

Total Marks = 90

**Q.2 (a) The Stakeholders:**

There are three broad types of stakeholder in an organization.

- **Internal** stakeholders such as employees and management
- **Connected** stakeholders such as shareholders, customers, suppliers and financiers
- **External** stakeholders such as the community, government and pressure groups

Stakeholders can influence the objectives of an organization in various ways:

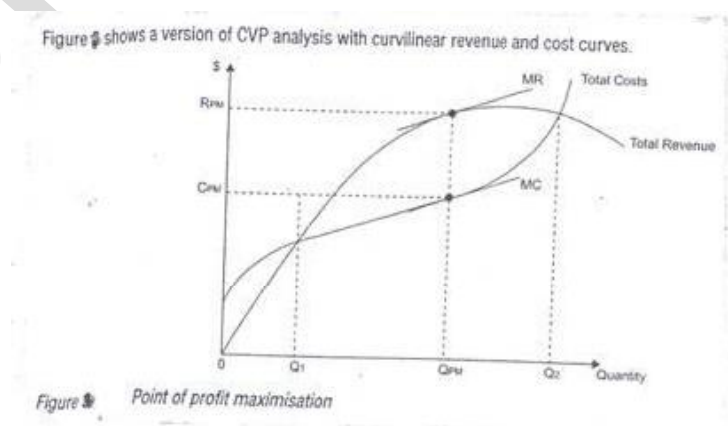
- (a) Supporting the actions of management through co-operation, providing funds, and agreeing to requests (such as for granting legal permissions)
- (b) Opposing the actions of management such as through the law, industrial action or boycotting its products
- (c) Participation in decision-making. Some stakeholders have a legal entitlement to be consulted. For example shareholders can vote on management proposals.

Firms are assumed to maximise profits to give the best income to their owners. However stakeholder theory suggests that other stakeholders can influence the actions of a firm to satisfy their own personal goals.

Economists Cyert and March upset the conventional view that firms seek a single goal of maximising profits by stating 'organisations do not have objectives. Only people have objectives'. In other words organisations do not have a single mind and a single purpose. They are instead a coalition of stakeholder groups with each group pursuing its own interests.

- (a) Shareholders and owners will require profits but may also seek other things such as prestige or avoidance of risks
- (b) Management will pursue their salaries and careers and may also use the firms resources for pet projects
- (c) Employees will seek wages but also job security, safe working conditions and promotions
- (d) External stakeholders such as customers, suppliers and regulators will constrain what the firm is able to do, for example by resisting rising prices or behaviour that pollutes the environment.

- (b) The level of output where a firm is able to obtain last possible unit of profit is known as point of profit maximization. One approach to determine this point is called total cost (TC) & total revenue (TR) approach.



TC curve is shaped showing varying level of efficiency at different level of output. While TR curve curvilinear, reflecting the need to reduce price progressively in order to sell greater output. Point of profit maximization is achieved at intersection of these two curves. There are two points of intersection. After the first intersection point both curve diverge and become further apart from each other with TR curve remains above TC curve which there profit margin. It is an indication to increase output to maximize profit. If one continues to increase output both curves reach furthest distance apart at a particular level of output. At this point, profit is maximum, hence this specific level of output is known as point of profit maximization. At any level of output beyond this both curves converge and come closer to each other.

**Q.3 (a) Risk:**

Before deciding whether to buy, hold or sell shares in a firm the investor will consider whether the returns from the firm are adequate to compensate them for the risks of investing in the firm.

Investing in share involves several risks:

- (a) The annual return on the share will vary according to the profits of the businesses.
- (b) The value of their shareholding will rise and fall according to market sentiment about the business.
- (c) Their shares could become worthless if the firm becomes bankrupt because ordinary shareholders rank for a pay-out from the proceeds of selling off the assets of the firm.

These risks are often classified into systematic risk and unsystematic risk.

Systematic risk is the risk associated with investing in any equities in a particular section of the market. For example shares in pharmaceutical industries may have greater systematic risks than shares in bakeries.

