



Effect of Banking Sector Performance in Economic Growth: Case Study of Pakistan

Syed Muhammad Hamza¹, Ejaz Ahmed Khan²

¹Muhammad Ali Jinnah University Islamabad

²International Islamic University Islamabad

Received: September 1, 2014

Accepted: November 13, 2014

ABSTRACT

This study aims to explore the impact of banking sector's performance on economic growth of Pakistan. Using a sample of ten commercial banks for the period from 2008 to 2012, we found a positive and significant association between measures of bank performance and economic growth. Results of linear regression show that measures of bank performance namely deposits, advances, profitability, interest earnings and investment have positive relationship with economic growth as measured by GDP. It is suggested to improve policy reforms in banking sector for economic development of Pakistan

KEYWORDS: Banking Sector, Economic growth, Investment.

1 INTRODUCTION

Banking is one of the most essential business all over the world. Banks play very vital role in the economy of a country. The banking sector is a backbone of the country's economy. Banking sector provides financial assistance to government and private sectors. In finance terms performance of the bank means profitability and stability in economic activities. If profitability of the bank is increasing constantly it mean that bank performance is increasing. The solvency position of the bank means ability to pay its debts, if the bank is in the strong solvency position it refers the bank performance is good. In the recent past the government interventions have been able to avoid a fall down in the banking sector. The banks are needed to take some measures to manage the risk and regular failure of the banking industry [1]. The main objective of this paper is to provide evidence on factors that impact on profitability. What are the determinants of bank's profitability and how financial statements and macroeconomic variables influence the profitability? As per the author's understanding no study has studied for the specific time and a number of banks. The study uses the data of the 21st century when the world economy has opened to different challenges [2]. The study also focuses the individual economy which has explored both internal and external challenges.

In Pakistan banks has well developed system, we conduct research on the impact of banking sector in the growth of Pakistan economy. In today's World Banks plays a major role in each economy and acts as a financial institution which receive deposits from the general public at lower rate of interest and lend to another at higher rates. The difference between these rates is called the profit which is also called the bank spread. In Pakistan banks are a leading institution and banking sector is growing rapidly from the last two decades.

The main objective of this research is to examine the determinant of the banking sector. For measuring the growth rate as we know that competition in banking sector take place. Every bank wants to become a leading bank in society and try to provide the maximum services to their customers and get deposit from their customers and the bank lends these deposits to others in form of loan and earn profit which increases the banking performance in the economy due to their profitability. Many governments have been actively working on the eradication of failure problems of the banks. In the same way Pakistani government has also been working on how to eradicate this problem.

As we know that the banking sector is growing rapidly which has a positive impact on our economy and growth rate increases which is good for our economy. The banking sector is providing up

* **Corresponding Author:** Ejaz Ahmed khan, International Islamic University Islamabad
ejaz_psychologist@yahoo.com

to date services and products which are helpful for customers and everyone attract towards banks and open their accounts and maintain deposits with bank by which bank lend these deposits at a higher rate to others and earn profit which increases the bank profitability. For the last few years banking sector flourished and now banks give the facility of online banking through you transfer your amount to anywhere where you want.

Most banks give this facility free of cost which attracts the customers and now a day's public show more confidence towards banks. People maintain their deposits also gold in their lockers which banks provide the facility to their account holder and charge nominal fee against the locker facility. The banking sector is growing day by day. Banks maintain its position in the economy for the development. Banking sector plays a vital role in the betterment of the economy due to this our growth rate increases which make our economy more stable and move towards development.

The banking sector has played a vital role in the economy. The economy flourished with the increase in the performance of the banking sector. In the present era there is a lot of competition takes place in the banking sector. Every bank is trying to compete another bank and want to take a higher place in the economy this is all due to competition and every bank is trying to compete other by offering latest product and services and trying to provide maximum facilities to their customers so that customer not divert to another bank and maintain deposit only with that bank which increase the bank profitability and bank have surplus money to lend.

1.1 Problem Statement

The banking sector is playing a vital role in the economy of the country but according to the current scenario the banking sector is facing the worst crisis. Dollar rate is increasing day by day. In our central bank we don't have enough reserve for issue currency notes so that our currency devalued in the foreign market. In Pakistan the policies are very strict so that Pakistan facing the problem of the trade deficit, unemployment and inflation in our country is increasing day by day.

