The Impact of Financial Development on Growth in the Middle East and North Africa (MENA)

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The Impact of Financial Development on Growth in MENA

I. Introduction – Dual Motivation

II. Results – Depth and Quality of Banking

III. Possible Causes

IV. Conclusions

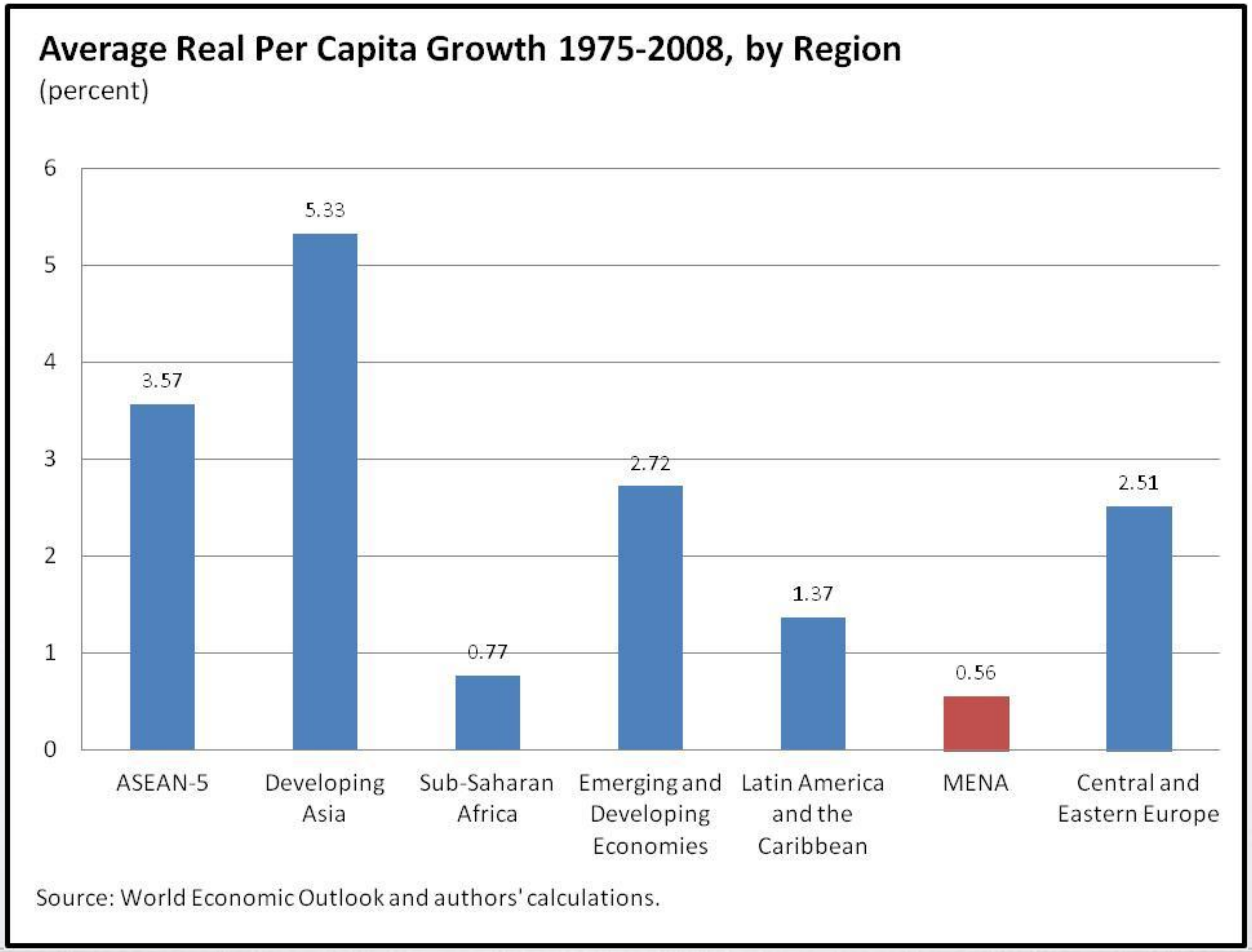
I. Introduction

Dual Motivation for this Study:

- Inadequate growth performance of the MENA region
- Region has highest levels of unemployment, youth unemployment and among the educated

