



Effects of banks on an Indian economy: An overview

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Abstract

The goal of this research is to look at the effects of banks on the Indian economy: An Overview. The current analysis demonstrates that there is a long-term relationship between bank performance and economic growth, and that bank profitability boosts growth. The financial assistance needed by the economy to expand and develop has been provided by a strong and sustainable banking sector. Rajput and Goyal (2019) study shows that banking stability has a direct impact on actual output and employability in an economy that revolves around financial stability and a poor financial performance in an economy cause economic instability, which leads to an economic crisis. It was observed that in the Indian economy, saving deposits in banks had a large positive influence on GDP (Sharma and Ranga) (2014) [43]. Emecheta and Ibe (2014) [11] discovered a statistically significant positive association between bank economic development, credit to the private sector, and wide money. It is clear that the banking industry has a favourable impact on Indian economic growth.

Keywords: banks, economy, India, economic growth, stability, effects

Introduction

The banking system is the lifeline of any modern economy. It is one of the important financial pillars of the financial sector, which plays a crucial role in the attainment of macro-economic objectives. It is very important for economic development of a country that its financing requirements of trade; industry and agriculture are met with higher degree of commitment and responsibility. Thus, the development of a country is integrally linked with the development of banking. In a modern economy, banks are to be considered not as dealers in money but as the leaders of development. A bank is a financial intermediary that accepts deposits and channels those deposits into lending activities. They are the active players in financial market. To attain development there should be a good developed financial system to support not only the economic but also the society. So, a modern bank plays a vital role in the socio-economic matters of the country.

An Indian perspective, banks are playing a crucial role in socio-economic progress of the country after independence. Indian banking continues to remain in the forefront of the financial system. During the last three decades, the Indian banking sector has achieved substantial progress on many fronts. By transforming class-banking to mass-banking, from wholesale banking to retail banking, the Indian banking system has become a potent tool in the socio-economic development of the economy.

In the Indian Context, the Evaluation of the Banking System

India's macroeconomic progress has been remarkable throughout the last six decades. Several adjustments have been made to the monitoring, external, and banking policies. The structural changes in the Indian financial sector, particularly in the banking system, have had a variety of effects on the evaluation of Indian banking. The functioning of commercial banks has changed since independence and the implementation of banking reforms. It is necessary to study the significant developments in the Indian banking sector in order to comprehend the changing function of banks, as well as the problems and challenges they face. The pre-reform phase and the reform phase are two separate periods in the evolution of banking sector changes. These are showing in the following figure:

- **The Evolutionary Stage:** Money lending activities in India can be traced back to the Vedic period, i.e. 2000 to 1400 BC, as per the CBEC (Central Banking Enquiry Committee, 1931). Professional banking has been documented in India since 500 BC. The bank was formed and developed in India during the latter decades of the 18th century. The first bank in India, however conservative, was founded in Calcutta in 1786 and was known as the Bank of Bengal. The industry experienced numerous ups and downs, as well as failures, over the course of its long history, culminating in the establishment of the RBI in 1935. The following diagram depicts the formation of banks in an Indian context.

