# 6.2: Components of the Financial System

## Suppliers of Capital

Suppliers of Capital refer to those people/institutions that have extra income during the current time period that they are not using on current consumption. Instead of doing nothing with that extra income (or stuffing it in the mattress), they are going to put that extra money (referred to as capital) into the financial system so that they can earn a rate of return on their capital. Suppliers of capital can refer to individuals, businesses or governments. For example, when an individual is saving for retirement that person is acting as a supplier of capital (with the money that they are investing into their retirement fund.)

## Demanders of Capital

Demanders of Capital refer to those people/institutions that need extra capital in order to meet their planned spending for the period. This could be

- An individual that is borrowing money for a new car
- A firm that is issuing bonds to expand production
- A firm that is issuing stock to expand production
- A local government issuing bonds to improve the area schools
- The federal government issuing bonds to finance government spending programs
- An individual selling off previous investments to fund their retirement
- Etc.

As you can see from the examples, demanders of capital include individuals, businesses, and governments. Also, it is important to note than many people will act as both suppliers of capital and demanders of capital during the same period. For instance, if I am saving $100 a month into a savings account to pay for a down payment on a house in a couple years and at the same time borrow money to buy a new car, I am both a supplier of capital in the first instance and a demander of capital in the second instance.

## Financial Markets

Financial Markets help to bring together suppliers and demanders of capital in a more efficient manner if these suppliers and demanders of capital meet certain characteristics with respect to the financial securities that are being traded. Financial markets work most efficiently if the following characteristics are met:

- The number of identical (homogeneous) financial securities are large
- There are a large number of potential buyers (suppliers of capital) and sellers (demanders of capital) for a particular security.

Let’s explain this a little bit. Consider a security like IBM common stock. One share of IBM common stock is identical the next (this is referred to as being homogeneous) and there are over 900 Million shares outstanding (as of May 15, 2018). There are also a large number of potential buyers and sellers. In a situation like this, it doesn’t matter who we buy from or which shares we buy, so a financial market works well. Since we don’t have to investigate the particular seller or the specific shares they are selling, we can just place an order with a broker to buy 100 shares of IBM stock and they will buy them quickly in the marketplace.

## Examples of financial markets may include

Stock Markets: NYSE (New York Stock Exchange) and NASDAQ (National Association of Securities Dealers Automated Quotations)
Bond Markets
Currency Markets
Derivative Markets


Figure 6.2.1: New York Stock Exchange

## Financial Intermediaries

Financial Intermediaries (Institutions) act to process transactions between suppliers of capital and demanders of capital in which the financial markets are not efficient. For instance, if I as an individual want to borrow money for a new car, this is not an optimal transaction for a financial market. The number of identical financial securities (my car loan) is one. My personal credit and income characteristics are important, so the supplier of capital will not want to lend me money without investigating these issues. Also, these characteristics are different than the next person that wants to take out a car loan. Because of this, the marketplace approach that works well with stocks and bonds does not work well for transactions in which:

- The number of identical financial securities is small
- The personal characteristics of the buyer (supplier of capital) or the seller (demander of capital) are important to determining the value of the security.
- The supplier or demander of capital needs an additional service other than merely the transfer of cash ⇔ securities.

In these situations, financial intermediaries specialize in efficiently analyzing the information necessary to conduct transactions between suppliers and demanders of capital. In addition, they often issue a different security to the supplier of capital than was issued by the demander of capital. For instance, consider the car loan. The bank gets capital to make car loans from depositors. Depositors (suppliers of capital) put cash into the bank in exchange for checking accounts, savings accounts, and certificates of deposit. The bank pools this capital and lends it back out to the demanders of capital (the person taking out the car loan). By specializing in acquiring deposits, structuring different securities to meet the needs of suppliers of capital vs. demanders of capital, and in evaluating credit risks, the bank moves money from suppliers of capital to demanders of capital more efficiently than a marketplace would for these smaller, individualized transactions.

### Examples of financial intermediaries may include

- Credit Unions
- Commercial Banks
- Mutual Funds
- Life Insurance Companies
- Credit Card Companies

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