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Saving, Investment, and the Financial System

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Abstract: *The financial system is a collection of economic organizations that assist in matching one person's savings with another's investment. It transfers scarce resources from savers to borrowers in the economy. A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds.*

Keywords: financial system

I. INTRODUCTION

The relation between money and what it will buy has always been a central issue of monetary theory. The contrast economists make between face (or nominal) values and real values—that is, between official values given in current dollars, pesos, pounds, yen, euros, and so on, and the same amounts modified by the price level—is critical to comprehending this subject. The latter is a "real" value, which refers to the amount of products, services, and assets that money can purchase. This can also be referred to as the money stock's true purchasing power.

- The financial system consists of the group of institutions in the economy that help to match one person's saving with another person's investment.
- It moves the economy's scarce resources from savers to borrowers.
- Describe the economic role of the financial markets and financial intermediaries.
- Know the sources of national savings.
- Understand the relationship between national saving and investment.
- Use the loanable funds model to understand the determination of the real interest rate and the impact of some policy actions
- Analyze the impact of fiscal deficits on interest rates.

What Is Saving?

People save money for both purchases and in case of emergencies. Saving is an essential part of personal finance that involves setting aside money for future use. Think of it as putting your money in a piggy bank, but instead of an actual piggy bank, you can use a savings account or a certificate of deposit (CD) that earns interest over time. You can save for different reasons, such as buying a new gadget, going on a vacation, or having an emergency fund for unexpected expenses.

Saving is an excellent way to meet short-term financial goals and prepare for unexpected situations, such as a car repair or medical bills By putting aside money regularly, you can build up a cushion that can help you weather tough times. Savings are generally low-risk, meaning your money is safe, but the interest rates received are also low.

Savings is the money kept aside after the expenses of an individual. It is the leftovers of the money after covering all his expenses of him. this is usually set aside by individuals in case of meeting an emergency which arises due to undesirable occurrence of events. Savings are mainly chosen by individuals who are not interested to take the risk and will require money every short interval.

Example:

One example of saving is setting aside a portion of your allowance or paycheck into a savings account every month. Let's say you want to save $1,000 for a new laptop, and you have ten months to do so. By setting aside $100 each month, you can reach your goal without having to pay interest on a loan or a credit card.

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What Is Investing?

Investing is a way to grow your money over time by putting it to work in financial instruments such as stocks, bonds, and mutual funds. Unlike saving, investing involves taking on some risk, but it also has the potential to earn higher returns over the long term.

Investing is a way to reach long-term financial goals, such as saving for college, a down payment on a house, or retirement. Because investing involves taking on some risk, it's essential to choose investments that align with your goals, risk tolerance, and time horizon. In general, the longer you can invest, the more risk you can take on, because you have more time to ride out the ups and downs of the stock market.

For instance, let's say you want to invest in a company like Apple. By buying shares of its stock, you own a tiny piece of the company and can benefit from its growth and profits. If Apple performs well, the value of its stock could increase over time, allowing you to sell it for a profit.

Example:

Using a 401(k) retirement plan is a good example of investing as it involves setting aside a portion of your income to invest in a diversified portfolio of stocks, bonds, and other financial instruments with the goal of growing your savings over time.

The Meaning of Saving and Investment:

Saving and investment are two ways to use your money for a purchase or goal down the road. Saving is setting aside income for future use and not using it for consumption. Saving is done for shorter-term needs where protecting and accessing your money easily are important. Investment is the process of investing funds in capital assets, such as buildings, equipment, and inventories, to generate returns.

National Saving

National saving is the total income in the economy that remains after paying for consumption and government purchases.

Private Saving

Private saving is the amount of income that households have left after paying their taxes and paying for their consumption.

Private saving = (Y – T – C)

Public Saving

Public saving is the amount of tax revenue that the government has left after paying for its spending.

Public saving = (T – G)

Saving and investment in the national income accounts: How saving and investment are measured in GDP, the relationship between saving and investment in a closed economy, and the role of net exports in an open economy.

The market for loanable funds: How the supply and demand of loanable funds determine the real interest rate, the factors that can shift the supply and demand curves, and the effects of government policies on saving, investment, and the interest rate.