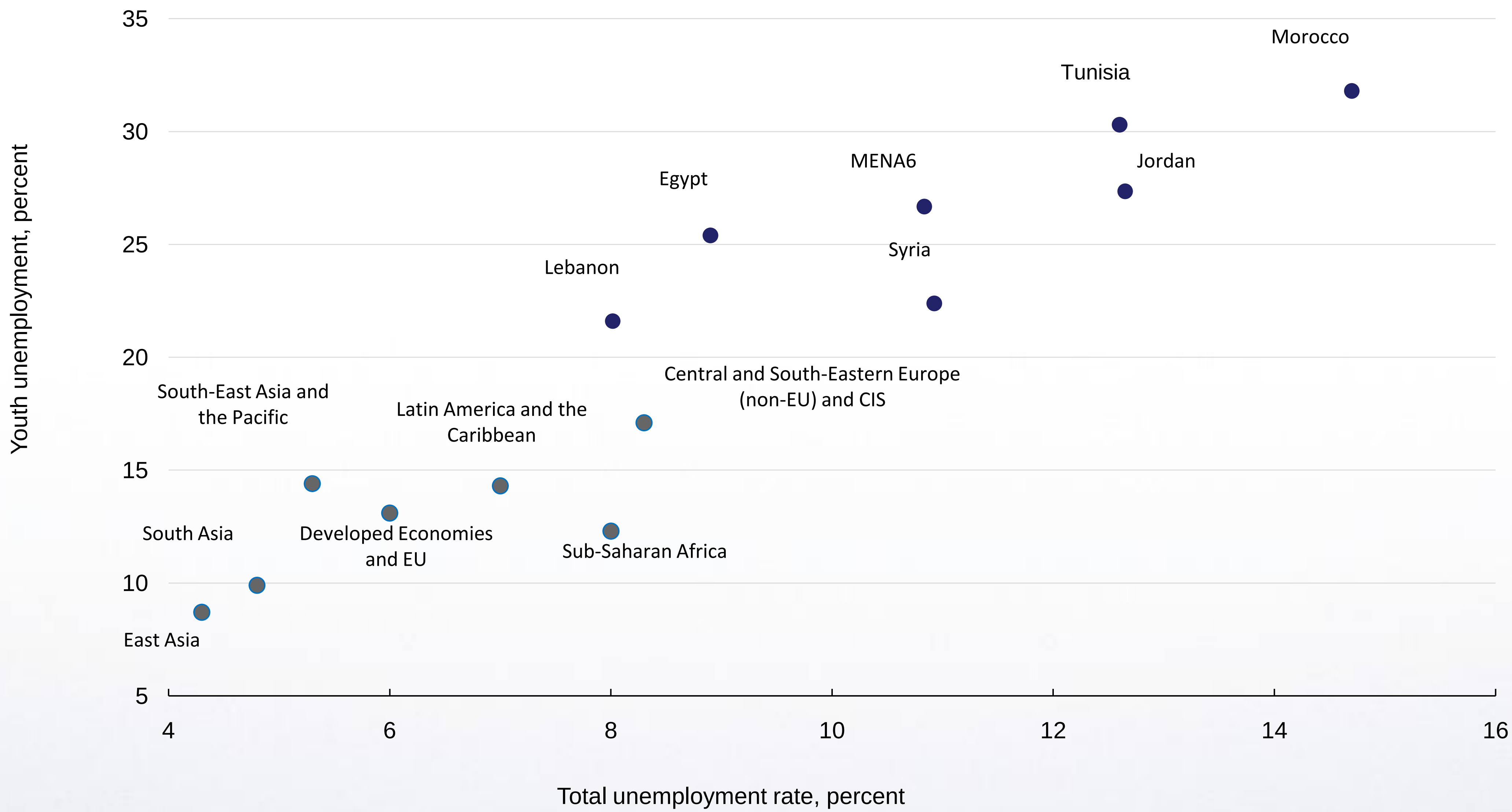
I. Introduction

- **Motivation 1**: Inadequate growth performance of the MENA region:



Unemployment Rates by Region[1,2]

(2008[3])



Sources: International Labor Organization; national authorities; IMF, *World Economic Outlook*; and IMF staff estimates.
[1]MENA6 countries are Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia.
[2]Total and youth unemployment rates for Morocco reflect data from Urban Labor Force Survey.
[3]Or most recent earlier year for which data are available.

I. Introduction

Previous studies:

- **Hakura (2004):** lower growth over 1980-2000 due to large governments (GCC), poor institutional quality (non-GCC), and political instability.
- **Guillaume & Rasmussen (2010):** lower growth in oil importers 1990-2008 due to lack of openness, low ease of doing business, high government consumption.
- **Bhattacharya & Wolde (2010):** lower growth over 1995-2008 due to labor skill shortages, poor access to finance (survey), and electricity constraints.
- **Abu-Bader & Abu-Qarn (2008):** evidence of weak links from finance to growth in 6 MENA countries.

I. Introduction

- **Motivation 2**: Finance and growth literature, beginning with King and Levine (1993) shows a robust causal relationship between financial depth (*FD*) and economic growth (*y*):

$$\dot{y}_{it} = \beta_0 + \beta_1 FD_{it} + \beta_2 X_{it} + \mu_i + \lambda_t + \varepsilon_{it}$$

- Standard result: $\beta_1 > 0$, using different methods: Cross section, Time Series, Dynamic Panels.
- However, does β_1 differ across regions or types of countries (in particular, oil exporters vs. others)?

I. Introduction

Summarizing, our main question is:

Is there a financial sector component to low growth in MENA, and if so,

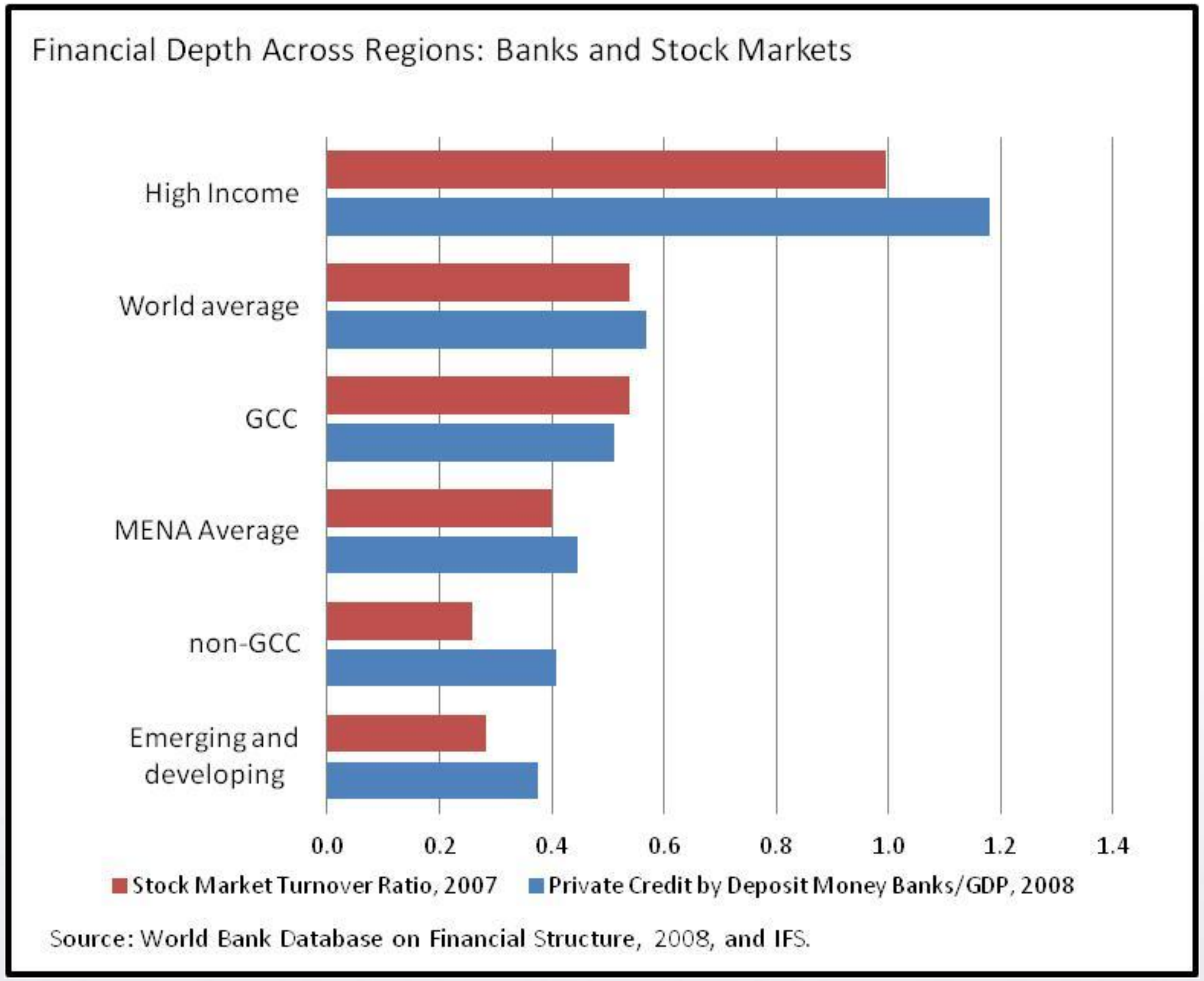
- is it insufficient financial depth (*FD* too low)?

and/or

- is it insufficient growth impact of existing depth (β_1 low), ie., a "*quality gap*"?

