International Journal for Multidisciplinary Research (IJFMR)
E-ISSN: 2582-2160 ● Website: www.ijfmr.com ● Email: editor@ijfmr.com

Banking and It's Relation to Types of Economies- A Comparative Scrutiny

Prathamesh Dhake[1], Kirti Arora[2]

[1,2]BBA-LLB(H), Semester 10

Abstract

The banking sector has long been regarded as one of the most important pillars supporting the economic development of a country. By mobilizing savings, providing credit, and facilitating financial transactions, banks help channel financial resources into productive economic activities. Over time, economists and policymakers have debated the extent to which the development of banking systems directly contributes to economic growth. While conventional economic thought suggests that stronger and more efficient banking institutions stimulate investment and expansion of businesses, recent financial crises and structural differences between economies indicate that this relationship may not always be straightforward.

This paper examines the role of banking sector development in influencing economic growth through a comparative perspective of developing and developed economies. It explores whether the expansion of banking systems consistently supports economic growth or whether, in some circumstances, rapid credit expansion may contribute to financial instability. The study also considers whether developing economies rely more heavily on banks for financing economic activity compared to developed economies, where capital markets and alternative financial institutions are often more established. In addition, the paper evaluates whether initiatives aimed at expanding access to banking services actually translate into long-term economic progress.

By analyzing economic trends, financial access, and patterns of credit allocation across different economic contexts, the paper aims to provide a balanced understanding of how banking systems interact with broader economic structures. In many developing economies, banks remain the primary channel through which individuals and businesses access financial services, making their development particularly significant for entrepreneurship, small enterprise growth, and infrastructure investment. In contrast, developed economies typically operate within more diversified financial systems where multiple financial institutions contribute to economic activity. The paper ultimately argues that while banking sector development plays a crucial role in economic progress, its effectiveness depends on sound regulation, financial inclusion policies, and the broader institutional framework within which banks operate.

Research Questions

The present study is guided by the following research questions, each addressing a specific dimension of the relationship between banking systems and economic development across different economic structures:

1. **Does the banking sector always contribute to economic growth or if there are shortcomings, could lead to economic instability.**

2. **is the banking sector development more important for growth in developing economies than that in developed economies?**
3. **can financial inclusion through banking lead to economic growth and development?**

Each of these questions is examined through comparative perspectives, institutional analysis, and selected case illustrations from different economic systems. Together, they aim to explore not only the contributions of banking institutions to economic development but also the structural challenges that may limit their effectiveness. The chapters that follow address these questions individually while identifying practical regulatory and policy approaches that could strengthen the positive role of banking in modern economies.

Chapter 1 - Does the banking sector always contribute to economic growth, or can it also lead to economic instability?

How banks are supposed to work?

At a practical level, banks collect deposits from savers, transform those deposits into loans for households, firms and governments, and provide payment services that let money circulate. That intermediation reduces transaction costs, pools risk, and channels savings into productive projects — the basic mechanism through which financial systems are supposed to support investment, job creation and productivity gains. Economically literate accounts of this role go back to thinkers who emphasized the bank's role in financing innovation and entrepreneurial activity.[1]

Types of economies

- Market-capitalist (example: United States): Private banks and capital markets allocate credit; profit incentives dominate allocation decisions.
- Mixed/developmental (example: India): Public policy shares space with private banking; state-guided priorities coexist with market forces.
- State-led (example: China): Large state-owned banks are instruments of economic policy; credit can be politically directed.

Each model uses banks differently, and those institutional differences matter for both growth and risk.

1. **Excessive or misdirected banking activity can cause economic harm.**

Banks can promote growth but they can also amplify leverage cycles, create asset bubbles, misallocate capital, and pass losses onto ordinary citizens and taxpayers when things go wrong. The policy problem is therefore dual: how to capture the growth-enhancing features of banking while containing its destabilizing tendencies.

Mechanisms of harm- Excessive credit growth and asset bubbles, the systemic risk channel

Illustration: The 2008 global meltdown began with mortgage credit booms in the U.S., securitization that obscured borrower risk, and leverage in major financial firms. When housing prices fell, the system contracted sharply and spilled into world trade, employment and public finances (2008 Global Financial Crisis).

