AN OVERVIEW OF ECONOMIC DEVELOPMENT THROUGH BANKING SYSTEM IN CURRENT SCENARIO

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ABSTRACT

The present paper helps to know about economic development through banking system in current scenario. Banks play a very significant role in the economic development of our country. Banks have control over a major part of the supply of money in circulation. 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. In fact, banks are the main stay of the economic development of a country. One of the most important problems of a developing economy is capital formation. Banks accept deposits from individuals and businesses, these deposits are made available to the businesses which make use of them for productive purposes in the country. In developing countries banks are now providing credit for development of agriculture and small scale industries in rural areas and also provide short and medium term loans to entrepreneurs to invest in new enterprises and adopt new methods of production. In current scenario the economic development of our country also depends on organization of internal trade and expansion of foreign trade, especially exports. Therefore policies of the banking system affect economic development of our country.

Keywords: *Banking System, Capital Formation, Economic Development, Monetary Policies, Social Change*

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INTRODUCTION:

In India, as in many developing countries, the banking sector has been the dominant element in the country's financial system. The sector has performed the key functions of providing liquidity and payment services to the real sector and has accounted for the bulk of the financial intermediation process. Besides institutionalizing savings, the banking sector has contributed to the process of economic development by serving as a major source of credit to households, government, business and weaker sectors of the economy like village and small scale industries and agriculture.

The present paper is to study about the relationship between role of banking system and economic development is a much debated issue in the empirical literature. The question whether economic growth of a country depends on the banking system of that country has been an extensive subject of empirical research since last few decades. This paper is an attempt to contribute to the empirical literature on the relationship between Banking system and economic development growth by testing the causality between bank policies and economic growth in India.

LITERATURE REVIEW

Theoretical development regarding the importance of banking sector for economic development has induced many empirical investigations. These studies use different econometric methodologies, which offer different results regarding the existence and direction of causality between banking sector and economic growth. We present a brief review of the literature.

Levine and Zervos (1998) use cross-sectional data for 47 countries show that stock market liquidity and banking development both positively affect growth, capital accumulation and productivity. Beck and Levine (2004) investigate the impact of stock markets and banks on economic growth using a panel data set for the period 1976-1998 and applying generalized method of moments techniques developed for dynamic panels.

Arestis et al. (2001) examine that relative impact of stock markets and banks on long-run economic growth in Germany, the USA, Japan the UK and France. They find a positive effect of banks on economic growth in most of the countries, but the effect of the former are more powerful. The same result is found by Hondroyiannis and Lolos (2005) for the Greek economy as well.

Mishkin (2007) examine the credit institutions intermediate between the surplus and deficit sectors of the economy. Thus, a better functioning credit system alleviates the external financing constraints that impede credit expansion, and the expansion of firms and industries. Kasekede (2008) support for the argument that countries with better/efficient banking systems grow faster while inefficient banking systems bear the risk of bank failure.

OBJECTIVES OF THE STUDY

- To highlight the role of banks in economic growth of India.
- To review the present status of economic development in India.
- To highlight the measures taken by banks and RBI for economic growth of India.

METHODOLOGY OF THE STUDY

Secondary research was conducted to review the present status of economic development in India. Data has been collected from the websites of the Reserve Bank of India, various news papers, magazines, Journals, articles, Research Papers, Publications of various Banks and also data has been taken from various committee reports submitted to Government of India.

EVOLUTION OF BANKING SYSTEM IN INDIA

Prior to 1969, all banks, except State Bank of India and its seven associate banks were privately owned. However there was a perception among policy makers that under private ownership, too many rural and semi urban-areas remained un-served by banks, whereas the banking industry has to be developed to "touch the lives of millions".

Further as India became an increasing planned economy, policy makers felt that, It would be difficult to undertake credit planning unless the link control of industry and banks in the same (private) banks is snapped by the nationalization of banks ‟ (Hazari Report , 1967). These considerations led to the Nationalization Act of 1969 which caused 14 largest privately owned domestic banks to be nationalized.

In 1980 under the same Act, the Government of India acquired ownership of 6more private banks, bringing the total number of nationalized banks to 20. Notwithstanding the positive role played by the banking sector since nationalization in institutionalizing savings and becoming a source of credit to the small borrower, the cumulative effect of excessive focus on quantitative achievement and social obligations took a toll on profitability and efficiency. Rates of return became low by international standards, the capital base was eroded, NPS‟ s were on the rise, and customer service was below expectation. These conditions led to gradual liberalization of banking sector operations since the mid 1980‟ s and culminated in the initiation of fundamental banking sector reforms of 1992 with the acceptance of key recommendations of the Narasimham Committee.