Unsystematic risk (or specific risk) is the risk associated with investing in a particular firm. For example a firm's shares may have high unsystematic risk due to the firm's high dependence on the sales of a single line of product.

A shareholders' risk return curve show the minimum rate of return that shareholders will accept as compensation for higher risks to their investments.

Figure shows a shareholders' risk-return curve (also called a shareholders indifference curve).

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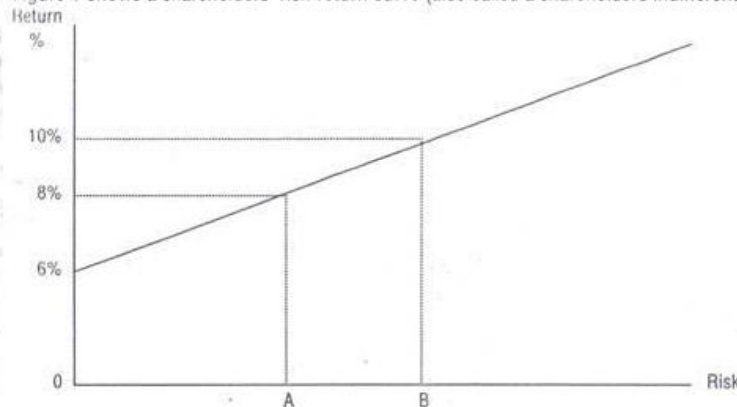


Figure Investors risk-return curve

In Figure if risk is 0 the investor regards 6% as the minimum return they will take for investing. This is sometimes called the risk free rate. If investors are asked to invest in the shares of Firm A they will require a return of at least 8% before they will do so. Firm B is seen as more risky and so the investors would require at least 10% return.

The higher the risk, the higher the required return.

(b) The four potential directions of growth for a firm.

- (a) Market penetration: the firm seeks to sell greater quantities of present range of products. This generally means it seeks to take market share away from rival firms.
- (b) Product development: the firm offers its existing customers a wider range of products by adding new product lines to its output.
- (c) Market development: the firm seeks new sorts of customers for its products by repositioning the product for different sorts of people, or by expanding into new geographical markets.
- (d) Diversification: the firm joins entirely new industries. Sometimes this may involve vertical integration in which the firm becomes its own supplier or customer, for example a film production studio launching its own television channel. This is also called related diversification. Sometimes firms will enter an entirely new industry, in which case this is called unrelated diversification of which an example might be an aeroplane manufacturer setting up an automobile manufacturer (as Saab did) or a musical instrument maker beginning to produce motorcycles (as Yamaha did).

The advantages and disadvantages of these different types of business expansion are summarised in the table below:

Horizontal expansion or integration	
<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>• Economies of scale from larger production quantities, ie lower costs.                             <ul style="list-style-type: none"> <li>- Technical economies (use of larger machines or more specialised machines)</li> <li>- Managerial economies (greater specialisation of middle managers)</li> <li>- Commercial economies (bulk buying and selling)</li> <li>- Financial economies (ability to borrow money more cheaply)</li> <li>- Risk-bearing economies (some greater spread of products made within the same general market should help the firm to spread its risks).</li> <li>- Knowledge economies (consolidating research and development facilities to advance technical knowledge)</li> </ul> </li> <li>• To increase market share with the possibility of achieving monopoly greater control over prices and quantities in the market.</li> </ul>	<p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Top management might be unable to handle the running of a large firm efficiently, ie there might be management diseconomies of scale.</li> <li>• The creation of a monopoly will be unacceptable to government.</li> </ul>
Vertical integration	
<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>• Gives the firm greater control over its sources of supply (backward vertical integration) or over its end markets (forward vertical integration).                             <ul style="list-style-type: none"> <li>- This should improve cost efficiency between the various stages of production, because</li> </ul> </li> </ul>	<p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Possible management diseconomies of scale, owing to lack of familiarity with businesses acquired.</li> </ul>