II. Results- Depth

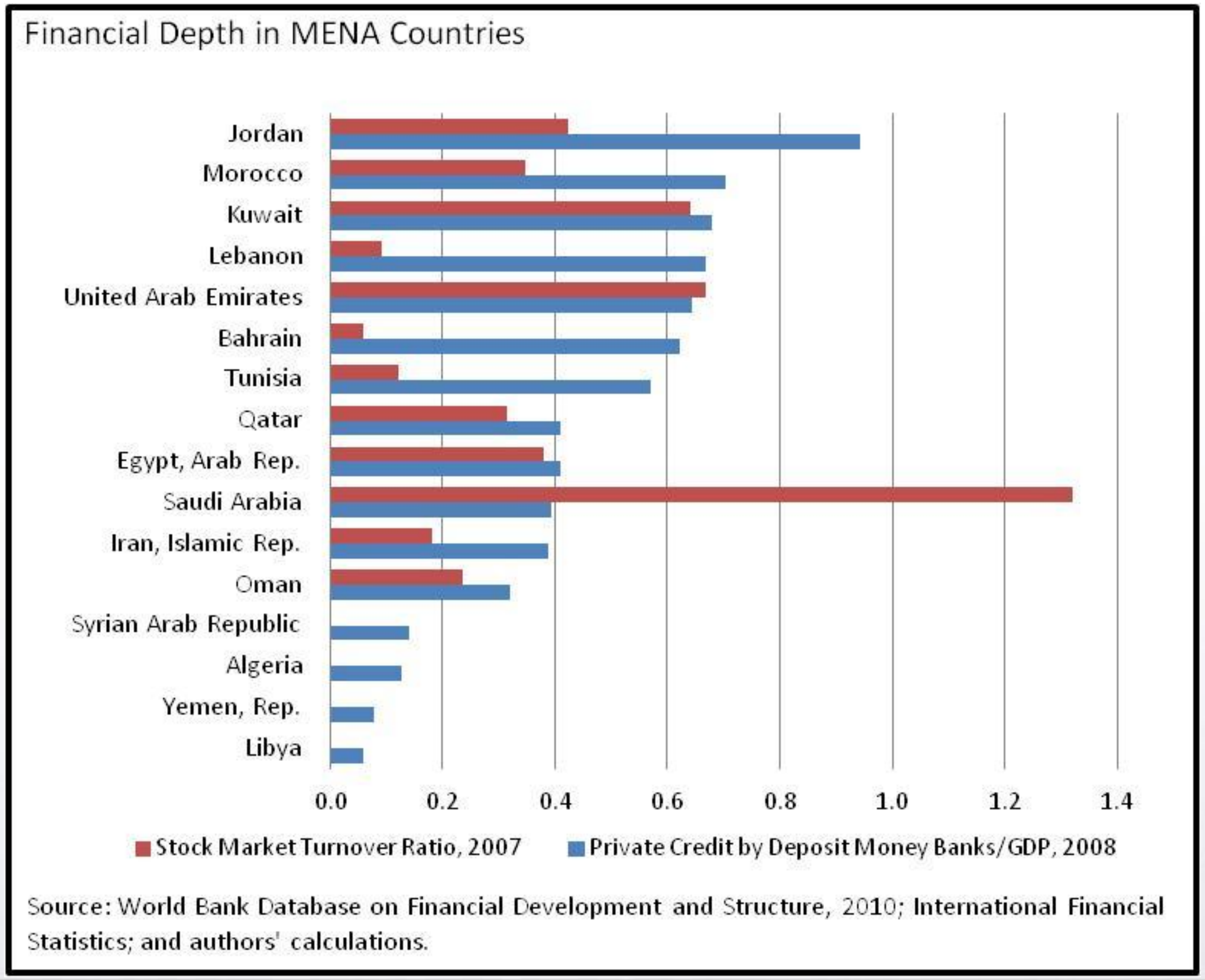
- First, depth does not seem to be the issue **at the aggregate level**:



II. Results- Depth

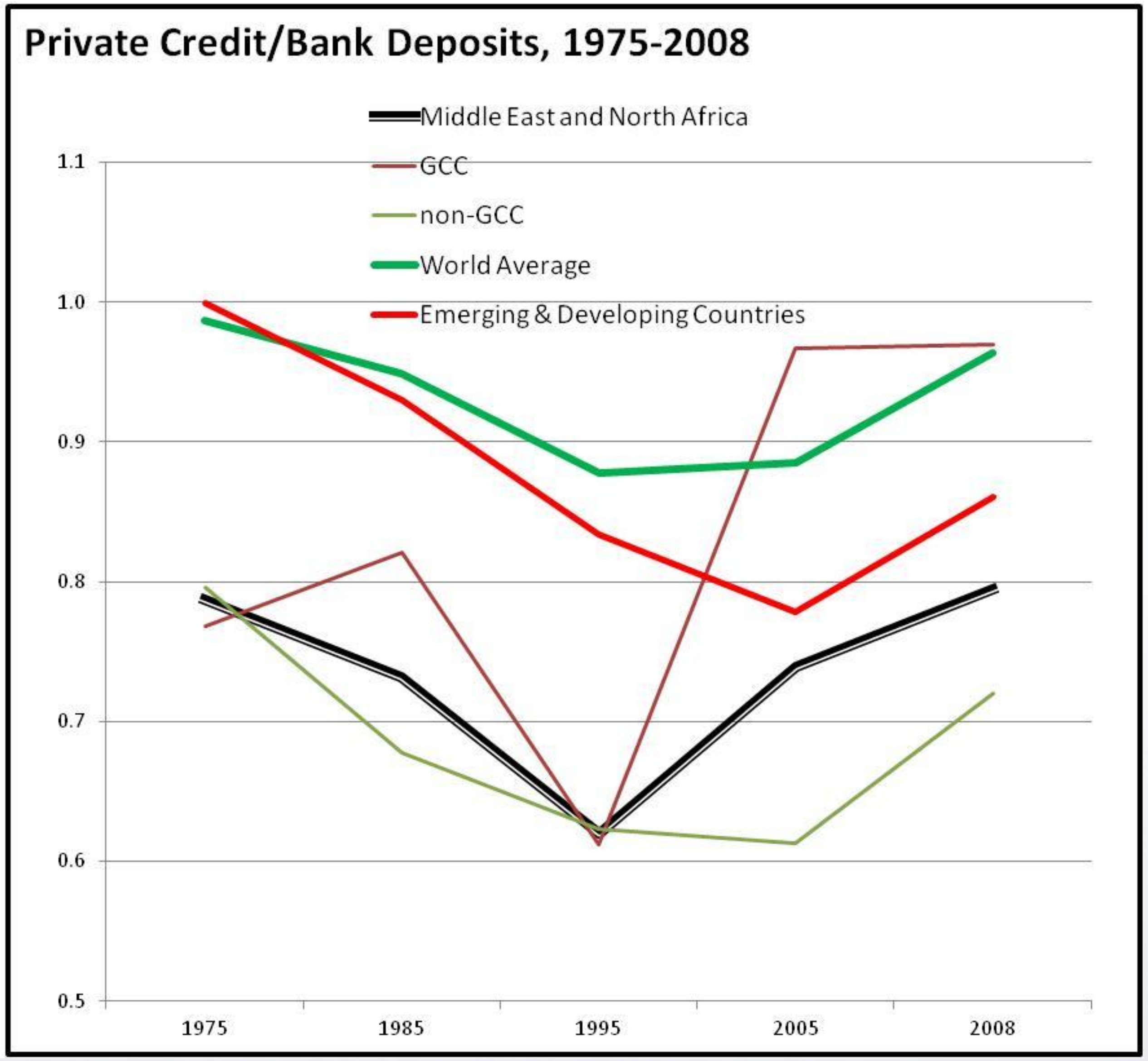
However, several issues:

