1-1 Finance in Society

OBJECTIVES

- ***Describe the role of finance in the economy.***
- ***Identify types of financial markets.***

FINANCIAL ACTIVITIES IN ACTION

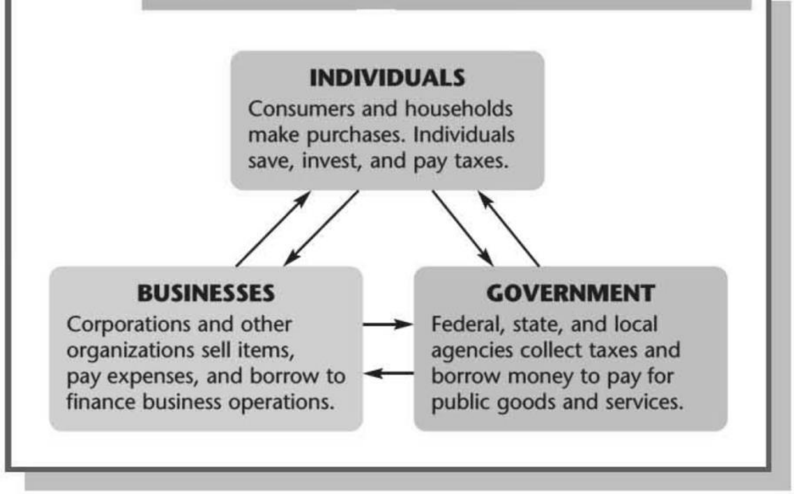
Each day, you probably participate in various financial transactions. These financial transactions might include buying items in stores, receiving a paycheck, or borrowing money to purchase a car. These transactions include paying and receiving money as well as using credit. Money is any item that serves as a method of payment. Most people think of money as coins, bank notes, checks, and debit cards. In the past, items that were used as money included salt, shells, cattle, and gold. Today, several types of online and electronic money are being used. Your money activities are the basis for financial events in society.

Finance refers to activities involved with saving, investing, and using money by individuals, businesses, and governments. Every person is involved in finance.

PARTICIPANTS IN FINANCIAL SYSTEMS

When people, businesses, and governments in a country have financial relationships, a financial system exists. These financial relationships may include saving, spending, paying taxes, earning interest, receiving a salary, or buying investments. As shown in Figure 1-1, the financial system of a country involves interactions among three main participants.

FIGURE 1-1 A Financial System



Individual Consumers and Investors. Your first role in the financial system is as a consumer. Every time you buy something, a financial exchange takes place. You are using cash or credit to pay for a purchase. This purchasing is an example of a financial activity. If you receive a paycheck or a gift of money, you may put this money in a bank account. Or, you may invest the money. These activities are other examples of ways you participate in the financial system.

Businesses. Everyone is dependent on the goods and services provided by various companies. These organizations sell items. The money received from these sales pays for operating expenses and hopefully provides a profit for the company.
Companies also borrow money. The use of credit by businesses represents a significant portion of our financial system.

Government. You and your neighbors use schools, parks, roads, police protection, and other public services. To pay for these services, government collects taxes and other fees. Federal, state, and local government agencies also borrow money to finance various projects.

FACTORS AFFECTING FINANCIAL ACTIVITIES

The financial systems in society are influenced by many factors. World events as well as consumer saving habits affect the financial environment.

Economic Conditions. A country's economic activities are a primary element of finance. Several economic factors have a major effect on financial activities.

- **Interest Rates**. The cost of money affects almost every aspect of finance. Interest rates are determined by the forces of supply and demand. When consumer saving and investing increase the supply of money, interest rates tend to decrease. As borrowing by consumers, businesses, and government increases, interest rates are likely to rise.
- **Consumer Prices**. The prices you pay for items tend to change. Inflation is a rise in the general level of prices. In times of inflation, the buying power of the dollar decreases. For example, if prices increased 5 percent during the last year, items that cost $100 a year ago would now cost $105. It now takes more money to buy the same amount of goods and services.

In the United States, the consumer price index (CPI), published by the Bureau of Labor Statistics, is used to measure the average change in prices.