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<p>there are no longer third parties trying to make a profit.</p> <ul style="list-style-type: none"> <li>- It should also increase the reliability of supplies (which is an important requirement for flexible manufacturing techniques)</li> <li>• By increasing control over the sources of supplies and/or the sales and distribution network, a firm can increase barriers to entry stopping new entrants joining the industry.</li> <li>• Achieves financial economies of scale and possibly some commercial economies. Otherwise few economies of scale unless production now becomes better co-ordinated through its various stages.</li> </ul>	
<b>Diversification</b>	
<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>• Risks are spread by operating in several industries. If one industry declines, others may thrive.</li> <li>• Economies of scope by having a larger product range and possibly economies of scale in finance and administration.</li> <li>• Expertise can be shared across which would previously have been unconnected.</li> </ul>	<p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• No technical or commercial economies of scale.</li> <li>• Possible management diseconomies of scale, owing to lack of familiarity with businesses acquired.</li> </ul>

**Q.4 (a) Law of Supply & Law of Demand:**

A fundamental characteristic of demand is this: All else equal, as price falls, the quantity demanded rises, and as price rises, the quantity demanded falls. In short, there is a negative or inverse relationship between price and quantity demanded. Economists call this inverse relationship the law of demand.

Many factors other than the price of the product being considered affect the amount purchased. For example the quantity of Nikes purchased will depend not only on the price of Nikes but also on the prices of such substitutes as Reeboks, Addidas, and Filas. The law of demand in this case says that fewer Nikes will be purchased if the price of Nikes rises and if the prices of Reeboks, Addidas, and Filas all remain constant. In short, if the relative price of Nikes rises, fewer Nikes will be bought. However, if the price of Nikes and the prices of all other competing shoes increase by some amount – say, \$5 – consumers might buy more, less, or the same amount of Nikes.

**Determinants of Demand: Factors That Shift the Demand Curve**

- Change in buyer tastes
- Change in number of buyers
- Change in income
- Change in the prices of related goods
- Change in expectations

As price rises, the quantity supplied rises; as price falls, the quantity supplied falls. This relationship is called the law of supply.

Price is an obstacle from the standpoint of the consumer, who is on the paying end. The higher the price, the less the consumer will buy. But the supplier is on the receiving end of the product's price. To a supplier, price represents revenue, which serves as an incentive to produce and sell a product. The higher the price, the greater this incentive and the greater the quantity supplied.

Consider a farmer who can shift resources among alternative products. As price moves up, the farmer finds it profitable to take land out of wheat, oats, and soybean production

and put it into corn. The higher corn prices enable the farmer to cover the increased costs associated with more intensive cultivation and the use of more seed, fertilizer, and pesticides. The overall result is more corn.

### Determinants of Supply

The basic determinants of supply are (1) resource prices, (2) technology, (3) taxes and subsidies, (4) prices of other goods, (5) price expectations, and (6) the number of seller in the market. A change in any one or more of these determinants of supply, or supply shifters, will move the supply curve for a product either right or left. A shift to the right, signifies an increase in supply: Producers supply larger quantities of the product at each possible price. A shift to the left, indicates a decrease in supply: Producers offer less output at each price.

### Determinants of Supply: Factors That Shift the Supply Curve

- Change in resource prices
- Change in technology
- Changes in taxes and subsidies
- Change in prices of other goods
- Change in expectations
- Change in number of suppliers

- (b) Externalities are the spillover effects of transaction which extends beyond the parties to the transaction and affect society as a whole. It is the difference between the private and social costs or benefits arising from an activity.

There are four sorts of externalities:

1. Positive externality in consumption
2. Positive externality in production
3. Negative externality in consumption
4. Negative externality in production

Demand and supply analysis can illustrate the consequences of externalities. If an adverse externality exists, (the social cost of supplying a good is greater than the private cost to the supplier firm), then a supply curve which reflects total social costs will be above the (private cost) market supply curve.