- Heterogeneity within MENA



II. Results- Depth

- Given high levels of deposits, MENA bank intermediation (credit) should be much higher, particularly in non-GCC:



II. Results - Quality

We undertake growth regressions, a la Beck and Levine (2004):

- Sample of 140 countries, including 14 MENA (GCC and non-GCC); 1975-2005, using five-year averages to smooth out cyclical variations.
- Dynamic panel GMM estimation (Arellano & Bover, 1995), with cross-section OLS as a robustness check.
- Dependent variable: per capita real GDP growth, per capita real non-oil GDP growth.
- ***FD***: Use private credit-GDP for banking, turnover ratio for stock market development, other measures as robustness checks.
- ***X*** (controls): Initial GDPPC, Education, FDI, C_g, Terms of Trade.

II. Results - Quality

Two types of heterogeneity incorporated:

- By region:

$$\beta_{10} FD_{it} + \beta_{11} FD_{it} \cdot REGION_i$$

- Oil exporters vs the rest:
  - Oil exporter dummy:

$$\beta_{10} FD_{it} + \beta_{11} FD_{it} \cdot OilX_i$$

  - Degree of oil dependence (oil real GDP/total real GDP)

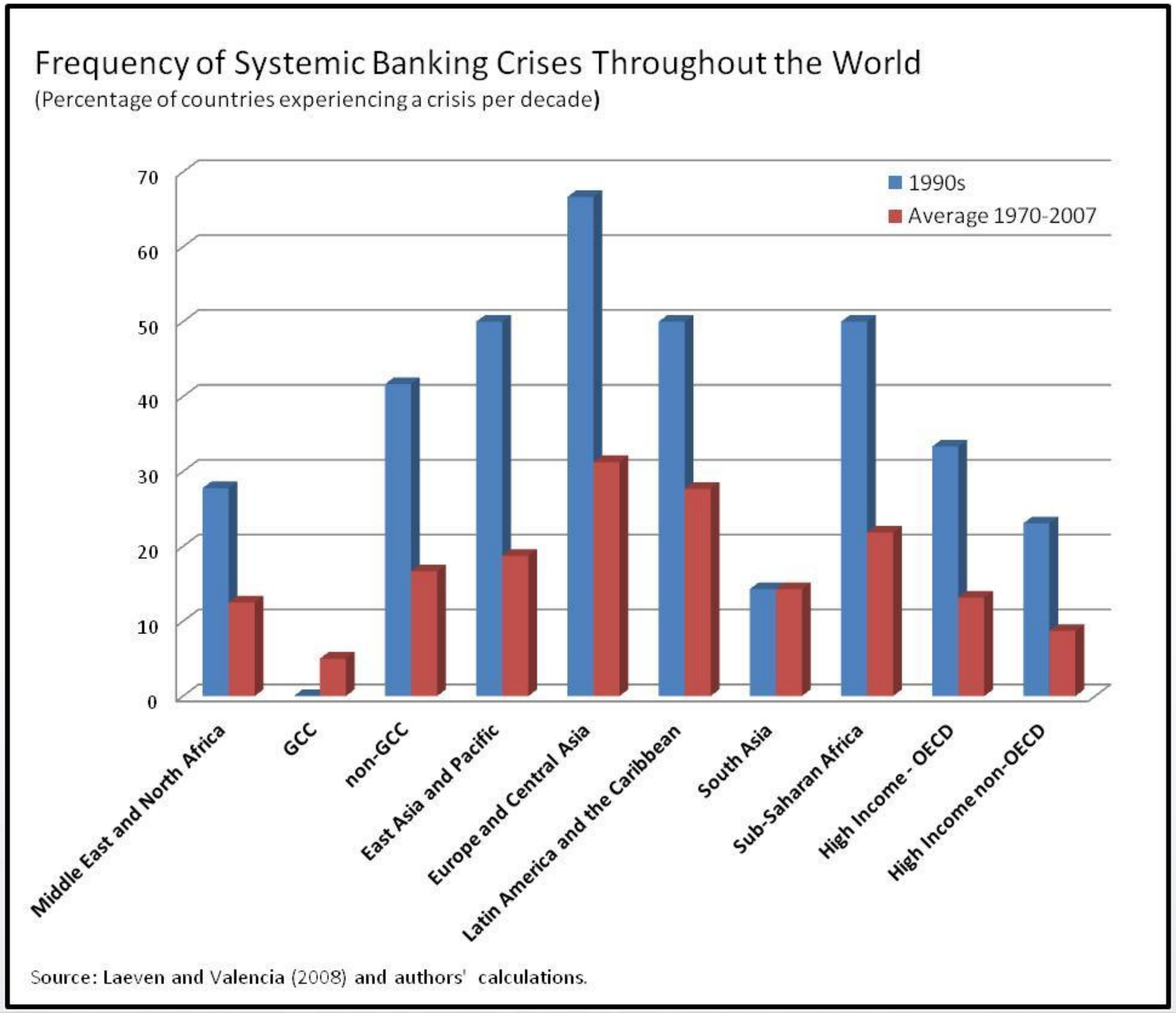
$$\beta_{10} FD_{it} + \beta_{11} FD_{it} \cdot Oildep_i$$

II. Results - Quality

- There is a **regional** and **oil** effect: **bank credit** has a smaller impact on growth
- However, no such effects for stock market depth
- The link between finance and growth weakens as the time period is expanded beyond the 1960-89 time period originally studied by King & Levine
- This may be linked to occurrence of financial crises

