Impact of Commercial Banks in Economic Growth and Development

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Abstract: The main objective of the thesis is to critically examine and analyse the effect of Commercial Banks in Economic Development. All sectors of the economy work in an inter-related and inter-dependent whole, therefore any malfunction of one or more sectors of the economy automatically affect the economy as a whole and so it is with the banking sector. Banks have always play an important role in a country’s economy all over the world irrespective of it economic and political policies. They are acting not only as the custodian of the wealth of the country but are also major contributors to economic development of countries all over the world. Commercial banks are involved in the process of increasing the wealth of the economy, particularly the capital goods needed for raising productivity so both developed and developing countries considers the service of the banking sector to enable its economy attain economic growth and development. According to Schumpeter (1934), commercial banking is one of the key agents in the whole process of growth and development of countries’ economies all over the world. Thus, the role of commercial bank in transforming the economic framework of countries all over the world cannot be over-emphasized. Therefore, achieving sustained economic growth and development within any economy can be possible amidst strongly to financial institution and precisely within the existence of a virile banking system.

Keywords: Bank, Central Bank, Commercial Bank, Development, Economic Growth, Fiscal Policy, Instruments, Monetary Policy.

1. INTRODUCTION
1.1 Background of the Study

It is well acknowledged in economics, Management, Business administration etc. that deposit taking banking institutions play a major role in promoting economic development through channelling of funds from those with excess to those in need for investment purposes. Scholars all over the world have asserted that there is close connection between commercial bank and economic growth and development. This is because, ordinarily, by the role and services commercial banks play which by simple mathematical logic would increase the GDP of a country. It is well acknowledged in economics literature that Central Bank of a country irrespective of the country’s economic or political policies play a major role in promoting economic development through the functions and services it renders.
However, for banks to be effective in fostering economic growth and development, it is important that the functions and services they provide to sectors of the economy that are essential for growth and development can act as catalysts to stimulate it. Furthermore, it is fundamental that banks effectively manage various risks that they are exposed to, in order to remain solvent in the end and be in a position to provide long-term capital to private and public sectors, which is more essential for economic growth and development.

Thus, for an economy to grow, it should have a well-developed and stable banking system that is resilient to external shocks to effectively play the role of financial intermediation, growth and development. The trust of the research work is to critically examine and analyse the effect of Commercial Banks in Economic growth and Development.

1.2 Statement of the Research Problem

The commercial banks all over the world are the common suppliers of funds for supporting domestic economic activities. Economist has acknowledged that the banking sector registers improved performance to growth and development at all the time. Whatever the case may be commercial Banks of all countries play a very significant role in the development of every economy. Empirical works that focused explicitly on banking sector performance and economic growth have yielded mixed results. Some of these works suggest that banking sector performance has affected positively and significantly on economic growth (see; Adelakun, 2010) while others reported an insignificant relationship between banking sector performance and economic growth (See. Ekpeyong & Acha, 2011; Odeniran & Udeaja, 2010).

However, other financial institutions such as pension funds, unit trusts and insurance companies also play a role in providing funds for domestic investment purposes, in that they also create a platform for raising domestic savings for economic growth and development. The role of non-banking financial institutions in providing funds for domestic investment is, however limited. This has therefore placed greater expectation on commercial banks to provide domestic credit that can stimulate the growth of the economy. Whatever the case may be commercial Banks of all countries play a very significant role in the development of every economy by mobilizing resources for productive investments.

1.3 Objectives of the Study

The overall objective of this study is to investigate how commercial banks’ performance affects economic growth. The study strives to accomplish the following specific objectives:

- To ascertain extent the Commercial Banks play major role in supplying liquidity to financial markets.
- To ascertain the impact of Commercial Banks on economic growth and development.

2. LITERATURE REVIEW

2.1 Theoretical Framework

Commercial banks are the most important components of the whole banking system. A commercial bank is an institution that provides services such as accepting deposits, providing business loans, and offering basic investment products. The main function of commercial bank is to accept deposit from the public for lending money to the borrowers. Commercial bank can also refer to a bank, or a division of a large bank, which more specifically deals with deposit and loan services provided to corporations or large/middle-sized business - as opposed to individual members of the public/small business. A commercial bank is almost certainly the type of bank you think of when you think about a bank because it is the type of bank that most people regularly use. The commercial banks activities are monitored and regulated by the Central Banks.

