy and sell. Buyers and sellers need never meet and do not need to know who they are transacting with.

Buyer ↔ Exchange ↔ Seller

Over the counter markets requires buyers and sellers to arrange transactions through individual negotiations.

Buyers ↔ Seller

Risk and Return

Generally the higher the risk the high the return.

Rank from low risk to high risk investments:

1. Secured Debt (bonds)
2. Unsecured Debt (bonds)
3. Preference Shares
4. Ordinary shares (equity)

Despite the risk/return order explained above, sometimes equity investments yield lower returns than bonds. This is known as the reverse yield gap.

The reverse yield gap is temporary. Shareholders may accept a lower return now for even higher returns in the long term.

Securitisation

Conversion of illiquid assets into market backed traded securities

Most common and oldest type of securitisation is the mortgaged baked bond or security (MBS).

Securitisation was the main cause of the US financial crisis in 2008.

ASSIGNMENT 1