II. Results - Quality

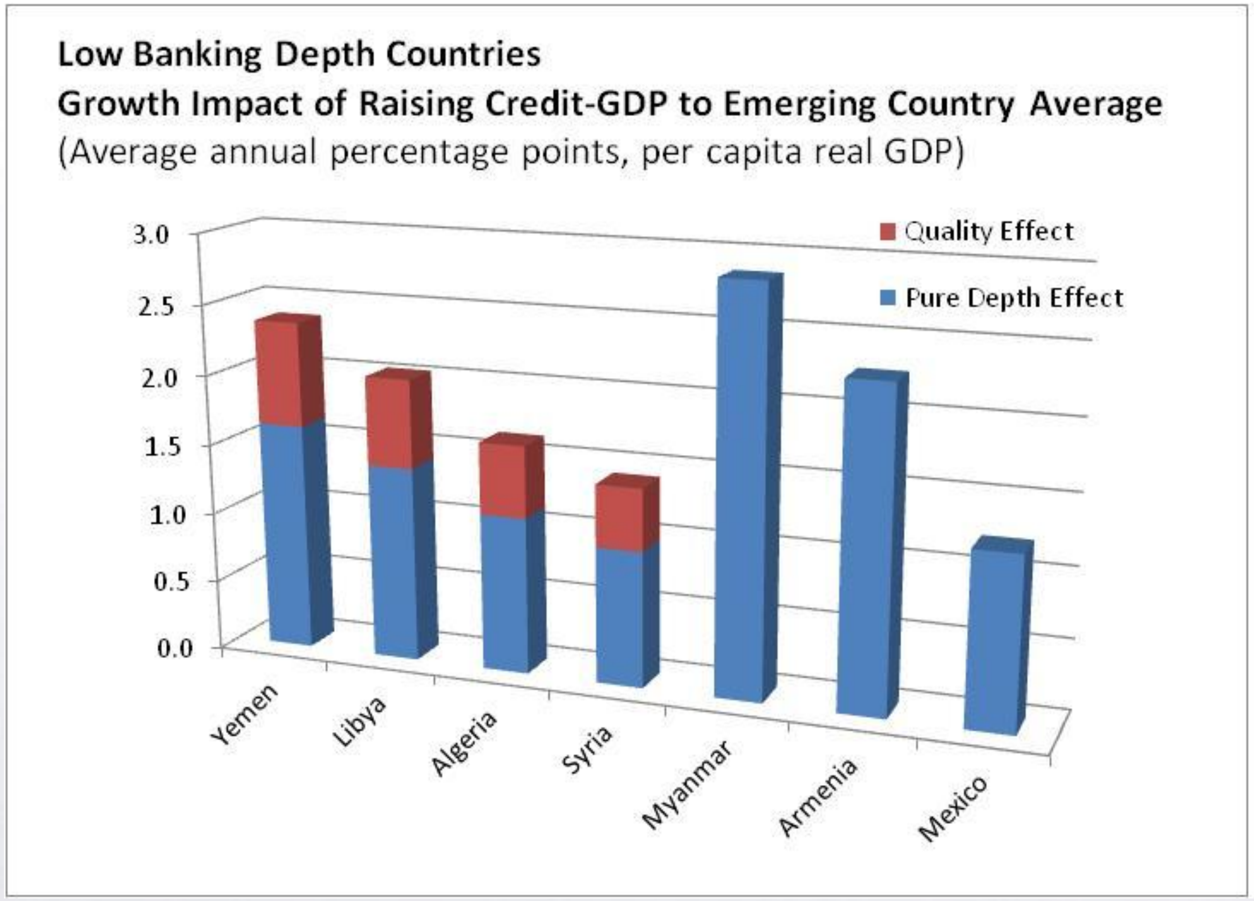
For MENA, this adjustment is relevant, as the region has been relatively immune to financial crises: finance-growth link restored

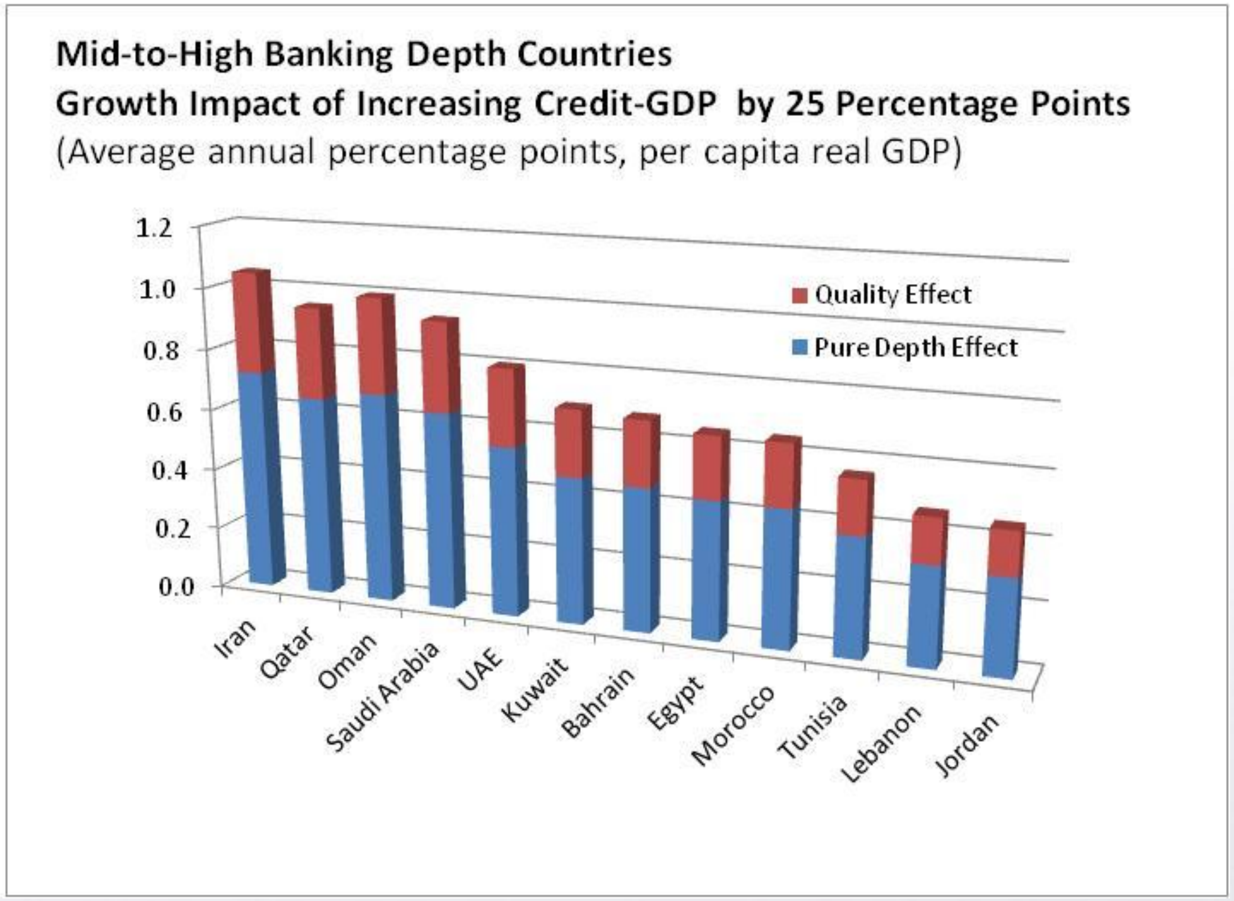


II. Results – How Large?

Quantifying the depth/quality effects of banking depth:

- **Conservatively**, the growth benefits of banking depth in MENA are ⅓ lower than in other regions (coefficient of 0.011 vs 0.016).