Figure shows two possibilities:

- a) If a free market exists, the amount of the good produced will be determined by the interaction of demand (curve D) and supply curve S. Here, output would be Y, at price  $P_y$
- b) If social costs are taken into account, and the market operated successfully, the supply curve should shift leftwards, and the amount of the good produced should be X, at price  $P_x$ .

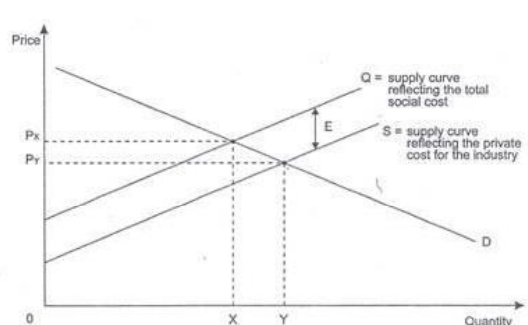


Figure Externalities

Given a free market, output of the good will exceed what it ideally should be (by  $Y - X$  in Figure), and so resources will have been over-allocated to production of this particular good.

In case of an adverse externality, the social cost of production exceeds the private costs. Hence the supply curve that reflects the social costs will be above (the private cost) the market supply curve. It means that if social costs are taken into account, the supply or output of the production will be lower at ideal level. While in a free market output of good will exceed that ideal level.

#### Q.5 (a) Motives for Foreign Exchange Dealing:

The main motives are:

- Transactions need:** a firm, individual or government hold its bank deposits in \$ but needs € to pay a supplier in a different country will exchange its balances via its bank or, for large organisations, issue a € denominated instrument to obtain the funds it needs.
- Finance trade:** a firm in Europe importing a cargo from USA will borrow \$ for 3 months to pay the suppliers and rely on selling the goods in € to repay the loan.
- Investment projects:** a construction firm from UK building a sports stadium in France using materials and suppliers from Europe and USA will need to borrow € and £ for several years before being paid in € when the stadium is complete. It will issue corporate bonds in € and \$.
- Risk management:** the examples in (b) and (c) show that firms are exposed to risks in trade. For example in (b) if the € falls in value against the \$ there is no guarantee that the proceeds of selling the cargo will repay the \$ loan taken. For this reason the firm may hedge its position by buying a forward contract today to be able to buy a set value of \$ in 3 months time in for a set value of €.
- Speculation:** the value of one currency against another changes though time. If the \$ is expected to appreciate (that means rise) against the € a speculator may today exchange their € assets (bank balances, bonds and so on) for assets denominated in \$. If the \$ rises they can sell them for € and make a profit on the transaction. Sometimes a speculator may buy in the morning and sell in the afternoon to make these profits.

Figure shows the application of demand and supply analysis to the determination of exchange rates.

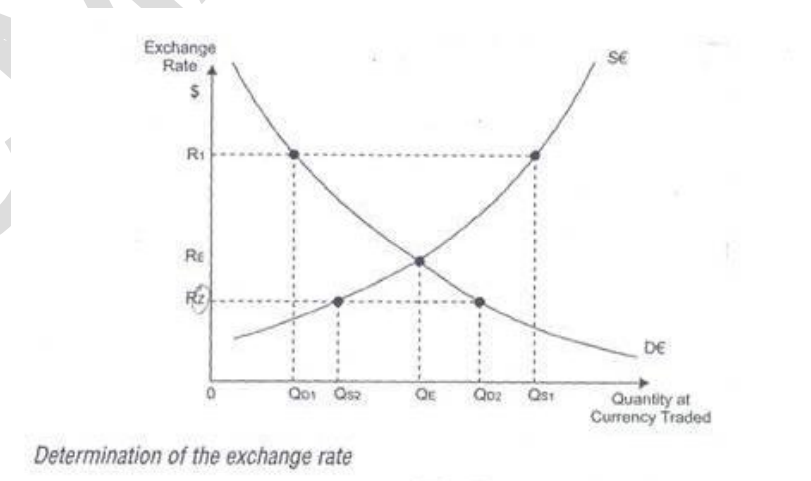


Figure shows the market for Euros. It shows the price of the Euro in terms of dollars.

