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Abstract

The aim of this paper is to study the growth and corporate governance implications of market concentration in the GCC banking sector. It will begin by defining corporate governance, its significance in the context of banks, and how it can be improved by more competition or less concentration in the banking market. It will then discuss the importance of corporate governance to "better functioning and well-behaved" financial systems, and how both can favorably affect growth. A discussion of the GCC economies and banking system will follow, with an emphasis on market concentration in the banking system. And to document empirically the effect of banking market concentration on growth, we estimate a growth model to capture this effect, and find that the effect is positive but conditioned by the level of financial development. The paper will close with a conclusion, whose main point is that policies aimed at opening the GCC banking market, and creating less concentration in the process, will have a positive effect on growth when the financial system is relatively more developed.

Corporate Governance and Concentration in the Arab Banking Sector and Economic Growth: The Case of the GCC Countries

I- Introduction

Corporate governance largely came to the center of the international development agenda following the East Asian financial crisis. The crisis, of course, had some painful social and economic consequences, which prompted an urgent analysis as to its origins. And it is no secret now that faulty corporate governance in the financial system was a major culprit. As a result, adherence to good corporate governance is currently recognized as crucial in averting financial crises. Good corporate governance is based on four main principles: fairness, transparency, accountability and responsibility; and besides reducing the vulnerability to financial crises, these principles reflect the standards necessary to provide legitimacy to the corporate sector, and to broaden and deepen access to capital (OECD, 2004). This is bound to have a positive, ultimate impact on growth, as the literature has shown (World Bank, 2006). It has also shown that countries can undergo better development and have higher living standards when the rule of the law prevails, contract are enforceable, barriers to entry into new business are low and monetary and fiscal policies are prudent and appropriate. And of particular significance to this paper is the issue of barriers to entry in the banking sector and its implications to good corporate governance and growth. Barriers to entry, as is well known, result in a concentrated banking market and consequently preserve the interests of a handful of banks enjoying significant market power.

The economic impact of banking market power has been the subject of analysis in a number of both theoretical and empirical studies; and the consensus from these studies is that market structure has indeed an impact on growth (Fritzer, 2004; and the references therein). However, the effect of banking market structure on growth that emerges from these studies is mixed: some economists argue that banks with market power will affect growth negatively while others believe the contrary. In case of the negative impact, the main argument is that banks with market power will charge higher loan rates and offer lower savings rates hence increasing their net margin. This will result in a reduction in the amount of funds available for loans as customers will become reluctant to take on more loans due to the high cost, and consequently will retard the

growth rate of the economy. As for the positive impact, the more salient argument is that banks with market power will enjoy the benefit of economies of scale in the production of banking services, and hence will gain more profits which ultimately will affect the economy's growth positively.

This paper will try to add to our understanding of the impact of financial structure on economic growth by investigating the impact of banking market concentration on growth in the context of the GCC (Gulf Cooperation Council) banking sector. The GCC countries (comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE) are in the process of easing or even dismantling their barriers to entry in the banking sector as part of their regional and international obligations (GCC membership, WTO membership, etc…). But the tight entry regulations that they had before had resulted in highly concentrated banking markets. The aim of this paper is to study the growth and corporate governance implications of this concentration. It will begin by defining corporate governance, its significance in the context of banks, and how it can be improved by more competition or less concentration in the banking market. It will then discuss the importance of corporate governance to "better functioning and well-behaved" financial systems, and how both can favorably affect growth. A discussion of the GCC economies and banking system will follow, with an emphasis on market concentration in the banking system. And to document empirically the effect of banking market concentration on growth, we estimate a growth model to capture this effect, and find that the effect is positive but conditioned by the level of financial development. The paper will close with a conclusion, whose main point is that policies aimed at opening the GCC banking market, and creating less concentration in the process, will have a positive effect on growth when the financial system is relatively more developed.

II- Corporate Governance: Definition, Importance, and Significance to Banks

The OECD principles define corporate governance as involving "a set of relationships between a company's management, its board, its shareholders, and other stakeholders (OECD, 2004). Corporate governance also provides the structure through which the objectives of the company are set, and determines the means for attaining these objectives and monitoring performance. In

addition, corporate governance refers to the structures and processes for the direction and control of corporations. It affects the distribution of responsibility and accountability among the main participants in the corporation, and the rules and procedures for making decisions on corporate affairs[1]. If implemented properly, corporate governance benefits companies in many aspects such as improving access to capital, attracting premium valuations and financing on improved terms. Moreover, it improves company performance by producing superior leadership, oversight and strategic direction, efficient information flows and work processes, and better compliance, accountability and less conflict (World Bank, 2006)[2].

