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Role Of Commercial Banks In Economic Growth And Development: A Theoretical Approach

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Abstract
The financial intermediation role of commercial banks in the economic growth and development of countries cannot be overemphasized. Commercial banks all over the world perform significant role in the allocation and distribution of economic resources in countries. The study originates from the PhD thesis of the author. The role performed by commercial banks in financial intermediation remains at the forefront of economic development of countries. Commercial banks enhance economic growth of countries by availing funds to customers for investment purposes and for financial deepening. The banking sector is therefore considered a strategic sector for these purposes as it directly connects with the real economic sector. In view of the role of commercial banks in economic growth and development, a stable banking sector should be maintained. This can be done by ensuring that favorable monetary policies are put in place by Central Banks in view of underlying economic conditions. Agency banking should be enhanced in developing countries as this will promote financial inclusion. Further studies can be done to empirically establish the role of commercial banks in economic growth and development based on country level data.
Keywords: ***Commercial Banks, Financial Intermediation, Economic Growth and Development***

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I. Introduction

Commercial banks all over the world perform significant role in the allocation and distribution of economic resources in countries (Sheefeni, 2015). Banks enhance economic growth of countries by availing funds to customers (borrowers) for investment purposes and as well as financial deepening (Otuori, 2013; Mbekomize & Mapharing, 2017). Channeling of funds from surplus spending units (SSU) to deficit spending units (DSU) is one among the major roles performed by banks in improving efficiency in the financial system (Tariq, Usman, Mir, Aman & Ali, 2014).

The profitability of commercial banks further enhances the growth of economies through financial inclusion (making funds available for borrowing by investors) and financial deepening (Tariq *et al*., 2014). This is due to the financial system not only serving as a platform for carrying out international transactions but also serves as a medium for foreign exchange traders (buyers and sellers) to interact and agree at an acceptable price for purposes of enhancing foreign transactions (Babazadeh & Farrokhnejad, 2012). The economic growth and development of countries is therefore largely dependent on the banking sector (Bilal, Saeed, Gull & Akram, 2013).

Banks over the years have increasingly transformed their mode of business so as to incorporate the new trending non-traditional activities in the financial sector. This in turn has ensured the retention of their position as financial intermediaries. Diamond and Dybvig (1983) analyzed the economic role of banks in the transformation of illiquid assets into liquid liabilities. Both investors and depositors are risk averse and this brings about difficulty in the timing of future opportunities which may lead to bank runs. However, through intermediation, investors are assisted to avoid long-term illiquid investments.

II. Theoretical Review

Bank-Led Theory was propounded by Cameron in 1972. The theory is based on the financial intermediation role performed by commercial banks and other banking institutions (Lyman, Ivatury & Staschen, 2006). Banking institutions develop financial products and services where they are distributed through authorized retail agents registered by the banks who handle most or all of the customer interactions. These bring about greater service network of banks which in turn enhances their profitability. The bank remains the provider of banking products and services and it is the institution where the accounts of customers are opened and maintained. Bank Led model promises the potential to significantly expand the outreach of banking services by utilizing various delivery channels. A different trading partner with experience and target market aside that of traditional banks which may ultimately be significantly cheaper as compared to bank based products and services. However, the customer account relationship still lies with the bank. The prepositions of Bank Led Theory support the intermediation role carried out by banks. The development of financial services and their distribution through various delivery channels and agents by commercial banks impacts is of high importance. The agents carry out intermediation services as bank representatives and therefore, generate additional income for banks. Bank Led Theory provides insights on commercial banks and the financial intermediation role carried out by these banks in the economy.