Commercial Banks are probably the largest source of financing for private capital investment in the country. A capital investment is the purchase of an asset with the intention of you either generating income from the asset, the asset appreciating over time, or both. Common capital purchases made by businesses include things like plants and equipment. A commercial bank is authorized to receive deposits, Disburse payments, Act as your agent to collect funds from another bank payable to you, Invest funds in securities for a return, Safeguard money etc. In fact, a commercial bank is a profit-based
financial institution that grants loans, accepts deposits, and offers other financial services, such as overdraft facilities and electronic transfer of funds.

Banks as financial intermediaries are expected to provide avenue for people to save incomes not expended on consumption. It is from the savings they so accumulate that they are expected to extend credit facilities to entrepreneurs and other industrialist. In other words, commercial banks are financial institutions that accept demand deposits from the public, transfer funds from the bank to another, and earn profit. According to Culbertson, “Commercial Banks are the institutions that make short make short term bans to business and in the process create money.”

The banking system is a catalyst and engine of growth that is responsible for being a life wire to every sector of the economy. It is evident that no sector in the economy can flourish or prosper without the support and services of the banking sector weather agricultural sector, manufacturing sector, mining or even services sector cannot do without banks. Commercial banks provide and encourage savings so the establishment of commercial bank especially in the rural areas makes savings possible; hence, accelerating economic development.

This paper describes the roles and functions of the Commercial Banks in promoting economic growth and development.

2.2 Commercial Banks

The name bank derives from the Italian word banco,"banko" "desk/bench", used during the Renaissance era by Florentine bankers, who used to carry out their transactions on a desk covered by a green tablecloth. However, traces of banking activity can be found even in ancient times. A commercial bank is a financial institution, which performs the functions of accepting deposits from the public and giving loans for investment with the aim of earning profit. In fact, commercial banks, as their name suggests, axe profit-seeking institutions, i.e., they do banking business to earn profit. Commercial banks play an important and active role in the economic development of a country. If the banking system in a country is effective, efficient and disciplined it brings about a rapid growth in the various sectors of the economy.

Commercial Banks generally finance trade and commerce with short-term loans. They charge high rate of interest from the borrowers and pay much less rate of Interest to their depositors with the result that the difference between the two rates of interest becomes the main source of profit of the banks. Their main objectives were to encourage local investors, support budding entrepreneurs and hence foster growth and development. In addition, the role of Commercial Banks in the Economic Development of a Country are promoting capital formation, accept deposits from individuals etc.

Commercial banks are regulated by the Central Banks in their respective countries. Central banks act as the supervisor of commercial banks, and they impose certain regulations to ensure banks operate within the stipulated rules. For example, central banks make it mandatory for commercial banks to maintain bank reserves with them. Some central banks set the minimum bank reserves, and this requires banks to keep a particular percentage of their customer deposits at the central bank. The reserves help to cushion banks against unexpected events like bank runs and bankruptcy.

A commercial bank is a financial institution that grants loans, accepts deposits, and offers basic financial products like savings accounts and certificates of deposit to individuals and businesses. It makes money primarily by providing different types of loans to customers and charging interest. The bank’s funds come from money deposited by the bank customers in saving accounts, checking accounts, money market accounts and certificates of deposit (CDs). The depositors earn interest on their deposits with the bank. However, the interest paid to depositors is less than the interest rate charged to borrowers. Some of the loans offered by a commercial bank include motor vehicle loans, mortgages, business loans, and personal loans. Commercial bank is borrowing and lending, i.e., acceptance of deposits and lending of money to projects to earn Interest (profit). In short, banks borrow to lend. The rate of interest offered by the banks to depositors is called the borrowing rate while the rate at which banks lend out is called lending rate. The difference between the rates is called ‘spread’.

Commercial Banks play an important role in the growth and development of economy in general and enterprise sector in particular. For example in India, Commercial Bank in India comprises the State Bank of India (SBI) and its subsidiaries, nationalized banks, foreign banks and other
scheduled commercial banks, regional rural banks and non-scheduled commercial banks. The total numbers of branches of commercial banks are more than 50,000 and the regional rural banks are approximately 8,000 covering 280 districts in the country. Commercial banks mostly provide short-term loan and in some cases medium term. According to the Data compiled by RBI, of all the advances given to small-scale industries by the commercial banks, the share of 'term loan' is nearly 30%.