- **Theory:** Credit-led growth can be supply-driven; banks chase profitable looking assets during booms, loosening screening and pricing, which raises the probability of widespread defaults. That produces a classic boom–bust cycle. As one actor later documented from the policy side, central bank responses are bulky and distributionally costly.[2]

[1] Joseph Schumpeter, The Theory of Economic Development (Harvard University Press, 1934).

- **Public effect:** Job losses, frozen credit for SMEs, lost household wealth and fiscal strain when governments bail out failing banks.
- **Solution (legislative/procedural):** Adopt counter-cyclical capital buffers, stricter loan-to-value (LTV) rules for risky lending, improve transparency on securitizations, and mandate stress-testing of major banks. These are concrete, enforceable rules that reduce leverage in booms and raise resilience for downturns.

2. Weak supervision and non-performing loans (NPLs), the credit rot problem

Illustration: Rapid credit growth in developing markets sometimes proceeds without parallel improvements in supervision; the result is high levels of distressed corporate debt that choke lending capacity. India's experience with infrastructure and corporate NPAs in certain periods illustrates how banks' balance sheets can become clogged, prompting a credit squeeze. (See central bank diagnostic reports.)[2]

- **Theory:** When banks carry hidden or unresolved bad assets, moral hazard and credit rationing occur: healthy firms lose access to finance while zombie firms survive on cheap or restructured debt.
- **Public effect:** Small businesses and households face credit scarcity, growth stalls and unemployment rise.
- **Solution:** Strengthen supervisory capacity (on- and off-site), create efficient asset-resolution mechanisms (bad banks/asset reconstruction companies with transparent pricing), and require timely provisioning and public disclosure of asset quality. Legal reforms that speed up debt recovery (insolvency frameworks) are part of the fix.

3. Political lending and resource misallocation - the policy-directed risk

Illustration: In state-directed systems, banks often channel cheap credit to strategic sectors or state-owned enterprises. That can accelerate infrastructure build-out but risks funding low-return projects and creating contingent liabilities visible only later. Observers repeatedly warn about concentrated credit risks in such systems — the underlying concern is not ideology but governance.[3]

- **Theory:** Credit allocation driven by non-commercial criteria reduces the economy's ability to generate market returns sufficient to service debt, raising systemic fragility.
- **Public effect**: If projects fail, taxpayers cover cost; inflationary or fiscal consequences reduce living standards.
- **Solution:** Increase governance transparency: publish loan-level data for large credits, require cost–benefit analysis and independent project appraisal, and separate fiscal risk from bank balance sheets (e.g., use explicit sovereign guarantees only when backed by transparent project returns).

4. Financial exclusion paradox -growth without access

Illustration: Large headline increases in deposit accounts (through policy drives) may not translate into regular usage, credit access, or productive finance. India's mass-account programs show reach, but not necessarily deep inclusion without complementary credit, literacy and product design (Pradhan Mantri Jan Dhan Yojana).

- **Theory:** Inclusion that is only nominal (accounts opened but unused) does not generate the saving–investment channel required for growth.

[2] Reserve Bank of India- periodic reports and diagnostics on asset quality and banking sector health.
[3] IMF staff assessments and country reports on state-led credit allocation and systemic risk.

- **Public effect:** Hopes of poverty reduction via financial access remain unfulfilled; meanwhile, banks face operational costs for dormant accounts.
- **Solution:** Pair access with uptake: financial literacy, small-credit products, digital payment rails, and incentives for active use; regulators should measure "active inclusion" (usage, credit access) not just account counts.

5. **Cross-cutting governance and regulatory prescriptions (compact policy package)**

- **Macroprudential toolkit:** countercyclical buffers, sectoral caps and dynamic provisioning to temper credit cycles. (Implementation is procedural and rule-based.) Bank for International Settlements standards offer a blueprint.[4]
- **Resolution architecture**: clearly defined "resolution" regimes so failing banks can be restructured or wound down without open-ended fiscal rescues.
- **Transparency and data**: mandating granular loan-level disclosures for systemically important banks to enable market discipline and better supervision.
- **Independent supervision:** reduce political interference in lending decisions for public banks by strengthening statutory autonomy and accountability.
- **Inclusion plus usage**: measure financial access by transaction frequency, credit take-up and savings rates; align subsidies and incentives to encourage meaningful usage rather than mere account opening.

