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Banking performance and industry growth in an oil-rich economy: Evidence from Qatar

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ABSTRACT

This article investigates whether bank performance measures of competition, efficiency, profitability and stability are contributory to industry growth for oil-rich countries. Qatar is chosen as a case study. The real growth of value added for the 42 non-oil sub-sector industries is regressed on the banking performance, together with the quantity-based indicators by taking account of the degree of external finance-dependence over the economically stable period 2000–2006. The results, which survive robustness and sensitivity tests, reveal that a competitive, efficient and stable banking system is indeed a source of enhancing financially-dependent industries to grow faster. Our empirical results serve to provide a useful insight for policy strategies of oil-exporting countries.
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1. Introduction

In this paper, we examine the effect of bank performance[2] on industry growth in the non-oil industry sectors for Qatar over the sample period 2000–2006 based on the panel linear model.[3] We regress the growth of 42 non-oil industry sub-sectors (out of 17 industries) on the performance of 11 banks in Qatar. Following the methodology of Rajan and Zingales (1998), we take into account the degree of external-finance dependence. Rajan and Zingales (1998) argue that, when a firm faces an investment opportunity, it typically relies on two important resources: one is the internal cash flow generated within the firm, and the other is the external sources of finance. If the sector has to rely heavily on the latter, then the development of financial intermediaries or financial markets would considerably affect their growth performance. For example, development in finance promotes accounting information and disclosure rules, and improves corporate governance, hence the cost of access to external sources will be reduced. In such a scenario, those firms which are technologically more dependent on external finance, would disproportionately benefit from financial development.[4]

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[2] In this paper, the term ‘bank performance’ refers to quality-based measures, including competition, efficiency, stability and profitability. This is distinguished from quantity-based indicators.

[3] Since the industry-level data for Qatar are only available for 2000–2006, the sample period for the empirical analysis is restricted. For example, there are only 27 industry observations during the financial crisis period 2008–2010, and even with firm-level data as an alternative to the industry-level data, there are not enough observations to conduct estimation beyond 2006.

[4] It has an important implication on the overall rate of growth in a country (Pang and Wu, 2009). Suppose a country has two types of industries of low (I_L) and high (I_M) reliance on external sources of finance, respectively. If both industries face an unexpected growth opportunity, banking performance has little impact on less externally dependent industries, since I_L can respond quickly to such an opportunity by using internal funds. Bank performance would, however, play an important role for industries that are more reliant on external finance. If high performance in the banking sector means more and/or qualitative funds for borrowers (for example, an efficient, competitive and healthy banking may have these characteristics), then one would expect the growth rate to be higher in a country with high banking performance.

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We consider four indicators of banking performance, namely, competition, efficiency, profitability and stability. Competition and efficiency in the banking sector are important for social welfare, since they are associated with low prices, high quality and the promotion of business innovation. Bank competition can enhance the accessibility of banking services to small and medium-sized businesses at an affordable cost.[5] Several empirical studies find that banking competition improves overall economic performance (Cetorelli & Strahan, 2006; Claessens & Laeven, 2005; Liu & Mirzaei, 2013; Maudos & Fernandez de Guevara, 2006). Bank efficiency seems to capture the allocative function of banks, in that the ability to use the available technology and to optimally combine the inputs into the production process can be considered a necessary condition for the effective allocation of resources. There is also broad consensus in the literature that a healthy banking system contributes to an efficient allocation of real economic resources, and an efficient management of wealth and capital accumulation. Profitability and stability are crucial indicators of banking system health. A stable and profitable banking sector is better able to withstand negative shocks and to contribute to the stability of the financial system as a whole.

The contribution of this paper is largely two-fold. It is argued that improvement in banking performance would have a more pronounced economic effect in the bank-based economies. If this is the case, non-trivial impact would be felt by firms in oil-rich countries. Firms in the oil-rich Arab countries traditionally rely almost solely on bank loans as a source of finance, as the regional bond markets are still largely underdeveloped. Rocha, Farazi, Khouri, and Pearce (2011), for example, argue that banks still play an important role in financing small and medium enterprises (SMEs) in the Middle East and North Africa (MENA) region. Banks in this region regard the SME segment as potentially profitable, and are, to some degree, engaged in SME lending. Rocha et al. also point out that financial services that are dominantly executed by commercial and Islamic banks constitute a major segment of market capitalization in the region. However, to the best of our knowledge, there is no study conducted for oil-rich economies in gauging the extent to which bank performance could affect economic growth. Thus, the analysis of banking sectors in these countries is one of the contributions to the literature.