Due to political instability and economic crisis in our country, the banking sector is passing from great disaster due to which financial performance of our banking sector is greatly affected. Merger & acquisition activities become now common & economic condition of our country are very poor that becomes a hurdle in growth of banking. Banking sector decline due to worst energy crisis. Energy crises in Pakistan is at peak point. Our whole economic collapse due to insufficient supply of energy.

Most of the industries transferred their operations in another country. Huge amount of capital is withdrawn from the bank. FDI investor is not interested in Pakistan. Banks earning decline due to withdrawn of capital.

1.2 Objectives of the Study

The main objective of this study was to study the impact of banking sector on the economic growth of Pakistan.

- To analyze the performance of the banking sector.
- Importance of banking sector to overall economic development.
- Socio economic contribution of banking sector
- Policy reforms in banking sector are linked to overall economic growth.

2 LITERATURE REVIEW

2.1 Economic growth

The gross domestic product is one of the most important economic indicators used by economic decision makers and government in planning and formulate the policies. Gross domestic product (GDP) is the most important economic indicator that tells us overall health of the economy. We are identifying its impact.

[3] "If by growth you mean the expansion of output of goods and services, then GDP or preferably real GDP – which measures growth without the effects of inflation – is perfectly satisfactory. It has been

built for this purpose. The letter P stands for “Product”, the result of production. Gross Domestic Product is defined as the sum of all goods and services produced in a country over time, without double counting products used in other output. It is a comprehensive measure, covering the production of consumer goods and services, even government services, and investment goods”.

2.2 GDP and Profitability

Profitability is calculated by return on total assets. It stands for the ratio which measures corporation earnings before interest and tax expenses against its total assets. This ratio indicates the firm’s efficiency of using its assets to produce earnings. Investor look this ratio and decide whether or not to invest in the company. Greater income shows efficient use of company assets.

This ratio tells us how profitable a company is relative to its total assets. The return on assets (ROA) ratio explains how management is using the company's total assets making a profit. The higher the return, the better organized management is in utilizing its asset base” [4].

H1: There is association between profitability and economic growth.

2.2 GDP, deposits and lending

Deposits are the money which people lend to banks and receive interest as profit. Banks use public deposits, without having deposits banks cannot able to invest and lend anywhere. There are different types of deposits like call deposits, saving deposits, Current deposits, and fixed deposits. After getting deposits banks give loan to needy people and receive interest.

H2: Deposits has some impact on economic growth.

H3: There is linkage between advances and economic growth.

2.3 GDP and investment

According to economist’s investments is the formation of newly created physical units like machinery, houses, factories, and goods inventories. According to finance, investment is the purchase of an asset or item with the hope that it will give healthy income or gain in the future and be sold at the higher price.

H4: There is association between investments and economic growth.

2.4 GDP and interest earning

An amount which company earn through its banks fixed deposits accounts and other investments.

[5] Studied that, significant difference in banking structure although many efforts are being made to create stability among variables. They use return on equity and return on asset as DV to measure the performance of single bank. They stated proofs in favor of some banks specific variables.

[6] Studied the banking changes in Serbia by using survey data results. Qualitative method has been use of results however this article find out the positive results.

[7] Studied the relationship between the banking performance and economic growth at stare level. Their study show the impact of banking performance on economic growth.

Contrary to this, [8] investigating on the factors affecting the profitability of banks in Pakistan. He takes the data of top fifteen commercial banks of a period 2005-2009. Purpose of this research is to find the relationship between bank profitability and the characteristics of banks. He adopts the methodology of (POLS) pooled ordinary least square to check the impact of loan, assets, deposits, economic growth in the major profitability of banks. Both internal and external factors have a strong impact on the profitability. In this the value of r square is 0.54 which shows that the 54% variation in the dependent variables. The result shows that size has positive relations with ROA. It indicates that larger banks have higher ROA.