The financial system: The different types of financial assets and institutions, the functions and characteristics of banks and other intermediaries, and the causes and consequences of financial crises.

The bond market and the stock market: How bonds and stocks are valued, the trade-off between risk and return, the role of ratings agencies and bond auctions, and the factors that influence stock prices.

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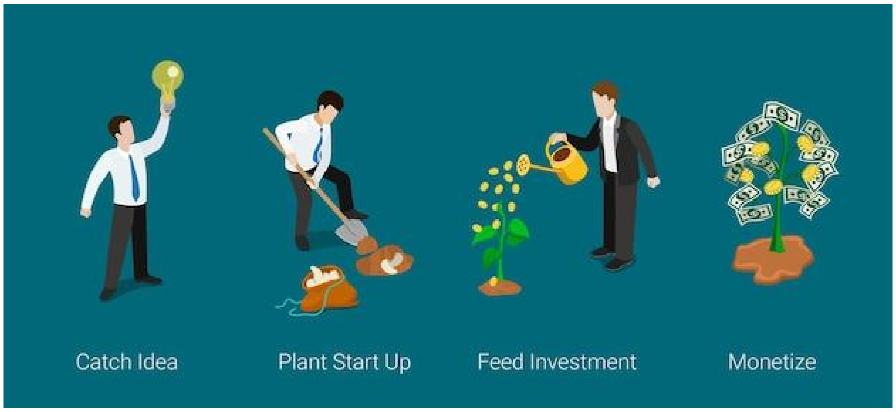

Financial Markets

The Stock Market

Stock represents a claim to partial ownership in a firm and is therefore, a claim to the profits that the firm makes.

The sale of stock to raise money is called equity financing.

Compared to bonds, stocks offer both higher risk and potentially higher returns.

The most important stock exchanges in the United States are the New York Stock Exchange, the American Stock Exchange, and NASDAQ.

When you hear a stock has lost or gained X number of points, it's the same as saying the stock has lost or gained X number of dollars; one point equals one dollar.

Since points represent actual dollar amounts, two stocks can rise or fall the same number of points—but register different percentage gains or losses.

These stock points are not the same as basis points for bonds, or currencies.

Index points are based on the relative movement of the components in the index.

Stock markets are venues where buyers and sellers meet to exchange equity shares of public corporations.

The Bond Market

The bond market is a marketplace where investors buy debt securities that are brought to the market by either governmental entities or corporations. Debt securities are contracts that promise to repay a certain amount of money with interest over a period of time. The bond market is global and operates over the counter through broker/dealers. The bond market is used to finance infrastructural improvements, pay down debts, and raise capital.

Characteristics of a Bond:

Term: The length of time until the bond matures.

Credit Risk: The probability that the borrower will fail to pay some of the interest or principal.

Tax Treatment: The way in which the tax laws treat the interest on the bond.

Municipal bonds are federal tax exempt.

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Meaning of Financial System

The financial system is a system that facilitates the movement of funds among people in an economy. It is simply a means through which funds are exchanged between investors, lenders, and borrowers. A financial system is composed of various elements like financial institutions, financial intermediaries, financial markets, and financial instruments which altogether facilitate the smooth transfer of funds.

This system exists at the regional, national, and international levels. It is an efficient tool that helps in the economic development of a country by linking savings and investments thereby leading to wealth creation. The financial system acquires money from people who are keeping it idle and distributes it among those who use it for yielding income and generates wealth in the country.

Most financial systems contain elements of both give-and-take markets and top-down central planning. For example, a business firm is a centrally planned financial system with respect to its internal financial decisions; however, it typically operates within a broader market interacting with external lenders and investors to carry out its long term plans.

A financial system is the set of global, regional, or firm-specific institutions and practices used to facilitate the exchange of funds.

Financial systems can be organized using market principles, central planning, or a hybrid of both.

Institutions within a financial system include everything from banks to stock exchanges and government treasuries.