An important feature that enhances good corporate governance and furthers its favorable implications is more competitive markets. There are several reasons to support this essential connection. First among them is the fact that incumbent firms in monopolistic markets earn excess profits that render needless any improvement in corporate governance to better perform and use resources more efficiently. Also, the deep pockets engendered by excess profits reduce the need by incumbent firms to rely on securities markets where external financiers often demand transparency and accountability of corporate insiders. An additional reason is that the lack of market competition accentuates ownership concentration, since incumbent firms remain private or may go public but without giving up control by issuing non-voting shares. And perhaps most interesting is the reason that existing corporate elites can use their influence to resist policy reforms, and in consequence entrench the position of the limited number of existing firms and the interests of their management and corporate insiders. Not surprisingly, countries that have more competitive and regulated markets have also proven to have better corporate governance practices and more developed financial markets (Khemani and Leechor, 2002).

[1] Shleifer and Vishny (1997) argue that corporate governance is also concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest among corporate claimholders. Perhaps as interesting, they add that "corporate governance mechanisms are economic and legal institutions that can be altered through the political process".

[2] In addition to corporate governance, there is just as importantly two other types of governance: national and global. National governance is defined as "the manner in which power is exercised in the management of a country's economic and social resources for development"; and covers, among others, aspects including a sound legal framework, prompt and efficient law enforcement processes, clear investment rules, and appropriate oversight and accounting systems to monitor and implement budgetary policies. Global governance, on the other hand, refers to the set of existing rules and institutional arrangements governing the global economy. Both governance levels, especially the national, have shown to be strongly associated with growth (Akoum, 2004).

As to banks, the Basel Committee on Banking Supervision published in 1999 (and updated in 2006) a special paper on a non-binding basis that aims at promoting the adoption of sound practices of corporate governance by banking organizations in the different countries concerned (BIS, 2006). It emphasizes that improving transparency through better disclosure of financial information, enhancing regulatory oversight, and stronger measures that improve accountability and better align shareholder and manager interests. More specifically, it stipulates the main elements of sound corporate governance in the banking industry as :

1. ***Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank***.
2. ***The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization***.
3. ***The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization***.
4. ***The board should ensure that there is appropriate oversight by senior management consistent with board policy.***
5. ***The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control function.***
6. ***The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment.***
7. ***The bank should be governed in a transparent manner.***
8. ***The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency (i,e "know-your-structure")[3].***

Banks, of course, play a vital role in the economy, and the continued strength and stability of the banking system is a matter of general public interest and concern both in regard to its linkages

[3] See BIS (2006). As far as we know, among the GCC countries Bahrain and Kuwait are the two countries who have so far adopted these principles and issued directives to the banks accordingly.

with the real sector and for providing the payment and settlement systems. Effective corporate governance is essential then to achieving and maintaining public trust and confidence in the banking system, which are critical to the proper functioning of the banking sector and the economy as a whole. Poor corporate governance may contribute to bank failures, which can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems, and the possibility of broader macroeconomic implications such as contagion risk and its impact on the payment system. Thus good governance in banks is important for the following reasons:

1. Banks tend to have very little equity relative to other firms. Moreover, banks' liabilities are largely in the form of deposits, and their assets usually take longer-term maturities that could result in maturity mismatches in the banks' balance sheets..

2. By their nature, banks manage liquidity and risk on highly leveraged balance sheets. Banks face a wide range of complex risks in their day-to-day business, including risks relating to credit, liquidity, exposure concentration, interest rates, settlement, and internal operations. The consequences of mismanaging their risks can be sever indeed – not only for the individual bank, but also for the system as a whole.

3. The complexity of many bank transactions means that good-quality accounts and financial reporting are vital to ensure appropriate levels of transparency.

4. Banks have diversified into new products and services, as they have grown in overseas representation and in the nature and scope of the risk they manage, so there is compelling need for a sound framework of regulation and governance .

5. Banks also are linked to each other through a complex chain of inter-bank relationships, which in the event of difficulty become mechanisms for the acceleration of contagion. The failure of a major institution or group of institutions regardless of the reason, is liable to set off through contagion the failure of other institutions and generate serious risks in both the banking and financial systems.

6. And lastly, there is also the particular risk of moral hazard in the operation of banks that gives shareholders and managers of insured banks incentives to engage in excessive risk-taking.

In sum, more competition enhances good corporate governance, and in turn good corporate governance strengthens financial systems, and a robust financial and banking system should ultimately benefit economic growth and well being.

III- Corporate Governance, Financial Systems, and Economic Growth

It is apparent from the previous section that good governance is essential for promoting growth. And the literature identifies several avenues through which corporate governance might affect growth (Claessens, 2006); these avenues are:

1. Increased access to external financing by firms, which can lead to greater investment, higher growth, and more employment creation.

2. Lower cost of capital and associated higher firm evaluation, which makes more investment attractive to investors and leads to growth and employment.

3. Better operational performance, through better allocation of resources and better management, which creates and adds to wealth.

