

Introduction to Financial System

What is a Financial System? A financial system is a complex network of institutions, markets, and instruments that facilitate the movement of money and capital between different parts of the economy.

This system includes banks, stock markets, bond markets, insurance companies, and other financial entities that play a crucial role in ensuring that money flows smoothly from those who have it (savers or investors) to those who need it (borrowers or businesses).

The primary purpose of the financial system is to facilitate economic activities by ensuring that resources are allocated efficiently. It helps in mobilizing savings, facilitating investments, providing liquidity, and managing risks.

Components of a Financial System:

- 1. Financial Institutions:** These include banks, insurance companies, pension funds, and investment companies that help channel funds between savers and borrowers.
- 2. Financial Markets:** These are platforms where financial assets like stocks, bonds, and currencies are traded. Examples include the stock market, bond market, and foreign exchange market.
- 3. Financial Instruments:** These are the products that are traded in financial markets, such as stocks, bonds, derivatives, and loans. They represent a claim on the future income or assets of the issuer.
- 4. Financial Services:** These include services provided by financial institutions such as investment advice, insurance, banking, and wealth management.

Flow of Funds in a Financial System:

- 1. Savings:**
 - Individuals and businesses save money in various forms like bank deposits, investments in stocks, bonds, or real estate. These savings represent the supply of funds in the financial system.
 - Example: A person deposits money in a savings account or buys shares in a company.
- 2. Intermediation:**
 - Financial institutions like banks, mutual funds, and insurance companies act as intermediaries. They collect money from savers and lend or invest it in businesses or other areas where there is a need for funds.

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 **ICSE**

 **NTSE**

 **Banking & Insurance**

 **Central Govt. Service**

 **State Govt. Services**

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o Example: A bank takes deposits from individuals and uses that money to provide loans to businesses or individuals.

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3. Borrowing:

o Businesses, governments, and individuals borrow money to finance their activities, such as expanding operations, building infrastructure, or buying homes.

 ICSE

o Example: A company issues bonds to raise money for a new project, or a person takes a loan to buy a house.

 NTSE

4. Investment:

o The borrowed money is used to finance productive activities. Businesses may use it to expand their operations, build new factories, or invest in research and development. This investment helps in generating economic growth.

 Banking & Insurance

o Example: A company uses the funds raised from selling bonds to build a new factory, or a government uses borrowed funds to construct roads and bridges.

 Central Govt. Service

5. Returns:

o The investments generate returns in the form of profits, interest, or dividends. These returns are then paid back to the investors or savers, providing them with an incentive to continue investing or saving.

 State Govt. Services

o Example: A company pays dividends to its shareholders from the profits earned, or an individual earns interest on their bank deposit.

 LAW Entrance

6. Reinvestment:

o The returns earned by savers and investors are often reinvested in the financial system, creating a cycle of continuous economic growth and development.

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o Example: A shareholder reinvests the dividends received into more shares, or a depositor reinvests interest earned into a fixed deposit.

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In summary, the financial system is the backbone of any economy, facilitating the flow of funds, supporting economic activities, and contributing to the overall prosperity and stability of the financial environment.

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