Financial Intermediation Theory was advanced by Diamond (1984). The theory explains how banks act as financial intermediaries in connecting depositors and borrowers together. In line with the theory, banks and other financial intermediaries serve as the main sources of external finance to businesses. The theory therefore provides strong predictions about the various transactions utilized by financial intermediaries, thereby providing a framework for the analyses of key issues relating to banking policy. Financial Intermediation Theory rests on the notion that intermediaries strive to minimize the inherent transaction costs and as well as informational asymmetries. The reduction of market imperfection leads to the creation and expansion of individual opportunities therefore resulting to a positive incentive outcome (Scholtens & Wensveen, 2003). Good corporate governance is also ensured by banks thereby leading to ease of transactions and less risky contracts in the financial sector. Financial intermediaries are traditionally huge, thereby creating economies of scale in the analyses and screening of potential borrowers while assessing their credit worthiness. By putting in place effective monitoring mechanism, commercial banks are able to carry out efficient role of delegated monitoring which in turn reduces monitoring costs (Andries, 2009). The Financial Intermediation Theory provides insights on the various roles of financial intermediaries in the economy, thereby enhancing economic growth and development.

III. Role of Commercial Banks in Economic Growth and Development

The banking sector openness directly and indirectly influences the growth of an economy through various unique ways (Sheefeni, 2015). The global improvement towards financial accessibility by commercial banks combined with the efficient intermediation roles which they perform have both lowered costs of finance thereby stimulating the accumulation of capital and in turn growth of the economy (Jabar & Awoyemi, 2015). Commercial banking institutions are vital for the smooth running and functioning of the financial systems. Banks serve as repositories and custodians of very important financial information. Therefore, banks have the potentials to eliminate the information asymmetry related problems in the financial sector.

Due to the intermediary role of banks in connecting borrowers and lenders, banks carry out significant functions in all economies (Malik, Khan, Khan & Khan, 2014). On the side of depositors, savers are provided with the opportunity to have interest income on their excess funds. On the side of borrowers, banks carry out the function of money creation as investors are provided with the needed funds for investment activities which include establishment and expansion of businesses. Consumers are also provided with opportunities to access their future income for purposes of consumption (Yüksel, Mukhtarov, Mammadov & Özsari, 2018). As such, banks perform the role of transforming illiquid assets into liquid assets. Commercial banks through these channels, bring about development by stimulating economic activity (Chimkono, 2016). Additionally, unemployment rate is reduced as banks offer employment opportunities to a large number of individuals to work in their various and numerous branches (Yüksel, Dincer & Hacioglu, 2015). Commercial banks therefore significantly contribute towards consumption and investment in the economy.

Economic development entails the enhancement of an economy’s productive capacity through the utilization of available resources that cushion against uncertainties and eliminate impediments hindering the achievement of investment objectives (Jabar & Awoyemi, 2015). Commercial banks through intermediation processes provide frameworks by which economic growth and development can be successfully achieved (Sule, Onwughalu & Batholomew, 2017). The financial system which is largely comprised of commercial banks serves as a channel which provides the various economic sectors with linkages which enhances growth. This consequently promotes economies of scale, expertise and specialization in the economy. As such, commercial banks provide an environment that is conducive for the implementation of various government financial and economic policies for purposes of achieving stability in exchange rates, balance of payment (BOP) equilibrium and employment levels in the economy. Additionally, commercial banks serve as vehicles upon which monetary policy is effectively transmitted by Central Banks, thereby providing means for the stabilization of the economy (Serwadda, 2018).

IV. Conclusion and Policy Implications

The financial intermediation role of commercial banks in the economic growth and development of countries cannot be overemphasized. The role performed by commercial banks through and by financial intermediation remains at the forefront of economic development of a country. Through the banking sector, the financial intermediation of savings allocation brings about an improvement in the level of growth and development in the economy. The efficient and effective savings allocation of identifying entrepreneurs with viable ideas capable of creating innovative production processes, services and products and funding them are major ways of achieving the objective of growth and development in the economy. The banking sector is therefore considered a strategic sector for these purposes as it directly connects with the real economic sector. In view of the role of commercial banks in economic growth and development as documented in the previous sections, a stable banking sector should be maintained. Favorable monetary policies should be put in place by Central Banks in view of underlying economic conditions. Agency banking should be enhanced in developing economies as this will promote financial inclusion. Further studies can be done to empirically establish the role of commercial banks towards economic growth and development based on country level data.

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