4. Reduce risk of financial crises as, more important, this risk can impose large economic and social costs.

5. Better relationships with all stakeholders, which helps improve social and labor relationships and areas such as environmental protection.

Equally important is the fact that without a properly functioning financial system these positive effects arising from good corporate governance would not be attained. We address below the importance of the financial system and its relation to growth.

The relationship between financial systems and economic growth has been well recognized and emphasized in the field of economic development (Levine, 1997 and 2003). And the numerous theoretical and empirical writings on the subject in the last forty years acknowledge that financial development is important and leads to economic growth. This is achieved through a variety of mechanisms, including mobilizing savings, collecting and analyzing information, screening potential entrepreneurs, allocating investment to highest-return projects, exerting corporate control, sharing risk, providing liquidity as well as overcoming asymmetric information problems that typically exist in financial markets.[4]

In fact, financial systems serve four broad functions that influence favorably savings and investment decisions, technological innovations, and hence economic growth:

1. They produce information ex ante about possible investments opportunities. Large costs are usually associated with evaluating firms, management and market conditions. This high cost may be beyond the ability of individual savers to collect, process and produce the necessary information on possible investments (Greenwood and Jovanovic,1990). Financial intermediaries hence undertake the costly process of researching investment possibilities for others, thus reducing information cost, and in the process improving resource allocation and accelerating growth.

2. They mobilize and pool savings and allocate capital. Mobilization is the costly process of aggregating capital from disparate savers to investors as it involves overcoming the transaction costs of collecting saving from numerous individuals; and the information

[4] Asymmetric information arises when one party to a transaction has insufficient information about the other party to make appropriate decisions. One aspect of asymmetric information is adverse selection, which arises before the transaction since it is difficult a priori to distinguish good from bad credit risk; another aspect is moral hazard, which occurs after the transaction since the lender is open to the risk that the borrower might use the funds recklessly and not repay the loan.

asymmetries associated with making savers feel comfortable in relinquishing control of their savings.

3. They monitor investment and exert corporate governance after providing finance. According to Bencivenga and Smith (1993), intermediaries that improve corporate governance reduce credit rationing which lead to higher capital accumulation. They also can increase total factor productivity (TFP) and the marginal productivity of capital by stimulating savers to hold more of their wealth in financial assets and by funding riskier but more productive technologies – which tend to have an *endogenous and continuous* effect on the growth rate.

4. They facilitate the trading, diversification and management of risk; and they ease the exchange of goods and services.

Financial systems, in turn, can be differentiated as being either bank-based or market-based. In bank-based systems, banks play a leading role in mobilizing savings and evaluating investments and in managing risk, whereas in market-based systems securities' markets are just as important in performing these crucial roles (Levine and Zevros, 1998).[5] A closer look at these systems would indicate that the bank-based system is also characterized by universal banking, and "insider" corporate control by banks of non-financial corporations (through their equity holdings or relationship banking); but universality is less prevalent under a market-based system, and corporate control is exercised by outsiders through the stock market (and banks' role is relegated to financing only or transaction banking). In this context, the GCC financial system is considered relatively a bank-based system – given that in most GCC countries market capitalization and turnover ratios are still below the average for high-income countries of 100% or more,

[5] There is an emerging synthesis now that goes beyond the mere bank-based/market-based distinction and that stresses the importance of the quality of financial services – limiting transaction and information costs, better risk management, etc. – that either system should provide (Bolbol, 2002). It also emphasizes that financial development is a *multifaceted process* encompassing in addition aspects that have to do with regulation and supervision, monetary policy, financial openness, and institutional capacities. In this regard, the recent concern with legal and regulatory reforms that strengthen creditor rights, contract enforcement, and accounting practices is a crucial development (La Porta et al, 1998)

notwithstanding the recent brief and fading boom in GCC stock markets -- but with less universality and relationship banking.

IV- Overview of the GCC Economies and Banking Sector

Over the past decade, and especially in the last four years, the GCC economies have performed rather well, buoyed by higher oil prices and by attempts to diversity their production base away from oil and gas (see tables (1) and (2)). They have done better than the group of rich countries, to whom they mostly belong, growing at more than 2.7% annually – especially in Bahrain, Qatar, and the UAE. Inflation also has remained subdued during most of the period, a hallmark of the GCC's exchange rate policy of pegging to the US dollar. However, the fall in the US dollar and the heating-up of the GCC economies in the later years have ignited inflationary pressures, especially in Qatar and the UAE. Budget deficits have remained largely under control – except perhaps in the UAE – but, again, they turned into surpluses in the later period. There are two interesting points in relation to budget deficits: 1) even when they are excessive, their impact on domestic interest rates is minimal because of their partial funding from drawing down of foreign assets; and 2) when turned into surpluses, budget balances mirror largely current account balances. The latter have been quite impressive as of late – reaching 31.1% of GDP in the case of Kuwait, for example – reflecting the fact that a large part of the higher oil revenues have been saved and made into foreign investments.