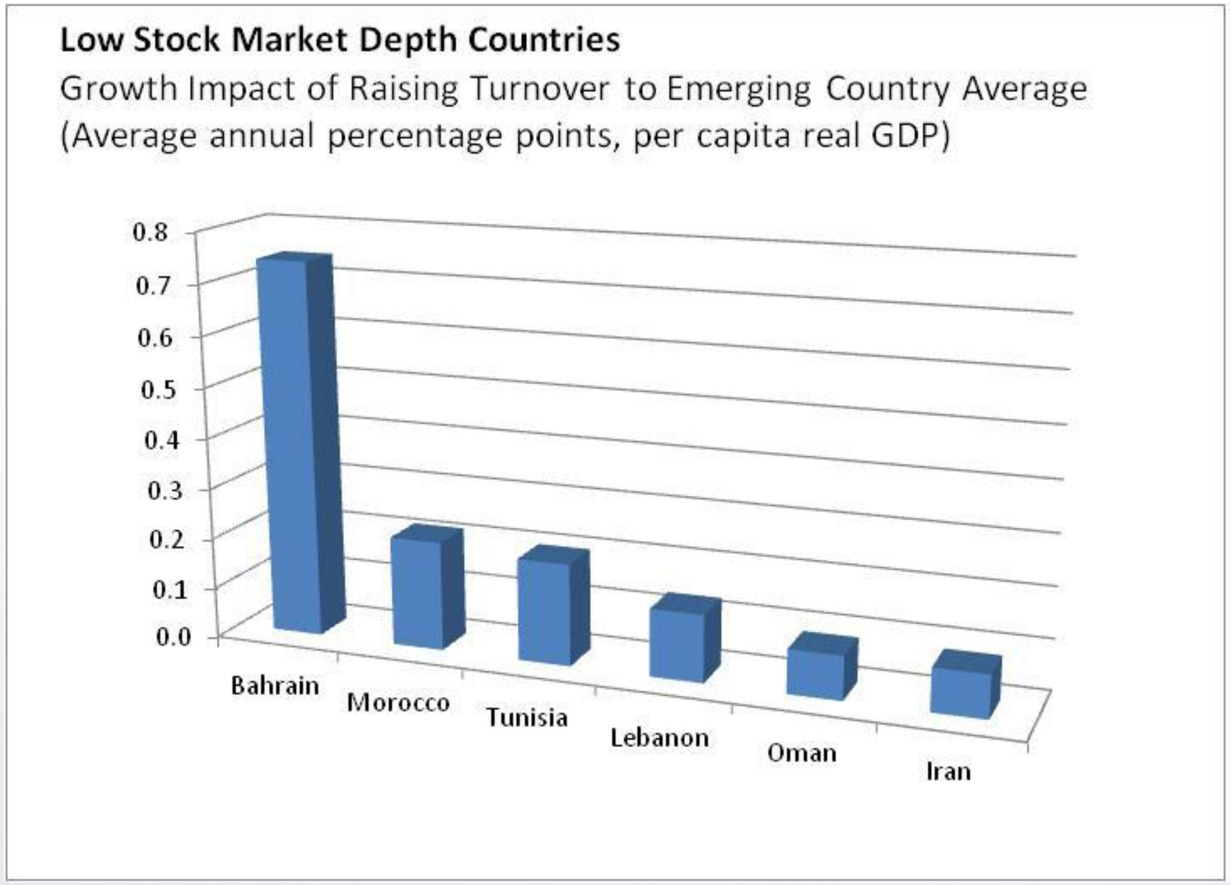


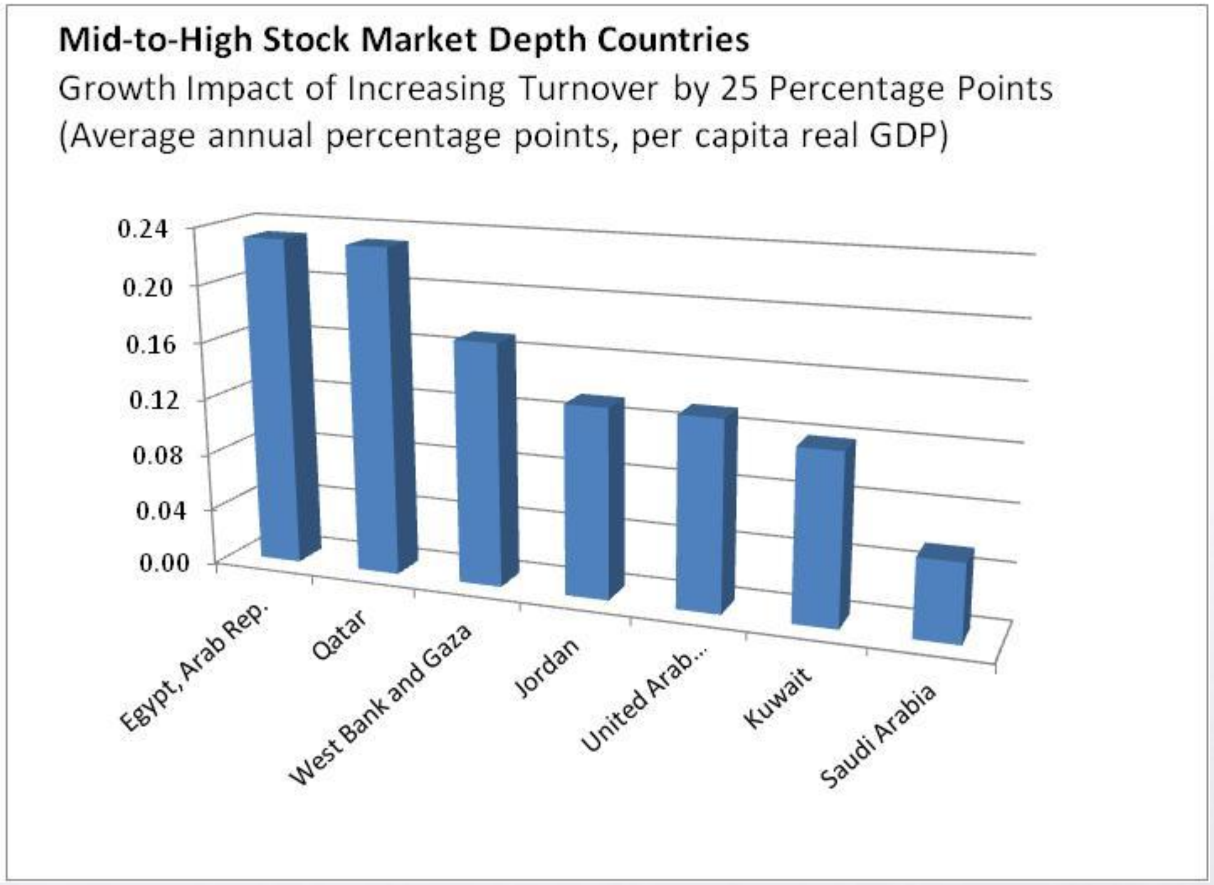


II. Results – How Large?

Quantifying the depth effects of stock market development:

- Sizable potential benefits from further stock market development.