FINANCIAL SYSTEM OBJECTIVES

On completion of reading of this Unit, you will be able to:

A state the meaning and structure of the financial system,
Explain the concepts, techniques and theories of the financial system,
Describe the impact of financial development on economic development, and,
Explain the evolution of policies on financial development especially since the beginning of liberalization.
To provide a structured system of payment
To give money the time value it deserves
To eliminate risks and compensate for them through the provision of goods and services
To enable the most efficient economic resource allocation
To ensure market stability in the economy
To provide a structured system of payment
To give money the time value it deserves
To eliminate risks and compensate for them through the provision of goods and services

Advantages of Financial system

Provides Payment System: The financial system provides a payment mechanism for the smooth flow of funds among peoples in an economy. Buyers and sellers of goods or services are able to perform transactions with each other due to the presence of a financial system.

Links Savers and Investors: The financial system serves as a means of bridging the gap between savings and investment. It acquires money from those with whom it is lying idle and transfers it to those who need it for investing in productive ventures.

Minimizes Risk: It aims at reducing the risk by diversifying it among a large number of individuals. The financial system distributes funds among a large number of peoples due to which risk is shared by many peoples.

Helps in Capital Formation: The financial system has an efficient role in capital formation of the country. It enables big corporates and industries to acquire the required funds for performing or expanding their operations thereby leading to capital formation in the nation.

Disadvantages of Financial system

Lack of Co-ordination among financial institutions: The financial system faces a lack of coordination among various financial institutions. The presence of a large number of financial institutions and government roles in controlling authorities of these institutions leads to a lack of coordination.

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Monopolistic Market Structure: Many institutions in the Indian financial system occupy a monopolistic position in the market. LIC and UTI are two institutions that have grabbed a large part of the life insurance business and the mutual fund industry. These large structures could lead to mismanagement or inefficiency of funds.

High Rate of Interest: There is a possibility of the high-interest rate charged by several financial institutions in the financial system of our country. Various institutions due to their monopolistic structure in the market may charge high or unfair interest rates.

Inactive Capital Market: Our country's financial system faces the problem of the inactive capital market. All corporates in India are mostly able to acquire funds through development banks and do not need to go to the capital market.

The Financial System, Saving and Investment Relationship

Saving and investment have a positive relationship in the financial system.

It's easy to become confused between the concepts of saving and investing. Most individuals use both of these phrases interchangeably. However, in economics, they are not always the same thing.

Anna could consider what she is doing with her money an "investment." Still, an economist might consider what she is doing to be saving rather than an investment.

As both saving and investment are equal in an economy, they have a positive relationship with one another. If the amount of savings was to increase, it would also lead to an increase in investment.

An important controversy in macroeconomics relates to the relationship between saving and investment.

Many economists before J.M. Keynes were generally of the view that saving and investment are generally not equal; they are equal only under condition of equilibrium.

Keynes in his famous work "General Theory of Employment, Interest and Money" put forward the view that saving and investment are always equal.

Savings and the Financial System - Key takeaways

The term savings refers to the dollars made available due to individuals foregoing some of their consumption

A financial system refers to a set of institutions such as banks, insurance companies, etc., that enable the efficient channeling of funds from savers to investors.

Financial assets are non-physical assets that gain value from a contract you make with the other party.

Financial intermediaries are financial institutions such as banks that help transfer funds from lenders to borrowers.

The term investment comes from the field of macroeconomics and refers to the act of purchasing new forms of capital, such as machinery or real estate.

Saving money means storing it safely so that it is available when we need it and it has a low risk of losing value.

Investment comes with risk, but also the potential for higher returns.

Investing typically often comes with a longer-term horizon, such as for children's college funds or one's retirement.

Both saving and investing are key pieces to one's personal finances.

SUMMARY

The U.S. financial system is made up of financial institutions such as the bond market, the stock market, banks, and mutual funds.

All these institutions act to direct the resources of households who want to save some of their income into the hands of households and firms who want to borrow.

National income accounting identities reveal some important relationships among macroeconomic variables.

In particular, in a closed economy, national saving must equal investment.

Financial institutions attempt to match one person's saving with another person's investment.

National saving equals private saving plus public saving.

A government budget deficit represents negative public saving and, therefore, reduces national saving and the supply of loanable funds.

When a government budget deficit crowds out investment, it reduces the growth of productivity and GDP.

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