FINANCIAL SYSTEM AND ITS COMPONENTS

Meaning of Financial System

- A Financial system is a network of financial institutions, financial markets, financial instruments, and financial services to facilitate the transfer and allocation of funds efficiently.
- According to Prasanna Chandra: the financial system consists of a variety institution, markets, and the instruments which are related in a systematic manner and provide the principal means by which savings are transformed into investments.
- It helps to transfer funds from individual and groups who save money to individuals and group who want to borrow money.
- The financial system also includes sets of rules and practices that borrowers and lenders use to decide which projects get financed, who finances projects, and terms of financial deals.
- It gives investors the ability to grow their wealth and assets.
- To attain economic development, financial systems are important since they induce people to save by offering attractive interest rates. These savings are then channelized by lending to various business concerns which are involved in production and distribution.

Functions of the Financial System

1) Intermediation and Resource Allocation

The financial system acts as an intermediary between those who have excess funds (savers) and those who need funds (borrowers). Financial institutions, such as banks, facilitate this process by accepting deposits from savers and providing loans or credit to borrowers. This intermediation function ensures efficient allocation of resources within the economy. It allows individuals and businesses to access capital for various purposes, such as investments, entrepreneurship, or consumption.

2) Facilitation of Payments and Settlements

The financial system provides the infrastructure for the efficient transfer of funds and settlement of transactions which is crucial for the smooth functioning of economic activities. This includes payment systems, electronic funds transfers and various mechanisms, checks, credit cards etc. Individuals and businesses rely on the financial system to make and receive payments securely and quickly.

Structure of Financial System

In most of the developing countries like India there is co-existence & co-operation between the organised/formal &unorganised/informal financial sectors. This is known as financial dualism.

Difference between organised and unorganised financial system

In the organized financial system, institutions operate within a formal regulatory framework, such as banks, stock exchanges, and financial intermediaries. These entities are subject to comprehensive oversight by regulatory bodies like the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). The organized system tends to be more extensive, providing a range of financial products and services to a diverse population. Less risky as govt regulated.

On the other hand, the unorganized financial system comprises informal entities that operate with no regulatory scrutiny. This sector includes local money lenders, chit funds, and microfinance institutions, often catering to specific communities or regions. The unorganized system may lack the formal structures and regulatory oversight found in the organized sector, making it riskier.

Efforts are ongoing to bridge the gap between these sectors, bringing the unorganized financial system into the formal fold to enhance financial inclusion and regulatory control.