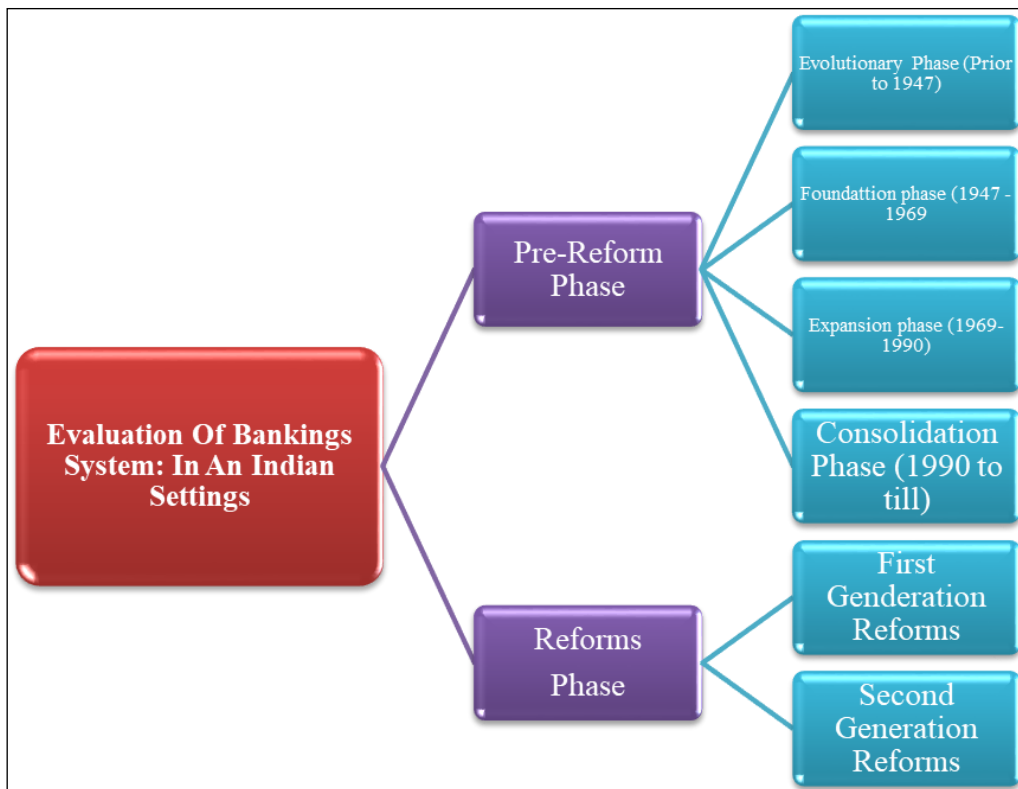


Fig 1

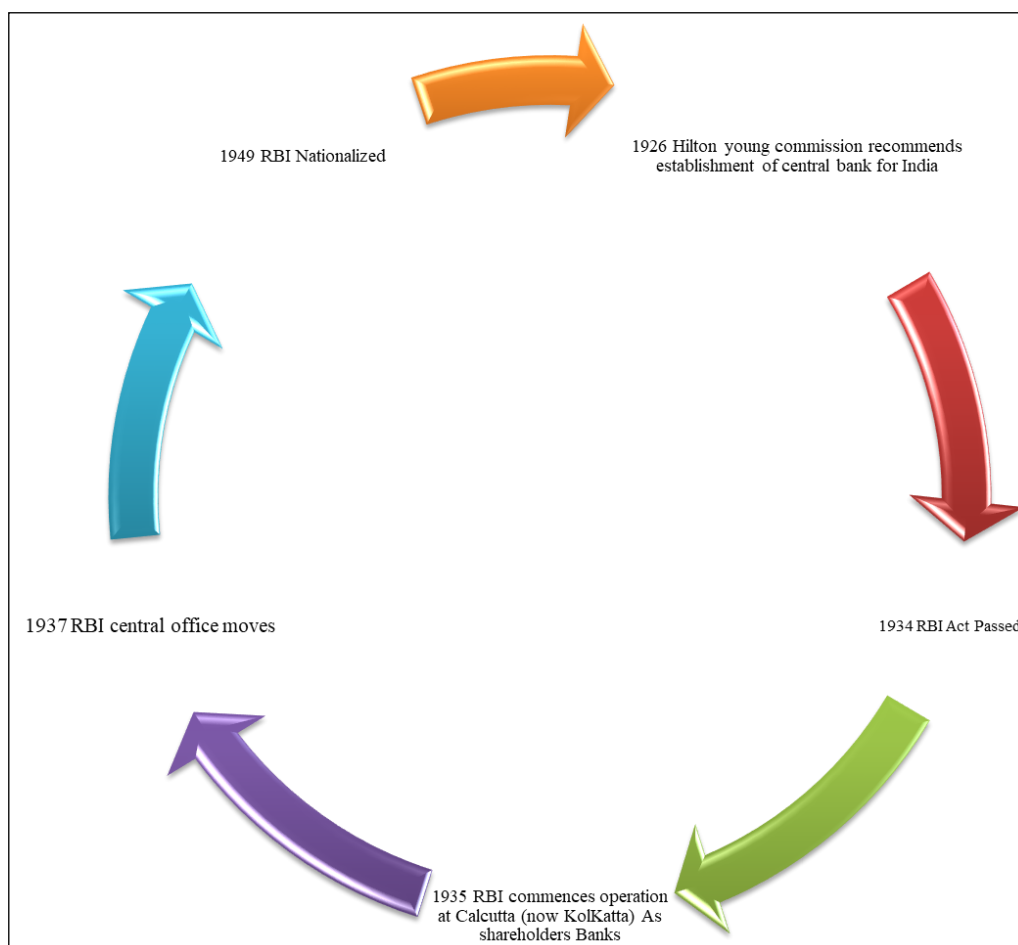


Fig 2: shows the formulation of banks in Indian contexts

- **The Foundation Stage:** this period encompasses the years 1947 to 1969. The government took the initial step by enacting the Banking Regulation Act in 1948, which went into effect in March 1949.

- **The Expansion Stage:** It encompasses the early 1960s, when 14 large banks were nationalised in 1969. The main goals of nationalisation were to provide adequate credit for agriculture, small industry, and exports, which were regarded priority sectors, to reduce regional imbalances, and to meet the credit demands of the general public—the poorer parts of society. Six more private sector banks were nationalised on April 15, 1980. Despite the fact that the banking system was extended to rural regions, credit gaps in rural lending were discovered. Between 1960 and 1991, the overall number of bank branches expanded eightfold, with rural branches accounting for the majority of the increase. As a result of this extraordinary expansion, the population per branch fell from 60,000 in 1969 to around 14,000 in 1991.
- **The stage of consolidation:** It all started with a series of policy decisions made by the Central Bank in 1985. The banks' control has been loosened. There was a noticeable pause in branch expansion at this time. The consolidation process necessitated action on multiple fronts.
- **The first generation banking reforms:** After 1993, the first generation of banking reforms resulted in the development of around 20 new private banks and 20 new international banks. The competition has been boosted by the introduction of modern, competent private sector banks as well as international institutions. During this stage, the Narasimham Committee and the government's process of financial sector reforms begun in 1991 have focused attention on the need to increase the operational efficiency and profitability of banks. Since 1991-1992, the RBI has changed the format of banks' balance sheets and profit and loss statements. In addition, the Committee submitted its Second Report on the Banking Sector in 1998. It made broad recommendations on capital adequacy, asset quality, NPAs, prudential norms, asset-liability management, earnings and profit, mergers and acquisitions, reducing government shareholding in public sector banks to 33 percent, creating global-sized banks, recasting bank boards, and revamping banking legislation.
- **The second generation reforms:** The second generation reforms focused on three interconnected issues: strengthening the foundation of the banking system, streamlining procedures, improving technology and human resource development systems, and structural changes in the system.