- (a) A high exchange rate against other currencies, such as R1, mean that a given amount of \$ can buy only a small amount of €. So demand for exports from Euro countries will be lower. This means demand for Euros will be lower.
- (b) A low exchange rate, say R2, means the same amount of \$ can buy a larger amount of €. Therefore demand for exports from Euro countries will be higher and, as a result, demand for Euros will be higher.

Understanding this diagram helps us understand two important aspects of the forex market:

- (a) How foreign exchange dealing establishes a rate
- (b) The factors determining the demand and supply for a currency.

#### Factors determining the demand and supply for a currency

Figure shows a downward sloping demand curve for the currency, the Euro, and an upward sloping supply curve for the Euro. These need to be understood.

The demand for currency extends as the exchange rate falls for three reasons:

- (a) **Trade effects:** as the exchange rate depreciates the world prices of products denominated in that currency also fall. For example in Figure assume that  $R1 = \$2$  to  $\text{€}1$ . This would mean something costing  $\text{€}20,000$  would cost  $\$40,000$  (ie  $\text{€}20,000 \times \$2$ ). If the exchange rate for the Euro fell to  $\$1$  then the  $\text{€}20,000$  item would now cost only  $\$30,000$  ( $\text{€}20,000 \times \$1.5$ ). If this  $\text{€}20,000$  item were a car, a piece of machinery, or a holiday then demand for it from abroad would extend. This would mean that foreign buyers would need  $\text{€}$  to pay for it and so the demand for  $\text{€}$  on the foreign exchange market extends above  $Q_{D1}$ . The opposite effect would happen if exchange rates rose.
- (b) **Portfolio effects:** this refers to the demand for investment assets. A fall in the exchange rates foreign investment assets such as bonds and equities cheaper to buy too. This makes the investment assets more attractive to investors who will obtain a yield from them and also potential capital gains if the exchange rate rises again and they can sell them and buy into their original currency. To buy the assets the investors need to buy the currency.
- (c) **Speculative effects:** as the rate depreciates some forex speculators will begin to buy the currency because they think it is likely to appreciate again in the future and allow them to enjoy a capital gain.

The supply of the currency is the persons holding the currency wishing to sell it to obtain other sorts of foreign exchange or assets.

#### (b) Aims of the Banks:

A commercial bank has three different and potentially conflicting aims which it must try to keep in balance. These are:

- (a) **Profitability.** A bank must make a profit for its shareholders. The biggest profits come from lending at higher interest rates. These are obtained with long-term lending, and lending to higher risk customers.
- (b) **Liquidity.** A bank must have sufficient liquid assets. It needs enough notes and coin to meet demands from depositors for cash withdrawals. It also needs to be able to settle debts with other banks.

For example, if on a particular day, customers of the Barclays Bank make payments by cheque to customers of HSBC Bank totalling  $\$200$  millions, and customers of HSBC make payments by cheque to customers of Barclays totalling  $\$170$  millions, Barclays will be expected to pay HSBC  $\$30$  million to

settle the net value of transactions. This is done by transferring funds between the bank accounts of Barclays and HSBC, which they keep with the Central Bank (as 'operational deposits'). A bank might also need to have some 'near liquid' assets which it can turn into liquid assets quickly, should it find itself with a need for more liquidity. Near-liquid assets earn relatively little interest. A bank will try to keep the quantity of such assets it holds to a safe minimum.

- (c) **Security.** People deposit their money with banks because they are regarded as stable and secure institutions. A bank might lend to some high-risk customers, and suffer some bad debts, but on the whole, a bank will be expected to lend wisely and securely, with a strong likelihood that the loans will be repaid in full and with interest.