In terms of outward orientation, the GCC economies have always been open with insignificant restrictions on the flows of goods and services and, to a lesser extent, on the flows of capital. This is reflected by their high trade ratios, and by their membership in the WTO, Arab Free Trade Area (AFTA), and, perhaps most crucially, by their desire to transform the GCC into a monetary union by 2010. The monetary union is expected to enhance financial harmonization and integration in GCC financial markets, and in the process help to deepen and widen their scope and functions. No doubt, this would be a welcome outcome, given the need to develop the GCC financial system since by one measure – the ratio of private domestic credit to GDP – it is still far below the comparable level which exceeds 100% for high-income countries.

We turn now to the performance of the GCC banking market in 2004. On the back of a strong regional economy, GCC banks recorded impressive performance results in the last three years of our study. In what follows is an overview of the main aspects of these developments, as manifested in table (3)[6].

The Saudi banking sector is the largest in the GCC, with its assets amounting to $147.7 billion and its deposits to $126.7 billion. As for the structure of assets, table (3) shows that loans comprised around 50% of total assets and investments and deposits constituted around 42%. This implies that Saudi banks adopt, to some extent, a conservative investment strategy. However, the profitability of the sector measured by ROA (rate of return on assets) and ROE (rate of return on equity) was higher than the average of the GCC banks. The ROA and ROE amounted to 2.51% and 24.87% respectively, compared with 2.2% and 17.4% for all GCC banks.

The second largest banking market in the GCC is the UAE market -- its size in terms of assets amounted to $77.2 billion and in terms of deposits $61.5 billion. The banks in the UAE had around 63.2% of their assets in loans and around 25% in investments and deposits. This market recorded an average of 2.29% as ROA and 16.64% as ROE -- somewhat close to the GCC average of 2.2% and 17.4%. As for the Kuwait banking market, its size amounted to $54.6 billions in assets and $42 billions in deposits. The ratio of loan to assets in this market is somewhat similar to that of Saudi Banks at 53%, whereas the ratio for investments and deposits reached 32%. The market also recorded higher than average ROA and ROE -- reaching 2.5% and 18% respectively.

The size of the Qatari banking market is relatively smaller with assets of $18.5 billions and deposits of $14.5 billions. The market deployed 61% of its assets as loans and 31% as investments and deposits. It also recorded lower than average of all GCC banks in terms of ROE (13.58%) and slightly higher in terms of ROA (2.32%). The Bahraini banking market size is relatively large, amounting to $51.3 billions in assets and $34.6 billions in deposits. However, it recorded the lowest loan to asset ratio among the GCC banking market -- averaging around 36%

[6] See Appendix II for the list of banks used in the study.

while that of investments and deposits around 60%. Also, it recorded lower than the GCC average in terms of ROA (1.99%) and higher than average in terms of ROE (18.09%). Lastly, the smallest banking market among the GCC countries is the Omani banking market. Its size amounted to $11.5 billions and $8.4 billions in terms of assets and deposits respectively. The Omani banks showed the highest loan to asset ratio among the GCC banks -- 71.4% for loans and 15.2% only for investments and deposits. As to its performance, the market recorded lower than the GCC average in terms of ROA and ROE, at 1.81% and 13.43% respectively.

On viewing these performances, one notices that Saudi banks recorded the highest profitability despite their modest loans to assets ratio. This can be explained either as a result of low non-performing loans and consequently less provisions or lower cost of attracting funds or both. But overall, all GCC banking sectors performed better than the standard averages of 10% ROE and 1% ROA – an outcome which can partly be attributed to the relatively concentrated nature of their banking markets[7].

V- GCC Banking Market Concentration

Traditionally, banking sectors in the Gulf Region – with the exception of those in Bahrain and Oman – have been protected from foreign competition through regulations that impose barriers to entry. However, a noticeable reversal in such policies has taken place as of late. In line with their international and regional obligations, the GCC countries have started tearing down barriers to foreign competition. In response, the financial landscapes in countries such as Kuwait, Saudi Arabia, and the United Arab Emirates (UAE) and Qatar have already undergone significant changes in the past couple of years.

Beginning with Kuwait, we note that in January 2004, the National Assembly approved an amendment to the 1968 Banking Law thereby permitting foreign banks to set up operations in Kuwait[8]. At the same time, the Central Bank of Kuwait have issued new licenses to Islamic

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7 See Al Karasneh and Fatheldin (2005) for more on the relation between profitability and concentration in GCC banks.

8 See EIU (2004a). However, the implications of this legislation should not be overstated given that it restricts foreign banks to one branch and requires that half the workforce is to be composed of Kuwaiti nationals within

banks, another move which is likely to increase competition among the existing commercial banks, as well as with the current sole Islamic bank.