RESTRUCTURING OF THE BANKING SYSTEM

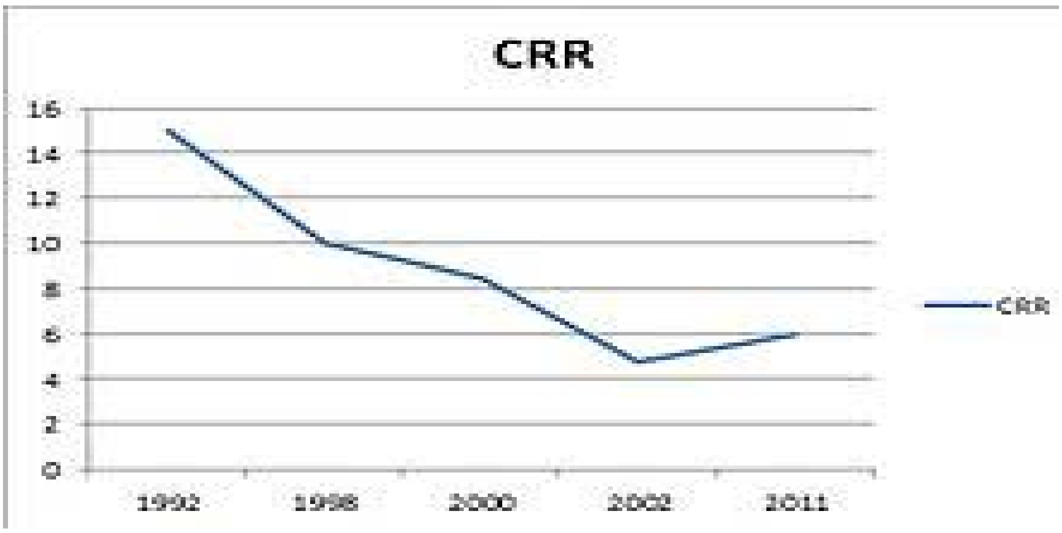
The Narasimham committee recommended 4-tier structure of the banking system consisting of : (a) Three of Four Large (international) banks .

(b) Eight to ten national banks with a network of branches throughout the country.

(c) Local works with operations confined to a specific region.

(d) Rural Banks with operations confined to rural areas and business confined to

The committee recommended bringing down the SLR of banks in a phased manner period of five years. It also recommended reducing of CRR from its present high level.



Cash Reserve Ratio Graph from 1992 to 2011

Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances .Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa.RBI is empowered to vary CRR between 15 percent and 3 percent. But as per the suggestion by the Narshimam committee Report the CRR was reduced from 15% in the 1990 to 5 percent in 2002. As of November 2012, the CRR is 4.25 percent.

Statutory Liquidity Ratio Graph from 1991 to 2011

Every financial institute has to maintain a certain amount of liquid assets from their time and demand liabilities with the RBI. These liquid assets can be cash, precious metals, approved securities like bonds etc. The ratio of the liquid assets to time and demand liabilities is termed as Statutory Liquidity Ratio. There was a reduction from 38.5% to 25% because of the suggestion by Narshimam Committee. The current SLR is 23%.

The committee also proposed that its directed credited programme should be phased out. The priority sector should be redefined to comprise small and marginal farmers, the tiny sector of the industry, village and cottage industries, small business and other weak sections .A special tribunal should be set up to speed up the process of recovery of overdue loans. An asset reconstruction fund should be set up to speed up the process of recovery of overdue loans.

ROLE OF BANKS IN ECONOMIC DEVELOPMENT

Banking sector is of special importance for the economic growth of developing and underdeveloped countries. The commercial banking sector which forms one of the backbones of the financial sector should be well organized and efficient for the growth dynamics of a growing economy. No underdeveloped country can progress without first setting up a sound system of commercial banking. The importance of a sound system of commercial banking for a developing country may be depicted as follows:

Capital Formation

The rate of saving is generally low in an underdeveloped economy due to the existence of deep-rooted poverty among the people. Even the potential savings of the country cannot be realized due to lack of adequate banking facilities in the country. To mobilize dormant savings and to make them available to the entrepreneurs for productive purposes, the development of a sound banking system is essential for a developing economy.

Monetization

An underdeveloped economy is characterized by the existence of a large non monetized sector, particularly, in the backward and inaccessible areas of the country. The existence of this non monetized sector is a hindrance in the economic development of the country. The banks, by opening branches in rural and backward areas, can promote the process of monetization in the economy.

Innovations

Innovations are an essential prerequisite for economic progress. These innovations are mostly financed by bank credit in the developed countries. But the entrepreneurs in underdeveloped countries cannot bring about these innovations for lack of bank credit in an adequate measure. The banks should, therefore, pay special attention to the financing of business innovations by providing adequate and cheap credit to entrepreneurs.

