Dissertation Literature Review

Sample

Analysis of the Role of the Banking System in the Economic Growth

The financial system is a sum of financial markets (money market, capital market, foreign exchange market), financial institutions (depository: commercial banks, savings houses, credit unions etc., and non-depository: investment funds, insurance companies, pension funds, etc.); financial infrastructure (payment systems) and financial instruments (securities and their derivatives) (Madura, 2006). The banking system is part of the financial system in which the banks participate. The main role of the banking system is to enable entities with surplus funds to invest and transfer to entities that have a lack of funding (and have well-established plans for new projects), with the ultimate goal of making a profit (Rose and Hudgins, 2006). By performing this role, the banking system supports economic activity and can be the basis for major investment projects and technological innovations. The banking system exists to enable overcoming the difficulties that occur in the operations of enterprises, i.e. to enable financing of long-term investment projects or maintenance of the current (short-term) liquidity. In order for an enterprise to finance the investment projects that are the basis for its growth, it should provide financial means. In addition, the founding assets, funds from past profits and those provided through a new issue of equity securities are available. But if assets cannot be created in such ways (the so-called equity capital), then they should be borrowed from external sources (the so-called debt capital). A surplus agent in the economy is the population and it can channel the excess funds to the deficient agent-enterprises (Mishkin, 2005). In the development of the economy, the financial system has emerged between the scarce and surplus entities and aims to allow the channeling of funds to be at a minimal cost and with minimal risk. If the channeling of funds from the surplus to the deficit agents occurs directly, i.e. without the existence of the financial institutions, there will be two types of costs: information and transaction costs. Depositors (surplus agents) will generate information costs in order to get to know the operation of the enterprise (a deficient agent) or to assess the productivity of the project (i.e. its ability to repay the borrowed funds). De Long (1991) includes information costs in the information costs and the costs generated for depositors to feel secure, which includes measures to increase the operational safety of deposited funds. Transaction costs, however, are measured by the time and means necessary to realize one transaction (De Long, 1991). If such costs did not exist, the need for a financial system would not have existed. Since they are present in the complex reality, the role of financial institutions consists in minimizing and overcoming them, in order to effectively allocate resources (Merton and Bodie, 1995) and indirectly support economic growth. The next section examines these links in more detail.

According to the above discussion, the role of the banking system is to identify the needs for financial services, create the necessary products and sell them at affordable prices by reducing transactional and information costs (Rose and Hudgins, 2006). Thus, the banking system is developing, and by responding to the needs of the economy, it can contribute to the overall economic development. The development of the banking system is closely connected with the banking competition, and motivated by the increased competition, the banks can offer a variety of products and services. At the same time, the increased international capital movement contributes to the increasing participation of the banks on the international financial markets, the consolidation of banks from different geographical areas and the

emergence of regional banking groups. These development trends of the banking system influence the reduction of the prices of the banking products, which in turn affects the stimulation of investments in new projects and technological achievements, which stimulates the economic growth.

By providing its core functions, the banking system affects its own growth. At the same time, the performance of the core functions defines channels to support the overall growth of the economy. These functions are (Merton and Bodie, 1995): Generating information on potential investment opportunities and potentials for capital allocation; Mobilization of savings; Monitoring and control over enterprise-borrowers; Risk management; Specialization and concentration of banking activities.

Generate information on potential investments and capital allocation: Immediately prior to making a decision to lend, the bank should make a detailed analysis of the operations of the enterprises - borrowers. Enterprise analysis creates information and transaction costs for assessing solvency, managers, and future investment plans, as well as risk not to recover funds if investment projects fail. If the banking system does not exist, then the large costs of individual depositors for finding and evaluating the enterprises will deter them from appropriately allocating capital, which will prevent enterprises from continuing their investment plans. By reducing these costs, the banking system can improve the allocation of capital, i.e. to channel it to the places of its most productive use (Loayza and Ranciere, 2002). Thus, investment projects can be realized, which is the basis for economic growth. At the same time, due to the benefits from the larger volume of available information and due to the diversification of its loan portfolio, the bank reduces the credit risk, that is, the risk that the funds given will not be recoverable. Reduced credit risk reduces the so-called investment costs - the interest rate, making capital becoming cheaper and more accessible (Romer, 2006). Consequently, on an aggregate level, through the management of information for the borrowers, financial intermediaries influence the realization of a greater number of investments, on lowering the interest rates, and thus stimulates the crediting of the economic activity. It all contributes to supporting and strengthening economic growth.

Mobilization of savings: Closely related to the previous function is the mobilization of funds, that is, the collection of mass from funds of a large number of individual savers. Savings deposits are low-denominational financial instruments, which also allows lower-income saving savers (Sirri and Tufano, 1995; Tsai and Wu, 1999). According to Levine (2004), as well as capital allocation, the mobilization of savings deposits involves overtaking the transaction costs associated with the collection of savings deposits from a number of different entities and overcoming the information costs associated with the trust of depositors in the financial institution, as well as their sense of control over savings. In other words, in order to reduce these costs, the bank takes advantage of economies of scale when it uses one information that it disposes of for more clients (Madura, 2006). A typical example is the so-called delegated oversight, when the bank controls the investments of the enterprises it finances, instead of the individual savers (Levine, 2004). If individual savers are to do that, then every saver will need to analyze the company again, which will accumulate huge costs. Hence, by utilizing economies of scale, banking systems increase the efficiency in mobilizing savings from individuals, thus allowing faster resource allocation, supporting investment projects and technological innovation, and thus affecting economic growth.

Monitoring and control over enterprises: A third channel through which the banking

system can influence the economic growth is the control of the manner of utilization of the debt capital in the undertaking-borrower by the bank. According to the previous discussion, banks mobilize savings from a large number of individuals and lend to businesses. According to Boyd and Smith (1994), it is crucial that, on behalf of depositors, banks oversee the utilization of funds by enterprises. If depositors individually perform this oversight, the costs will be high, which will contribute to the price of capital (interest rate) to increase. Hence, the monitoring and control of the beneficiaries of the funds by the bank's creditor will affect the rational and productive utilization of the capital, thereby increasing the value of the enterprise and, consequently, contributing to overall economic growth. Some studies add that the role of banks as controllers of the utilization of assets of enterprises positively influences the long-term relationships between enterprises and the bank, which offers the opportunity to gain mutual trust, the opportunity to finance long-term capital projects, and innovative technologies. And, by directing capital into long-term projects, economic growth is supported. In the short term, when the bank has established effective supervision of the company, it knows the performance and performance of the enterprise, hence the procedure for financing the activities of the enterprise is shortened. The shortened funding period allows the company to keep the holding of cash at a minimum. Excess free money can be invested in financing its own activities and thus increase the productivity of operations. Consequently, the monitoring of the company's activities positively reflects the productivity, the accumulation of capital and the growth of the enterprise. In this way, enterprise monitoring supports the overall growth of the economy.

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