

The Financial System

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- Savers:

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- Smoothing consumption

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 - Reducing risk

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 - Working capital

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- Savers:
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- Borrowers
 - Working capital
 - New capital equipment

Circular flow

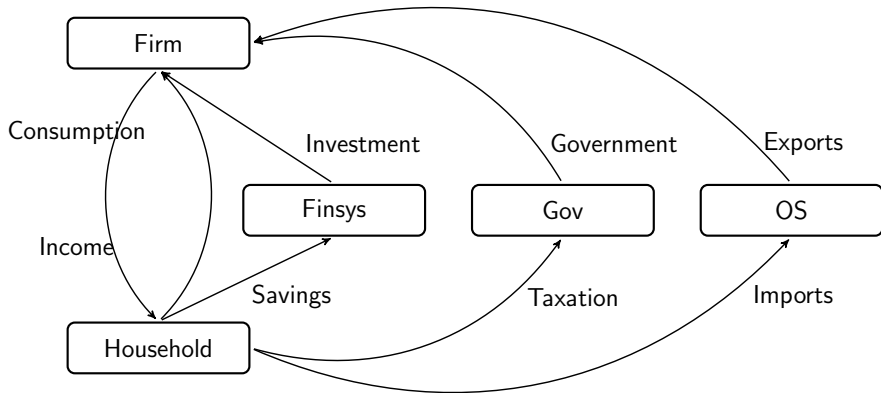


Figure : Circular flow of income

Financial institutions

■ Financial markets

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- Financial markets
- Stock market

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- Bond

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- Financial intermediaries

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- Securitisation

Savings and GDP

Recall, total expenditure in the economy

$$Y = C + I + G + NX \quad (1)$$

For a closed economy, this becomes

$$Y = C + I + G \quad (2)$$

Investment

To understand more about the role of financial markets, take C and G from each side of Equation 2

$$Y - C - G = (C - C) + I + (G - G)$$

$$Y - C - G = I$$

Investment is equal to the income left after consumption and government spending have taken place

National savings

Savings are the income after consumption and government spending. Therefore,

$$S = I$$

$$S = Y - C - G$$

Composition of national savings

Let T be the amount that the government takes from households in taxes less the amount that the government pays in benefits. Add and subtract T from Equation ??,

$$S = \underbrace{(Y - T - C)}_{\text{Private Savings}} + \underbrace{(T - G)}_{\text{Public Savings}} \quad (3)$$