#### Functions of the Commercial Banks

- (a) **Providing a payment mechanism.** The bank clearing system is a way of transferring money between accounts within a branch of a bank, between different branches, and between different banks. The clearing system enables individuals and firms to make payments by cheque, and therefore acts as a system for transferring money. Banks also enable individuals and firms to make payments by using direct debits, standing order, and electronic transfers. Again, in these ways, the banks provide a money transmission service.
- (b) **Providing a place for individuals, firms and government to store their wealth.** Banks compete with other financial institutions to attract the funds of individuals and firms. The banks then hold the money in two main types of account:
- (i) Current accounts
  - (ii) Deposit accounts
- (c) **Lending money** in the form of loans or overdrafts.
- (d) **Acting as financial intermediaries** by accepting deposits and lending, and in doing so transforming the risk characteristics and maturity characteristics of the lending.
- (e) **Providing customers with a means of obtaining foreign currency, or selling foreign currency,** whenever they require it. Banks play a central role in the foreign exchange markets.

The banks also provide a wide range of other commercial and financial services to customers which generate them earnings and facilitate trade for the banks' corporate customers.

#### Q.6 (a) The Unemployment Rate:

The unemployment rate is the percentage of the labour force unemployed:

$$\text{Unemployment rate} = \frac{\text{unemployed}}{\text{labor force}}$$

There are three types of unemployment: frictional, structural, and cyclical.

#### Frictional Unemployment

At any given time some workers are "between jobs". Some of them will be moving voluntarily from one job to another. Others will have been fired and will be seeking reemployment. Still others will have been laid off temporarily because of seasonal demand. In addition to those between jobs, many young workers will be searching for



their first jobs.

As these unemployed people find jobs or are called back from temporary layoffs, other job seekers and laid-off workers will replace them in the “unemployment pool”. So even though the workers who are unemployed for such reasons change from month to month, this type of unemployment persists.

Economists use the term frictional unemployment – consisting of search unemployment and wait unemployment – for workers who are either searching for jobs or waiting to take jobs in the near future.

### **Structural Unemployment**

Frictional unemployment blurs into a category called structural unemployment. Here, economists use “structural” in the sense of “compositional”. Changes over time in consumer demand and in technology alter the “structure” of the total demand for labour, both occupationally and geographically.

### **Cyclical Unemployment**

Cyclical unemployment is caused by a decline in total spending and is likely to occur in the recession phase of the business cycle. As the demand for goods and services decrease, employment falls and unemployment rises. For this reason, cyclical unemployment is some times called deficient-demand unemployment.

### **Economic Cost of Unemployment**

Unemployment that is above the natural rate involves great economic and social costs.

**GDP Gap and Okun’s Law.** The basic economic cost of unemployment is forgone output. When the economy fails to create enough jobs for all who are able and willing to work, potential production of goods and services is irretrievably lost. Unemployment above the natural rate means that society is operating at some point inside its production possibilities curve. Economists measure this sacrificed output as the GDP gap – the amount by which actual GDP falls short of potential GDP.

Potential GDP is determined by assuming that the natural rate of unemployment prevails. The growth of potential GDP is simply projected forward on the basis of the economy’s “normal” growth rate of real GDP.

Macroeconomist Arthur Okun was the first to quantify the relationship between the unemployment rate and the GDP gap. On the basis of recent estimates, Okun’s law indicates that for every 1 percentage point by which the actual unemployment rate exceeds the natural rate, a GDP gap of about 2 percent occurs. With this information, we can calculate the absolute loss of output associated with any above-natural unemployment rate.

### **Unequal Burdens**

An increase in the unemployment rate from 5 to, say, 7 or 8 percent might be more tolerable to society if every worker’s hours of work and wage income were reduced proportionally. But this is not the case. Part of the burden of unemployment is that its cost is unequally distributed.

### **Noneconomic Costs**

Severe cyclical unemployment is more than an economic malady; it is a social catastrophe. Depression means idleness. And idleness means loss of skills, loss of self-respect, plummeting morale, family disintegration, and socio-political unrest. Widespread joblessness increases poverty, heightens racial and ethnic tensions, and reduces hope for material advancement.