Practical takeaways for readers

Banks are neither unalloyed engines of prosperity nor inevitable sources of collapse; they are institutional amplifiers of both growth and risk. How a nation's banks interact with its institutions (courts, regulators, fiscal authorities) and political incentives largely determines whether credit expansion fuels sustainable development or sows' instability. The policy goal is therefore institutional, design rules and procedures so that banks can finance productive activity while bearing the consequences of excessive risk-taking themselves, not shifting the burden to the public.

Chapter 2- is the banking sector development more important for growth in developing economies than that in developed economies?

1. Is the banking sector development more important for growth in developing economies than in developed ones.

Banking sector increases a country's resilience and promotes economic growth. It facilitates savings, stability, financial inclusion, investment, innovation, technological integration and offers diverse services. The development of the banking sector has a significant impact on the growth of a country. It functions as a backbone of the individuals, businesses and the government. An advanced banking system fosters better screening process and extends credit on a larger scale, which is used for business investment and innovation, resulting in productivity and higher returns. *Recent industry- and firm-level research suggests that the level of banking sector development has a large, causal impact on real per capita GDP growth [Rajan and Zingales 1998; Demirgiig-Kunt and Maksimovic 1999].* Banking sector development is defined as a cumulative outcome of its (1) depth (size as compared to the economy), (2) access (availability to the individuals to avail loans or other financial services), (3) efficiency (smooth operation and risk mitigation capacity) and (4) functionality (trust of the individuals on the system). The

[4] Basel Committee / Bank for International Settlements publications on capital buffers and macroprudential policy.

developed economies like United States, Sweden, Germany, Canada, Japan possess more prominent banking sector as compared to developing economies like India, Malaysia or Egypt.[5]

2. **But is it always the case? Does the banking sector development is always directly proportional to growth of an economy? Does it reach a maximum limit beyond which the benefits of banking sector development begin to decline, and costs start to rise and have developed economies touched these limits?[6]**

Various studies including cross-country OLS, panel regressions, semi-parametric models, and an industry-level "Rajan–Zingales" style test have observed a non-linear relationship between banking sector development and economic growth. A nuanced pattern is witnessed in developed countries where the finance rises to a certain limit i.e. 80-100% of its GDP and after that, it starts declining.[7]. We are going to shed light on these questions.

In this chapter, we are going to dive in how development in banking sector impacts developing and developed economies differently. Banking sector maintains the flow of money in both the groups but developing economies like India experience higher marginal pay off with the banking sector development because of the following factors[8]:

a) **Thin capital base**: - Every unit of credit is used for higher return projects like buying of machinery, investment in plant, providing higher marginal returns when compared to already rich countries.

b) **Small-scale businesses**: Developing economies such as India have several small enterprises with limited capital which are heavily dependent upon the banks or other financial sources to raise funds for investment purposes. Banking sector development promised them ease, and cuts the expenses when money is brough from outside.

   -For example: India opened **over 57 crore** basic bank accounts under PMJDY (as of **March 4, 2026**)—a huge on-ramp to formal finance. The deposits in these accounts are about **₹2.98 lakh crore**. The next step is to **turn access into actual, productive credit[9]**

c) **Receiving side of the curve**: In contrast to the advanced economies, developing/emerging economies have limited capital, so every additional credit is utilized for productive investment. They have room for more growth.

d) **More room to grow**: Studies by the International Monetary Fund (IMF) have revealed that the benefits of banking sector development rise to a certain point, after which it starts declining and might render negative results. The high-income economies have already fulfilled their basic requirements whereas low to middle income economies are still on the receiving end of the curve.

e) **Quality over Quantity**: More capital does not promise higher returns. A better screening process to analyse the financial flow is necessary to mitigate risk and boost innovation. The 2008 crisis in United States serve as an epic example of how quality overweighs quantity.

f) **Pace matters**: Nor just the size, but depth, access and efficiency are equally important. When finances grow too big, too fast without balanced risk-taking approach and systematic regulations, it always leads to negative outcome.

