

The flow of funds system

What is it?

- The flow of funds is a system of social accounting that permits financial market analysts to evaluate the flow of savings through various sectors of the economy.
- It enables us to analyze saving-deficit sectors and the means by which they finance the excess of their investment in real assets over saving, together with the behavior of saving surplus sectors and the way they invest in financial markets.

How it works?

1. Divide the economy into a workable number of sectors:
 - Households and non-profit organizations
 - Non-financial businesses
 - Government
 - Banking system (includes the central bank)
 - Nonbank finance
 - Rest of the world
2. Start with a balance sheet and prepare source and use of funds for each sector

<i>Assets</i>	<i>Liabilities & SHE</i>		<i>Uses</i>	<i>Sources</i>
Money	Financial liabilities	→	Δ Money	Δ Financial liabilities
Financial assets			Δ Financial assets	
Real assets	Net worth		Δ Real assets	Δ Net worth

How it works? (cont'd)

3. Create a matrix of (net) flow of funds for the entire economy

Let's see an example for a closed economy:

	Households		Business firms		Financial institutions		Governments		All sectors		
	U	S	U	S	U	S	U	S	U	S	
Net worth (savings)		101		77		4			-3		179
Real assets (investments)	82		96		1				179		
Money	2		2			5	1		5		5
Other financial assets	37		18		60		17		132		
Financial liabilities		20		39		52		21			132
	121	121	116	116	61	61	18	18	316	316	

Mainly serve as intermediaries:
Financial assets and liabilities
almost cancel each other out.

Money is a liability item
for central banks

The gov't is
running on a
budget deficit

Savings = Investments for
the economy as a whole,
but not within sectors.