- **Money Supply**. The amount of money in circulation in an economy is another important influence on financial activities. The money supply, which includes coins, paper currency, and checking accounts, affects spending and borrowing. Too much money in circulation can result in lower interest rates but higher consumer prices. In contrast, too little money in the economy may push up interest rates, resulting in reduced consumer spending and increased unemployment.

Governmental Regulations. Without rules, financial systems would be confusing. Imagine if anyone could issue stocks or bonds without being concerned about the value of a company. Many people would be cheated. As a result, governments create regulations for fairness in financial transactions. In the United States, the Securities and Exchange Commission (SEC), created in 1934, is one of the primary financial regulatory agencies. The main goals of the SEC are (1) to promote clear and full investment information and (2) to protect investors against fraud and deception. Other federal agencies that regulate financial activities include the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCVA).

Global Business Activities. You often buy and use products from around the world. International trade is the basis of many financial activities. When a country exports more than it imports, its trade surplus benefits the country's economy. A trade deficit (more imports than exports) can hurt a country's economy. A trade deficit can also affect the value of a nation's money. Since countries use different money systems, the value of currencies vary as a result of global financial transactions. The foreign exchange rate is the value of a country's currency in relation to the value of the money of another country. The value of a nation's currency is most influenced by international trade, the nation's political stability, and economic conditions in the country.

FINANCIAL MARKETS

Whenever you buy or sell something, you participate in a market. This market might be a store, an online auction, a garage sale, or a stock exchange in any major city around the world. A financial market is a location (physical or online) where buyers and sellers of financial products meet to conduct business. Financial markets involve the buying and selling of various assets and investments. While some investments are physical (houses, land, gold, rare coins), other investments represent ownership (stocks) or lending (bonds). A security is an investment instrument issued by a corporation, government, or other organization representing ownership or a debt. Stock is a security representing ownership in a corporation. In contrast, a bond is debt, money that is borrowed by a company or government. In addition to stocks and bonds, other examples of securities include mutual funds, certificates of deposit (CDs), and commodity futures.

TYPES OF FINANCIAL MARKETS

While many types of financial markets exist around the world, as shown in Figure 1-2, they are commonly classified into two major categories: money markets and capital markets.

FIGURE 1-2

Types of Financial Markets

Money Markets (short-term debt securities)	Capital Markets (long-term securities)
Treasury Bills	Treasury Notes and Bonds
Certificates of Deposit (CDs)	Corporate and Municipal Bonds
Commercial Paper	Common and Preferred Stock

Money Markets. All organizations need money to operate on a daily basis. While sales increase cash flows, often additional funds are needed for short periods of time. Money markets are financial markets where short-term debt securities (less than one year) are bought and sold. Some examples of short-term securities are Treasury bills, certificates of deposit, and commercial paper. Investments in these short-term debt securities usually have a lower risk than investments with longer maturities.

Capital Markets. When an organization is in need of funds for long-term use, it will become involved in capital markets. These markets buy and sell various debt and equity securities that are issued for more than a year. Debt securities represent borrowing by companies or governments. Examples of debt securities include bonds, issued by corporations, and municipal bonds, issued by state and local governments. In contrast, equity securities represent ownership. The most common type of equity security is stock.

VALUE OF SECURITIES

Investors are continually interested in the value of assets they own. Many factors can affect the value of a security. The most common of these are

- **Supply and Demand**. As more people desire a certain investment, the value of it will likely increase. Well-managed, profitable organizations are likely to attract more investors, increasing the value of the company's stock. If demand for a company's stock goes down, the value of it will decrease.
- **Future Cash Flows**. When making an investment, both individuals and companies expect to receive money in the future. Larger amounts of future cash flows will increase the value a person will pay for an investment. The expected return is the amount of future cash inflows. The rate of return (or yield) is the relationship between the amount received and the cost of an investment. For example, if an investor receives $1,000 for a $10,000 investment, the rate of return is 10 percent ($1,000 divided by $10,000).
- **Risk**. Every investor and every business manager must consider risk. These dangers may include changing economic conditions, political uncertainty, and shifting consumer buying preferences.
- **Liquidity**. The value of a security is often influenced by its ability to be converted to cash. Liquidity refers to the ease and speed with which an investment can be converted into cash.
- **Interest Rates**. The cost of money, measured by interest rates, is another important factor affecting the value of an investment. For example, if interest rates rise, more people will likely put money in savings accounts instead of buying stock. This change will usually result in lower stock values.