[5] Banking system z-scores by country, around the world | TheGlobalEconomy.com
[6] Rethinking Financial Deepening: Stability and Growth
[7] Too Much Finance?; by Jean-Louis Arcand, Enrico Berkes and Ugo Panizza; IMF Working Paper 12/161; June 1, 2012
[8] Too Much Finance?; by Jean-Louis Arcand, Enrico Berkes and Ugo Panizza; IMF Working Paper 12/161; June 1, 2012
[9] pmjdy.gov.in]

However, the developed economies experience financial deepening and beyond a certain point (which is 80-100% GDP), banking sector-growth link becomes inverted U-shaped. After the said limit, more lending stops helping and growth starts to decline. The advanced economies already have efficient capital to fund their basic requirements, so every additional credit from the bank does not yield higher marginal payoffs.

A. Illustrations-

Yes, bank crisis: Yes, Bank was established in India in 2004. It expanded quiet rapidly between 2014-2019. It was considered one of the fastest growing banks. It focused primarily on the corporate lending to large companies, thereby competing with fellow commercial banks. The problem arose when it started lending large loans to financially stressed companies. Many borrowers defaulted on their payments which created liability for the banks in terms of Non-performing assets(NPAs). These NPAs increased at an unprecedented rate which created stressful situation for the investors. What followed next was, the bank had reported fewer bad loans which got exposed during inspections by the Reserve Bank of India. It created tension among public shareholders about the poor management of the bank. Eventually, the crisis arose because of misallocation of funds to companies without proper checks and balances and abiding by the risk mitigation strategies. The bank primarily focused on maximizing the returns at a swift rate, rather than concentrating on sustainable growth.

Silicon Valley Bank (SVB) Collapse: The world witnessed another major crisis when the Silicon Valley Bank of the United States collapsed in 2023. This bank was founded in 1983 and its primary customers were technology startups, Venture capital firms and Technology entrepreneurs. During the period of Covid-19 (2020 - 2021), market crashed which dramatically increased the Venture capital investment. A large amount of fundings were deposited in the Silicon Valley Bank. The assets grew from around $60 billion in 2019 to over $200 billion in 2022. The SVB invested these deposits in the long-term US government bonds and Mortgage-based securities. The problem arose when the Federal Reserve raised the interest rates in 2022, and as a result bond prices fell down and they Long term bonds lost market value. The bank suffered huge loss as it had invested mostly in the government bonds. This created panic among its customers and they started withdrawing money from the bank. Customers made the withdrawal request of around $42 billion a day and the bank did have enough credit to complete the request. As a result, on March 10, 2023, the bank was shut down by the regulators and all its assets were wound up to First Citizens Bank. It was the largest failure of the bank in the United States since 2008.
Thus rapid growth without proper risk mitigation leads to crisis.

B. Problems-

The analysis depicts that Banking sector plays an integral role in the economy of a nation. It is a fast-booming industry which is highly volatile and fragile. It shows a directly proportional relationship with the growth till a certain limit, after which it starts deteriorating. This might have an extreme negative impact on the economy of a nation. The misallocation of funds, fast pace growth with brittle funding, poor interest rate, can turn growth into crisis in no time.

3. Scrutiny and findings

The purpose of this is to discuss how banking sector development impacts the growth of developing and developed economies differently. The most observed pattern reveals that the banking sector development gives more positive outcome in developing countries than in developed ones. We can say that higher credit/GDP, larger allocation of credit, affordable interest rates, faster growth pace, larger banking sector size does not promise positive outcome. However, it does not indicate that the banking sector should

stop progressing after a certain limit. That interpretation would be highly invalid and unjustified. Any day, we need finances for the growth. We are supposed to create a balance so that we put the finances to a greater use. The governments should enforce stricter regulations and enforce policies for the allocation of funds towards research and development. If funds are constrained towards high return sectors such as real estate, it would curb productivity and drive talent away. Prudent screening/monitoring procedure is required to be followed before allocation of funds to mitigate the risk. Stricter enforcement of policies for the good of a nation and its citizens should be prioritized.

Institutions such as World Bank of India and International Monetary Fund have repeatedly shown in their studies that closing the gaps between accessibility and depth is not sufficient. We should emphasize on efficiency and functionality of the banking system. Fast paced growth does not provide long term gains, rather a calibrated growth with proper risk analysis does. The objective is not to grow too fast, but to grow steadily, sustainably, and with adequate regulatory oversight. The patterns of the banking industry should be carefully reviewed regularly to maintain proper checks and balances and ensure that the private credit/GDP does touch the optimal limit of 80 – 100% GDP. The failure of various banks such as SVB, Signature, First Republic could have been avoided if there were proper checks and balances on the pace of their growth.