Banks' Impact on the Indian Economy

India has a substantial banking sector, which is also one of the country's largest service suppliers (Kumari, 2017)^[25]. Credit cards, debit cards, ATM services, Telebanking, internet banking, electronic payments, consumer finance, life insurance, mutual funds, pension funds, regulation services, and stockbroking services are all provided by the banking sector (Kumari, 2017; Muniswamy, 2018)^[25, 33]. Further, capital markets and non-bank financial institutions play a minor role. It is obvious that the banking sector plays a critical role in enhancing economic growth and development, which is dependent on a country's effective financial institutions (Sharma *et al.*, 2012)^[44]. Financial development is beneficial in increasing demand for goods and services, and so plays an important part in sustaining a country's economic prosperity (Liang and Reichert, 2006)^[27]. The banking industry is beneficial in converting deposits into productive investment, generating new capital, and accelerating economic progress (Tanwar *et al.*, 2020)^[49]. By offering numerous services to the rest of the economy, any modern financial system helps to economic development and the improvement of living standards. These include clearing and settlement systems to allow trade, financial resource channelling between savers and borrowers, and a variety of risk and uncertainty-management solutions. In general, these varied services can be performed by banks or other financial organisations, or directly through capital markets. Banks and other financial intermediaries arise as an efficient reaction to the fact that knowledge is expensive. Banks specialize in analyzing borrowers' creditworthiness and providing continual monitoring to ensure borrowers keep their obligations. The disparity between the rates they provide to the aggregated pool of savers and the rates they offer to potential borrowers compensates them for these services. This is known as "maturity transition" and it is central to modern banking. Banks serve as a reservoir for deposits before converting them into long-lived (illiquid) assets such as housing loans and commercial financing. Furthermore, banks play an important role in providing payment and settlement services, which are required for consumers, businesses, and other financial institutions to settle day-to-day transactions. As a country develops, the capital markets often play a larger role in supplying financial products and services than banks do. Raising corporate finance through securities, for example, competes with or exceeds that supplied by the banking sector in many advanced economies. During the global crisis, India's greater connectivity with the global economy meant that it could neither be expected to be immune to the crisis or to be disconnected from it. While the Indian banking sector remained largely unscathed due to its relatively little activities outside India or exposure to subprime lending by foreign investment banks, the global crisis has hit India in three unique channels. Financial markets, trade flows, and exchange rates are examples of these channels. The banking industry includes equity markets (which are directly affected by foreign institutional investment (flows), external commercial borrowings (ECBs) those fuel corporate investments, FDI, and remittances are all part of the financial sector. The global financial crisis had varying effects on these distinct sub-sectors of the financial sector. The Indian banking sector has remained relatively unscathed, at least directly, by the global crisis, through prudent laws and a proactive regulator (Rajiv Kumar and Vashisht, 2009)^[23]. Very few studies have attempted to investigate the effects of bank profitability on economic development. Haralayya