While investors are likely to consider all of these factors, often the risk-return relationship is of primary importance. Higher-risk investments are connected with higher potential returns. A person has the opportunity to make more money, but often will have a loss.

1-2 Personal Financial Decisions

OBJECTIVES

- ***Explain the personal financial planning process.***
- ***Describe common personal financial decisions.***

FINANCE IN YOUR LIFE

Do you have enough money to buy all you desire? Probably not. The problem of scarcity requires that you make financial decisions. Most people want to use their finances to obtain the most satisfaction from the money they have available. Financial and personal satisfaction result from a process called personal money management or personal financial planning.
Personal financial planning is the process of managing your money to achieve personal economic satisfaction.

The main benefits of proper personal financial planning include:

- Better actions for using your finances
- Effective control of your spending
- Improved personal relationships
- A sense of freedom from financial worries

A comprehensive financial plan can enhance the quality of your life and increase your satisfaction by reducing uncertainty about your future needs and resources. A financial plan is a formal report with a summary of your current financial situation along with plans for future financial activities. You can create this document on your own or you can seek assistance from a financial planner or use a money management software package.

INFLUENCES ON PERSONAL FINANCIAL DECISIONS

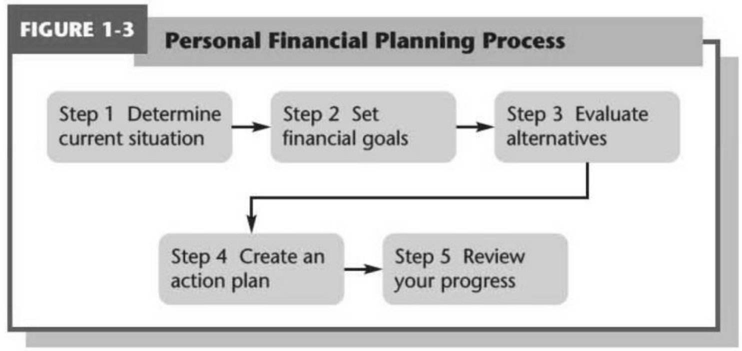
Your financial situation and the decisions you make are affected by various personal and economic factors. These influences include age and household size as well as interest rates and inflation.

Personal Life Situation. Teens spend money differently than people in their 30s or 40s. Personal factors such as age, income, household size, and personal beliefs influence spending and saving patterns. Your life situation is also affected by events such as graduation, dependent children leaving home, changes in health, engagement and marriage, divorce, birth or adoption of a child, retirement, a career change, a move to new area, or the death of a spouse, family member, or other dependent.

Economic Factors. As with all financial decisions, economic conditions such as inflation, interest rates, and unemployment will affect your personal financial planning. Higher consumer prices will affect spending habits. Lower interest rates may influence you to borrow money to make a certain purchase.

THE FINANCIAL PLANNING PROCESS

Effective personal financial planning requires a logical system. Personal financial advisors often recommend steps similar to those in Figure 1-3.



Step 1: Determine Current Situation

Personal financial planning activities should start by knowing where you are now. Begin the financial planning process by knowing the amount of your income, savings, living expenses, and debts. Prepare a list of current amounts for items owned (assets) and amounts owed to others (liabilities). In addition, a detailed list of amounts you spend for various items will give you a foundation for your financial decision making.

Step 2: Set Financial Goals

Knowing where you are going is important for every aspect of life. As a result, goal setting is central to financial decision making. A personal financial goal is a desired outcome for financial planning. Financial goals help you plan, implement, and measure the progress of your spending, saving, and investing activities. As you set personal financial goals, be sure that these desired targets are:

- **Realistic**. Know that you will not be able to afford certain things.
- **Specific and Measurable**. Exact goals help you see your progress. Instead of a goal "to save some money," you should say "to save $200 a month."
- **Time-Specific**. Your goal should set a specific time limit such as "to payoff credit card debts within 18 months."
- **Action-Based**. Explain how you will achieve the goal.