Saudi Arabia has also taken steps in a similar direction. One of the most significant developments there took place in May 2004, when the Saudi Arabian Monetary Authority (SAMA) granted new single-branch licenses to several global players including BNP Paribas, Deutsche Bank, and JP Morgan Chase, and authorized HSBC to establish an investment bank with its local affiliate – Saudi British Bank. By then, several regional banks such as Gulf international Bank, National Bank of Kuwait, National Bank of Bahrain and Emirates International Bank had all already secured licenses to operate in the kingdom as part of the GCC agreement to open up their regional financial markets. In addition, four finance houses, who had been operating outside the official banking sector, merged into a sizeable bank with a considerable branch network. Also worth mentioning is the fact that the Saudi banking system has seen two mergers in its recent history, with United Saudi Commercial Bank merging with Saudi Cairo Bank in 1997, and the resulting United Saudi Bank merging with Saudi American Bank (SAMBA) in 1999[9].

And in the UAE, much like its counterparts in Saudi Arabia and Kuwait, the Central Bank announced in 2005 that it would be issuing new licenses to foreign banks, and also indicated that it would soon allow existing foreign banks to open more branches (current restrictions limit foreign banks to a maximum of eight branches), provided that they comply with Emiratisation quotas[10]. Such a policy represents a reversal of an almost two-decades long policy of not issuing any licenses to new banks: with the exception of Dubai Bank (which was set up in 2002 by using a dormant license held by Emirates Bank International) no new banks have been allowed to establish operations following the country's 1980s banking sector crisis[11]. Since then, nine institutions have disappeared, with eight consolidating and one liquidating. Still, it remains

a period of three years. Furthermore, new foreign entrants are unlikely to want to compete in the traditional banking areas in which competition is already fierce, and are instead more likely to focus on areas such asset management. The same also applies to the Saudi banking system.

9 See EIU (2004b).

10 See EIU (2004c). Decree No.43 calls for 4 percent of employees of financial institutions to be nationals.

11 There was a run on the currency which caused a near-crisis and led to the collapse of two banks.

unclear how many banks will wish to enter the market given that it is already somewhat over-banked.

With a monetary union planned for 2010 the GCC financial markets are becoming increasingly integrated. Bahrain, Qatar, Dubai and Saudi Arabia are all moving ahead with competing plans to become regional financial hubs. Banks from across the region have opened branches and sought new licenses within each other's jurisdictions. Also, the dismantling of trade and investment barriers within the region, could induce GCC banks to merge with one another in an attempt to create pan-GCC franchises.

The most widely used measures of monopolistic power in the banking market are concentration ratios. Their popularity stems from the relative ease with which they can be calculated and understood. The two main measures of market concentration that have been proposed in the literature are the concentration ratio (CRk) and the Herfindahl-Hirschman Index (HHI). CRk is the market share of the k largest banks, ignoring the remaining banks in the market; and the HHI, which is based on the idea that the behavior of a market is dominated by a small number of large banks, and is calculated by summing the squared market shares of all banks in the market. For example, for a market consisting of four firms with shares of thirty, thirty, twenty and twenty percent, the HHI is 2600 ($30^2 + 30^2 + 20^2 + 20^2 = 2600$).

According to U.S. guidelines that are considered standard in this regard, the banking industry is considered to be a competitive one if HHI is less than 1,000, somewhat concentrated if the HHI lies between 1,000 and 1,800, and very concentrated if HHI is more than 1,800 (US Department of Justice, 2006). We use both these measures to assess the degrees of concentration in the GCC banking markets, considering the CR*k* ratio in terms of assets, and for the shares of the top three banks in each country (CR3). The results are reported in table (4) and discussed below.

Table (4) shows that the Saudi banking market can be viewed as a moderately concentrated market based on the two measures of bank concentration. The share of the top three banks in terms of assets amounted to 54% in 2004 compared with 60% in 1995. This decline in the share of the top three banks was also reflected by the HHI index which amounted to 1454 in 2004

compared with 1623 in 1995. A similar picture is obtained when we look at the UAE banking market. The share of the top three banks amounted to 47% in 2004 compared with 55% in 1995. The HHI index amounted to 1210 in 2004 compared with 1508 in 1995. Thus the UAE banking market is considered to be a moderately concentrated market based on the HHI criterion.

As for the Kuwaiti banking market, it seems to be highly concentrated on the basis of the two measures of bank concentration. The share of the top three banks in terms of assets amounted to 60% in 2004 compared with 63% in 1995. The HHI index also declined as it amounted to 1908 in 2004 compared with 2059 in 1995. The HHI index in the Kuwaiti banking market exceeds 1800 which according to the *1800 Rule* can be viewed as a highly concentrated market.