Incidental to commercial banks primary function of financial intermediation is the monitoring function and credit creation ability of banks (Scholtens and Van Wesveen, 2000). Banks with their superior information on clients, usually gathered from their privileged position of holding the current accounts of such clients, are able to efficiently monitor such customers to ensure repayment of loans advanced them. The following points highlight the significance of commercial banks:

- They promote savings and accelerate the rate of capital formation.
- They are source of finance and credit for trade and industry.
- They promote balanced regional development by opening branches in backward areas.
- Bank credit enables entrepreneurs to innovate and invest which accelerates the process of economic development.
- They help in promoting large-scale production and growth of priority sectors such as agriculture, small-scale industry, retail trade and export.
- They create credit in the sense that they are able to give more loans and advances than the cash position of the depositor’s permits.
- They help commerce and industry to expand their field of operation.
- Thus, they make optimum utilisation of resources possible.

The other important primary function of banks-money creation-can be better appreciated through an example. A bank that mobilizes $20,000 cannot lend all of it out. This is because of the reserve requirement stipulated by monetary authorities. If we assume 10% reserve requirement, this means the bank in our example can legally lend out $18,000. When it does so, the $20,000 deposit liability will still be standing against it, while it has created $18000 asset. The total amount will no longer be $20,000 but $38,000. Economists take this a step further and use the reserve requirement to calculate theoretical money multiplier, the number by which bank credit activities multiply the money supply.

Using the equation 1/r = M.

Where r = reserve requirement expressed as a percentage
M = money multiplier (http://www.ehow.com).

This ability of banks to create money has several economic implications, especially with regards to interest rates and prices. This is one of the reasons banks get special regulatory attention from regulatory bodies.

Commercial banks play such an important role in the economic development of a country that modern industrial economy cannot exist without them. They constitute nerve centre of production, trade and industry of a country. In the words of Wick-sell, “Bank is the heart and central point of modern exchange economy”.

2.3 Bank and Economic Growth

Writing on the role of banks in economic growth, Steiner, et al (1963) opined that banks are important to the economy because they influence the level of economic activities in two ways, namely: by expansion and contraction of loans and investment. These activities alter the nation’s money supply, and by extension affect the size of loans, influence what is produced, how much is produced and where it is produced. Similarly, Ubom (2009) identified banks as agents of economic development. This is because they invest directly in the economy (e.g. by buying the shares of other companies) and grant loans to others for investment and purchase of securities.

Economic growth can be defined as an increase in a nation’s output, which is most commonly measured by the gross domestic product (GDP). The benefits stemming from economic growth are wide ranging. (Harper, 2011). Economic growth is the increase in the inflation-adjusted market value of the goods and services produced by an economy over time. It is conventionally measured as the percent rate of increase in real gross domestic product, or real GDP.
Economic growth is an increase in the capacity of an economy to produce goods and services, compared from one period of time to another. It can be measured in nominal or real terms, the latter of which is adjusted for inflation. Traditionally, aggregate economic growth is measured in terms of gross national product (GNP) or gross domestic product (GDP), although alternative metrics are sometimes used. “Economic growth means the annual increase in real per capita income of a country over the long period. Thus, Professor Arthur Lewis says, “economic growth means the growth of output per head of population.” Since the main aim of economic growth is to raise the standards of living of the people. Economic growth remains one of the macroeconomic goals of every government and there are several studies on the subject. Harper (2011) however suggests that to achieve economic growth, that two options are available. These options are:

- Using resources ‘extensively’ (that is producing more by using more of the available resources).
- Using resources ‘intensively’ (that is producing more while using the same amount of available resources). However, the key to sustainable economic growth is to use resources ‘intensively’ that are to realize productivity gains (Harper, 2011:89).

Azege (2009) holds that banks contribute to the economy by mobilizing savings from the surplus economic unit and making these funds available to the deficit economic unit. By so doing, banks are able to finance investments. Many scholars share in the opinion that savings mobilized by banks are utilized by the deficit economic unit for investment which improves capital accumulation, expands output and invariably leads to economic growth (Hakenes, Schmidt & Xie, 2009, Badun, 2009, Montiel, 2003, Merton & Bodie, 1995, Levine, 2001, Levine, 2005, Miwa & Ramseyer, 2000, Offiong, 2005).