III. Possible Causes for Lack of Quality

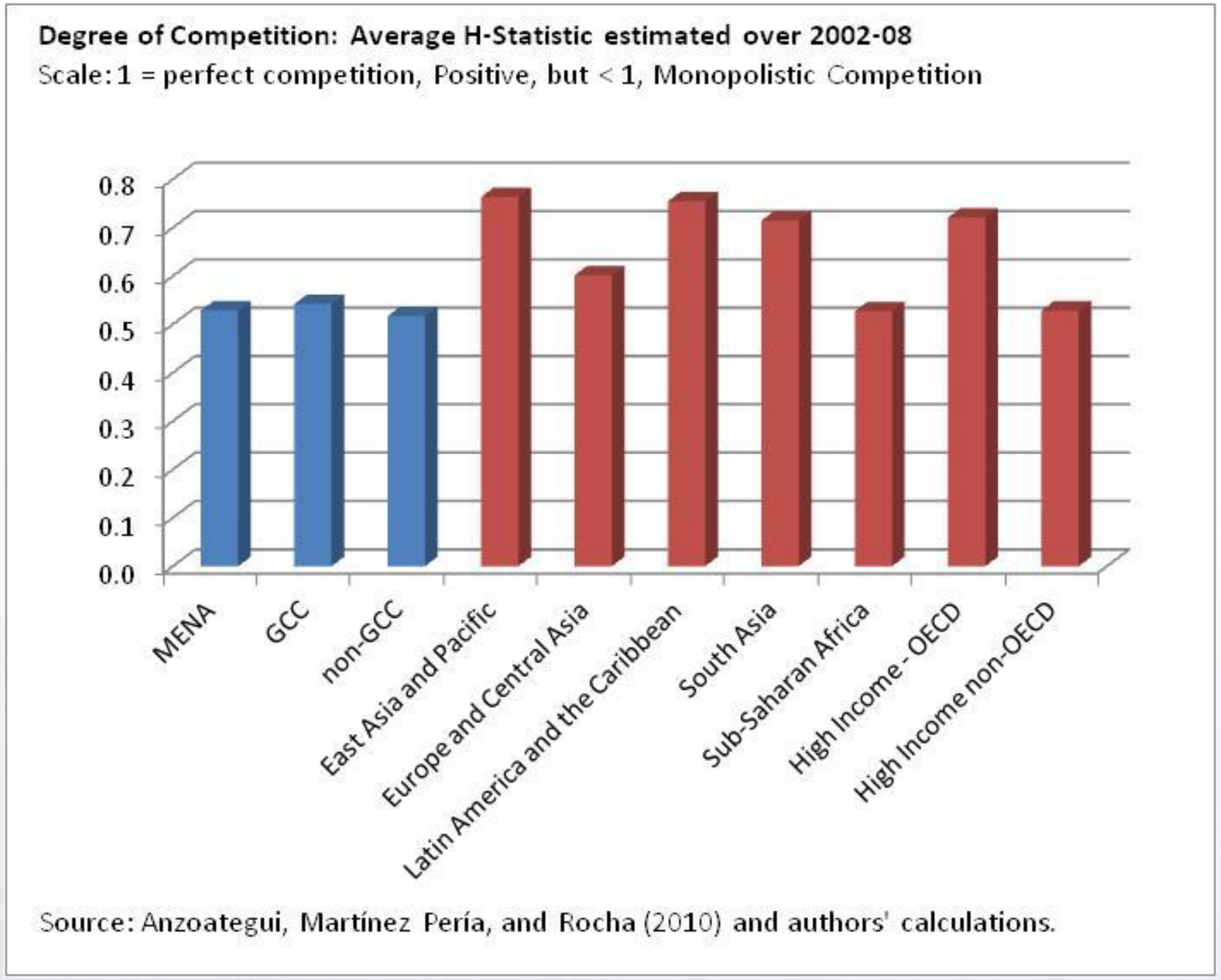
Results on quality are consistent with recent work (World Bank Flagship Report on Finance in MENAS) analyzing the output of MENA financial systems:

- Despite relatively large size, MENA financial systems have fallen short in providing access
  - To credit, especially to small and medium-size enterprises
  - To households, in terms of deposits and other banking services

- Loan concentration also tends to be very high, possible prevalence of connected and/or name lending

III. Possible Causes for Lack of Quality

One possible cause: **lack of banking competition**, as shown by Anzoategui, Martínez Pería, and Rocha (2010).