Among all the GCC banking market, the Qatari banking market displayed the highest level of concentration by using the two measures of concentration. The share of the top three banks amounted to 95% in 2004 compared with 93% in 1995. This high concentration picture is also obtained when we consider the HHI measure. This measure amounted to 3668 in 2004 compared with 5178 in 1995. The second to be ranked in terms of high concentration is the Bahraini banking market. In this market, the share of the top three banks in terms of assets amounted to 82% in 2004 compared with 86% in 1995. The HHI also conveys the same picture and it amounted to 2542 in 2004 compared with 2822 in 1995. Finally, the Omani banking market exhibited the same picture in terms of high concentration. The share of the top three banks amounted to 74% in 2004 compared with 67% in 1995. The HHI also reflected a high concentration measure and it amounted to 2542 in 2004 compared with 2822 in 1995.

By and large, the banking market in the GCC countries can be viewed as ranging from moderately-to-highly concentrated market, with Qatar exhibiting the highest concentrated market and UAE the lowest.

VI- Impact of Banking Market Concentration on Growth

The impact of banking market structure on economic growth has been addressed in a multitude of empirical studies and the findings of these studies regarding such relation has been mixed, as

we argued earlier. In what follows we provide an eclectic summary of these findings; and then present and report the results of a growth model that has banking market concentration as one of its explanatory arguments.

1. Relation Between Banking Market Concentration and Growth

The relation between banking market structure and growth can go either positive or negative and is contingent on a host of influential aspects, perhaps prime among them is the size of the market, extent of regulations, and levels of income and financial development. Starting with the negative impact that concentration can have on growth, the main view stems from the fact that market power allows banks to charge higher loan rates and offer savers lower deposit rates thus increasing the net interest rate margin. This will result in reducing the quantity of funds available for credit and therefore the rate at which the economy can grow (Pagano, 1993). Another argument supporting the negative impact on growth maintains that large banks tend to depress capital accumulation via either credit rationing and /or excessive monitoring, since relatively more and frequent loans induce entrepreneurs to undertake more productive though riskier projects (Guzman, 2000). Also, Demirguc-Kunt et al (2003) show that entry regulations that increase net margins and profits deter banks from enhancing their efficiency and upgrading their services, and in the process deny the banking system to play its intermediation role in a full and efficient manner.

On the other hand, the essential view that a highly concentrated market may have a positive impact on growth is that concentration could have a positive effect on bank lending, provided concentration is mostly the result of cost efficiency considerations. Concentrated banking sectors may take advantage of economies of scale in the production of banking services, and in consequence potential cost savings may lead banks to extend more loans and to acquire higher market shares (Fritzer, 2004). Another argument is based on the view that a highly concentrated market may result from regulations which promote depositor protection; and financial systems with higher degree of investor protection have shown to serve growth and financial development better (La Porta et al, 1997) – keeping in mind the difficulty in striking the right balance between higher investor protection (implying a more concentrated market due to stricter legal

requirements) and more competition. In addition, an interesting argument is that banks with market power facilitate access to credit to young and unknown firms knowing that they will be capable of extracting future rents from those firms that eventually become profitable (Peterson and Rajan, 1995). This is because in highly competitive credit markets banks know that they may not be able to maintain ties with successful firms: once these firms get established, they will seek the lowest cost supply of credit available elsewhere in the market. Thus competition in banking can induce credit rationing in the sense that potentially high quality, but young and unknown, entrepreneurs may not get funded.

2. Methodology and Model Specification

We present here the methodology and model that allow for testing the impact of bank concentration on economic growth in the GCC countries.[12] The banking data used in the analysis cover 50 GCC banks and the period 1995-2004, and obtained from *Financial Operating Reports for the GCC Banks* published by the Institute of Banking Studies in Kuwait. As for the macroeconomic data, they were obtained from the database of the *Unified Arab Economic Report* of the Arab Monetary Fund. The econometric analysis was conducted using the following specification:

$$\mathbf{RGDPG = Constant + a_1(Concentration)_{iK} + a_2(BankDevelopment)_{iK} + a_3(Bank\ Development*Bank\ Concentration)_{iK} + a_4(Control)_{iK} + Error_{iK}}$$

where:

RGDPG = Real Gross Domestic Product Growth

Concentration = Market structure measure, calculated by 3-bank asset concentration ratio and HHI index. As mentioned earlier, the sign of the concentration variable is *ambiguous a priori*.

[12] For details pertaining to the descriptive statistics of all variables employed in this study for each country, refer to Appendix 1.

Bank Development = Credit to the private sector to GDP (Credit/GDP) as an indicator or measure of financial intermediation. This variable is expected to be positively associated with growth.

Bank Development*Bank Concentration = Interaction variable to capture the variation of the effect of banking structure at different stages of financial development. The significance of the interaction variable is that it indicates that the impact of bank concentration on growth is conditioned by financial development.