The analysis presented above, demonstrates that once an economy reaches financial depth, the priority should not be given on increasing the volume of credit but on improving the choice of allocation of credit, in order to ensure that the financial flow is directed towards the productive sectors and responsible borrowers who can generate real and sustainable growth. To achieve this, the banking sectors require clear guardrails on the size, speed and structure of credit expansion. Stringent regulatory policies and effective dispute resolution mechanism are essential so that the banking sector development continues to strengthen the real economy instead of creating future risks or vulnerabilities.

Chapter 3- Can Financial Inclusion Through Banking Lead to Economic Growth and Development?

Financial inclusion can and does support economic growth, but only when access becomes active use savings, reliable payments, affordable credit and basic insurance and when those services are delivered with consumer protections, proper data, and viable business models. Mere counts of accounts are a weak proxy for development.[10]

1. What is financial inclusion and the role of banks & NBFCs?

Financial inclusion means people and firms can obtain and use useful, affordable, and responsible financial services saving, credit, insurance and payments through regulated channels. Banks provide the basic public-good elements: a safe place to deposit money, regulated intermediation (turning deposits into loans), and settlement systems that let payees accept and transfer funds reliably. Non-bank financial companies (NBFCs) such as microfinance institutions, consumer financiers and many fintech firms complement banks by designing small-ticket loans, reaching last-mile customers, and offering alternative underwriting when formal credit histories are thin.[11] Put simply: banks give safety and scale; NBFCs give product fit and distribution. When coordinated well, they create a practical ladder from small transactions to productive investment.

[10] World Bank, Global Findex Database 2021.
[11] Reserve Bank of India, Report on Trend and Progress of Banking in India.

2. **Comparative evidence: succinct country snapshots**

- **Kenya - payment-led inclusion (M-Pesa):** Kenya's mobile-money revolution showed that removing payment frictions can immediately expand people's economic footprint. M-Pesa allowed remittances, reduced cash costs, and enabled new small businesses. Studies find improved household welfare and more resilient informal firms where mobile money spread but payments alone did not automatically lead to large-scale investment unless complemented by credit and savings products. (M-Pesa).[12]
- **Bangladesh- targeted microfinance (Grameen):** Microcredit institutions helped many households' smooth consumption and start micro-enterprises; the social impact on poverty reduction and women's empowerment is documented in several field studies. Yet microcredit is typically limited in scale relative to the needs of manufacturing or large-service firms and cannot substitute for formal SME finance. (Grameen Bank)[13]
- **United States- deep markets, uneven pockets**: Broad access exists, but underserved communities (rural, minority neighborhoods) still face higher-cost credit and fewer local banking options. Inclusion here is about targeted regulation and community banking models as much as infrastructure.
- **China- near-universal accounts, skewed credit allocation:** Account ownership and digital payments are widespread; however, historically a large share of credit went to state-backed firms. Recent fintech growth is broadening retail and SME credit, but allocation priorities matter for whether inclusion supports broad-based growth.
- **Brazil- social transfers + accounts:** Linking social transfers to bank accounts expanded financial footprints for poor households and created predictable transactional demand that banks could build on. The lesson: combining transfers with accounts can stimulate usage.

Countries that combined cheap digital payments, identity systems, targeted micro/SME credit and consumer safeguards saw more evidence that inclusion supports growth. Headline account numbers alone are insufficient.

3. **Mechanisms through which inclusion can (and cannot) support growth:**

- **Consumption smoothing & resilience:** access to savings and small loans helps households absorb shocks and avoid asset sales.
- **Micro-investment & entrepreneurship:** predictable small loans fund inventory, tools and working capital for micro-enterprises.
- **Market access via payments:** cheaper payments expand market reach for informal firms.
- **Efficient public transfers:** direct transfer into accounts reduces leakage and raises effective demand.

If these channels work together, inclusion raises productive investment and human-capital spending; if they don't, headline metrics can be misleading.