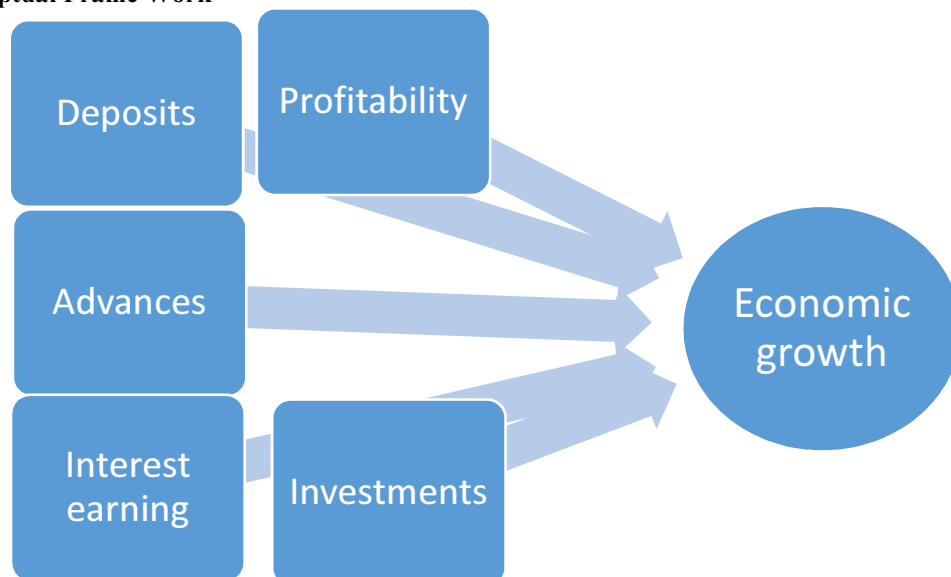
[9] Invested on the technical efficiency of the banking sector in Pakistan. It takes the sample of almost 30 banks which includes foreign, local and private banks. It takes the data from banks between 1995-2000 and measures the efficiency of banks in Pakistan. Pakistan is a developing country and it is in the process to maintain the market economy where the state bank play its role in establishing and make the banking sector efficient. The model which he used to investigate is the Data envelopment analysis (DEA) which is linear model technique and used for measuring the organization performance. The result shows that there is a potential in a bank to increase their efficiency. In paper efficiency score 100 shows that the bank is technically efficient.

[10] Conducts research on the banking. He wants to check the impact on growth of Pakistan through the banking sector. As you all know that today's banks are involved in advances the credit to public and private at some interest rate through which bank can earn the profit which increases the profitability of banks and increases the performance of the bank. In his paper he takes the data of thirty years and through regression equation he checks the impact and the result which is found is that there is a positive impact of financial reforms on the economic growth of Pakistan. It is suggested to the Government to overcome the problem of inflation which makes more growth of the economy of Pakistan.

The theory shows the positive impact of risk taking behavior on its profitability. [11] Also studied the relationship of risk taking behavior and profitability, he concluded that under the strict regulation policy and pressure bank can increase their capital. [12] Also shown his research on the German banking sector, they stated that banks try to increase their capital ratio and attempt low and vice versa. Most significant studies conducted by [13]. They explored the relationship of ownership structure and banks profitability. They explained that all power is in hand of majority shareholder more voting right, owner force to take more risk.

H5: There is relation between interest earning and economic growth.

3 Conceptual Frame Work



4 METHODOLOGY

A sample of 10 banks were collected to evaluate the role of banking sector performance in economic growth. In this research we have taken the secondary data, all types of data is collected from financial statements of banks. We take samples of 10 commercial banks and data which we collected is from 2008-2012. We have taken six variables, growth, deposits, investment, advances, profitability, interest earning. The dependent variable is growth and the independent variables are deposits, investment, advances, profitability, interest earning.

Data is collected from the financial statements of banks. The deposit is on the liability side of the balance sheet and these are deposits of customers maintained by banks in customer accounts. Advances are on the assets side of the balance sheet. Advances are the assets of the bank through which bank earns profit by lending it to borrow at some interest rate. Investment is also on the assets side of the balance sheet. The investment is basically which we have taken is invested in stock, securities etc.

profitability (profit after tax) is in the income statement. We have taken from income statement which shows the profits of banks. Interest earning is taken from the income statement. This is the earning which bank earns from advances, the rate of interest which bank charge on advances is interest earning. We take the percentages of all the data we divide each variable value on the total asset value and take the percentage of the data.

