University of Jijel
Departement of Economic Sciences

Module : English for Specific Purposes ***Teacher :Manel.A***
Level : M1_ Economics of Money and Banking ***Academic year :2024-2025***

Functions of Banks in an Economy

Banks being financial intermediaries provide money in the economy through credit creation and facilitating liquidity. Banks are able to generate credit many times more than the initial deposits they receive from the public subject to regulations relating to cash reserves to be maintained and customers' cash requirements. The resources of banks are generated mainly through a variety of deposits, both short time and long term from the public. The ability of the bank to generate more deposits depends on the interest rate offered and the marketing skills of the bank. Shorter duration and higher interest on deposits will add to the operational risk of the banks. Bank's role in the economy is necessitated on account of differences in the preference of public in terms of maturity requirements, risk requirements, denomination of currency and access to adequate information. The existence of market imperfection such as transaction and contracting cost also strengthen the need for the functioning of banks.

Banking industry differs from other industries in the economy in terms of its asset structure and legal obligations and developmental functions. Besides offering a variety of loans and advances to different needy clients, banks also provide a lead role in translating the development objectives of the government through lead bank schemes and priority sector lending and financial inclusion. In the process of performing these functions, banks have to manage a variety of risks which are inherent in banking operations. One of the major risks that affect the bank is credit risk which is reflected in the proportion of non-performing assets (NPA) held by the banks. The maturity structure of various assets and liabilities of the bank poses liquidity risk to the bank. The fluctuation in interest rates is another source of risk. Exchange rate risk arises to the bank when they provide foreign currency loans to their customers or when they make investments in foreign securities or accept foreign currency deposits.

The success of banking business depends on public confidence in the ability of the banks to meet their obligations. Banks face many financial risks such as credit risk, liquidity risk, foreign exchange risk, interest rate risk, operational risk and market risk. The nature of assets held by the bank and the manner in which these are financed inherently causes problems for the bank. Mismatch in maturity structure in both assets and deposits lead to payment problems. Poor credit assessment and monitoring leads to increase in non-performing assets.

As per the survey conducted by Bank for International Settlement (BIS), the major causes for bank failures are poor asset quality and management practices, fraud and weak economic environment. Deterioration in asset quality has been attributed to loss from credit transactions, connected lending, inherited portfolios, steep increase in commodity price movements, excessive diversification and fraud.

Most often certain business practices forecast the failure of banks. Holding of excessive loan portfolios that are not protected, deteriorating financials and higher deposit rates than market rates have indicated future failure of banks. Holding off-balance sheet bank liabilities and creative accounting also disclose possible bank failures in the future.

Central banks in many countries develop models to combat bank failures. UK, US, Spain and Chile are some of the countries that have come out with support mechanism and in certain cases closure of banks to restore credibility in banking.

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❖ **<u>Text based Activities</u>**

1. **answer the following qustions:**

- What are the primary sources of funds for banks?
- Explain why banks play a vital role in the economy
- List three major risks faced by banks and explain one
- What are the causes of bank failures according to the BIS survey?
- What is the importance of public confidence in the banking system?
- How do banks manage credit risk?
- What risks do banks face due to fluctuations in interest rates?

2. **Determine whether the following statements are true or false:**

- Banks provide a variety of loans and advances to clients based on their credit risk assessments.
- Banks are not required to manage risks related to foreign currency deposits.
- Interest rate risk is a major factor affecting the financial stability of banks.
- The success of the banking business depends solely on the interest rates offered.
- Deterioration in asset quality can result from poor credit transactions and fraud.
- Banks do not face any risks related to foreign exchange transactions.
- Poor credit assessment and monitoring can increase the proportion of non-performing assets (NPAs) in a bank.
- A bank's ability to generate deposits depends primarily on the interest rate offered and the marketing skills of the bank.

3. **Complete the following sentences based on the text:**

- Banks act as financial intermediaries by providing ____________ to the economy through credit creation.
- The success of the banking business depends on public ____________ in the ability of banks to meet their obligations.
- One of the major risks faced by banks is ____________ risk, which arises from fluctuations in exchange rates.
- Banks must manage the ____________ risk arising from mismatches in the maturity structure of their assets and liabilities.
- According to the BIS survey, major causes of bank failure include poor asset quality, fraud, and a ____________ economic environment.
- Banks provide liquidity by transforming short-term deposits into ___________ loans, which helps in stabilizing the economy.
- The major causes for bank failures, as per the Bank for International Settlement (BIS), include poor asset quality, ___________, and weak economic environments.

4. **Multiple Choice Questions (MCQs).**

- What is one of the primary functions of banks in an economy?

a) Selling commodities

b) Credit creation

c) Manufacturing goods

d) Political policymaking

- Banks generate resources primarily through:

a) Government subsidies

b) Investment in foreign markets

c) Deposits from the public

d) Real estate transactions

- Which of the following is a major risk banks face?

a) Inflation

b) Non-performing assets (NPA)

c) High production costs

d) Technological innovation

- Central banks address banking failures through:

a) Investment in real estate

b) Closure of banks and support mechanisms

c) Increasing loan interest rates

d) International trade agreements

- What is a significant cause of bank failures, as per the BIS survey?

a) Excessive government intervention

b) Poor asset quality and management practices

c) Lack of international trade

d) High liquidity reserves.