4. **Indian schemes explained simply, issues, and practical solutions --What these schemes are?**

- **Pradhan Mantri Jan Dhan Yojana (PMJDY):** a national drive that encouraged and facilitated the opening of zero-balance bank accounts for low-income households across the country. It aimed to bring previously unbanked people into the formal financial system so they could receive payments, save safely and access government transfers.[14]

[12] Tavneet Suri & William Jack, "The Long-Run Poverty and Gender Impacts of Mobile Money," Science, 2016.
[13] Muhammad Yunus, Banker to the Poor, 2007.

- **Aadhaar (Aadhaar):** a government biometric identity system that assigns a unique number to residents, allowing easy identity verification. For financial inclusion, Aadhaar simplified Know-Your-Customer (KYC) checks, making account opening faster and cheaper.
- **National Payments Corporation of India (NPCI) and Unified Payments Interface (UPI):** NPCI is the organization that built affordable digital payments infrastructure; UPI is a real-time payments system that lets users send and receive money using simple identifiers (no bank details). Together they massively lowered the cost of electronic payments.

--Problems observed (problem → how it affects people → evidence / explanation):
Problem: Nominal rather than active inclusion- many accounts opened under PMJDY remain dormant or used only for occasional government transfers.
Public effect: No meaningful savings accumulation or credit history forms; households remain exposed to shocks.
Why it happens: poor product design, lack of incentives for repeated use, and limited last-mile financial literacy.
Problem: Credit mismatch and thin files — formal banks hesitate to provide small business loans because origination costs are high and credit histories thin. NBFCs/fin techs step in but often at higher cost and with less protection.
Public effect: SMEs remain credit-constrained; households may resort to informal, high-cost lenders.
3] Problem: Consumer protection and data privacy — rapid digital onboarding and algorithmic lending can produce opaque terms and aggressive recovery practices for vulnerable borrowers.
Public effect: Over-indebtedness, privacy risks and erosion of trust.
Problem: Fragmented product pathways, payments, savings, credit and insurance are often offered by different providers without smooth linkages.
Public effect: Households cannot leverage payment history into credit access or insurance uptake.

5. Solutions (practical, legislative and procedural; specific and actionable):

- **Move from account counts to outcome metrics:** adopt national legislation or regulatory guidance that measures active inclusion — for example, accounts with at least three transactions a quarter, the share of households with access to formal credit in the last 12 months, and the percentage of micro-enterprise loans disbursed. Tie program funding and targets to these outcome metrics.
- **Regulated NBFC–bank partnership framework:** create a statutory template for risk-sharing contracts that let banks cheaply source small loans through accredited NBFC partners (who handle origination) while banks provide funding and compliance oversight. Include standardized loan-level reporting to reduce due-diligence costs.
- **Targeted, transparent credit guarantees:** legislate limited, time-bound partial credit guarantees for productive micro/SME lending (not consumption), with independent appraisal and ex-post audits to reduce moral hazard.
- **Expand credit-information coverage with privacy safeguards:** require inclusion of small-ticket and alternative data (payment flows, utility bills) into credit registries with consumer consent, dispute resolution and data portability provisions.
- **Consumer protection law for digital finance:** pass rules requiring simple, prominent disclosure of interest rates and fees, caps on excessive rollover penalties for small loans, and fast grievance redres-

sal for digital financial products.

- **Financial literacy + product nudges:** fund community programs that teach not only how to open accounts, but how to use savings, small credit and basic insurance products; require providers to offer a basic, low-fee starter product that encourages transaction usage and builds credit histories.0

6. Multiple perspectives

- Optimistic view: When identity, payments and accounts combine — as in India — the infrastructure exists to rapidly deepen inclusion; product design and regulation are the bottlenecks.
- Cautious view: Digital access can create new risks (privacy, debt) and may generate illusory gains if usage remains shallow.
- Policy-oriented view: Treat inclusion as an ecosystem problem: rails + identity + credit pathways + consumer safeguards + measurable outcomes.

7. How to judge whether inclusion is working (recommended indicators)

- Active account ratio — percentage of accounts with regular transactions.
- Access to formal credit — share of households/SMEs that used formal credit in last 12 months.
- SME loan rejection rate — by firm size.
- Frequency of small digital payments per capita.
- Consumer grievance resolution time and outcomes.
- These are operational, measurable, and policy-relevant.