In this research we check the performance of bank on the growth and performance of being measured by deposits, investment, advances, profitability, inters earning. We check that these variables have a positive impact on growth or negative. We conduct research on this topic. After selecting the above mentioned variables, we check the impact of banking performance of Pakistan on growth in a following way.

$$\text{GDP} = f(\text{DEP}, \text{INV}, \text{ADV}, \text{PRF}, \text{INE})$$

Where GDP represent the growth, f is the function and DEP, INV, ADV, PRF, INE, represent respectively, deposits, investments, advances, profitability and interest earning.

We can write in following way:

$$\text{GDP} = \alpha + \beta_1 \text{DEP} + \beta_2 \text{INV} + \beta_3 \text{ADV} + \beta_4 \text{PRF} + \beta_5 \text{INE}$$

Table 1 Regression Analysis

Variables	GDP			
	B	R ²	ΔR^2	F
Constant	7.19			
Deposit	-.036**	.501	.707	8.81***
Advances	.012*			
Investment	-.034***			
Profitability	.037*			
Interest	.036*			

*p < .05, **p<.01, ***p<.00

5 Conclusion

In this study we have researched the role of banking sector in the economic growth of Pakistan. We gathered data from time period 2008 to 2012 of 10 banks. We used linear regression model for analyzing the data. The table above shows the result of linear regression in SPSS. We can see in table Model Summary that ΔR^2 value is 0.707, which represent the change explained by model. In the results deposit (-.36, P < .01) and investment (.01, P < .05) significantly negatively predicted GDP whereas advances (.34, P < .001), profitability (.37, P < .05), and interest (.036, P < .05), were significantly positively predicted GDP.

$$\text{GDP} = 7.194 - 0.036 \text{DEP} - 0.034 \text{INV} + 0.012 \text{ADV} + 0.037 \text{PRF} + 0.036 \text{INE}$$

It is to be suggested that in Pakistan banking sector is contributing a major role in economic development, so the policy makers have to adopt efficient policies that increase the performance of banking sector in Pakistan and which is much helpful for the economic growth.

REFERENCES

1. John, K., John, T. A., & Saunders, A, "Universal banking and firm risk-taking", Journal of banking & finance, 18(2), (1994) 307-323.
2. Pasiouras, F., & Kosmidou, K, "Factors influencing the profitability of domestic and foreign commercial banks in the European Union", Research in International Business and Finance, 21(2), (2007) 222-237.

3. Lequiller, F, "The new economy and the measurement of GDP growth", 2001.
4. Francis, J., LaFond, R., Olsson, P., & Schipper, K, "The market pricing of accruals quality", *Journal of Accounting and Economics*, 39(2), (2005) 295-327.
5. Barth, J. R., Nolle, D. E., & Rice, T. N, "Commercial banking structure, regulation, and performance: an international comparison", *Managerial Finance*, 23(11), (1997) 1-39.
6. Bitzenis, A., Misic, A., Marangos, J., & Andronikidis, A, "Evaluating the banking reforms in Serbia using survey results", *Studies in Economics and Finance*, 25(1), (2008) 49-71.
7. Samolyk, K. A, "Banking conditions and regional economic performance evidence of a regional credit channel", *Journal of Monetary Economics*, 34(2), (1994) 259-278.
8. Javaid, S., Anwar, J., Zaman, K., & Ghafoor, A, "DETERMINANTS OF BANK PROFITABILITY IN PAKISTAN: INTERNAL FACTOR ANALYSIS", *Journal of Yasar University*, 6(23), (2011).
9. Saleem, M, "Technical Efficiency of the banking sector in Pakistan", *SBP Research Bulletin*, 4(1), (2008) 61-80.
10. Rehman, W., Rehman, C. A., & Sahid, A, "Intellectual capital performance and its impact on corporate performance: An empirical evidence from Modaraba sector of Pakistan", *Australian Journal of Business and Management Research*, 1(5), (2011) 08-16.
11. Rime, B, "Capital requirements and bank behaviour: Empirical evidence for Switzerland. *Journal of Banking & Finance*, 25(4), (2001) 789-805.
12. Koetter, M., Bos, J. W., Heid, F., Kolari, J. W., Kool, C. J., & Porath, D, "Accounting for distress in bank mergers", *Journal of Banking & Finance*, 31(10), (2007) 3200-3217.
13. Laeven, L., & Levine, R, "Bank governance, regulation and risk taking", *Journal of Financial Economics*, 93(2), (2009) 259-275