**Mohamed Khaider University, Biskra**

**Faculty of Economics, Commerce and Management Sciences**

**Commerce Department**

**Module:** English
**Branch:** Finance and International Trade
**Level:** Second year Master

# Lecture 01: The Financial System

## Learning Objectives

After teaching this Lecture the Students should be able to:

- *Define the Financial System*

- *Identify the Elements that make up the financial System*

- *Name and define the Sectors of the Economy that constitute the Savers and Borrowers*.

The Lecture is about the Fundamentals of the financial System. It is an attempt to explicate this System by going back to the basics, and it is better to show and illuminate its Components. The following definitions cover the essence of the financial system

## 1- Defining the financial System

The financial System is a set of arrangements embracing the lending and borrowing of funds by non-financial economic units and the intermediation of this Function by financial intermediaries so as to facilitate the transfer of funds, to create Money when required, and to create markets in debt and equity instruments (and their derivatives) so that the price and allocation of funds are determined efficiently. A financial system consists of institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment and providing facilities, including payment systems, for the financing of commercial activity. The role of financial institutions within the system is primarily to intermediate between those that provide funds and those that need funds, and typically involves transforming and managing risk. Particularly for a deposit taker, this risk arises from its role in maturity transformation, where liabilities are typically short term (for example, demand deposits), while its assets have a longer maturity and are often illiquid (for example, loans). Financial markets provide a forum within which financial claims can be traded under established rules of conduct and can facilitate the management and transformation of risk.

From the above definitions we could say:

- The Lenders and Borrowers, i.e. the non-financial economic units that undertake the lending and borrowing process.

- The financial Markets, i.e. the institutional arrangements that exist for the issue and trading (dealing) of the financial instruments.

- The financial intermediaries, which intermediate the lending and borrowing process, meaning that they interpose themselves between the lenders and borrowers

- The financial Instruments which are created to satisfy the needs of the various participants.