Control = Control variables which include inflation and budget balance to GDP (BB/GDP). The former is expected to have negative impact on growth and the latter to be positively associated with growth.

i, k = number of years and countries respectively.

The regression equation was estimated using four models so as to enrich the specification and to check for robustness of the results.

3. Results

Regression results for testing the impact of market concentration on economic growth are reported in table (5). All of the equations are estimated using OLS. In general, the explanatory power of the regressions are plausible given the cross-sectional nature of the sample.

The coefficient of the CR3 variable in Models 1 and 3 is positive and statistically significant at the 10% level or less. Therefore, as in other studies, bank concentration can be viewed as a positive factor in explaining economic growth in the GCC countries. The same exercise is done but this time replacing CR3 by the HHI index in Models 2 and 4, to test whether different market structure measures will have different impact on growth. The coefficient of the HHI variable is positive and statistically significant at the 5% level. Again, this confirms that market structure has a positive impact on growth in the GCC banking sector. This positive impact is mostly related to the efficiency of more bank lending due to cost advantages as banks reap economies of scale in the production of banking services.

In all Models the control variables results show that inflation and budget balance appear to have an insignificant impact on growth (except for the positive effect of budget balance in Model 2). This is because inflation is largely moderate in the GCC countries and as a result its effect on growth is neutral. As to budget balance, its insignificant effect reflects the fact that budgets in the GCC play neither a counter-cyclical role nor cause crowding out (or crowding in). Moreover, the bank development indicator, Credit/GDP, is *positive* throughout but significant in Models 3 and 4 only. The lack of robustness of this variable indicates the indecisive effect of bank credit on GDP, perhaps because a good part of it could be unproductive consumer and/or inefficient investment credits.

As far as the interaction variable is concerned, it posits that the impact of market structure in the banking sector may vary at different stage of the financial development. To test for this argument, regressions were run by adding to the basic model specification the interaction between market structure and the level of development of the banking sector. Models 3 and 4 report the results and they are quite interesting. Both concentration variables, CR3 and HHI, remain positive and significant, and so is the financial development variable, Credit/GDP, as we mentioned above. However, the interaction variable comes as negative and significant in both regressions. This means that there is a threshold of financial development beyond which concentration's effect on growth becomes *negative*, and these thresholds can be calculated to be quite the same for each concentration measure: Credit/GDP equal 48% in the case of HHI, and 47.5% in the case of CR3[13]. The most probable explanation for these results is that with widening financial development in excess of 48%, increasing concentration runs into diseconomies of scale and the resulting inefficient scale of lending operations translates to higher cost of loans and lower growth.

More important, we can see from Appendix I that only Kuwait and the UAE have average Credit/GDP ratios in excess of 48%, indicating that at this level of financial development more bank concentration can actually hurt growth; whereas Oman, Qatar, and Saudi Arabia (Bahrain

[13] The result is as follows: d (RGDPG)/d (Concentration) = 0.36 – 0.0076 Credit/GDP. This is equal to zero when Credit/GDP is 47.5% = 0.36/0.0076. Any level of Credit/GDP above 47.5% will make the effect of concentration on growth, or d (RGDPG)/d (Concentration), negative. The same procedure is used to calculate the threshold for HHI.

being a border case at 47.5%) have average ratios less than 48%, confirming that further financial development has room to keep bank concentration's impact on growth positive.

VII- Conclusion

It is widely believed that good corporate governance in financial markets can contribute to stability and growth. One important element in the nexus of good corporate governance is more competition in financial markets, since it becomes imperative on management and ownership to perfect their relationships so as to better perform and withstand the competition. The GCC financial system is still predominately bank based, and the resulting banking sector is fairly concentrated. Bank market concentration seems to have a positive effect on growth in the GCC countries likely because of scale economies, although this effect depends on the level of financial development, with the effect turning negative when the level of financial development exceeds 47.5% in terms of the ratio of credit to GDP. The GCC banking sector is bound to witness more competition in the coming future due to two developments: 1) fulfillment of regional and international binding promises to allow more entry into its banking markets; and 2) competition from securities' markets, especially the stock market. The paper has shown that these concentration-reducing measures could increase growth in the GCC economies, especially in Kuwait and the UAE, and their policy implementation should therefore be hastened.

