Finance and Financial Markets

Second Edition

Keith Pilbeam

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To Fiona, Penny and Eamon

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Preface

The importance of financial markets, institutions and instruments to the successful operation of a modern economy has grown markedly during the last four decades. Indeed, the world of finance has itself undergone remarkable changes during this period. Financial institutions have become less regulated and increasingly international in their outlook. Markets are less segmented, with changes in money markets, foreign exchange, bond markets, stockmarkets and derivative markets becoming ever more inextricably linked. Moreover, domestic and foreign markets are increasingly interdependent with movements in foreign financial markets exerting significant impacts on domestic markets. More recently, the range of international financial markets has increased with developing countries such as China and India experiencing very high rates of economic growth and attempting to improve the functioning of their financial institutions and markets, with, likewise, the Eastern-bloc countries keen to develop their financial services sectors. Finally, the range of financial instruments traded has mushroomed, with investors and borrowers being able to choose from an ever-increasing range of risk–return products. A good example of this latter phenomenon has been the exponential growth of trading in derivative instruments such as options, futures and swaps.

The increasing importance of finance has inevitably been reflected in the popularity of courses dealing with finance theory, financial markets and financial instruments at both the undergraduate and postgraduate level. Indeed, these days virtually all MBA programmes have finance-related core or elective courses. This second edition of *Finance and Financial Markets* is designed to be a comprehensive and at the same time accessible introduction to financial institutions, markets and instruments aimed at undergraduate and MBA students. Many excellent books on finance are written to quite an advanced level and tend to adopt a relatively technical approach to the topic. The aim of this book is to provide a less technical and more practically

oriented introduction to the field of finance whilst maintaining a reasonable degree of rigour. The book provides enough coverage to satisfy most introductory courses; however, it is hoped that the book will also serve as a springboard to the more advanced texts.

The opening five chapters provide an introduction to the world of finance and cover the basic theory relating to the operation of financial institutions and the domestic and offshore (Eurocurrency) money markets. Chapters 6 to 10 deal with both the theory and practice relating to capital markets. The theory covers areas such as portfolio diversification, the capital asset pricing model, the Gordon growth model and the efficient market hypothesis, while the practice looks at the domestic and international bond markets and equity markets.

Chapters 11 and 12 are devoted to the foreign exchange market, with Chapter 11 providing an introduction to the spot and forward markets and Chapter 12 providing an analysis of purchasing power parity theory and more modern theories of exchange rate determination. Chapters 13 to 16 are concerned with derivative instruments. Chapter 13 looks at forwards and futures contracts, and specific examples of currency, bond and equity index contracts are included. Chapters 14 and 15 look at options; Chapter 14 looks at what options are and how they can be used for speculative and hedging purposes, and at various option strategies, whilst Chapter 15 focuses on the more complex issue of option pricing and in particular the Black–Scholes option pricing formula. Chapter 16 looks at the swap market, which since the first swaps agreements were made in the 1980s has become increasingly important to the operation of domestic and international bond markets. Finally, Chapter 17 provides an analysis of the crucial issue of regulation of the financial sector.

This second edition has undergone quite substantial change including a substantial amount of new data being added and extensive rewriting along with the incorporation of more worked examples. One of the most significant changes is the inclusion of multiple choice and short answer type questions. The aim of these questions is to enhance student understanding and give lecturers the chance to see the type of questions that they might set for students to test their understanding of the material covered in the book. Solutions to the multiple choice are included and lecturers may obtain answers to the short answer questions at the website.

One final point about this book is that the fast changes in the world of finance make it hard for any author to keep abreast of all developments. To this end, the present book is not heavy on institutional detail, preferring to concentrate on the key theories and underlying principles. A thorough understanding of these should enable the reader to understand and interpret developments for themselves.

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