Step 3: Evaluate Alternatives

Whenever you make decisions, you should consider various solutions. For example, if you need transportation, alternatives may include buying a car, using public transportation, renting a car, or paying a friend for rides. As you develop alternatives, be sure to consider:

- **Continuing** the same course of action.
- **Expanding** your current actions.
- **Changing** to a new course of action.

The more creative you are in developing alternatives, the more likely you will be successful. But, remember that if you decide to be cautious and do nothing, this is also a choice that has consequences.

- **Opportunity Cost**. Every course of action you choose to take means you will give up something else. For example, a decision to invest your money in stock may mean you cannot take a vacation. Opportunity cost is what you give up by making a choice. These trade-offs may not be measured in dollars. The resources you give up (money or time) also have a value that is lost. One way to measure opportunity cost is with the time value of money, which measures the increase in an amount of money as a result of interest earned. Saving instead of spending money today will result in a larger amount in the future. Every time you spend, save, invest, or borrow, consider the time value of money. For example, spending money from a savings account means lost interest earnings. The items you buy may have a higher priority than the amount of interest earned.

- **Risk**. Uncertainty is a part of every decision. For example, selecting a college major and choosing a career field involve risk. What if you don't like working in the field you chose or cannot obtain employment in it? Some decisions have a very low risk, such as putting money in an insured savings account. Be sure to gather information about risk before making any financial decision. Good sources of risk information are your experiences and the experiences of others, as well as library and online sources.

Step 4: Create an Action Plan

After you evaluate the alternatives, you should develop an action plan to achieve your goals. For example, you can increase savings by reducing your spending. Or, you might increase your income by working extra time or by getting a second job. To implement your financial action plan, you may need assistance. For example, you may use the services of an insurance agent or an investment broker.

Step 5: Review Your Progress

Finally, after you have taken action, regularly review your financial decisions. While an annual review is recommended, changes in your personal situation may require more frequent evaluations. When life events affect your financial needs, the financial planning process will provide a way to adapt to those changes. Regularly reviewing this decision-making process will help you make proper adjustments for your current life situation.

PERSONAL FINANCIAL DECISIONS

As you implement the financial planning process, you will make decisions in five areas:

OBTAINING FINANCIAL RESOURCES

People commonly obtain financial resources from employment, investments, or ownership of a business. Your education, talents, and efforts provide a foundation for your future earning potential.

PLANNING THE USE OF FINANCIAL RESOURCES

A wise spending plan, often called a budget, is the foundation for achieving personal financial goals. Financial planning is not designed to prevent your enjoyment of life. Wise spending can help you obtain things you want. Quite often, people make unplanned purchases. These impulsive decisions usually result in financial difficulties. Writing down how you spend your money will help you plan today and in the future. Spending less than you receive is the only path for achieving personal financial security.

SAVING AND INVESTING DECISIONS

Your future financial security must start with a regular savings plan. These funds might be needed for emergencies, unexpected bills, replacement of major items, or buying special items. After establishing a basic savings plan, you should consider investments that offer greater financial growth. Many types of investments are available. People invest for two primary reasons: (1) current income and (2) long-term growth. Financial advisors commonly recommend diversification, which is investing in a variety of assets. For example, you may someday own stocks, bonds, mutual funds, real estate, and collectibles such as rare coins.

BORROWING ACTIVITIES

The wise use of credit is necessary to avoid financial difficulties. Many people in our society overuse and misuse credit. These poor financial planning decisions commonly result in household stress, bankruptcy, and other personal and financial troubles.

MANAGING FINANCIAL RISKS

Every financial decision has risks. The use of insurance and other risk management actions benefits both individuals and businesses. When planning your finances, be sure to determine your need for auto, home, health, life, and disability insurance coverage.

1-3 Business Financial Activities

OBJECTIVES

- ***Describe financial institutions commonly used by businesses and consumers.***
- ***Explain the sources and uses of funds of businesses.***

TYPES OF FINANCIAL INSTITUTIONS

Both individuals and businesses need financial institutions to handle money receipts, payments, and lending. These organizations, also called financial intermediaries, provide a wide range of financial services. As shown in Figure 1-4, financial institutions are commonly viewed in two main categories-deposit institutions and non-deposit institutions.