At the individual level, research links increases in suicide, homicide, fatal heart attacks and strokes, and mental illness to high unemployment.

**(b) TYPES OF INFLATION:**

Economists distinguish between two types of inflation: demand-pull inflation and cost-push inflation.

**Demand-Pull Inflation**

Usually, changes in the price level are caused by an excess of total spending beyond the economy's capacity to produce. When resources are already fully employed, the business sector cannot respond to this excess demand by expanding output. So the excess demand bids up the prices of the limited real output, causing demand-pull inflation. The essence of this type of inflation is "too much spending chasing too few goods."

**Cost-Push Inflation**

Inflation may also arise on the supply, or cost, side of the economy. The theory of cost-push inflation explains rising prices in terms of factors that raise per-unit production costs at each level of spending. A per unit production cost is the average cost of a particular level of output. This average cost is found by dividing the total cost of all resource inputs by the amount of output produced. This is,

$$\text{Per - unit production cost} = \frac{\text{total input cost}}{\text{units of output}}$$

Rising per-unit production costs squeeze profits and reduce the amount of output firms are willing to supply at the existing price level. As a result, the economy's supply of goods and services declines and the price level rises. In this scenario, costs are pushing the price level upward, whereas in demand-pull inflation demand is pulling it upward. The major source of cost-push inflation has been so-called supply shocks.

**Nominal and Real Income**

There is a difference between money (or nominal) income and real income. Nominal income is the number of dollars received as wages, rent, interest, or profits. Real income is a measure of the amount of goods and services nominal income can buy; it is the purchasing power of nominal income, or income adjusted for inflation. That is,

$$\text{Real income} = \frac{\text{nominal income}}{\text{price index (in hundredths)}}$$

Inflation need not alter an economy's overall real income – its purchasing power. It is evident from the above equation that real income will remain the same when nominal income rises at the same percentage rate as does the price index.

**Who is Hurt by Inflation?**

Unanticipated inflation hurts fixed-income recipients, savers, and creditors. It redistributes real income away from them and toward others.

**Who is unaffected or Helped by Inflation?**

Some people are unaffected by inflation and others are actually helped by it. For the second group, inflation redistributes real income toward them and away from others.

**Flexible-Income Receivers**

People who have flexible incomes may escape inflation's harm or even benefit from it. For example, individuals who derive their incomes solely from social security are largely unaffected by inflation, because social security payments are indexed to the CPI. Benefits automatically increase when the CPI increases, preventing erosion of benefits from inflation.

**Debtors**

Unanticipated inflation benefits debtors (borrowers). In our earlier example, Chase

Bank's loss of real income from inflation is Bob's gain of real income. Debtor Bob borrows "dear" dollars but, because of inflation, pays back the principal and interest with "cheap" dollar whose purchasing power has been eroded by inflation. Real income is redistributed away from the owners of Chase Bank toward borrowers such as Bob.

**Q.7****Principal Sources of Short-term Capital:**

- (a) Credit agreements allow businesses to borrow money for the immediate purchase of goods or services and to pay for them over an extended period of time. These agreements take a variety of forms including bank loans, overdraft facilities, credit card, trade credit, hire purchase and lease finance.
- (b) Bank overdrafts are a short-term facility which allow businesses to borrow money up to an agreed limit. The bank will charge interest on the amount overdrawn, but the overdraft can be a valuable means of overcoming a short-term cash flow problem or working capital shortage.
- (c) Bills of exchange are a means of one business providing credit to another business for a short period, usually for 3 months. The lender makes up the bill for a specified sum payable at a future date and the borrower accepts the bill by signing it. Once the loan has been made there may be secondary trading in the bill, that is the loan will be sold on to a third party. The bill will be bought from the drawer at a discount from the face value of the loan, this discount representing an interest charge on the amount owed.
- (d) Banks and companies with good credit ratings raise funds by issuing unsecured promissory bearer notes that can be interest-bearing or discounted. These notes usually have short lives of up to 270 days.
- (e) Retained cash. A business can also solve the short term mismatch of payments and receipts (the cash flow problem) by retaining a reserve of cash in its bank accounts to use in periods where expenditure exceeds income.