2.4 Role of Commercial Banks in the Economic Growth and Development

Commercial banks play an important and active role in the economic development of a country. If the banking system in a country is effective, efficient and disciplined it brings about a rapid growth in the various sectors of the economy. The following is the significance of commercial banks in the economic development of a country:

- It gives loans and advances: The second major function of a commercial bank is to give loans and advances particularly to businessmen and entrepreneurs and thereby earn interest. This is, in fact, the main source of income of the bank. A bank keeps a certain portion of the deposits with itself as reserve and gives (lends) the balance to the borrowers as loans and advances in the form of cash credit, demand loans, short-run loans, overdraft as explained under.
  - Cash Credit: An eligible borrower is first sanctioned a credit limit and within that limit, he is allowed to withdraw a certain amount on a given security. The withdrawing power depends upon the borrower’s current assets, the stock statement of which is submitted by him to the bank as the basis of security. Interest is charged by the bank on the drawn or utilised portion of credit (loan).
  - Demand Loans: A loan, which can be recalled on demand, is called demand loan. There is no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Those like security brokers whose credit needs fluctuate generally, take such loans on personal security and financial assets.
  - Short-term Loans: Short-term loans are given against some security as personal loans to finance working capital or as priority sector advances. The entire amount is repaid either in one instalment or in a number of instalments over the period of loan.

- Banks promote capital formation: Commercial banks accept deposits from individuals and businesses, these deposits are then made available to the businesses which make use of them for productive purposes in the country. The banks are, therefore, not only the storehouses of the country’s wealth, but also provide financial resources necessary for economic development.
- Investment in new enterprises: Businessmen normally hesitate to invest their money in risky enterprises. The commercial banks generally provide short and medium term loans to entrepreneurs to invest in new enterprises and adopt new methods of production. The provision of timely credit increases the productive capacity of the economy.
Promotion of trade and industry: With the growth of commercial banking, there is vast expansion in trade and industry. The use of bank draft, check, bill of exchange, credit cards and letters of credit etc. has revolutionized both national and international trade.

Commercial banks invest their surplus fund in 3 types of securities:
- Government securities.
- Other approved securities.
- Other securities. Banks earn interest on these securities.

Development of agriculture: The commercial banks particularly in developing countries are now providing credit for development of agriculture and small-scale industries in rural areas. The provision of credit to agriculture sector has greatly helped in raising agriculture productivity and income of the farmers. Example is this 2018 Nigeria Government is trying to achieve this in conjunction with commercial banks.

Credit Creation: While granting loans to customers, banks do not provide the loan in cash to the borrower. Instead, the bank creates a deposit account from which the borrower can draw funds. This allows the borrower to withdraw money by cheque according to his needs. By creating a demand deposit in the borrower’s account without printing additional money, the bank increases the amount of money in circulation.

Balanced development of different regions: The commercial banks play an important role in achieving balanced development in different regions of the country. They help in transferring surplus capital from developed regions to the less developed regions. The traders, industrialist etc. of less developed regions is able to get adequate capital for meeting their business needs. This in turn increases investment, trade and production in the economy.

Influencing economic activity: The banks can also influence the economic activity of the country through its influence on-
- Availability of credit
- The rate of interest

If the commercial banks are able to increase the amount of money in circulation through credit creation or by lowering the rate of interest, it directly affects economic development. A low rate of interest can encourage investment. The credit creation activity can raise aggregate demand, which leads to more production in the economy.

Implementation of Monetary and Fiscal policy: The central bank of the country controls and regulates volume of credit through the active cooperation of the banking system in the country. It helps in bringing price stability and promotes economic growth within the shortest possible period.

Monetization of the economy: The commercial banks by opening branches in the rural and backward areas are reducing the exchange of goods through barter. The use of money has greatly increased the volume of production of goods. The non-monetized sector (barter economy) is now being converted into monetized sector with the help of commercial banks.