DEPOSIT INSTITUTIONS

Deposit institutions, also called depository institutions, accept deposits from people and businesses to use in the future. This category of financial institutions includes commercial banks, thrift institutions, and credit unions:

FIGURE 1-4

Types of Financial Institutions

Deposit Institutions	Non-Deposit Institutions
Commercial bank	Life insurance company
Savings and loan association	Investment company
Mutual savings bank	Consumer finance company
Credit union	Mortgage company
	Check-cashing outlet
	Pawnshop

Commercial Banks. These financial institutions are often called full-service banks and offer a wide range of financial services. Commercial banks offer checking accounts, provide savings accounts, make loans, and offer other services to individuals and businesses. In recent years, many banks have expanded with full-service branch offices in shopping centers and grocery stores.

Thrift Institutions. Two types of financial institutions are commonly viewed in this category:

- **Savings & Loans**. A savings and loan association (S&L) specializes in savings accounts and making loans for home mortgages. In recent years, these financial institutions have expanded to offer a greater variety of financial services and have become more like banks. Today, many S&Ls use the words savings bank in their names.
- **Mutual Savings Banks**. While a mutual savings batik provides a variety of services, it is organized mainly for savings and home loans. This type of financial institution is owned by the depositors. The profits of the mutual savings bank go to the depositors. Mutual savings banks are located mainly in the northeastern United States.

Credit Unions. A credit union is a user-owned, not-for-profit, cooperative financial institution. Credit unions are commonly formed by people in the same company, government agency, labor union, profession, church, or community. Serving members only, credit unions accept savings deposits and make loans for a variety of purposes. Today, credit unions also offer a wide range of financial services.

NON-DEPOSIT INSTITUTIONS

The other major category of financial institutions is non-deposit institutions. This group includes life insurance companies, investment companies, consumer finance companies, mortgage companies, check-cashing outlets, and pawnshops.

Life Insurance Companies. People commonly buy life insurance to provide financial security for their dependents. Besides protection, many life insurance companies also offer financial services such as investments. By investing in companies, life insurance companies help to expand business in an economy.

Investment Companies. Investment companies allow people to choose investment opportunities for long-term growth of their money. Many investors in our society own shares of one of the more than 30,000 mutual funds worldwide made available by investment companies.

Consumer Finance Companies. These organizations specialize in loans for durable goods, such as cars and refrigerators, and for financial emergencies. While consumer finance companies make loans, they do not accept savings as do banks and other financial institutions.

Mortgage Companies. Buying a home is an important activity in the economy. Mortgage companies, along with other financial institutions, provide loans for purchasing a home or other real estate.

Check-Cashing Outlets. People without bank accounts often use check-cashing outlets (CCOs) to cash paychecks and for other financial services. CCOs offer a variety of services such as electronic tax filing, money orders, private postal boxes, utility bill payment, and the sale of bus tokens. Most services at a CCO are more expensive than at other financial institutions.

Pawnshops. Offering small loans based on the value of some tangible possession (such as jewelry), pawnshops commonly charge higher fees than other lending institutions.

SOURCES AND USES OF FUNDS

The availability of money for business operations is a fundamental element of any financial system. The sources (inflows) and uses (outflows) of cash and credit provide necessary funds for current and long-term business activities.

SOURCES OF FUNDS

Businesses and other organizations require money for day-to-day activities. Source of funds refers to the inflow of cash that can be used for paying various expenses. Three common sources of funds are available for companies.

- Revenue refers to the inflow of cash from business operations. These funds result from sales of goods and services. Examples of revenue include store sales for a retailer, premiums for an insurance company, fees for a law office, and tuition for a college or university.
- Investor funds are the result of money from existing or new owners of a company. Selling the stock of a company is an example of investor funds. Or, if you own a small business, you might ask additional investors to provide funds.
- Borrowing is common among most businesses and other types of organizations. Loans, notes, bonds, and mortgages are some methods used to borrow funds. This money may be used to expand international trade operations or build a new factory.

USES OF FUNDS

The daily operations of organizations also involve making payments for various business costs and other expenses. The use of funds involves outflow of money by a company. Current expenses and capital expenditures are the main uses of funds.