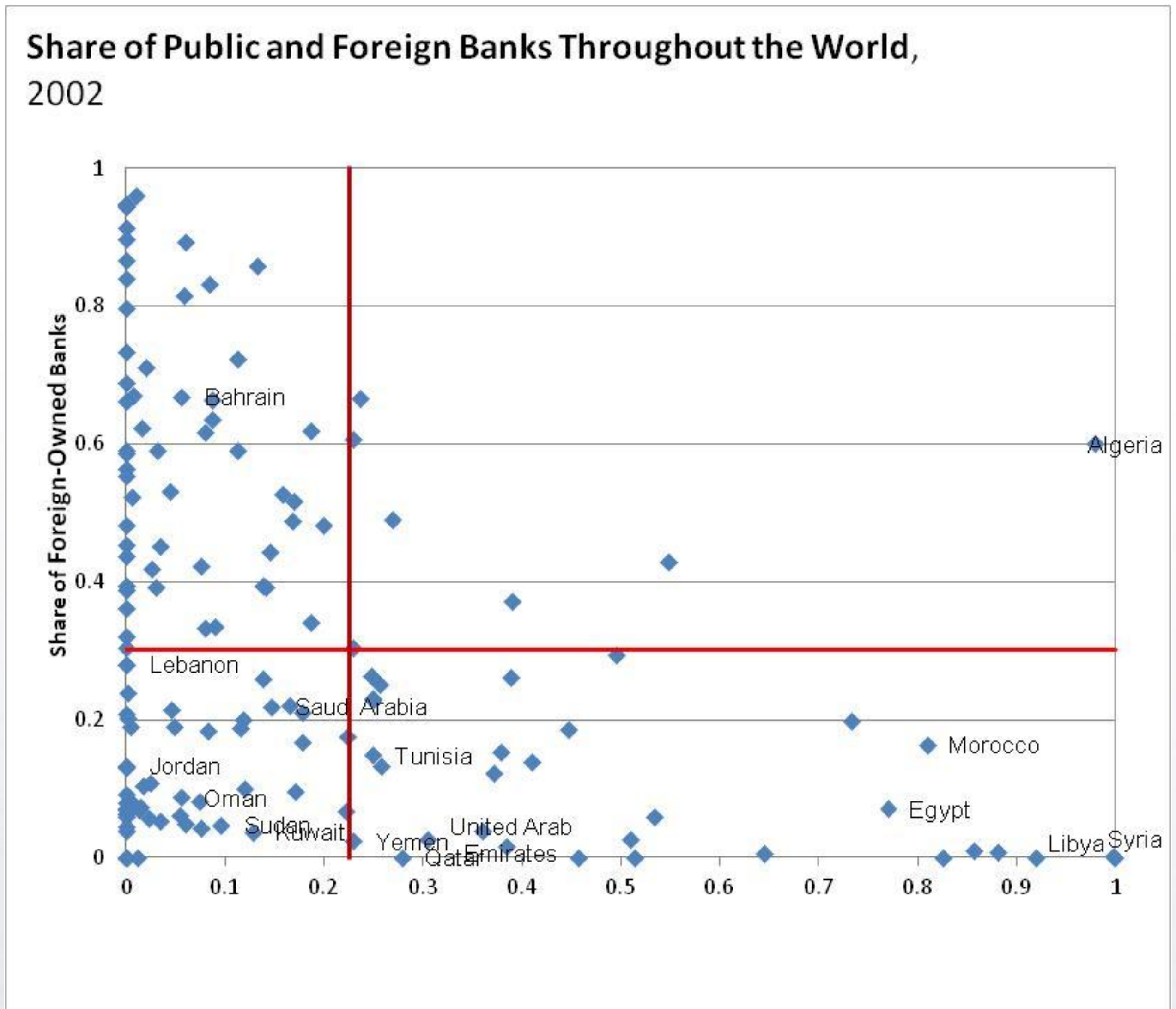


- When estimated region-wide, MENA significantly less competitive than other regions (exc SSA).

- 2nd stage regressions showed that lack of competition is linked to:
  - ❖ poor credit information
  - ❖ constraints to entry
  - ❖ lack of alternatives to bank finance

III. Possible Causes for Lack of Quality

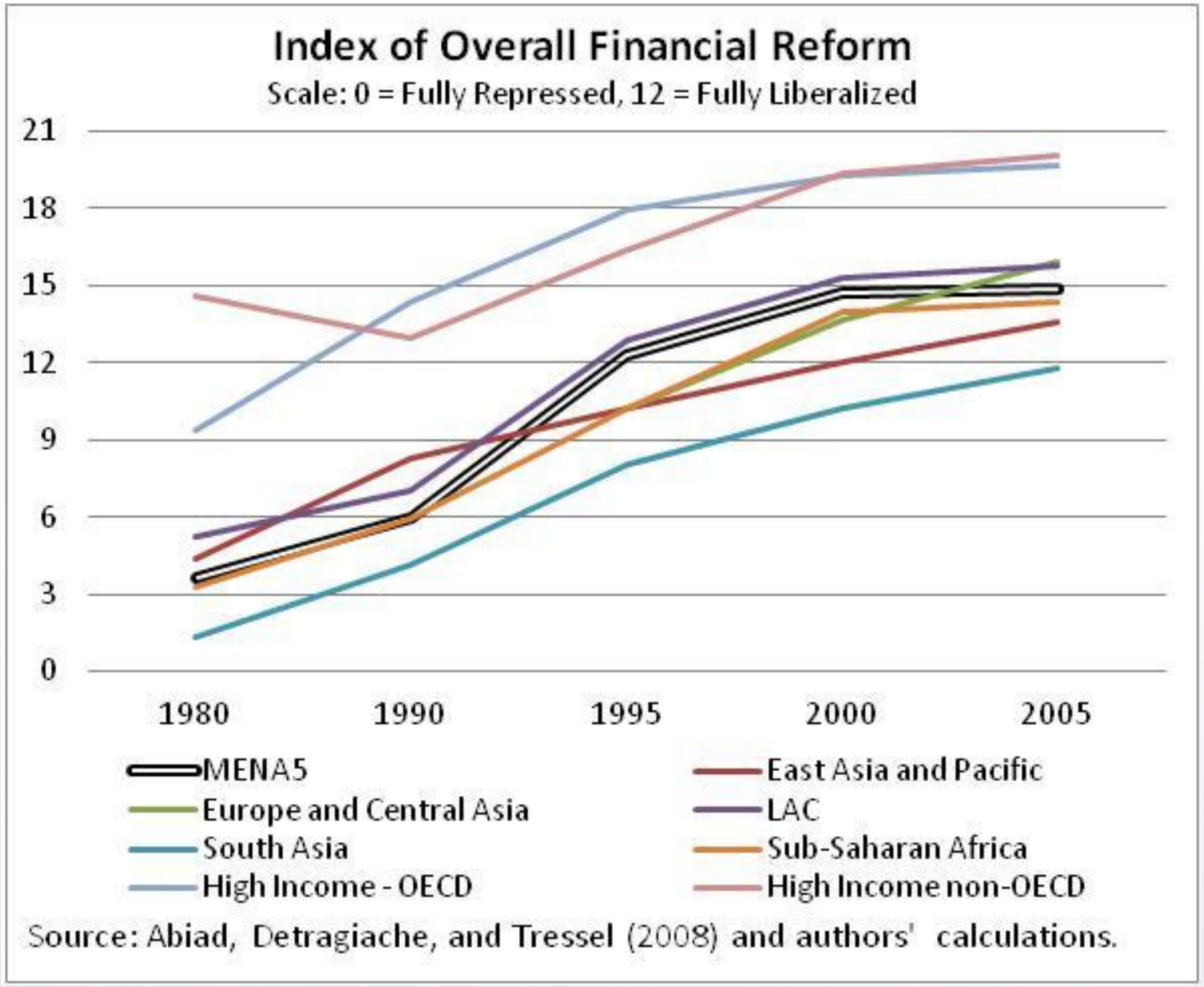
A second (related) possible cause: **bank ownership**, often high state participation, low foreign penetration (although heterogeneity).



- State ownership has been associated with low depth worldwide…
- …while foreign penetration is associated with greater efficiency, competition.
- Korner & Schnabel (2010): growth is not necessarily adversely affected by state bank participation, but is so when coupled with:
  - ❖ low financial depth
  - ❖ weak institutions

III. Possible Causes for Lack of Quality

A third issue: **status of financial reform**, difficult to measure, but information available for five MENA countries (ALG, EGY, JOR, MAR, and TUN)



Using Abiad, Detragiache & Tressel (2008):

• Overall intermediate level compared to other regions, but…

•…overtaken by Europe and Central Asia in 2005…

•…lowest progress in reform 2000-05

• Weakest areas: capital account openness and privatization

IV. Conclusions

- We find that, on average, financial depth (banks and markets) in MENA is comparable to that of other regions. However,
  - Insufficient depth in some countries
  - Banking depth (credit) not as high as it should be, given ability to attract deposits, particularly in non-GCC
- A "quality gap" is evident; for given banking depth
  - Growth benefits of financial depth are significantly smaller vs other regions
  - Consistent with other findings on lack of access to financial services
  - Banking competition is also weaker

IV. Conclusions

- Policy should aim to
  - To encourage financial depth where most lacking
  - To improve quality of banking depth
- In the following areas:
  - Legal rights of creditors, macroeconomic stability
  - Continuing to progress on financial reform
  - Credit information environment and relaxing entry restrictions
  - Reassessing the role of state banks
  - Development of domestic debt markets