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# Role of Commercial Bank in the Economic Development of Bangladesh

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***Abstract***

*Banks have always played an important role in the country's economy. They play a decisive role in the development of the industry and trade. They are acting not only as the custodian of the wealth of the country but also as resources of the country, which are necessary for the economic development of a nation. The general role of commercial banks is to provide financial services to general public and business, ensuring economic and social stability and sustainable growth of the economy.Using yearly data on GDP as well as various commercial banks development indicators, covering the period July 2008 to July 2018, the study employed the Auto-Regression methodology in determining existence of the short-run and long-run relationships. Research is based upon the secondary data, which provide the findings on 10 commercial banks and how it is helpful in economic development of Bangladesh. This study used four explanatory variables to measure banking sector growth such as; banking credits facilities, customer deposits, number of branches, and interest rate on credits. It also used gross domestic product to measure economic growth inBangladesh. The main objective of the study is to critically examine and analyze the role of commercial banks on the economic growth of Bangladesh. The study portrays how loans and credit affect the GDP and consequently the level of economic growth of Bangladesh.The study thus concluded that commercial banks' development indicators have an impact on economic growth in Bangladesh and recommend reforms in the banking industry to ensure increased lending to support the economy.*

**Keywords**: Commercial Banks, GDP, Bank Credit, Economic Development, Social Stability.

## Introduction

After the independence of Bangladesh, all banks and financial institutions were nationalized. To ensure smooth competition, to provide better quality services, to make finances available to the individual

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entrepreneurs as well as to businessmen, and thus to accelerate the growth of the national economy as a whole, the government allowed the establishment of the banks in the private sector from 1983. It is well acknowledged in the economics literature that deposit-taking banking institutions play a major role in promoting economic development through the channeling of funds from those with excess to those in need for investment purposes. However, for banks to be effective in fostering economic growth, they must lend to the right sectors of the economy that are essential and can act as catalysts to stimulate growth. Furthermore, it is fundamental that banks effectively manage various risks that they are exposed to, to remain solvent in the long run and be in a position to provide long-term capital which is more essential for economic growth and development. In this regard, for an economy to grow, it should have a well developed and stable banking system that is resilient to external shocks to effectively play the role of financial intermediation

## Theoretical Framework

### *Concept of Banking*

The banking system plays an important role in the modern economic world. Banks collect the savings of the individuals and lend them out to a business- people and manufacturers. Thus, the banks play an important role in the creation of new capital (or capital formation) in a country and thus help the growth process. Banks arrange for the sale of shares and debentures. Thus, business houses and manufacturers can get fixed capital with the aid of banks. There are banks known as industrial banks, which assist the formation of new companies and new industrial enterprises and give long-term loans to manufacturers.

The banking system can create money. When a business expands, more money is needed for exchange transactions. The legal tender money of a country cannot usually be expanded quickly. Bank money can be increased quickly and used when there is a need for more money. In a developing economy (like Bangladesh) banks play an important part as a supplier of money.

The banking system facilitates internal and international trade. A large part of the trade is done on credit. Banks provide references and guarantees, on behalf of their customers, based on which sellers can supply goods on credit. This is particularly important in international trade when the parties reside in different countries and are very often unknown to one another.

So it is undoubtedly true that banks are the mostinfluencing component of the financial structure and thegrowth of the financial structure itself acts as a facilitatingfactor in the economic transformation of a country.The financial sector of Bangladesh, like most

developingcountries, is dominated by banking enterprises. Currently,the banking sector of Bangladesh comprises of nationalized commercial banks (NCBs), 5 government-ownedspecialized banks (SBs) dealing mostly withdevelopment finance in specialized sectors, 30 private commercial banks (PCBs), and 10 foreign commercialbanks (FCBs).

The banking system, before the liberation of Bangladesh, wasprivately owned, urban-based, and profit-oriented. Afterliberation in 1971, the development strategy which wasfollowed in the pre-independence period underwent a qualitative change. The then government in powernationalized and reorganized all the financial institutionsexcept a few foreign bank branches. The governmentwhich assumed power in Bangladesh adopted economic policies and programs ensuring social control.

***Economic growth***

Economic growth is the increase in the goods and services produced by an economy, typically a nation, over a long period. It is measured as a percentage increase in the **real gross domestic product (GDP)** which is gross domestic product (GDP) adjusted for inflation. **GDP** is the market value of all final goods and services produced in an economy or nation. So how does a nation or economy continually increase the GDP such that the economic growth trends upward? There are three main types of economic growth theories over time that has all attempted to answer that exact question. The Classical, Neo-Classical, and Modern Day theories will each be described.

The **classical theory of economic growth** was a combination of economic work done by Adam Smith, David Ricardo, and Robert Malthus in the eighteenth and nineteenth centuries. The theory states that every economy has a steady state GDP and any deviation off of that steady state is temporary and will eventually return. This is based on the concept that when there is a growth in GDP, population will increase. The increase in population thus has an adverse effect on GDP due to the higher demand on limited resources from a larger population. The GDP will eventually lower back to the steady state. When GDP deviates below the steady state, population will decrease and thus lower demand on the resources. In turn, the GDP will rise back to its steady state.

**Literature Review**

Furthermore, Christopolus and Tsionas (2004) examined the relationship between financial development and economic growth in ten developing countries and found no causal link between financial deepening and output growth in the short run while they found unidirectional though no bidirectional causality between financial developments to output in the

long run. Financial debts, moreover, the result indicates that causality runs from financial development to economic growth, but not in the opposite direction.

Sikder and Wadud and Hasan (2015) investigate the presence of a long-run relationship between financial development and economic growth in Bangladesh and India. They are found evidence of the bidirectional causal relationship between financial development and economicgrowth in both countries.

Bangladesh has come a long way in its economic growth. From a meager US$ 5.70 billion in 1972, the gross domestic product (GDP) increased to US$ 285.82 billion in 2018. The Bangladesh economy is the 42nd largest in the world in nominal terms and 31st largest in terms of Purchasing Power Parity (PPP). Recently, Bangladesh graduated from least developed country (LDC) status to a lower middle-income country and hopes to become a developed country by 2041.

Four distinct growth phases are discernible (Ahmed 2012; Khuda and Barkat 2017) in the country's economic journey. The first phase (1990-1996), one of subdued growth rate expansion, witnessed less than 4.0 percent annually in aggregate terms and less than 3.0 percent in per capita terms. The second phase (1996-2003) witnessed a growth rate fluctuating between 4.0 and over 5.0 percent and around 4.0 percent per capita. The third phase (2004-13) witnessed a growth rate of around 6.0 percent and per capita growth of around 5.0 percent. The fourth phase (2013--) witnessed a growth rate of over 6.0 percent and reached over 7.0 percent during the last two financial years.

With acceleration in the growth of per capita income, there has been considerable progress in poverty reduction (Raihan and Khondker 2012). Poverty declined from 56.7 percent in 1991 to 24.3 percent in 2015. Today, it is around 22 percent. As a result of considerable decline in poverty, especially during 2001-10, the number of poor people declined, with the size of the population below the upper poverty and lower poverty lines declining by around 8.58 million and 8.61 million respectively. However, there is high and rising income inequality.

In some neighborhood countries, Gautum (2014) examined the relationship between economic growth and financial development in Nepal using data from 1975 to 2012. He found evidence which confirms that financial development causes economic growth. Financial development is the cause for economic growth in terms of short-term dynamics, while economic growth sustains financial development in the longrun.

Petkovski and Kjosevski (2014) investigate the negative relationship between economic growth to bank credit and interest margin in central and south Eastern Europe. They used bank credits, interest rate, and the ratio of quasi money as independent variables while gross domestic product as a proxy variable.

However, Abubakar and Gani (2013) re-investigated the long-run relationship between financial development indicators and economic growth in Nigeria. The findings revealed that in the longrun, liquid liabilities of commercial banks and trade openness exert a significant positive influence on economic growth, conversely, credit to the private sector, interest rate spread, and government expenditure exert a significant negative influence.

Recently, Medjahed and Gherbi (2016) investigated the impact of the development of the banking sector on economic growth in MENA countries. They found a negative impact of financial development on the economic growth of MENA countries during the short and longrun.

Similarly, Furqani and Mulyany (2009) investigated the dynamic interactions between Islamic banking and economic growth of Malaysia by employing the co-integration test and Vector Error Correction Model (VECM) to see whether the financial system influences growth and growth transforms the operation of the financial system in the long-run. They found evidence of a bidirectional relationship between Islamic banks and fixed investment and there is evidence to support the growth-led finance hypothesis of GDP and Islamic Bank.

Abdulh and Omar (2012) examine the short-run and the long-run relationships between Islamic banking development and economic growth in the case of Indonesia. They found a significant bi-directional relationship in the short-run and long-run periods between Islamic financial development and economic growth.

In addition, Prochniak and Wasiak (2017) examine the impact of the financial system on economic growth for 28 EU and 34 OCED countries. Their empirical result shows a positive significant relationship between the banking system and economic growth. However, some banking variables have a negative effect on economic growth.

Few studies in Bangladesh primarily discussed and analyzed the role of financial development in fostering economic growth. So, this study adds new evidence from Bangladesh economy. Therefore, this study extends the existing literatures through examining the impact of banking trends on Bangladesh economic growth.

**The objective of the study**

The main objective of the paper is to study the effect of banking sector development on the economic development of Bangladesh. The objective

is to measure howIndividual factors that affect banking sector growth such as; banking credits facilities, customer deposits, number of branches, and interest rate on credits affect gross domestic product to measure economic growth inBangladesh.

Sub objectives of the study are the following.

- To examine the effect of banking credits facilities on gross domestic product.
- To examine the effect of customer depositson gross domestic product.
- To examine the effect of several brancheson gross domestic product.
- To examine the effect of interest rate on credits on gross domestic product.

**Research Question and Scope**

In light of the discussions above, the main objective of this study is to analyze the relationshipthat exists between commercial banks' development; as the largest providers of domestic creditin the economy, and economic growth in Bangladesh during the period July 2008 to July 2018. Furthermore, the study will try to determine the direction of causality between commercial Banks' development indicators and economic growth over the same period to establish

Whether commercial banks' development results from the development in the real sector or whether the expansion of the banking sector precedes economic growth. As such, this study will attempt to answer the following research questions:

1. Does commercial banks' development lead to economic growth?
2. What is the relationship between banking sector development indicators and gross domestic product?

***Research Hypothesis***

This section presents the formulation of the research hypothesis. So, the alternative hypothesis argues that the explanatory variables; banking credits, banks deposits, number of branches, and interest rate have a significant impact on gross domestic product as argued by McKinnon (1973), King and Levine (1993), and Ehikiorya and Ismailia (2014).

Based on the reviewed literature the following hypotheses have been formulated:

**H01*:*** Banking credit has no significant effect on gross domestic product.

**Ha1**: Banking credit has significant effect on gross domestic product.

**H02:** Banks deposits have no significant effect on gross domestic product.

**Ha2:** Banks deposits have a significant effect on gross domestic product.

**H03:** Number of branches has no significant effect on gross domestic product.

**Ha3:** Number of branches has a significant effect on gross domestic product.

**H04:** Interests rate no has a significant effect on gross domestic product.

**Ha4:** Interest rate has a significant effect on gross domestic product.

## Data and Methodology

### *Sources of Data*

This research examines the impact of changes in the banking sector on economic growth. It can be estimated by using time series data over the period July 2008 to July 2018. The research initially includes 10 commercial banks operating in Bangladesh.The study panel data are yearly and obtained from financial stability reports. The choice of the period in this study was entrusted to the data variables availability included in the estimated model. On other hand, this paper uses some financial indicators to measure the banking industry development such as banking credit (BC), banking deposits (BD), the number of bank branches (BB), and interest rate (I). Moreover, it uses the gross domestic product as a proxy of economic growth (EG).

### *Model and Variables*

The econometric model is employed to evaluate the impact of banking variables on gross domestic product. Typically, the functional relationship between financial development and economic growth can schematically be formulated as follows:

$\Delta$ EGt = $f$ (BC, BD, BB, I)

Thus, this hypothetical model can be specified including logarithm for banking indicators as follows:

Log EGt = β0 + β1 Log BCt + β2 LogBDt + β3 Log BBt + β4 It

Where the explained variable EG is the logarithm of gross domestic product at period t. β0 represents a constant or intercept. Further, explanatory variables coefficients include; β1 is the coefficient effect of banking credits, β2 is the coefficient effect of banks deposits, β3 is the coefficient effect of number of branches, and β4 is coefficient effect of interest rate. While et is residual errors. Therefore, **Table 1** describes the explanatory and dependent variables.

**Table 1:** Identification of dependent Variable and Explanatory Variable

| Variable | Definition | Predicted sign | |
|---|---|---|---|
| **Dependent Variable** | | | |
| Economic growth | Growth in gross domestic product | + | |
| **Explanatory Variables** | | | |
| Banking Credits | Change in credit facilities ( year to year ) | + | |
| Banking Deposits | Change in total banking deposits | + | |
| Number of branches | Change in the number of branches (year to year) | + | |
| Interest rate | The average of interest on credit | - | |

***Source:*** *Literature Survey*

***Data analysis andStatistical tools***

The present study SPSS 17.0 is used to conduct the regression analysis.

Pearson Correlation coefficient is used to find out the relationship between gross domestic product and individual variables. The variables used in the study are quantitative.

Regression analysis is used as a method to find out which of the independent variables (banking credits facilities, customer deposits, number of branches, and interest rate on credits) affecting the dependent variable Growth in the gross domestic product were significant concerning predicting themost influential economic development determinants. Regression analysis is conducted to reveal the linear relationship between gross domestic product and other independent variables. The variables are retained in the regression model based on high t value ($|t|>2$) and low p-value ($p<0.05$).

**Research Findings**

***Correlation***

**Table 2 (Correlation between Gross Domestic Product and Other Individual Variables)** shows the correlation among the different variables in the study. The dependent variable gross domestic productshares a significant positive correlation with banking credits facilities (r=0.615, sig=0.030) customer deposits (r= 0.756, sig= 0.029) and number of branches (r=0.688, sig=0.045). The other variable interest

rate on credits(r= -0.556, sig= 0.429) shares negative relation with the variable gross domestic product but the relation is not statistically significant.

***Test of Hypothesis***

**H01*:*** Banking credit has no significant effect on gross domestic product.

**Ha1**: Banking credit has a significant effect on gross domestic product.

In this case, both the variables Banking creditand gross domestic productare continuous variables. At the significant level of 0.05, we found that |t|-value > 2 (t-value 3.793) and p-value=.030 **Table-3 (Regression Analysis of Gross Domestic Product and Banking credit)** which is less than 0.05. Hence, we can reject the null hypothesis and accept that banking credit has a significant effect on gross domestic product.

**H02:** Banks deposits have no significant effect on gross domestic product.

**Ha2:** Banks deposits have a significant effect on gross domestic product.

In this study, both the variables gross domestic productand banks depositsare continuous. At the significance level of 0.05, we found that |t|-value > 2 (t-value 3.280) and p-value=.027 **Table-4(Regression Analysis of Gross Domestic Productand Banks Deposits).** Hence, we can reject the null hypothesis and accept that banks depositshavea significant effect on gross domestic productin the selected sample of 10 commercial banks.

**H03:** Number of branches has no significant effect on gross domestic product.

**Ha3:** Number of branches has a significant effect on gross domestic product.

In this case, both the variables gross domestic product and the number of branches are continuous. At the significance level of 0.05, we found that |t|-value < 2 (t-value -4.940) and p-value=0.035**Table-5 (Regression Analysis of Gross Domestic Productand Number of Branches).**we can reject the null hypothesis and accept that number of brancheshave a significant effect on gross domestic product in the selected sample of 10 commercial banks.

**H04:** Interests rate no has a significant effect on gross domestic product.

**Ha4:** Interest rate has a significant effect on gross domestic product.

In this case, both the variables gross domestic product and Interests rate are continuous. At the significance level of 0.05, we found that |t|-value < 2 (t-value -0.940) and p-value=0.375 **Table-6 (Regression Analysis of**

**Gross Domestic Productand Interests rate).** Hence, we can accept the null hypothesis in this case based onthe significance level because the p-value exceeds the significance level of 0.05. Therefore, it can be said that the Interests rate has no significant effect on gross domestic productin the selected sample of 10 commercial banks.

## Conclusions

The primary objective of the paper is to study the relationship between the independent variables (banking credits facilities, customer deposits, number of branches, and interest rate on credits) affecting the dependent variable Growth in gross domestic product and to understand how these factors affect the economic development of Bangladesh. Using the least square model, regression analysis and correlation the researcher examined whether the banking industry contributes to economic growth in Bangladesh'seconomy in the period from July 2008 to July 2018. This study used four explanatory variables to measure banking sector growth such as; banking credits facilities, customer deposits, number of branches, and interest rate on credits. It also used the gross domestic product to measure economic growth inBangladesh.

In summary, Gross Domestic Product is strongly influenced by some of the banking indicators, especially banking credits facilities, customer deposits, and a number of branches. This paper found that more funding to economic sectors tends to enhance and improve economic conditions in Bangladesh, partially local productivity in public and private sectors. Therefore, the banking industry is considered one of the props for building the productive capacity of Bangladesh's economy.

Conclusively, banking credits, customer deposits, and a number of branches are the main determinant of economic growth in Bangladesh and is considered the core internal funding source for Bangladesh economy. The other variable interest rate according to the result does not affect the growth of the gross domestic product. However, funding economic sectors in Bangladesh is relatively low and under the required level. Therefore, this finding could be interesting for some policymakers in Bangladesh especially BangladeshBank (BB). This paper recommends that Bangladesh banks should lower the cost of debt to provide more domestic funding and to improve their credits policy to reinforce local fundraising capacity and investments.

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