- Current expenses include rent, materials, wages and salaries, utilities, repairs, advertising, supplies, and other necessary business costs. Most business expenses involve items used up in a year or less.
- Capital expenditures are long-term spending for items that will be used over a longer period of time (more than a year). For example, a building or a computer system will probably be paid for and used over several years. These long-term costs, also called capital projects, are necessary for companies to produce, store, and deliver goods and services.

FOCUS ON: Similarities of Personal and Business Financial Planning

Budgeting: In a similar way as a company plans its financial activities, a budget is also an important personal financial planning tool. The budgeting process for both households and companies must start with setting goals. Your personal plan for spending will depend on what you want to achieve, such as saving for college or buying a car. A company also sets goals when creating a budget. These goals may include spending more for advertising, building a new factory, or increasing employee salaries. Like your goals, these business goals will affect how a company spends its money.

Financial Statements: When you keep track of your income and spending, you are creating an income statement. If you create a list of what you own (assets) and what you owe (liabilities), you have started developing a balance sheet. These two financial statements, the income statement and balance sheet, are vital financial planning tools for both individuals and companies. A company uses these financial reports to measure its progress. In a similar way, individuals and families can use an income statement and balance sheet to assess spending patterns and calculate the achievement of financial goals.

Banking Services: When you open a bank account, you might need to save for the future or make payments using a checking account. In the future, you may need to borrow money to buy a house or a car. These are two examples of loans made to individuals. Banking services used by companies serve a similar purpose. Businesses desire to store money (savings), make payments (checking), and borrow for organizational needs (loans).

1-4 Government Finances

OBJECTIVES

- ***Identify government financial activities.***
- ***Describe sources of government funds.***

GOVERNMENT FINANCIAL ACTIVITIES

Government plays a significant role in every economic system. Your role as a citizen and voter influences the decisions and actions taken by government. In a private enterprise system, government's role is much less extensive than in other economic systems but is still an important one. The role of government in the economy frequently changes as newly elected officials take office.

FUNCTIONS OF GOVERNMENT

Governments participate in many economic and business activities related to the financial system of a society. Several fundamental roles of government are common, including:

- Providing public services for members of the society
- Protecting citizens, consumers, businesses, and workers from dangers
- Regulating financial and other business activities, while promoting competition
- Providing information and assistance to businesses
- Purchasing goods and services for government operations
- Hiring public employees to serve citizens
- Raising revenue to finance various public services and government projects

Each of these roles has either a direct or indirect impact on business activity, economic growth, and the operation of a society's financial system.

LEVELS OF GOVERNMENT

In the United States, three levels of government exist. The public service agencies in each of these levels serve various needs.

Federal Government. The main role of the federal government is to oversee the activities that involve two or more states or other countries. In general, the U.S. Constitution gives the federal government the power to regulate foreign trade and interstate commerce. Business transactions involving companies in more than one state are called interstate commerce. For example, a financial institution that conducts business with people in several states would be regulated by the federal government.

State Government. State governments regulate business activities within their own boundaries. Intrastate commerce refers to business transactions involving companies that do business only in one state. For instance, a lending company that provides loans only within a state's boundaries would be regulated by that state and not the federal government.

Local Government. All states have delegated some of their legislative authority to local governments. Local governments include county boards and city or town councils. Local governments commonly provide services needed for an orderly society, such as police and fire protection.

SOURCES OF GOVERNMENT FUNDS

Government must have a way to raise money to finance operations and pay wages to its workers. Government income is called tax revenue. Governments obtain a large portion of their revenue through the collection of taxes. In addition, governments raise revenue in other ways. Fines for traffic violations and other violations of the law provide revenue for government. Fees and licenses are also a source of income. Certain types of enterprises require a business license. For example, insurance and real estate agents pay a fee for the privilege of conducting business. Governments also charge fees for such things as driver's licenses and fishing privileges.

TAXES

A government establishes tax policies to pay for the services it provides. Taxes are levied on earnings, the value of property, and on the sale of goods and services.

- Your earnings as an individual are subject to an income tax. Income taxes are levied on the income of individuals. The individual income tax is the largest source of revenue for the federal government. Corporate income taxes also provide government revenue. The corporate income tax is based on business profits.
- A major source of revenue for local governments is the real estate property tax. This tax is based on the value of land and buildings. Most property tax revenue is used to pay for schools and other local government services, such as police protection and community parks. Businesses also pay a property tax.
- The cost of buying things can be increased by a sales tax. A sales tax is a state or local tax on goods and services that is collected by the seller. If you buy a can of paint for $ 15.00 and the state sales tax is 6 percent, the seller collects $15.90 from you. The seller then will pay 90 cents to the state, but you were the one who provided the money for the tax.