**Principal Sources of Long-term Capital:**

- (a) Issued share capital. Share capital might be in the form of ordinary shares (equity) or preference shares. Bear in mind that only the ordinary shareholders are owners of the company, and preference shares are comparatively rare.
- (b) Retained profits and other reserves. Retained profits are profits that have been kept within the company, rather than paid out to shareholders as dividends. These provide a source of internally generated funds.
- (c) Borrowing and long-term loans. Companies borrow from banks and from private or institutional investors. Investors might purchase debt securities issued by the company. The company promises to repay the debt at a date in the future, and until then, pays the investors interest on the debt. Debt capital includes debentures and, for larger companies, Eurobonds and commercial paper.

Debentures and other loan stock are long-term loans, the terms of which are set out in a debenture trust deed. Debentures issued by large companies are traded on the stock market.

Bonds are financial securities issued by government or businesses to provide them with long-term borrowing. The bonds bear a fixed nominal (or coupon) rate of interest. The market in secondary dealings for bonds involves selling the bonds at various prices in order to keep the effective interest rate in line with current interest rates. Eurobonds are bonds sold outside the jurisdiction of the country in whose currency the bond is denominated.

- (d) Venture capital (private equity). Venture capitalists are prepared to finance risky

ventures such as start ups. Because they accept a high degree of risk (with many of their ventures producing little or no return) they require a very high return from the ones that do succeed. They also require a clear exit route that allows them to realise their capital, such as a public flotation issue of shares.

- (e) Mezzanine finance: this in effect, combines aspects of both debt and equity finance. Although the financing is initially given as a loan (debt capital), the lender has the rights to convert to an equity interest in the company if the loan is not paid back in time and in full.

Financial intermediaries are institutions which channel funds from savers to borrowers:

Financial intermediaries are institutions which channel funds from savers to borrowers. In doing so, the intermediaries provide a link between savers and borrowers, meaning that individual savers and borrowers do not have to make individual arrangements between themselves.

#### **Advantages of Financial Intermediaries**

- (a) Ease of saving. Financial intermediaries provide obvious and convenient ways in which a saver can save money. Instead of having to find a suitable borrower for his money, the saver can deposit his money with a financial intermediary that offers a financial instrument to suit his requirements. So the financial intermediary acts as a conduit to channel funds from net savers to net borrowers. It also pays interest on the savings so the saver earns a return on his money.
- (b) Provide liquidity: they are a ready source of fund for borrowers. Even when money is in short supply, a borrower will usually find a financial intermediary prepared to lend some. Intermediaries are an efficient, and often cost-effective, source of money for borrowers.
- (c) Aggregation. They can package up the amounts lent by savers and lend on to borrowers in bigger amounts. Without aggregation, a borrower would either have to find a lender who is prepared to lend the amount he wants to borrow, or else would need to use a number of different lenders in order to raise the amount of funds he wants to borrow.
- (d) Maturity transformation. Financial intermediaries bridge the gap between the wish of most lenders for liquidity and the desire of most borrowers for loans over longer periods. They do this by providing investors with financial instruments which are liquid enough for the investors' needs and by providing funds to borrowers in a different longer term form (for example, mortgages).
- (e) Security. Provided that the financial intermediary is itself financially sound, the lender's capital is secure. Bad debts would be borne by the financial intermediary in its re-lending operations.
- (f) Risk transformation. An individual saver may not wish to lend to an individual borrower, considering that borrower to be a bad debt risk. However, the financial intermediary can borrow from a number of different savers and then provide funds to the borrowers with minimal risk to any single saver.

**THE END**