**2- Flows of Funds through the financial System**

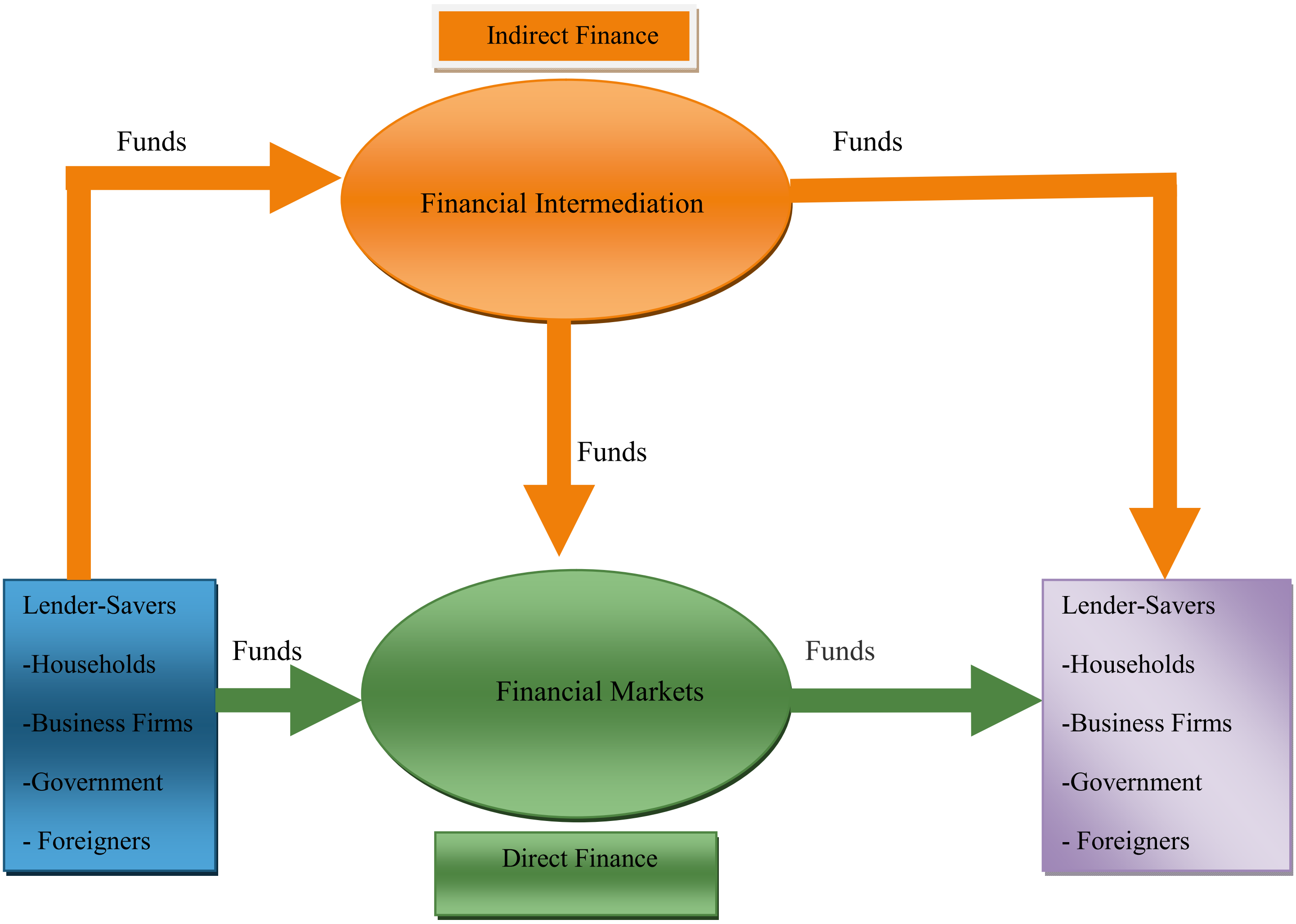


**Figure 01**: Flows of Funds through the financial System

From the above figure we could say that those who have saved and are lending funds, the lender-savers, are at the left, and those who must borrow funds to finance their spending, the borrower-spenders, are at the right. The principal lender-savers are households, but business enterprises and the government (particularly state and local government), as well as foreigners and their governments, sometimes also find themselves with excess funds and so lend them out.

The most important borrower-spenders are businesses and the government (particularly the federal government), but households and foreigners also borrow to finance their purchases of cars, furniture, and houses. The arrows show that funds flow from lender-savers to borrower-spenders via two routes (Financial Intermediation and Financial Markets).

3- **Key Terms to learn**

**-** Lend (v): makes funds available to a person or business with the expectation that the funds will be repaid. Repayment will include the payment of any interest or fees.[1]

- Borrow (v): To ask for an amount of money from somebody or something that you intend to give back, usually after a period of time.

- Funds: A fund is a pool of money that is allocated for a specific purpose.

- Debt and Equity instruments: Debt is something, usually money, borrowed by one party from another. A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date, usually with interest. Equity, typically referred to as shareholders' equity (or owners' equity for privately held companies), represents the amount of money that would be returned to a company's shareholders if all of the assets were liquidated and all of the company's debt was paid off in the case of liquidation. In the case of acquisition, it is the value of company sale minus any liabilities owed by the company not transferred with the sale.

- Financial institutions: A financial institution (FI) is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, and currency exchange.

- Deposit: means money held at a bank. It is a transaction involving a transfer of money to another party for safekeeping.

- Liabilities: A liability is something a person or company owes, usually a sum of money. Liabilities are settled over time through the transfer of economic benefits including money..

- Assets: An asset is a resource with economic value that an individual, firm, or country owns or controls with the expectation that it will provide a future benefit

- Loans: a sum of money that is lent to another party in exchange for future repayment of the value or principal amount.

- Save (v): To keep or not spend money so that you can use it later. A savings account is an interest-bearing deposit account held at a bank or other financial institution. Though these accounts typically pay a modest interest rate, their safety and reliability make them a great option for parking cash you want available for short or long-term needs. Saving for a short or long-term goal like buying a car or going on vacation, or simply sweeping surplus cash you don't need in your checking account so it can earn more interest elsewhere.

- Spending: To give or pay money for something.

- Households: Family members, individuals

- Business enterprises: A business is defined as an organization or enterprising entity engaged in commercial, industrial, or professional activities.

- Government: A group of people who legally control and run a country

- Foreigner: A person or Firm that belongs to a country that is not your own

- Excess funds: A surplus describes a level of an asset that exceeds the portion used.

- Purchase: as a verb means the act of buying something and as a noun means the thing that you buy

- Financial Intermediation: A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund..