THE FINANCIAL SECTOR AND THE ROLE OF BANKS IN ECONOMIC DEVELOPMENT

Imola Drigă, *Assoc. Prof., Ph.D., University of Petroşani, Romania*, imola.driga@gmail.com
Codruța Dura, *Assoc. Prof., Ph.D., University of Petroşani, Romania*, codrutadura@yahoo.com

ABSTRACT*: The paper discusses the main functions of banks and their role in the economy as financial intermediaries. Any market economy requires the existence of a banking system able to ensure the mobilization of available money and guiding them towards the pursuit of efficient economic activities so that the banking system plays an important role in the economy of any country. Financial intermediaries channel funds from those who have savings to those who have more productive uses for them. They perform financial services that reduce the costs of moving funds between borrowers and lenders, leading to a more efficient allocation of resources and faster economic growth. Thus, banks are essential component for modern economy, not only in terms of turnover, but also as the primary financier of the national economy.*

KEY WORDS: economic growth, financial development, financial crisis, bank lending, non-performing loans, corporate loans.

1. INTRODUCTION

As finances represent the means and methods through funds are obtained, controlled, allotted and used [7], market economy requires a strong banking system that enables funds redistribution. Banks perform various roles in the economy. Beside performing an important role in corporate governance and improving the information problems between investors and borrowers, banks contribute to economic development.

A bank can be associated with a financial service conglomerate able to provide basic financial services and properly function within the economic, political, legal and international environment that determines its profit and expansion opportunities, interest rates, exchange rates and the particular resources a bank need [10]. The efficiency of the banking system is a key determinant of sustainable growth. Thus, banks are essential for any modern economy, not only in terms of turnover, but also as the primary financier of the national economy.

2. FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH

To understand why financial sector development may be positively related to economic growth, it is necessary to understand the critical function the sector provides to the economy. The financial sector is unique because of the risk and uncertainty faced by both savers and investors [21]. In order to perform their functions, banks provide a large array of financial services to attract customers and to meet their demands. The Economist has often described banks as intermediaries between savers and users of capital. Banks are special intermediaries because of their unique capacity to finance production by lending their own debt to agents willing to accept it and to use it as money [5].

Being at the same time borrowing and landing institutions, banks also offer other types of services, such as: payments, settlements and funds transfer, foreign exchange transactions, savings and investment services, payroll services, financial advice, investments and bill finance, safe-deposit boxes. So as to provide these financial services, commercial banks perform certain functions within the national economy [10]: the function of deposit' acceptance, attracting temporarily available resources from business and individual customers; the investment function, granting loans for those in need of financial support; the commercial function that enables fund transfer between account holders determined by various activities. Altogether, banks channel savings into productive capital, facilitate productive use of surpluses to generate employment and promote economic welfare and provide risk-free income to depositors.

The financial sector and its role in the process of economic development have attracted notable attention over the last decades. A large body of theoretical literature exists on financial system offering important contributions to the understanding of banks as key determinants of economic growth. A number of researchers in the early and late 1990's (just to mention some: Diamond, Dybvig, Barro, King, Levine, Zervos, Pagano, Stiglitz) and more recent studies (of: Bossone, Armenta, Gregoric, Kosak, Allen, Carletti, Taghipour) concluded that financial development promote economic growth. Diamond and Dybvig show how financial intermediaries can enhance risk sharing, which can be a precondition of liquidity and can thus improve welfare. In their model, without an intermediary (such as a bank), all investors are locked into illiquid long-term investments that yield high payoffs only to those who consume at the end of the investment. Financial markets can also transform illiquid assets into financial instrument (liquid liabilities). With liquid financial markets savers/lenders can hold assets like equity or bonds, which can be quickly and easily converted into purchasing power. Financial intermediaries make longer-term investments more attractive providing different forms of finance to borrowers [9].

As Joseph Stiglitz states, well-functioning financial systems, including banks, enable selecting the most productive recipients for these resources and ensure the use of these resources in high return activities. On the other hand, inadequately functioning financial systems tend to transfer capital to low-productivity investments. The differences in terms of growth can be huge [20]. Both theory and research suggests that better developed financial systems facilitate external financing for firms, illustrating a mechanism through which financial development influences long-run economic growth. In particular, financial development involves certain improvements *in the production of ex ante information about possible investments, monitoring of investments and implementation of corporate governance, trading, diversification, and management of risk, mobilization and pooling of savings and exchange of goods and services*, functions which may influence savings and investment decisions and consequently economic growth [17].

Nevertheless, the relationship between financial economic development and economic growth is highly controversial, as Boon pointed out. The supply leading theories believe that the development of financial sector is essential for economic growth, whereas the demand following theories consider financial development as merely sensitive to economic growth [4]. Further more, there are several studies showing a split in the relationship between bank lending and economic growth - the so-called "*creditless recoveries*" (Calvo, Izquierdo, Talvi; Takáts, Upper and others) [6], [23].

3. BANK LENDING TO PRIVATE SECTOR IN ROMANIA

Generally, credit is defined as an immediate purchasing power exchanged for the promise to repay it at a later date with interest and protect the pledged collateral until the loan is fully paid. A credit transaction is a business activity that involves two sides: a borrower, which generally is an individual or a firm and a lender that may be a lending institution such as a commercial bank or other intermediary involved in the purchase [10]. The efficiency of the process through which savings are channelled into productive activities is crucial for growth and general welfare. Banks are one part of this process being important players in corporate funding. Despite the trend of globalisation in recent years, the importance of banks in different economies varies significantly. As the traditional role of a bank is lending, bank loans consist of domestic credit to the private sector [1].

By providing financial services to all firms with good growth opportunities, the financial sector helps the economy to grow. It is not just a matter of the overall volume of lending, but it is crucial which companies are financed and on what terms. At the same time, as a consequence of banking products and services development, increasing competition in the area and extension of the private sector, one of the main challenges for Romanian banks became lending profitable loans by maintaining risks at a reduced level.

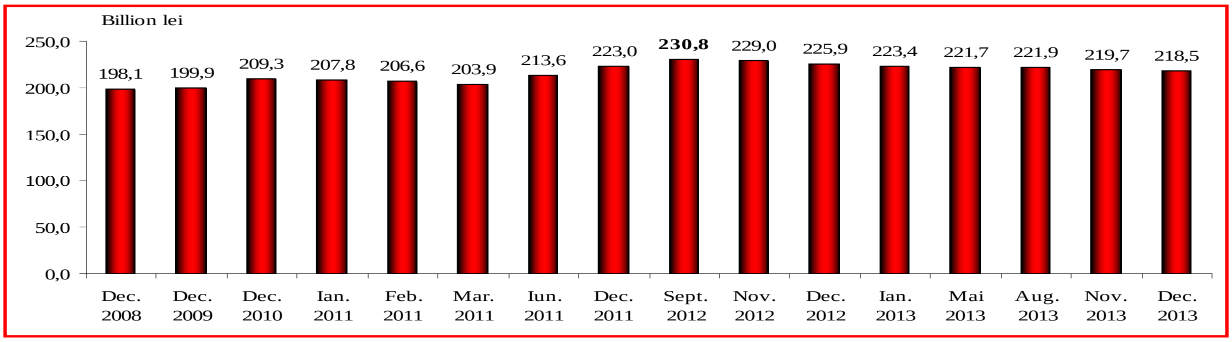
The Romanian banking system witnessed a gradual increase of financial intermediation, especially after 2005, non-government credit being the main factor behind bank asset expansion. Further rise in lending carried on in 2006 and 2007 as credit institutions kept expanding their lending activity, even after the onset of the global financial turmoil, in their effort of gaining a bigger market share. Structural analysis indicates that the rise in loans to households was the driver of credit expansion. According to statistics released by the NBR, the share of loans to households increased to 48.1% at end of 2007 from 42.5% a year earlier. The upward trend in lending was maintained in 2008 and the domestic banking sector continued to be the main financing source for the real economy (accounting for 66% of total funds).

However, after these positive evolutions, the financial crisis that began in 2007 has strongly influenced developments both in real and financial sectors. The deterioration of the domestic economic environment in the late 2008 and in the first month of 2009 caused the decline in demand. Consequently, the dynamics of bank assets and non-government credit was reduced.

The set back in bank lending began in 2008 when the growth rate of loans granted to the private sector slowed down in the context of a challenging macroeconomic environment. This trend continued in the next coming period until mid-2011. Starting with the latter half of 2011 and for the first nine months of 2012 lending to the private sector witnessed a restart. In the following period, however, the dynamics of private sector loans re-entered negative territory for both national currency- and foreign currency-denominated loans, accelerating gradually till December 2013 (see figure 1).

Recent evidence shows that, in terms of volume, total loans to non-financial corporations decreased starting with mid-2009 from 28128.9 million lei as recorded in March 2009 to 16183.2 million lei in December 2013. Nevertheless, between 2009 and 2013 there was a change of strategy in terms of bank lending. More specifically, the share of loans to enterprises increased. If in 2009 credit to households was higher than corporate loans (about 5%) since the end of 2010 there has been a reversal of the situation. Thus, during 2012 credit flows to firms was 15% higher than lending to individuals on average. But, the last quarter of 2012 marked the beginning of decrease of loans offered both to individuals and non-financial corporations.

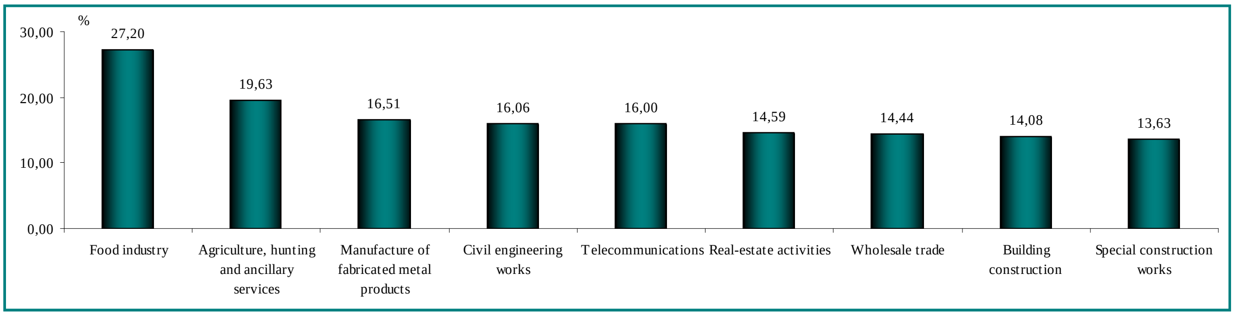
Nevertheless, the conditions of lending to the private sector (non-financial corporations and households) recorded regular developments in 2011, 2012 and the first half of 2013. Credit flows tend to be mainly directed towards more efficient sectors that are supportive of Romania's sustainable economic growth. Thus, corporate funding registered favourable structural developments especially in case of lending to companies producing high value added goods (*medium high-tech* and *high-tech*) and to firms in the tradable sectors.



Source: based on data from the NBR's Monthly Bulletins, Dec. 2008 - Aug. 2013

Figure 1. Private sector loans, 2008-2013

According to statistics released by the NBR, during April-September 2013 companies doing business in tradables sectors accessed more loans from banks and non-bank financial institutions than firms doing business in non-tradables sectors. This trend indicates a sustainable economic growth upheld to some extent by the financial system. Besides, analysis of the main sectors of the economy indicates that firms in the agriculture sector and trade applied mostly for bank loans, accessing funds mainly through credit lines, bank overdraft and investment loans. Firms in the food industry and agriculture sector rely significantly on bank financing service (see figure 2).



Source: based on data from NBR, Financial Stability Report, 2013

Figure 2. The share of bank debt in total balance sheet debt

If lending standards would discriminate more strongly between firms based on the credit risk posted throughout an economic cycle, access to financing might improve for those sectors playing an important role in generating added value across the economy. As a matter of fact, discriminating between lending conditions by economic sector is part of the macro-prudential toolkit that is to be used across the EU [24].

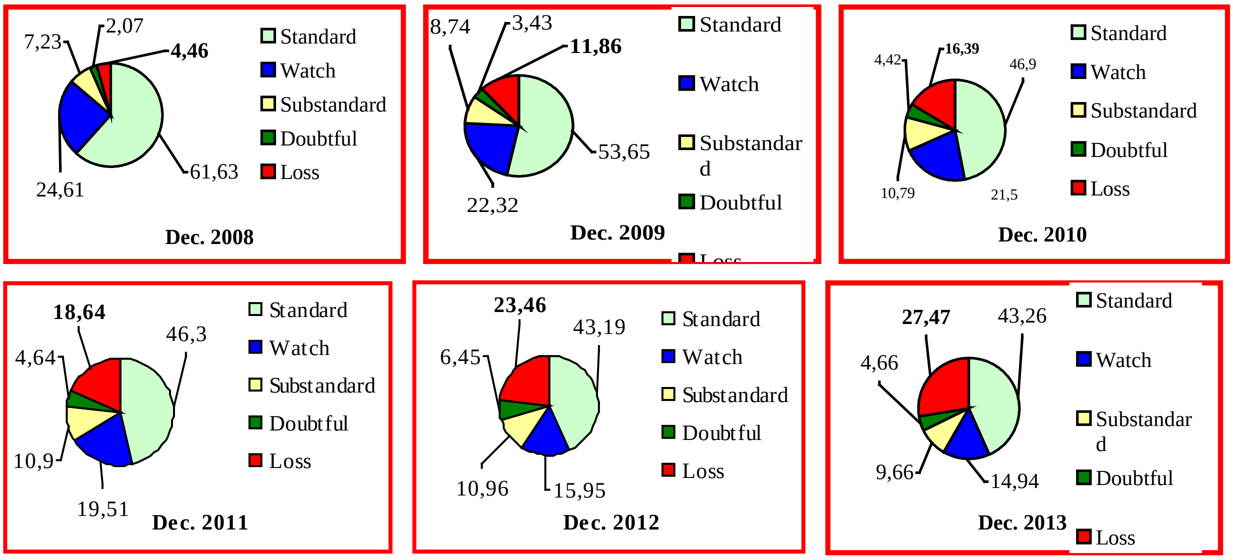
Due to further constraints on customers' financial standing and the still fragile economic growth, *the quality of the loan portfolios* of banks registered an ongoing worsening. The assessment of credit quality based on prudential reports reveals a constant deterioration in loan quality that started in late 2008. The slower economic growth, the rise in inflation and the depreciation of the national currency exerted a severe adverse impact illustrated by the significant deterioration of the quality of banks' loan portfolio [24]. Thus, for the period 2008-2013 the exposure of the banking system to loans granted to individuals and non-financial corporations highlights the increase of "loss" and "doubtful" loans, while "standard" and "watch" loans recorded a downward trend [12]. According to data released by the NBR, the quality of loan portfolios has remained a vulnerability to the Romanian banks' due to the pressure put on the financial standing of borrowers and the restraint in lending (see table 1 and figure 3).

After the financial crisis, economic recovery is difficult especially when funding depends overwhelmingly on banks which are in the process of capitalization and additionally their appetite to grant loans is considerably diminished by over-indebtedness.

Table 1. The evolution of the quality of the loan portfolios of banks

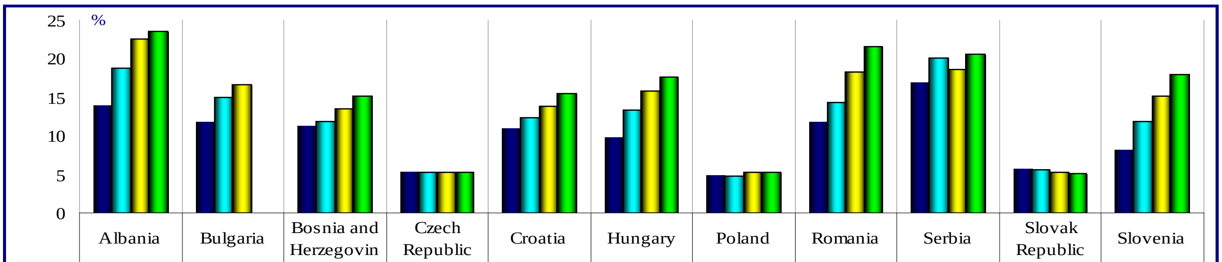
	Standard	Watch	Sub-standard	Doubtful	Loss
Dec. 2008	61.63	24.61	7.23	2.07	4.46
Dec. 2009	53.65	22.32	8.74	3.43	11.86
Dec. 2010	46.90	21.50	10.79	4.42	16.39
Dec. 2011	46.30	19.51	10.90	4.64	18.64
Dec. 2012	43.19	15.95	10.96	6.45	23.46
Dec. 2013	43.26	14.94	9.66	4.66	27.47

Source: processed based on data from the NBR's Monthly Bulletins, 2008-2013



Source: processed based on data from the NBR's Monthly Bulletins, Dec. 2008 – Aug. 2013

Figure 3. The evolution of the quality of the loan portfolios of banks



	Albania	Bulgaria	Bosnia and Herzegovin	Czech Republic	Croatia	Hungary	Poland	Romania	Serbia	Slovak Republic	Slovenia
2010	14	11,9	11,4	5,4	11,1	9,8	4,9	11,9	16,9	5,8	8,2
2011	18,8	15	11,8	5,2	12,3	13,4	4,7	14,3	20	5,6	11,8
2012	22,5	16,6	13,5	5,2	13,8	15,8	5,2	18,2	18,6	5,2	15,2
2013	23,5	0	15,1	5,2	15,4	17,6	5,2	21,6	20,6	5,1	18

Source: based on data from World Bank's database. Note: Bulgaria 2013 – N/D; Bank NPLs to total gross loans are the value of non-performing loans divided by the total value of the loan portfolio (including non-performing loans before the deduction of specific loan-loss provisions). The loan amount recorded as non-performing should be the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue.

Figure 4. NPLs ratio in Central and Eastern Europe, 2009-2013

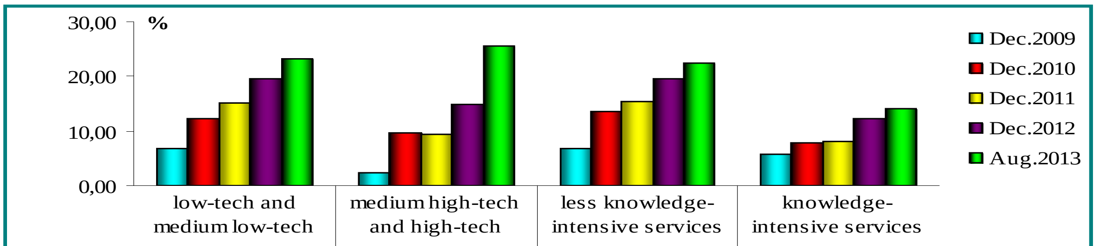
In 2009, Romania already had a rate of non-performing loans (*NPLs represent loans overdue for more than 90 days and/or with legal proceeding initiated*) more than the average in CEE (see figure 4). NPLs continued to rise in terms of both volume and ratio (*NPLs ratio is the key loan portfolio quality assessment indicator from a prudential perspective and is calculated based on prudential reports on loan classification; it represents gross exposure to loans and interest overdue for more than 90 days and/or with legal proceeding initiated, classified in national regulations under "Loss 2", per total classified loans and interest*).

Although the large volume of non-performing loans is still a major concern, in 2011 Romania ranked among the states with a moderate rate of decline in loan quality.

However, the still modest economic growth rate associated with the downtrend in lending has led to significant accumulation of non-performing loans in 2012 and 2013.

Taking into account the way non-financial corporations from different sector of activity honoured their debts, banks may consider implementing internal lending standards that would favour companies operating in the sectors that can contribute to sustain change in the economic growth pattern. The NBR's results show that the firms grouped into medium-high tech and high-tech sub-sectors posted an average non-performing loan ratio below the economy-wide average over the last seven years (see figure 5).

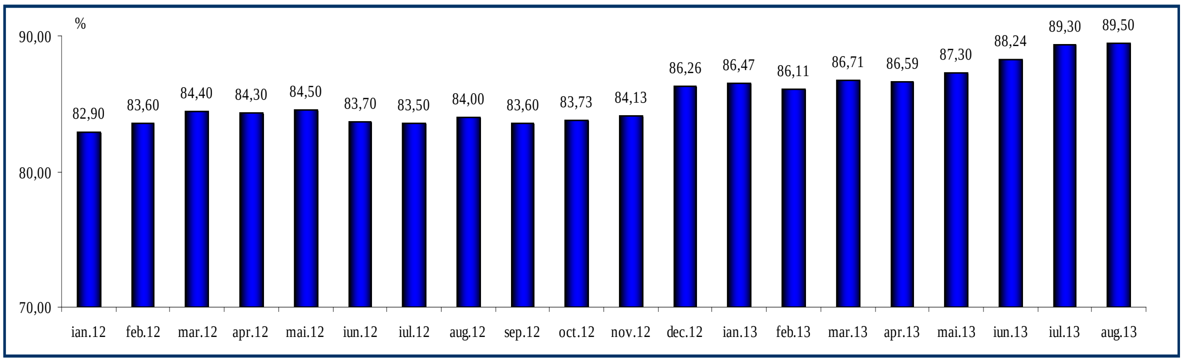
Further more, evidence shows that the risk attached to the loan portfolios in the balance sheets of banks in Romania is mitigated by the comfortable provisioning, which covers expected losses (see figure 6). Besides, the provisioning level calculated for the Romanian banking system is the highest among the countries in the region.



	low-tech and medium low-tech	medium high-tech and high-tech	less knowledge-intensive services	knowledge-intensive services
Dec.2009	6,72	2,34	6,85	5,73
Dec.2010	12,20	9,76	13,51	7,86
Dec.2011	15,19	9,43	15,27	7,99
Dec.2012	19,60	14,92	19,65	12,18
Aug.2013	23,16	25,62	22,51	14,02

Source: based on data from NBR, Financial Stability Report, 2013

Figure 5. NPLs ratio for companies, by technological intensity, Dec. 2009 - Aug. 2013



Source: based on data from NBR, Financial Stability Report, 2013

Figure 6. Coverage ratio of non-performing loans

4. CONCLUSIONS

Banks as financial intermediaries are expected to provide basic financial services for everyone. Banking, considered as mirror of economic growth, can contribute to economic development in at least two ways: directly, by increasing balance sheet items, and indirectly, through financing. In the global economy, the growing importance of banks is obvious, given that in the context of accelerating the development of information systems and communications, we are witnessing the emergence of global financial networks.

Many researchers argue that a sound and efficient banking system is significant in achieving economic development. Thus, well functioning banks accelerate economic growth, while poorly functioning banks are an obstacle to economic progress and aggravate poverty.

The effects of the global financial crisis occurred in the Romanian banking system at the end of 2008 when the growth rate of loans granted to the private sector slowed down in the context of a challenging macroeconomic environment and this trend kept on until mid-2011, the Romanian banking system being confronted with poor lending activity and NPLs outburst. However, in the latter half of 2011 and for the first part of 2012 lending to the private sector resumed and since mid-2013 lending growth has been moderately accelerating and in the next years corporate lending is expected to provide growth in both lending and the economy.

Some authors argue that the set back in bank lending would not be an impediment to economic growth, stressing out that last year's advance of the Romanian economy (3.5% economic growth, despite of reduction in the volume of bank credit) would acknowledge what the so-called "creditless recoveries" support. Most experts, however, believe that although economic growth in Romania between 2011 and 2013 has relied on exports and in 2014-2015 most probably will be based on underutilized industrial production capacities, in medium and long term the economy needs appropriate funding sources such as capital market, foreign direct investment, European funds and especially banking sources [8]. Therefore, the separation between finance and economic growth may be only temporary since better access to finance can help existing firms to grow and new firms to enter the market, which in turn supports growth at the aggregate level.