Paying taxes is a responsibility of citizens and businesses. You should pay your fair share of tax but not more than your share. Tax laws and policies are established to help make the paying of taxes fair and equitable. Whether a particular tax or tax policy is fair and equitable is always subject to debate. Businesses also pay a lot of taxes to all levels of government.

BORROWING

Government income from taxes and other sources may not always be enough to cover the costs of providing services. Borrowing is another activity of government. When a government wants to build a building, such as a new courthouse or convention center, the funds needed are often raised through borrowing. Governments often borrow money by selling bonds. When you buy a government bond, you are helping to finance the services provided by government. Banks, insurance companies, and other financial institutions help finance our governments by purchasing bonds in large quantities. By borrowing money, the government becomes a debtor and must pay interest on its debt.

Federal Government Borrowing. Bonds issued by the U.S. government are backed by the "full faith and credit" of the federal government. Bonds issued by our federal government are considered the least risky of all debt. The U.S. federal government issues four main types of debt securities:
- U.S. Savings Bonds
- Treasury Bills
- Treasury Notes
- Treasury Bonds

State and Local Government Borrowing. Many local governments issue bonds to finance various public service projects. A municipal bond is a debt security issued by a state or local government. These bonds are commonly issued by states, cities, counties, and school districts. While municipal bonds usually pay lower interest than most other investments, these can still be very attractive for two reasons:
- They are low in risk.
- The interest earned is not subject to income tax.

FOCUS ON: Dollarlzation In Ecuador and Elsewhere

As you pay for your purchase in Ecuador with U.S. dollars, you receive some coins in change. While these coins are the size you expect, something is different. You look at the coins and notice these are not U.S. quarters, dimes, and nickels. What's going on? While the U.S. dollar is the official currency of Ecuador, the country does not have enough U.S. coins to handle the many business transactions. Paper currency is abundant. As. a matter of fact, over 60 percent of all U.S. paper money is in circu lation outside the United States. But coins are scarce. Due to this shortage, Ecuador had to create its own coins with a similar shape but a different design. In the late 1990s, Ecuador faced many economic difficu lties including high inflation, increased poverty, and a declining value of the sucre (its previous currency). Actions to address these problems included adoption of the U.S. dollar as official currency. Dollarization is the official use of a currency by a country other than its own currency. In addition to Ecuador, other countries that officially use the U.S. dollar include EI Salvador, Panama, and East Timor. The term "dollarization" most often refers to the use of the U.S. dollar by other countries. This word also can indicate when any country uses the currency of another country. For example, Tuvalu, located in the Pacific region, uses the Australian dollar. Monaco uses the euro as its official currency. This small Western European country had previously used the French franc.

Chapter Summary

- ***A financial system involves financial activities among individuals, businesses, and government. Major factors that affect financial activities are changing economic conditions, government regulations, and global business activities.***
- ***The two major types of financial markets are money markets and capital markets. The value of investment securities is influenced by supply and demand, future cash flows, risk, liquidity, and interest rates.***
- ***Personal financial planning involves a five-step process: (1) determine current situation, (2) set financial goals, (3) evaluate alternatives, (4) create an action plan, and (5) review progress.***
- ***The major areas of financial decision-making are obtaining financial resources, planning the use of resources, saving and investing, borrowing, and managing financial risks.***
- ***The major types of deposit institutions are commercial banks, savings and loan associations, mutual savings banks, and credit unions. Non-deposit financial institutions include life insurance companies, investment companies, consumer finance companies, mortgage companies, check-cashing outlets, and pawnshops.***
- ***Common sources of funds are company revenue, investor funds, and borrowing. The use of funds involves outflow of money for current expenses and capital expenditures.***
- ***Federal, state, and local governments provide public services, protect citizens and others, regulate financial activities, provide information, purchase goods and services, hire public employees, and raise revenue.***
- ***The main sources of government funds are taxes and borrowing.***