Investment promotes economic growth. **Investment** is the act of redirecting resources from being used today so that they can create future benefits. The **financial system** makes investment possible by allowing the transfer of money between savers and borrowers. Savers are households and businesses that lend out their savings. Borrowers are governments and businesses who use the money they borrow to build roads, factories, and homes. Borrowers may also use these funds to develop new products or provide new services.

**Financial intermediaries** are institutions which help channel funds from savers to borrowers. Examples include banks and mutual funds, funds which pool savings from many people and invest this money in different ways. Financial intermediaries provide three major advantages to investors. They reduce risk by helping people invest in a variety of opportunities. The idea of spreading out investments to reduce risk is called **diversification**. Financial intermediaries also provide information and liquidity to investors.

Saving and investing involves trade-offs. For example, savings accounts have very low risk, and are liquid, but they also have a low return. **Return** is the money, such as interest, an investor receives above and beyond the sum of money initially invested. An investment with higher risk or less liquidity usually offers a higher potential return. Investors will be more tempted to take on more risk, or to give up liquidity, if they have a chance of earning more money on their investment.

**TEXT SUMMARY**

Investment, the key to economic growth, is made possible by a financial system of savers, borrowers, and intermediaries.

**GRAPHIC SUMMARY: Market Supply Curve**

The financial system makes possible the transfer of money between savers and borrowers.

**REVIEW QUESTIONS**

1. How does a financial system make investment possible?

2. **Diagram Skills** What are three examples of financial intermediaries?
Bonds are loans that the government or a corporation must repay to an investor. Bonds usually pay a fixed amount of interest at regular intervals for a set amount of time. At maturity, the end of that period, the issuer repays the par value, or the original amount of investment, to the bondholder.

Investors like bonds because they are good investments and usually have low risk. However, because bonds are low-risk investments, their returns are often less than those of other investments. Issuers like bonds because once the bond is sold interest rates on that bond will not go up or down. However issuers must make fixed interest payments and repay the principal when due—even in bad years.

There are several types of bonds. Savings bonds are issued by the United States government. The United States Treasury Department issues treasury bonds, and state and local governments and municipalities issue municipal bonds. Interest on government-issued bonds is exempt from certain taxes. Corporations sell corporate bonds to raise money to expand their businesses.

Other types of financial assets include certificates of deposit (CDs) and mutual funds. Markets for financial assets are often classified according to the length of time for which funds are lent. Capital markets are markets in which money is lent for longer than a year. Money markets are markets in which money is lent for less than a year.

<table>
<thead>
<tr>
<th>TYPE</th>
<th>ISSUER</th>
<th>RISK</th>
<th>TAX EXEMPTION</th>
<th>USED FOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings and Treasury Bonds</td>
<td>U.S. Government</td>
<td>Very low</td>
<td>Exempt from state and local taxes</td>
<td>Federal government activities</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>State and local governments</td>
<td>Low</td>
<td>Exempt from income taxes at federal level and in issuing state</td>
<td>State and local government activities</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>Corporations</td>
<td>Moderate</td>
<td>Not tax exempt</td>
<td>Expansion of businesses</td>
</tr>
<tr>
<td>Junk bonds</td>
<td>Corporations</td>
<td>High</td>
<td>Not tax exempt</td>
<td>Finance corporate takeovers</td>
</tr>
</tbody>
</table>

Corporations and governments borrow money by selling bonds and other financial assets.

Bonds help businesses expand and governments build public works. There are different kinds of bonds to serve different needs and different kinds of investors.

1. How is interest on bonds usually paid?
2. Chart Skills What is one purpose of junk bonds?
By selling stock, corporations raise the money that is necessary to start their businesses and keep them growing. Investors in stocks may make a profit in two ways: by receiving dividends, a payment made by corporations to stockholders; and by selling the stock for more than they paid for it. The difference is called a capital gain. However, purchasing stock is risky. The stock price may decrease. Investors who sell their stock for less than they paid for it experience a capital loss.

Stock is bought and sold in markets called stock exchanges. When people talk about "the stock market" they usually mean the New York Stock Exchange (NYSE), the largest in the country. The performance of the NYSE is often measured by the performance of the few stocks included in the Dow Jones Industrial Average, or "The Dow." When the stock market rises steadily over a period of time, a bull market exists. When it falls for a period of time, people call it a bear market. During the bull market of the 1920's, there was a great amount of speculation, high-risk investment with borrowed money in hope of big returns. This period ended in the stock market collapse called the "Great Crash" of October 1929. Another great bull market occurred in the 1990s.

**THE BIG IDEA**
Corporations sell stock to investors in order to raise money. Stocks are traded in markets called stock exchanges.

**GRAPHIC SUMMARY: Milestones in the Dow Jones Industrial Average, 1929–1999**

The Dow Jones Industrial Average climbed steadily since the Great Depression of the 1930s before rising sharply in the bull market of the 1990's.

**REVIEW QUESTIONS**
1. What is the difference between a capital gain and a capital loss?
2. Graph Skills  When did the Dow Jones Industrial Average reach its lowest point after the Great Crash?
IDENTIFYING MAIN IDEAS

Write the letter of the correct answer in the blank provided. (10 points each)

1. Investment is the act of
   A. depositing money in a savings account.
   B. redirecting resources from being used today so they can create future benefits.
   C. using resources for current needs.
   D. developing new products.

2. A financial system brings together
   A. savers and borrowers.
   B. savers and consumers.
   C. banks and mutual funds.
   D. governments and businesses.

3. The purpose of a financial intermediary is to help channel funds
   A. from one bank to another.
   B. from saving bonds to building projects.
   C. from savers to borrowers.
   D. from stocks to bonds.

4. Which of the following is a reason for diversification?
   A. to get the highest possible return
   B. to get the most dividends
   C. to eliminate risk
   D. to reduce risk

5. Bonds are
   A. loans.
   B. dividends.
   C. stocks.
   D. certificates of deposit.

6. A bond’s par value is generally repaid
   A. after 30 years.
   B. when the lender demands it.
   C. at maturity.
   D. when interest rates change.

7. Which of these bonds are issued by the United States government?
   A. corporate bonds
   B. savings bonds
   C. junk bonds
   D. municipal bonds

8. Investors who sell stocks for less than they paid for them experience a
   A. capital gain.
   B. capital loss.
   C. return on investment.
   D. negative dividend.

9. When the stock market falls over a period of time, it is known as a
   A. bear market.
   B. bull market.
   C. crash.
   D. depression.

10. Speculation is
    A. low-risk investment with borrowed money in hope of small returns.
    B. high-risk investment with borrowed money in hope of big returns.
    C. investment of large amounts of money in mutual funds.
    D. diversifying purchases of stock into many different kinds of companies.