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The resilience of oil-rich economies to the global financial crisis: Evidence from Kuwaiti financial and real sectors

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ABSTRACT

This article investigates the resilience of oil-rich economies to the recent global financial crisis, with a particular emphasis on Kuwait as a case study. We explore how the crisis affected the market power of banks and, furthermore, how the crisis was transmitted to the real sector of industrial growth. Three main results emerge. First, we find that bank competition in Kuwait was only marginally dampened during the crisis period. Second, the financial crisis penetrated the real sector through a weaker and less significant relationship between bank performance and industrial growth compared to the pre-crisis situation. Accordingly, industries depending more on external finance suffered disproportionately more during the crisis. Third, these findings apply to oil-rich Arab countries and, with respect to the adverse real effect of the crisis, to oil-exporting countries. Overall, these results confirm the vulnerability of oil-rich economies to the crisis, requiring appropriate policy actions to support financial stability and prevent declines in real economic activity.

1. Introduction

The recent global financial crisis affected the performance of the banking sector not only in developed countries, but also in emerging ones (Efthyvoulou and Yildirim, 2014). In addition, in many countries the crisis was also transmitted to the real sector (Lane and Milesi-Ferretti, 2010; Klapper and Love, 2011; Jo, 2014; Moore and Mirzaei, 2014; Wan and Jin, 2014). By destabilizing the financial sector, the crisis affected the performance of the real economy through reducing the availability of credit and increasing uncertainty about future gains and thus decreasing the level of investment and consumption. There are, however, significant variations in response to the crisis across countries. The degree to which countries have been affected by the crisis has differed quite considerably (Giannone et al., 2011). In this paper, we examine the resilience of oil-rich economies to the crisis, with a particular emphasis on Kuwait as a case study. Specifically, we examine the impact of the crisis on the level of competition among 16 Kuwaiti banks and further investigate how the crisis affected 20 sectors of the economy. We also enrich our study by systematically comparing the resilience of Kuwait's economy to the crisis with that of other oil-exporting countries in order to investigate the overall impact of the crisis on oil-rich economies.

One concern among policymakers is how to maintain the sustainability of financial markets. A sustainable financial system can contribute to economic growth by financing the real economy more efficiently. It is argued that a sustainable

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banking sector needs to be more resilient, while remaining competitive. Financial crises, however, can affect the sustainability of financial sectors by, for example, reducing competition among banks. The theory yields ambiguous predictions about the impact of financial crises on bank competition (Cubillas and Suárez, 2013). On the one hand, bank market power could be reduced during a financial crisis if banks behave more prudently. While being risk averse could ensure that a bank is able to weather a crisis, it could also mean that the bank loses standing in the marketplace due to investing in low-risk projects, which leads to low returns and consequently a reduction in bank margins, thus reducing bank market power (Detragiache et al., 2000). On the other hand, the market power of the banking sector may increase if banking crises reduce the number of banks operating in the market. During a crunch period, less stable and inefficient banks often merge to avoid bankruptcy. Because this leaves fewer competitors in the market, the relative power of survival banks can actually increase during a financial crisis (Laeven and Valencia, 2008). In addition, efficient and solvent banks in the pre-crisis period are usually those which survive the crisis (Mirzaei, 2013). Because these well-structured banks are already in a favorable position, they can then increase their market share and profit margins whilst cutting costs after the crisis (Berger, 1995). These effects may also allow an increase in bank market power.

The impact of the crisis on Kuwait, and on Middle East and North Africa (MENA) countries, is not negligible (Al-Hassan et al., 2010). There is some evidence that the banking sector in Kuwait has been affected negatively by the crisis. A Kuwaiti commercial bank, for instance, suffered huge losses from derivative transactions (Maghyereh and Awartani, 2014). Khediri et al. (2015) also find that the crisis affected bank profitability in oil Arab countries, and Espinoza and Prasad (2010) point out the vulnerability of banks in the region to the 2008 global crisis. In fact, the presence of multinational banks and the increasing prevalence of external financing have rendered the banking systems quite vulnerable to the crisis.

It is likely that banks then passed on their own vulnerability to their customers in the form of higher lending rates and/or a lower quantity of funds, which increased the cost of capital for borrowing companies. As a result, some planned corporate investment projects would no longer make economic sense. Consequently, corporate growth and, in the aggregate, economic growth were likely to decrease during the crisis. Popov and Udell (2012) find that the supply of credit during the crisis was affected by changes in the financial conditions of banks. In addition, poor banking performance during the crisis would have a more pronounced economic effect on bank-based economies and hence we expect the real sector in oil-exporting countries to have been affected more severely. Oil-rich Arab countries, for instance, traditionally rely almost solely on banks as a source of debt, as the regional bonds markets are still largely underdeveloped. Rocha et al. (2011) argue that banks play an important role in financing SMEs in the MENA region. Thus, if the crisis had an adverse effect on bank performance in the Kuwait banking sector, it was probably transferred to the real sector.

The structure of Kuwait's banking sector is fairly similar to those of other oil-rich Arab countries, so that it is an appropriate case study for investigating the resilience of oil-exporting economies to the crisis. Maghyereh and Awartani (2014) point out that the banking sectors of all countries in the region are moderately concentrated, have a substantial share of Islamic banks, and faced significant reforms over the last decade. Maghyereh and Awartani (2012) study banking sector integration in the oil-rich Arab countries over 1998–2009, finding a significant convergence in efficiency among banks and considerable homogeneity of the banking markets in the region. Al-Hassan et al. (2010) also show that financial markets in the region exhibit a number of common structural characteristics across countries and that the banking sector dominates the financial market. There has also been a push for member countries to integrate their economies, which has left them open to common shocks[1] (Espinoza et al., 2010). The current crisis highlights the importance of linking macroeconomic conditions to the health of the banking system. Thus, the present study will enhance our understanding of the real effects of the crisis on oil-rich countries and assist policymakers in acting appropriately.

By using data for 16 banks and 20 non-financial industries in Kuwait, three main results emerge. First, we find that bank competition in Kuwait was only marginally dampened during the crisis period. This is because of the potential reduction in the number of banks in the market following shutdowns and mergers and acquisitions of inefficient and/or failed banks. Second, the financial crisis affected the real sector of non-financial industries by deteriorating the significance of the relationship between bank performance and industry growth that existed in the pre-crisis period. During the normal pre-crisis period, industries depending more on external finance grew fast, as the banking sector became more competitive and efficient. The global crisis, however, put an end to this, leading to a more vulnerable economy. Accordingly, industries depending more on external finance suffered disproportionately more during the crisis. Third, these findings apply to oil-rich Arab countries and, with respect to the adverse real effect of the crisis, to oil-exporting countries. Overall, these results confirm the vulnerability of oil-rich economies to the crisis, requiring appropriate policy action to support financial stability and prevent declines in real economic activity.

The remainder of the paper is organized as follows. Section 2 presents a literature review and Section 3 the methodology used to estimate the impact of the crisis on bank competition and industry growth. This section also contains an explanation of our data. Section 4 reports the results, followed by the conclusions in Section 5.

[1] Note, however, that oil-rich Arab countries may also exhibit some significant differences, as they are progressing towards economic diversification at different rates and in different directions (Sturm et al., 2008).