

Capital markets

Countries



What are the main functions of capital markets? Using flow-of-funds analysis, explain how the corporate sector is financed? Introduction This essay has been divided into two parts. Part one purposes to introduce the main functions of Capital Markets. A description of what capital markets actually are will be given, before discussing they're main functions. The main function of capital markets is that of intermediation and this intermediation brings about liquidity and risk reduction that would otherwise not be possible. There will then be a brief discussion on the types of intermediaries.

Part 2 of the essay discusses how through the flow-of-funds analysis, how the corporate sector is financed. The main source's offinancefor firms is either internal or external financing. If choosing external financing the firm must decide whether to issue debt or equity, a description of each of these will be given. The differences between public and private external financing will also be listed. Part 1 Capital markets are an arena in which firms and other institutions that require funds to finance their operations come together with individuals and institutions that havemoneyto invest.

To invest wisely individuals and firms must have a thorough understanding of these capital markets. A financial system is a set of markets for financial instruments, and the individuals and institutions that trade in those markets. The facilities offered by a financial system are as follows: 1. Intermediation between surplus and deficits units 2. Financial services such as insurance and pensions 3. A payments mechanism 4. Portfolio adjustment facilities They all have the effect of channelling funds from those who have a surplus to those who have a deficit.

The main function of capital markets is that of intermediation. Typically household and overseas sectors will be in financial surplus meaning that their current consumption is less than current expenditure or investment. They will therefore be net lenders to the financial markets. Industrial, commercial and government sectors will be typically in financial deficit, meaning that their current income is insufficient to meet their current expenditure or investment needs. These sectors will therefore be net borrowers from the financial markets.

Capital markets allow for financial intermediaries to provide a channel for the transmission of funds as intermediaries make loans to ultimate borrowers out of the funds which ultimate lenders made available to them. Lenders and borrowers are brought together more quickly, more efficiently and therefore more cheaply than if they had to search each other out; and the intermediary is able, through superior knowledge and economies of scale, to reduce the risk of transaction for both parties. Without loss of generality, we can say that the preferred position for an individual in financial surplus is to 'lend short'.

The firm is typically in deficit and wishes to finance that deficit on a long term basis; that is, it wants to be in a position to 'borrow long'. The motives and reasons for sectors to borrow and lend differ and in some cases conflict. It is the function of the financial system and corporate sector to reconcile these differences, as cheaply and effectively as possible. Both groups are engaged in the net acquisition of financial assets, the vital difference is that for lenders to acquisition is positive and for borrowers it is negative.

To induce those with surplus to lend they wish to get the maximum return for the minimum of risk, lenders also have a positive attitude toward liquidity. Capital markets offer many different types of loans to borrowers and create a wide range of assets for lenders. The general consequences of financial intermediation are the creation of financial assets and liabilities that would otherwise not exist and the creation of liquidity. The ways in which the conflicting wants of borrowers and lenders are reconciled by financial intermediaries are (a) maturity transformation, (b) risk reduction, (c) search and transaction costs and (d) monitoring.