Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: International Trade
Level: Third year Bachelor

Lecture 04: An overview of 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

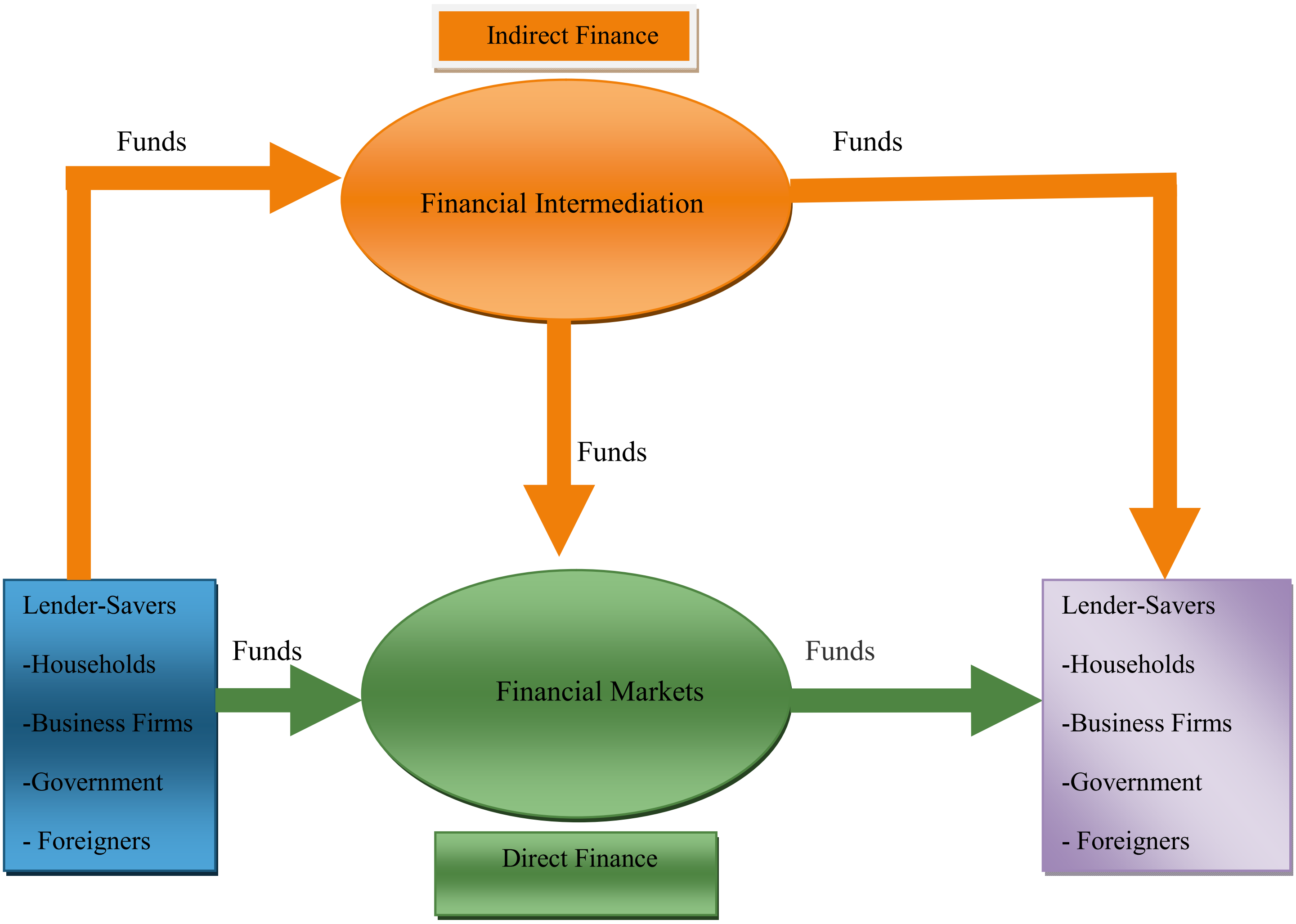

Figure 01: Flows of Funds through the financial System

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).