5. REFERENCES:

[1]. Allen F., Carletti, E., *The roles of banks in financial systems*, Oxford Handbook of Banking, 2008

[2]. Armenta M.W., *The Financial Sector and Economic Development: Banking on the Role of Human Capital*, Journal of Public and International Affairs, Princeton, USA, vol.18, pp.188-203, 2007

[3]. Barro R., *Economic Growth in a Cross Section of Countries*, The Quarterly Journal of Economics, Vol. 106, No. 2, pp. 407-443, May 1991

[4]. Boon T.K., *Do Commercial banks, stock market and insurance market promote economic growth? An analysis of the Singapore Economy*, Working paper of the School of Humanities and Socal Studies, Nanyang Technological University, 2005

[5]. Bossone B., *Do banks have a future? A study on banking and finance as we move into the third millennium*, Journal of Banking & Finance, vol.25, pp.2239-2276, 2001

[6]. Calvo G.A., Izquierdo A., Talvi E., *Phoenix miracles in emerging markets: recovering without credit from systemic financial crises*, National Bureau of Economic Research, 2006

[7]. Ciuhureanu A.T., Balteş N., Brezai L., *The Financial Management's Role in Modern Organizations. Interferences and Differences Between the Management of the Accounting Activity and the Financial Management*. Anale. Seria Ştiinţe Economice. Timişoara, vol. XV, pp. 597-600, 2009

[8]. Dăianu D., *Poate creşte economia fără finanţare?*, Ziarul Financiar, 21 apr. 2014

[9]. Diamond D.W., Dybvig P.H., *Bank Runs, Deposit Insurance and Liquidity*, Journal of Political Economy, University of Chicago, vol. 91, no. 3, pp.401-419, 1983

[10]. Drigă I., *The Role of the Banking System in the Sustainable Development of the Economy*, Annals of the University of Petroşani, Economics, vol.6, pp.55-60, 2006

[11]. Drigă I., Guţă A.J., *Romanian Bank Lending during the Financial Crisis*, Revista Tinerilor Economişti, Craiova, Year VII, No.12, pp.22-27, April 2009

[12]. Drigă I., *Financial crisis and bank profitability - the case of Romania*, Annals of the University of Craiova, Economic Sciences Series, pp.34-45, 2013

[13]. Gregoric A., Kosak, M., *SME Financing and Multiple Bank Relationships in Transition Economies*, 2007

[14]. Iuga I., Lazea R., *Study Regarding the Influence of the Unemployment Rate over Non-Performing Loans in Romania Using the Correlation Indicator*, Annales Universitatis Apulensis Series Oeconomica, vol.14(2), pp.496-511, 2012

[15]. King R.G., Levine R., *Financial intermediation and economic development. Capital markets and financial intermediation*, pp.156-189, 1993

[16]. Levine R., Zervos S., *Stock markets, banks, and economic growth*, American Economic Review, pp.537-558, 1998

[17]. Levine R., *Finance and Growth: Theory, Evidence & Mechanism*, Handbook of Economic Growth, Amsterdam: North-Holland, 2004

[18]. Pagano M., *Financial Markets and Growth: An Overview*, European Economic Review, vol.37, pp.613-622, 1993

[19]. Răscolean I., Slusariuc G.C., Dobra R. Păsculescu D., *Graphical simulation program for credits portfolio quality analyze*, Proceedings of the 1st International Conference on Intelligent Control, Modelling and Systems Engineering (ICMS '13), Valencia, pp.133-139, 2013

[20]. Stiglitz J., *The Role of the Financial System in Development*, Fourth Annual Bank Conference on Development in Latin America and the Caribbean, San Salvador, El Salvador, June 29, 1998

[21]. Stiglitz J., *Bankruptcy Laws: Basic Economic Principles*, Washington, 2003

[22]. Taghipour A., *The Role of Banking System Development in Economic Growth: The Case of Iran*, Iranian Economic Research, 2009

[23]. Takáts E., Upper C. **,***Credit and growth after financial crises*, Bank for International Settlements, no.416, 2013

[24]. National Bank of Romania, *Financial Stability Report*, 2008-2013

[25]. National Bank of Romania, *Monthly Bulletin*, 2008-2013

[26]. National Bank of Romania, *Survey on the access to finance of the non-financial companies in Romania and their capacity to cope with adverse financial conditions*, dec.2013, jun.2014

[27]. World Bank, *database*, http://www.worldbank.org/