Finance for Priority Sectors

The banks in underdeveloped countries generally hesitate in extending financial accommodation to such sectors as agriculture and small scale industries, on account of the risks involved there in. They mostly extend credit to trade and commerce where the risk involved is far less. But for the development of these countries it is essential that the banks take risk in extending credit facilities to the priority sectors, such as agriculture and small scale industries.

Provision for Medium and Long term Finance

The commercial banks in underdeveloped countries invariably give loans and advances for a short period of time. They generally hesitate to extend medium and long term loans to businessmen. As is well known, the new business need medium and long term loans for their proper establishment. The commercial banks should, therefore, change their policies in favor of granting medium and long term accommodation to business and industry.

Cheap Money Policy

The commercial banks in an underdeveloped economy should follow cheap money policy to stimulate economic activity or to meet the threat of business recession. In fact, cheap money policy is the only policy which can help promote the economic growth of an underdeveloped country. It is heartening to note that recently the commercial banks have reduced their lending interest rates considerably.

Role of Central Bank (RBI)

- The main objectives for the establishment of the Central Bank were as follows :
- To manage the monetary and credit system of India.
- To stabilizes internal and external value of rupee
- For balanced and systematic development of banking in the country
- For the development of organized in the money market in the country.
- For proper arrangement of agriculture finance.
- For proper arrangement of Industrial Finance.
- To establish monetary relations with other countries of the world & international financial institutions.
- For proper management of public debts.
- For centralization of cash reserves of commercial banks.

Reserve Bank of India as banker to the government, collects and disburses government income and receipts, manages the issue and redemption of government debt, advises the government on all matters pertaining to financial activities, and makes loans to the government. As banker to the nation's banks, RBI holds and transfers banks' deposits, supervises their operations, acts as a lender of last resort, and provides technical and advisory services. Monetary policy for both domestic and foreign purposes is implemented, decided by the national banking authorities, using a variety of direct and indirect controls over the financial institutions. Coins and notes that circulate as the national currency are usually the liability of the central bank.

The central bank of the country(RBI) 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 of time.

The Government of India has now undertaken a large number of projects for the economic reconstruction of the country. Banks can generate an adequate volume of credit and conduct it along useful productive channels. They can distinguish between the essential and non-essential factors of the economy between productive and non-productive investment, between speculative arid non-speculative borrowings and thus help in the growth of the economy. It is earnestly hoped that the Government will take some more positive steps to ensure that the real benefits of an organized banking system percolate down to the poor illiterate masses of India.

Factors of Monetary Policy Affect Economic Growth

The Reserve Bank of India will factor in the impact of the government's economic reforms on growth and inflation while formulating its monetary policy.

The central bank tries to maintain price stability through controlling the level of money supply. Thus, monetary policy plays a stabilizing role in influencing economic growth through a number of channels. However, the scope of such a role may be limited by the concurrent pursuit of other primary objectives of monetary policy, the nature of monetary policy transmission mechanism, and by other factors, including the uncertainty facing policy makers and the stance of economic policies. In addition, the concurrent target of intermediate goals may have implications on the attainment of the ultimate objective of achieving sustainable growth.

Other objectives of the monetary policy of India, as stated by RBI, are:

- Price Stability
- Controlled Expansion Of Bank Credit
- Promotion of Fixed Investment
- Restriction of Inventories
- Promotion of Exports and Food Procurement Operations
- Desired Distribution of Credit
- Equitable Distribution of Credit
- To Promote Efficiency
- Reducing the Rigidity