Secondly, it is related to the specific features of the oil-rich countries. Theory makes ambiguous predictions about the finance-growth relationship in resource-based economies (Aghion, Bacchetta, Ranciere, & Rogoff, 2009). One argument is that the financial system might be less important as growth depends less on finance-intensive sectors, whereas the other theory suggests that financial-system development might be more important to compensate for the negative effects of ‘Dutch disease’ and also to diversify the economy.[6] In the case of the MENA region, the latter argument is supported. The oil-rich Arab states are strongly dependent on the hydrocarbon sectors (Ayadi & Pieter de Groen, 2013), and they have a long-term policy objective to diversify their economic activities with a view to reducing their dependency on natural resources that may be depleted in the future. Having a competitive, efficient and sound banking sector may thus have a pivotal role in this strategy of economic diversification. Infrastructure and non-oil industrial sectors are the core of the diversification. It is expected that those industries that are more dependent on external funds will benefit disproportionately if the performance of the banking sector is of a good quality in this region.[7] In this respect, this paper may be contributory to policy makers by providing policy implications.

Qatar provides a good case study for examining the relationship between bank performance and industry growth in the MENA region. During the period of 2001–2010 the country’s GDP growth increased significantly reaching around 17 percent in 2010 which is well above other countries. Although Qatar is an oil-rich economy, the non-oil and gas sector still plays an important role in the country’s economic growth, accounting for around 38 percent of the overall GDP in 2008. The manufacturing sector grew by 32 percent over the period of 2006–2008, and among others, refining, chemical, fertilizers, and steel are the major sub-sectors of the manufacturing sector. A large infrastructure spending programme that would boost demand for cement, steel and other materials highlights the important role of the manufacturing sector in this country, potentially increasing the share of GDP. Given the fact that growth in some manufacturing sectors in Qatar has relied heavily on external finance, and firms have to relay the bulk of finance from banks due to a less developed capital market, the role of the banking sector is of vital importance. In practical terms, Qatar is one of the rare countries in the region that reports its industry data during 2000–2006 through the United Nations Industrial Development Organization (UNIDO) database, making it possible to conduct the study. Al-Hassan, Khamis, and Oulidi (2010) show that financial markets in the region exhibit a number of common structural characteristics. For example, the banking sector is relatively concentrated with a few domestic players dominating the market. Over the past two decades oil-rich Arab countries have taken important steps to achieve economic and financial integration. Espinoza, Prasad, and Williams (2010) show a regional financial integration following such policies. The economic structure of these countries is also similar, exhibiting convergence on many macroeconomic indicators, and they are likely to face common shocks. Thus, studying the impact of bank performance on Qatari industry growth could be generalised to other oil-rich countries, where the data are too sparse to conduct a detailed analysis. Understanding the impact of bank performance on industry growth will assist policy makers in setting policies that facilitate access to external finance for their manufacturing sectors.

Empirical evidence reveals that, while the quantity of finance does not matter for industry growth, a competitive and efficient banking system allows financially dependent industries to grow faster. For example, when we measure the economic relevance of banking-system competition for industry growth, it is found that industry growth increases by 10% p.a., if we move from the 75th percentile market power to the 25th percentile level among Qatari banks. Similarly, the total impact on growth is raised by 10% p.a. if we move from the 75th percentile of bank inefficiency to 25th percentile level. The stability of the banking system is also found to be an essential component for industry growth. These results remain after robustness and sensitivity tests.

The remainder of this paper is organised as follows. Section 2 presents a literature review of the finance-growth relationship. Section 3 contains the model specification used for hypothesis testing. The description of data is also presented in this section. The empirical results are reported in Section 4 with some robustness tests. Section 5 is for conclusions.

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[5] It is, however, argued that severe competition may deteriorate bank market power which may, in turn, deter lending relationships with borrowers, increasing financial obstacles.

[6] Beck (2011) shows that financial development is as important for economic growth in resource-based economies as in other countries. Resource-based economies have less developed financial systems, and there is, in general, a credit constraint amongst firms due to poor provision of bank loans.

[7] For example, Hasanov and Huseynov (2013) examine the impact of bank credits on non-oil economic growth in Azerbaijan. They find that bank credits have a positive impact on non-oil tradable sectors’ output.

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