Microeconomics

Economics, Microeconomics

1. Investment recovery is very important in order to keep the flow of money circulating in an economy. When banks make loans to individuals or business they expect to get that money back according to the terms of the contract. Financial institutions make plans based on the account receivables of monthly loans payments they expect to receive on a timely manner. When a loan investment is not recovered and it goes into default it starts a domino effect for the bank institutions. The investment that is not recovered leads to a bank loss. In order to make up for the loss incurred the bank has to pass forward the effect of this incident to its other customers which are charged higher interest rates on their future loans and their current money deposits receive a lower interest rate return. The money supply of the banks is also diminished due to event of a loan investment that is not recovered.

2.

Corporations in America follow similar financial decisions to individuals concerning their outstanding debt. Whenever market conditions are favorable corporations look for ways to refinance their debt. The difference between a corporation and individual is that companies utilize different mechanism to achieve refinancing. Corporate debt can be refinanced by utilizing a bond mechanism. A bond is commercial paper sold in denomination of $1000 to individuals or business which allows the corporation to raise money. The bonds have a fixed interest rate called the coupon rate. If market conditions changed corporation can issue a set of bonds at lower interest rate in order to eliminate its outstanding bonds and pay less money in the long run.

3.

Downgrading of debt occurs when the chances of recovering the outstanding debt diminishes because the debtor has not been paying their payment or time. If a loan goes beyond 90 days without a payment being received the debt is said to have gone in default. At this time the chances of collecting the money goes does down significantly. From the perspective of an outsider these financial assets of the bank represent a downgraded asset.

The $700 billion bailout plan targeted these types of downgraded assets which the government would buy up to create greater liquidity in the banking system. Another way downgrading of debt occurs is when corporate debt such as bonds are downgraded by agencies such as Moody’s. Moody’s has a system which gives a grade to the commercial paper issued by banks and governments. If the organization is having financial problems the grade of their outstanding debt is downgrade by Moody’s to protect potential investors. A lower grade means that the financial instrument has higher risk and consequently should pay out a higher interest rate.

4.

Banks are becoming more selective about the loans they give out to medium and large corporation because of the precedent that occur during the last few years in which many companies were not able to pay their obligations. In bad economic times companies do not generate the same types of revenues as they did before. If the banking industry refuses to fund many of these companies it could have a detrimental effect on the entire economy. Corporation utilized short term lines of credit to pay their payroll to employers and to pay their suppliers. IF this credit is not there many companies will incur in mass layoff of their staff and other companies will suffer the consequence of not getting their invoices for material supplied paid on time or at all if the companies go out of business. The lack of loans will also hurt the capabilities of companies to invest in new project that increase their production capacity.