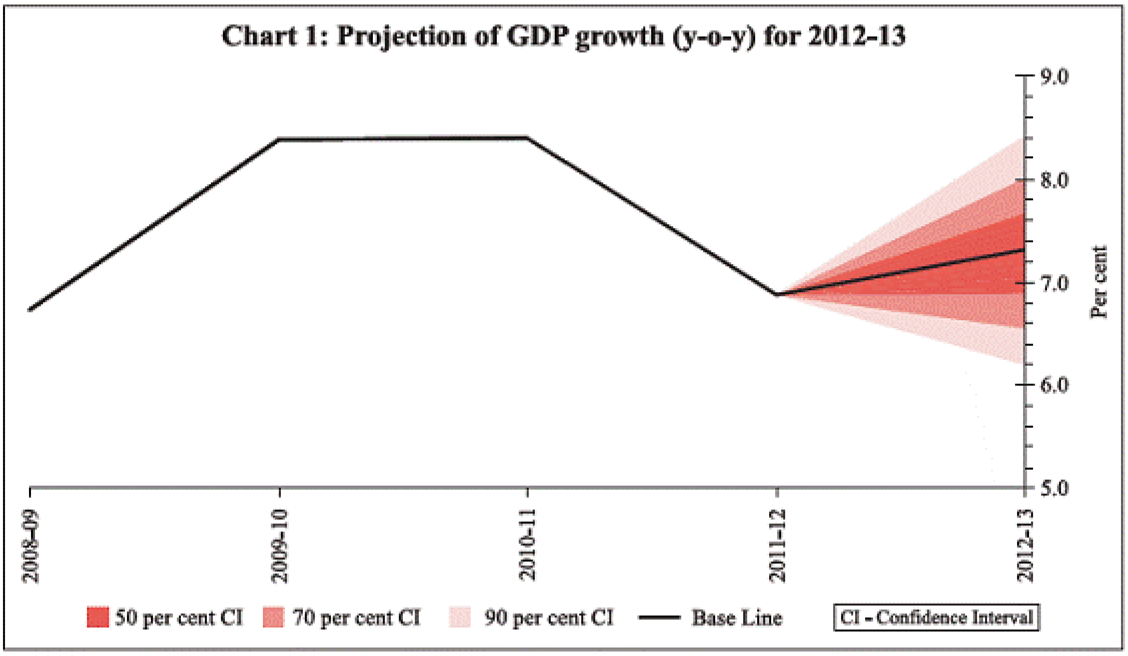
FINDINGS

Over the years, 30-40% of gross household savings have been in the form of bank deposits and around 60% of the assets of all financial institutions accounted for by commercial banks. According to the RBI, India needs to limit the gap to 2.5%-3.0% of GDP to avoid any stress on its external debt.

GDP growth moderated to 6.1 per cent during Q3 of 2011-12 from 6.9 per cent in Q2 and 8.3 per cent in the corresponding quarter of 2010-11. This was mainly due to moderation in industrial growth from 2.8 per cent in Q2 to 0.8 per cent in Q3**.** The services sector held up relatively well (with growth being 8.7 per cent in both Q2 and Q3 of 2011-12). Overall, GDP growth during April-December 2011 slowed significantly to 6.9 per cent from 8.1 per cent in the corresponding period of the previous year.

The advance estimate of the GDP growth of 6.9 per cent for 2011-12 by the Central Statistics Office (CSO) is close to the Reserve Bank's baseline projection of 7.0 per cent.

Going forward into 2012-13, assuming a normal monsoon, agricultural growth could stay close to the trend level. Industry is expected to perform better than in last year as leading indicators of industry suggest a turnaround in IIP growth. The global outlook also looks slightly better than expected earlier. Overall, the domestic growth outlook for 2012-13 looks a little better than in 2011-12. Accordingly, the baseline GDP growth for 2012-13 is projected at 7.3 per cent (Chart 1).



On the basis of the current assessment and in line with policy stance outlined in Section III, the Reserve Bank announces the following policy measures.

Repo Rate

It has been decided to:

- reduce the repo rate under the liquidity adjustment facility (LAF) by 50 basis points from 8.5 per cent to 8.0 per cent with immediate effect.

Reverse Repo Rate

The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands adjusted to 7.0 per cent with immediate effect.

Marginal Standing Facility

In order to provide greater liquidity cushion, it has been decided to:

- raise the borrowing limit of scheduled commercial banks under the marginal standing facility (MSF) from 1 per cent to 2 per cent of their net demand and time liabilities (NDTL) outstanding at the end of second preceding fortnight with immediate effect.

Banks can continue to access the MSF even if they have excess statutory liquidity ratio (SLR) holdings, as hitherto.

The MSF rate, determined with a spread of 100 basis points above the repo rate, stands adjusted to 9.0 per cent with immediate effect.

Bank Rate

The Bank Rate stands adjusted to 9.0 per cent with immediate effect.

Cash Reserve Ratio

The cash reserve ratio (CRR) of scheduled banks has been retained at 4.75 per cent of their NDTL.

The central bank considers 6% as the threshold for inflation, above which expectations of higher prices increase among consumers and companies, making it difficult to control inflation, Mr. Gokarn told a conference of business leaders in the southern city of Chennai.

CONCLUSION

In this paper we investigated the dynamics of the causal relationship between role of banking sector and economic development in India. It is inferred from the study that monitory policies in India has a direct effect on economic development of the country. Economic growth spurs credit market development in India appears to have long term implications for the country. Economic development will encourage risky investments in productive avenues through effective and efficient mobilization and allocation of funds. The investors who basically rely on bank credits will become more confident and encouraged in their financing activities. Economy development will necessarily generate opportunities for investment, which will attract the new class of entrepreneurs with handful of innovative ideas and this will inevitably ensure higher economic growth in the long-run. Hence, the scope for further empirical research is to include more variables in studies of causality between economic development and bank reforms.

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