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20CSE1030

Economics Term Assignment

Topic: Role of Commercial Banks in Economic Development

Introduction:

Without a sound and effective banking system, no country can have a healthy economy. A well organized banking system is a necessity for the economic development of a country. Banks being a fundamental components of financial system are the most effective way to generate the credit flow of money in markets.

A commercial bank is a financial institution which accepts deposits from the public and lends loans for the purposes of consumption and investment to make profit. The essential role of a bank is to connect those who have capital with those who seek capital. It is necessary to encourage people to deposit their surplus funds with the banks. These funds are used for providing loans to the industries thereby making productive investments. A bank is therefore a financial intermediary that accepts deposits and channels those deposits into lending activities.

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Role of banks in development of economy

1. Mobilizing savings for capital formation

Banks mobilize the small savings of the people scattered over a wide area through their networks of branches all over the country and make it available for productive purposes. Banks offer attractive schemes to attract the people to save their money with them and bring the savings mobilized to the organized money market. By mobilizing savings, the bank channelize them into productive investments. Thus they help in the capital formation of a developing country.

2. Creation of Credit

Banks create credit for the purpose of providing more funds for development projects. Credit creation leads to increased production, employment, sales and prices and thereby they cause faster economic development. Activities like inventions and innovations, research and development and initiatives are impossible due to insufficiency of funds in few poor countries. Banks remove the deficiency of capital by providing different types of funds that lead to economic development.

3. Financing Industry

The commercial banks finance the industrial sector in a number of ways. They provide short term, medium term and long term loans to industry. Commercial banks provide an incentive for the entrepreneurs to take risks and to use idle resources for more and better production. Banks provide loans to develop the various economic sectors.

It results in a reduction in imports and increase in exports. Accordingly, banks are very important to achieve self sufficiency.

In India, the commercial banks undertake short term and medium term financing of small scale industries and also provide hire-purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is underdeveloped in such countries.

4. <u>Smoothing of trade and commerce</u>

The commercial banks help in financing both internal and external trade. The bank provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all type of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issueing drafts, etc.

A well developed banking system provides various attractive services like mobile banking, internet banking, debit cards, credit cards etc. these kind of services fast and smoothen the transactions. So; bank helps in developing trade and commerce.

Today international trade, without involving banks is so difficult and international trade is necessary for economic development. Commercial banks are helpful in increasing international trade through ways like provision of credit facilities, low rate of interest for the exporters, opening of letter of credit, arrangement of foreign exchange.

5. Development of Agriculture sector
Commercial banks provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provides agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernisation and mechanisation of their farms, for providing irrigation facilities, for developing land, etc.
They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming pisciculture and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional banks operate under a commercial bank. Thus the commercial bank meet the credit requirement of all types of rural people.

6. Implementation of Monetary Policy
Monetary policy is a important policy of any govt. The major aim of monetary policy is to stabilize financial system of the country from the dangerous of inflation, deflation, crisis, etc.
The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends on the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.
Thus the commercial banks contribute much to the growth of a developing economy by granting loans to

agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

7. Bank Rate Policy

Economists are of the view that by changing the bank rates, changes can be made in the money supply of a country. In India, RBI regulates the rate of interest ~~of~~ to be paid by banks for the deposits accepted by them and also the rate of interest to be charged by them on the loans granted by them.

8 Financing Employment Generating Activities

The commercial banks provide loans for the education of young persons studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepenenrs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help in human capital formation but also in increasing entrepeneurial activities in developing countries.

9. Finance to Government

Nowadays, government has to face budget deficits because of increased expenditures and falling revenues. Here in this situation, the government has to depend upon defecit financing to meet the budget deficits. Government is acting as the promoter of industries in underdeveloped countries for which finance is needed. Banks provide long-term credit to Govt. by investing their funds in Govt securities and short term finance by purchasing Treasury bills.

10. **Encouraging right type of industries & Arbiters of Risk.**
The banks help in development of right type of industries by extending loan to right type of persons. They grant loans and advances to manufacturers whose products are in great demand. The manufacturers in turn increase their products by introducing new method of production and assist in raising the national income of the country.
Most significant role of commercial banks in economic development is as arbiters of risk. This occurs primarily when banks make loans to business or individually. Bank examines the borrower's finances including income, credit score and debt level, among other factors before lending a loan to individual. By weeding out risky borrowers, commercial banks lessen the risk of financial losses.

III) Conclusion:

The commercial banks not just features deposit, withdraw and borrow of money but also play a vital role in the economic development. It is difficult to see how, in the absence of banks, could small savings be stimulated or even made possible. It is also difficult to see who would distribute these saving among entrepeneurs. It is through the agency of the banks that the community's savings automatically flow into channels which are productive.

Thus the banks have come to play a dominant and useful role in promoting economic development by — mobilising the financial resources of the community and by making them flow into the desired channels.