Discounting bills of exchange or bundles: A bill of exchange represents a promise to pay a fixed amount of money at a specific point of time in future. It can also be en-cashed earlier through discounting process of a commercial bank. Alternatively, a bill of exchange is a document acknowledging an amount of money owed in consideration of goods received. It is a paper asset signed by the debtor and the creditor for a fixed amount payable on a fixed date. It works like this. Suppose, A buys goods from B, he may not pay B immediately but instead give B a bill of exchange stating the amount of money owed and the time when A will settle the debt. Suppose, B wants the money immediately, he will present the bill of exchange (Hundi) to the bank for discounting. The bank will deduct the commission and pay to B the present value of the bill. When the bill matures after specified period, the bank will get payment from A.

Provision of overdraft: An overdraft is an advance given by allowing a customer keeping current account to overdraw his current account up to an agreed limit. It is a facility to a depositor for overdrawing the amount than the balance amount in his account.

In other words, depositors of current account arrange with the banks that in case they have drawn a cheque, which do the deposit, then the bank not cover should grant overdraft and honour the cheque. The security for overdraft is generally financial assets like shares, debentures, life
insurance policies of the account holder, etc. However, it is good to note that overdraft is different from loan. Difference between Overdraft facility and Loan are:

- Overdraft is given without security in current account but loans are given against security.
- In the case of loan, the borrower has to pay interest on full amount sanctioned but in the case of overdraft, the borrower is given the facility of borrowing only as much as he requires.
- Whereas the borrower of loan pays Interest on amount outstanding against him but customer of overdraft pays interest on the daily balance.

- Export promotion cells: In order to increase the exports of the country, the commercial banks have established export promotion cells. They provide information about general trade and economic conditions both inside and outside the country to its customers. The banks are therefore, making positive contribution in the process of economic development.

- Agency Functions: Commercial banks serve as agents of their customers by helping them in collecting and paying cheques, dividends, interest warrants, and bills of exchange. In addition, they pay insurance premiums, utility bills, rent, and other charges on behalf of their clients. Banks also trade shares, securities, and debentures, and they provide advisory services for customers that want to buy or sell these investments. In property administration, commercial banks act as trustees and executors of the estate on behalf of their customers. Banks charge a nominal fee for the agency functions performed on behalf of their clients.

- Agency functions of the bank: The bank acts as an agent of its customers and gets commission for performing agency functions as under:
  - Transfer of funds: It provides facility for cheap and easy remittance of funds from place-to-place through demand drafts, mail transfers, telegraphic transfers, etc.
  - Collection of funds: It collects funds through cheques, bills, bundles and demand drafts on behalf of its customers.
  - Payments of various items: It makes payment of taxes. Insurance premium, bills, etc. as per the directions of its customers.
  - Purchase and sale of shares and securities: It buys sells and keeps in safe custody securities and shares on behalf of its customers.
  - Collection of dividends, interest on shares and debentures is made on behalf of its customers.
  - Acts as Trustee and Executor of property of its customers on advice of its customers.
  - Letters of References:
    - It gives information about economic position of its customers to traders and provides similar information about other traders to its customers.

- Performing general utility services. The banks provide many general utility services, some of which are as under:
  - Traveller’s cheques. The banks issue traveller’s cheques and gift cheques.
  - Locker facility. The customers can keep their ornaments and important documents in lockers for safe custody.
  - Underwriting securities issued by government, public or private bodies.

- Role of Banks in 21st century: The commercial banks are now not confined to local banking. They are fast changing into global banking i.e., understanding the global customer, using latest information technology, competing in the open market with high technology system, changing from domestic banking to investment banking etc.

The commercial bank are now considered the nerve system of all economic development in the country.

3. CONCLUSION

This study was meant to find out the effect of Commercial Banks in Economic Development. From the research study, it has been proven that Commercial Banks plays a very important and vital role in economic growth and development. The commercial banks play a vital role in its economic growth and development.
The study assessed banks contribution of Commercial Banks to economic growth and development. It approached banks contribution from the financial intermediation role these institutions play. From this perspective, it related the savings mobilization and lending functions of banks to the growth rate of the gross domestic product, which causes economic growth and development. The result of the analysis led to the conclusion that commercial banks’ contribution to economic growth and development is in fact very insignificant.

If you are interested in advancing your career in corporate finance or researching on Commercial Bank these articles will help you on your way.

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