Chapter one

THE FINANCIAL SYSTEM

Chapter content

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Introduction to Financial system

Definition:

- ***Financial system*** is a system that aims at establishing and providing smooth, regular, efficient and effective linkage between savers(depositors) and investors(borrowers).
- It is a set of complex and closely connected instructions, practices, agents and claims related to the financial aspects of the economy.
- The financial system moves the economy's scarce resources from savers to borrowers

The Role/Functions of the Financial System

- **Saving Role/Function -** Bonds, stocks, deposits, and other financial claims sold in the money and capital markets provide a profitable, relatively low-risk outlet for the public's savings
- **Liquidity Role/ Function-** The financial system **provides liquidity for savers holding financial instruments but who are in need of money.**
- **Wealth Role/Function -**For the business and individuals choosing to save, the financial instruments sold in the money and capital markets provide an excellent way to store wealth (to preserve value or hold purchasing power) until funds are needed for spending in the future periods.

Role of FS cont'd ....

- **Credit Role/Function-** provide a continuous supply of credit for the business, consumers and governments
- **Payments Role/ Function-**financial assets, mainly checking accounts , debit and credit cards , serve as a medium of exchange in the making of payments
- **Risk Role/Function-** financial system provides a way to diversify risk
- **Policy Role/Function-** financial market has been the principal channel through which the Federal Government has carried out its policy of attempting to stabilize the economy

Goals of the Financial System

1. To facilitate the flow of funds from savers to investors.

- ✓ savers (entities with a surplus of funds)
- ✓ investors (entities with a deficit of funds)

- Ultimate investors *sell financial assets* to savers; they use the proceeds to *buy real assets* (i.e. the same as investment).

Goals ....Cont'd

- Clients or economic units of the financial system are:
  - ***Households***
  - ***Business firms***
  - ***Government***
- Each economic unit must operate with in a budget constraint imposed by its total income for the period.

Goals .....Cont'd

- Agents or economic units can invest using:
  - **Own funds** - by spending accumulated savings. They bypass the FS entirely, except for saving.
  - **Indirect finance** – funds come from financial intermediary, which are then invested.
  - **Direct finance** – fund are provided to the investors directly in financial markets, without the use of financial intermediaries.
    - *Funds are provided by ultimate investors to the firm in need of financing.*

Goals .....Cont'd

2. To allow economic agents to share risks.

- FS provide the transformation of the risk characteristics of assets.

- Financial system perform risk sharing by:
  - *enhancing risk diversification,*
  - *Resolving information asymmetry problem that avoids adverse selection*
  - *reducing information and transaction costs.*

Goals ....Cont'd

3. To generate liquidity.

- Two important notions of liquidity:
  - ***The market liquidity of an asset:***
    - Is the ease with which it may be traded.
    - Financial markets enhance market liquidity.
  - ***Funding liquidity :***
    - Is the ability of an entity to come up with cash on short notice.
    - The FS supplies this liquidity

Financial Assets and their characteristics

- **Financial assets**, often called **financial instruments**, are intangible assets, which are expected to provide future benefits in the form of a claim to future cash.
- Assets owned by a given company can be classified as either **real asset** or **financial asset**

Real Assets

- The material wealth of a society is determined ultimately by the productive capacity of its economy
- This productive capacity is a function of the **real assets** of the economy.

Real assets …Cont'd

- Examples are land, building, knowledge, machines, inventions, business plans, goodwill, etc
- A **real asset** is anything that generates a flow of goods or services over time.

Financial Assets

- A **financial asset** is a legal contract that gives its owner a claim to payments, usually generated by a real asset.
- Financial instruments are no more than sheets of paper.
  - *Their value is derived from the value of the underlying real assets.*
    - Examples include *stocks, bonds, bank deposit, bank loans, options, futures, etc.*

Financial Assets …Cont'd

- Unlike real assets, financial assets
  - *do not represent a society's wealth;*
  - *do not contribute directly to the productive capacity of the economy.*
  - *Instead they are claims to the income generated by real assets or claims on the income from the government.*
  - *They are a means by which individuals hold their claims on real assets.*
  - *They does not depreciate*

Properties of Financial assets

- **Currency:** Financial Assets are exchange documents with an attached value
- **Divisibility:** Financial Instruments are divisible into smaller units
- **Convertibility:** Financial Assets are convertible into any other type of asset
- **Reversibility:** the new converted (formed) asset may be transferred back into the original financial instrument.
- **Liquidity :** Financial assets can be converted to cash without significant loss
- **Cash Flow:** The holding of the financial instrument results in a stream of cash flows

Cont'd.....

- According to the **structural approach,** the financial system of an economy consists of three main components:

1. Financial markets
2. Financial intermediaries (institutions)
3. Financial regulators

- **Financial markets** are markets where people buy and sell financial instruments like stocks, bonds and future contracts.

Cont'd.....

- Financial markets provide the following three major economic functions:
  - *Price discovery*
  - *Liquidity*
  - *Reduced transaction cost-* ***reduce search cost & information costs***
  - Financial markets are classified into **money markets versus capital markets**, **cash versus derivative markets**, **primary versus secondary markets**, and **exchange-traded versus over-the-counter markets.**

Cont'd.....

- **Financial institutions** are what make financial system work. They facilitate the flow of funds:
  - *by selling financial claims to generate funds &*
  - *use the money to buy financial claims of economic units, there by funding them.*
  - These are banks, insurance companies, investment banks, pension funds, credit unions

Cont'd.....

- **Regulators of financial activities:** they play a major role in keeping the health of financial system of a given economy.

- They are government and other related bodies who sets different rules and regulations for the participants of the financial system and also they monitor every aspect of the system.