UNIT-4

A financial system **refers to the** complex network of institutions, markets, instruments, and practices that facilitate the flow of funds between savers, investors, and borrowers within an economy. It encompasses all mechanisms through which financial resources are mobilized, allocated, and utilized to support economic activities.

What are the role of financial system?

The financial system plays a crucial role in the development and smooth functioning of an economy. Its roles can be summarized as follows:

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1. Mobilization of Savings

- Encourages individuals and institutions to save money.
- Channels savings from households (surplus units) to businesses and government (deficit units) for productive use.

2. Allocation of Resources

- Ensures that funds are invested in the most productive projects.
- Helps in prioritizing sectors that contribute to economic growth.

3. Facilitation of Payments

- Provides mechanisms for smooth transactions through banking services, digital payments, and settlements.
- Ensures efficiency in trade and commerce.

4. Risk Management

- Provides instruments like insurance, derivatives, and hedging tools to protect against financial losses.
- Helps businesses and individuals manage uncertainty.

5. Liquidity Provision

- Makes it easier to convert assets into cash quickly.
- Provides flexibility to investors and businesses in meeting short-term financial needs.

6. Price Discovery

- Financial markets help determine the price of financial assets through demand and supply mechanisms.
- Ensures transparency in pricing of stocks, bonds, and commodities.

7. Promotion of Economic Growth

- By efficiently mobilizing and allocating funds, the financial system supports industrial expansion, infrastructure development, and overall economic progress.

8. Supporting Monetary Policy

- Acts as a channel for implementing central bank policies, like controlling inflation, interest rates, and money supply.

The **financial system** is structured to connect **savers (surplus units)** with **borrowers (deficit units)** through various institutions, markets, and instruments. Its structure can be understood in terms of **components** and **functional classification**.

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1. Structure of Financial System

The financial system can be broadly divided into the following components:

A. Financial Institutions

These are intermediaries that channel funds from savers to borrowers. They are of two types:

1. Banking Institutions
   - Commercial banks, cooperative banks, regional rural banks.
   - Accept deposits and provide loans.
2. Non-Banking Financial Institutions (NBFIs)
   - Finance companies, insurance companies, pension funds, mutual funds.
   - Provide credit, investment, and risk management services.

B. Financial Markets

Markets where financial instruments are issued, traded, and priced. Types include:

1. Money Market – Short-term funds (up to 1 year)
   - Treasury bills, commercial papers, call money.
2. Capital Market – Long-term funds (more than 1 year)
   - Primary Market: New securities are issued (IPOs).
   - Secondary Market: Existing securities are traded (stock exchanges).
3. Derivative Market – Futures, options, and swaps for risk management.

C. Financial Instruments

- Instruments that represent claims on money or assets:
  - Equity instruments – Shares, stocks.
  - Debt instruments – Bonds, debentures, loans.
  - Hybrid instruments – Convertible bonds, preference shares.

D. Regulatory and Supervisory Bodies

- Ensure stability, transparency, and efficiency of the system:
  - Central banks (e.g., RBI in India)
  - Securities regulators (e.g., SEBI)
  - Insurance regulators (e.g., IRDAI)

E. Financial Services

- Activities that facilitate smooth functioning of financial markets and institutions:
  - Fund transfer, portfolio management, advisory services, factoring, leasing, credit rating.

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2. Summary Diagram of Financial System Structure

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Financial System
│
├── Financial Institutions
│   ├── Banking Institutions
│   └── Non-Banking Financial Institutions
│
├── Financial Markets
│   ├── Money Market
│   ├── Capital Market
│   └── Derivative Market
│
├── Financial Instruments
│   ├── Equity
│   ├── Debt
│   └── Hybrid
│
├── Regulatory Bodies
│
└── Financial Services
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The **financial system** plays a vital role in **economic development** because it acts as the backbone for mobilizing resources, allocating capital efficiently, and supporting productive activities. Here's a detailed explanation:

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1. Mobilization of Savings

- A developed financial system encourages individuals and institutions to save money by offering secure and profitable avenues (banks, mutual funds, insurance, etc.).
- These savings are then pooled and made available for investment in productive sectors like industry, agriculture, and infrastructure.

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2. Efficient Allocation of Resources

- The financial system ensures that funds are directed toward the most productive investments.
- Helps prioritize sectors that generate higher returns and contribute to economic growth.
- Reduces wastage of resources by providing credit based on risk assessment and project viability.

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3. Promotion of Investment

- Availability of funds through banks, capital markets, and financial institutions enables businesses to expand operations.
- Encourages entrepreneurship and innovation, which leads to industrialization and economic diversification.

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4. Facilitation of Trade and Commerce

- Payment systems, credit facilities, and banking services smoothen business transactions.
- Reduces transaction costs, promotes efficiency, and increases economic activity.

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5. Risk Management

- Financial instruments like insurance, derivatives, and hedging tools help manage uncertainties.
- Reduces financial losses for businesses, encouraging them to take productive risks that stimulate economic growth.

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6. Price Discovery and Information

- Financial markets provide information about the cost of capital and investment opportunities.
- Helps businesses and policymakers make informed economic decisions.

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7. Employment Generation

- Investment financed through financial systems leads to industrial and commercial expansion.
- This creates jobs in various sectors, contributing to social and economic development.

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8. Support for Government Policies

- Financial institutions help implement fiscal and monetary policies by mobilizing resources for development projects.
- Enables funding of infrastructure, education, health, and other sectors crucial for growth.