& Aithal (2021) ^[15] the results shows that broad money to reserve ratio and Domestic credit to private sector have a positive impact on per capita GDP. Domestic consumption expenditure is also showed a positive impact on per capita GDP. Real interest rate and consumer price inflation have a negative impact on per capita GDP. Hence, it is suggested that India needs to control interest rate and consumer price inflation to increase the demand of goods and service in domestic market. It would be useful to create employment opportunities and accordingly per capita GDP in India. Alam, Rabbani, Tausif and Abey (2021) ^[3, 4] the results indicate that the bank-related variables are co-integrated with economic growth. Further analysis indicates a significant relationship between interest margin and return on assets with economic growth. In addition, lending capacity and investment activities are not significantly associated with economic growth, leading to the policy recommendation to improve upon these two factors in order to achieve higher growth rates. Rajput and Goyal (2019) study results that the banking stability has a direct impact on the real output and employability which revolves around the financial stability of an economy. A poor financial performance in an economy creates a distress in the economic stability leading to an economic crisis. Mohamed and Soliman (2017) ^[32] studied the impact of Basel III reforms for Egyptian banks. It has been found that there is a negative impact over the smaller or financially weaker banks and find it challenging to maintain their pace with lack of funds. Mehta and Bhavani (2017) ^[29] studied the impact of variables in profitability in 19 banks of UAE from 2006-2013. The results declare that the Capital Adequacy Ratio and improved asset quality has a huge impact on profitability of banks. The authors recommended a profitability enhancing model for better performance in banks. Islam and Hasan (2017) ^[17] studied the performance and determinants of profitability for commercial banks in Kosovo. They used ROAE (return on Average Equity), ROAA (Return on Average Assets and NIM (Net Interest Margin). It concluded that the internal factors like the asset quality, Capital adequacy and Management Efficiency affect the profitability. Roy and Samanta (2017) ^[40] find the substantial difference among the gross Non- performing asset and the Net Non-Performing Asset position of Public Sector Banks in India. The paper also endeavors the impact on the net profit of the selected banks due to GNPA from 2011 to 2016. The study discloses the declining trend of GNPA of all the banks. Mushtaq (2016) ^[34] conducted a causal analysis and co-integration analysis for Pakistan from 1961 to 2013 amid economic progress and banking activity (deposit and credit) in Pakistan. Barhate and Tambol (2016) Green banking is beneficial for the economy as a whole. Green banking will guarantee an improvement in asset quality by green projects. Government should formulate green policy guidelines by proving financial incentives for going green. Menicucci and Paolucci (2016) ^[30] study revealed that the CAR ratio, higher deposit ratio and the bank size are positively related to the profitability. Deka (2015) study concludes that there is a strong need for diversification for the green banking initiatives and guidelines. Narang (2015) the study provides detailed analysis of the green banking initiatives by SBI, PNB, HDFC and ICICI bank. Banks have paved their way towards a digital economy by paperless banking. Sharma and Ranga (2014) ^[43] studied the Indian economy and determined that banks' saving deposits have a significantly affirmative effect on GDP. Emecheta and Ibe (2014) ^[11] found that there is a significantly affirmative relationship between bank economic development and credit to the private sector and broad money in Nigeria. Islam (2014) ^[17] study concluded that management and proper implementation of strategies could improve the profitability of banks than improved economy will be also improved. Roman and Danuletiu (2013) ^[39] study reveals that the bank specific variables and external factors affect the profitability, like the assets quality, liquidity and management in the banks have a significant impact. Bahl (2012) the Green banking practices via internal and external process can have a positive impact on the effectiveness. The results obtained from the primary data analysis conclude that the level of awareness among the respondents is quite low. Alper and Anbar (2011) ^[5] talked about the determinants of bank's profitability in Turkey for the time period of 2002- 2010. The paper talks about the positive and negative impacts on the bank profitability via Return on Assets (ROA) and Return on Equity (ROE). The size of assets and interest rates had a positive impact on the profitability of banks whereas the size of loan had a negative impact. Nwanyanwu (2010) ^[35] study outcomes showed that the banks in the economy aid in making funds accessible by moving excess funds from depositors (with no instant requirements of those funds) and channelling those funds as a credit to investors who have excellent ideas for generating surplus funds in the economy, but have a deficiency of the funds to implement those ideas. Uppal (2009) ^[50] study resulted that the public sector banks did not achieve the target due to priority sector lending process in comparison to the Private and Foreign Banks. Sahoo and Nayak (2007) paper concludes by stating that the firms could attain higher return on environment friendly projects and banks should go green to ensure the flow of investment toward greener projects. Adeniyi (2006) ^[1] study outcomes showed that the banking sector is a prominent one in the financial sector, as it has stood as one of the most extensive means of attracting many developing nations. Pain (2003) ^[36] found that both macroeconomic factors and Bank specific factors were responsible for the catastrophe. Macroeconomic factors like real GDP growth real interest rates and lagged aggregate lending growth and Bank specific factors like the loan portfolio to be the determinants. Salas and Saurina (2002) ^[42] talk about the bank level variables which could explain the loan problem in Spain during 1985-1997, even after regulating the economic factors like GDP growth, indebt of family and firm using the Panel data. Economic growth actually leads to economic development, for which capital required is provided through the financial services industry (Beckett *et al.* 2000) ^[6]. Capital formation through the mobilization of resources by the financial services industry and accumulation should be the key element of economic growth strategy (Berger 2000) ^[7].

Conclusion

Based on previous research, the primary goal of this study is to assess the effects of banks on the Indian economy. Previous research has shown, both conceptually and empirically, that the banking industry has a favourable impact on the Indian economy. A rising economy like India necessitates the optimal combination of risk capital and long-term resources for corporations to select an acceptable mix of debt and equity, especially for infrastructure improvements, which is the need of the day. A properly-functioning domestic capital market is also required for the banking sector to raise capital and support expansion, as well as to maintain an appropriate capital adequacy ratio to manage risk. Bank investments are also becoming in popularity. In a nutshell, the financial operations of the banking industry contribute significantly to India's economic development. Furthermore, the banking industry fosters economic growth and development.

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