Table (1): GCC Macroeconomic Indicators, Average 1995-2004 (%)

	Bahrain	Kuwait	Oman	Qatar	S. Arabia	UAE
GDP Growth	4.78	4.17	3.8	8.5	2.86	6.24
Inflation	0.46	1.68	-0.14	3.12	0.37	2.92
Exports + Imports/ GDP	147.11	90.72	89.53	87.44	65.87	142.02
Credit to the Private Sector/ GDP	47.49	54.93	36.14	31.63	27.95	50.72
Budget Balance/GDP	-2.3	1.8	-3	1	-1.2	-7.5

Source: Arab Monetary Fund Database; IMF, *Regional Economic Outlook: Middle East and Central Asia.*

Table (2): GCC Selected Economic Indicators (2004)

Country	GDP Growth (Percent)	Nominal GDP(billions of US dollars)	Nominal GDP Per Capita (US dollars)	Population (million)	Inflation (Percent)	Current Account Balance (Percent of GDP)	Overall Fiscal Balance (Percent of GDP)
Bahrain	5.4	10	14286	0.7	2.3	4	0.3
Kuwait	6.2	49	18148	2.7	1.3	31.1	23.6
Oman	5.6	21.8	8385	2.6	0.8	1.7	8.5
Qatar	11.2	28.5	40714	0.7	6.8	26.5	18.9
Saudi Arabia	5.3	236.8	9510	24.9	0.4	20.7	9.6
UAE	9.7	89.7	20861	4.3	5	10.2	19.5

Source: Same as table (1).

Table (3): GCC Banking Market Size and Performance (2004)

Country	Banks	Loans US$ billion	Assets US$ billion	Deposits US$ billion	ROA	ROE
Saudi Arabia	9	73.5	147.7	126.7	2.51	24.87
UAE	16	48.8	77.2	61.5	2.29	16.64
Kuwait	8	29	54.6	42	2.48	17.93
Qatar	4	11.3	18.5	14.5	2.32	13.58
Bahrain	7	18.3	51.3	34.6	1.99	18.09
Oman	6	8.2	11.5	8.4	1.81	13.43

Source: Institute of Banking Studies (Kuwait), *Financial Report of GCC Banks*. The reported figures cover only domestic banks and exclude other financial institutions such as Islamic banks.

Table (4): GCC Banking Structure (1995, 2000, 2004).

	CR3 1995	CR3 2000	CR3 2004	HHI 1995	HHI 2000	HHI 2004
Saudi Arabia	0.60	0.60	0.54	1623	1578	1454
UAE	0.55	0.51	0.47	1508	1935	1210
Kuwait	0.63	0.62	0.60	2059	1935	1908
Qatar	0.93	0.93	0.95	5178	4677	3668
Bahrain	0.86	0.87	0.82	4349	3566	2597
Oman	0.67	0.80	0.74	2822	2443	2542

Source: Same as table (3).

Table (5): Econometric Results

Dependent Variable: RGDPG				
Variables	**Model 1**	**Model 2**	**Model 3**	**Model 4**
Constant	-0.043	1.7	-20.4	-6.12
	-(0.11)	(0.66)	(-1.85)*	-(1.21)
CR3	0.059		0.36	
	(1.61)*		(2.27)**	
Credit /GDP	0.016	0.02	0.52	0.22
	(0.35)	(0.43)	(1.98)**	(1.83)*
Inflation	0.22	0.18	-0.03	-0.02
	(0.86)	(0.70)	-(0.13)	(-0.07)
BB/GDP	0.11	0.12	0.09	0.10
	(1.54)	(1.65)*	(1.27)	(1.45)
HHI		0.0009		0.004
		(1.99)**		(2.20)**
Interaction			-0.0076	-0.00083
			(-1.95)**	-(1.79)*
R^2	10.9	13	16.8	17.9
Durbin-Watson	1.8	1.9	1.8	1.8

Figures between parentheses are *t*-statistics

** Significant at 5% level

 * Significant at 10% level

Appendix I: Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.
Panel A: UAE (10 observations)					
BB/GDP	-7.52	-5.28	-0.39	-16.14	5.23
CR3	0.51	0.50	0.55	0.47	0.02
CREDIT/GDP	50.72	49.90	60.80	45.70	4.42
RGDPG	6.07	6.55	12.40	0.10	4.15
INFLATION	2.92	2.9	4.6	1.4	0.99
HHI	1307.02	1272.47	1508.42	1210.35	96.63
Panel B: Bahrain (10 observations)					
BB/GDP	-2.34	-2.20	2.20	-5.74	2.95
CR3	0.86	0.86	0.86	0.82	0.01
CREDIT/GDP	47.49	47.70	52.30	41.60	3.77
RGDPG	4.78	4.70	7.20	3.10	1.00
INFLATION	0.65	-0.1	4.6	-3.6	2.39
HHI	3742.34	3684.19	4377.00	2597.32	585.56
Panel C: Saudi Arabia (10 observations)					
BB/GDP	-1.21	-3.00	11.39	-8.86	6.11
CR3	0.58	0.58	0.61	0.54	0.02
CREDIT/GDP	28.84	28.30	37.80	23.30	4.63
RGDPG	2.86	2.60	7.70	-0.70	2.82
INFLATION	0.37	0.2	5	-1.3	1.66
HHI	1559.82	1584.56	1623.98	1454.18	55.41
Panel D: Oman (10 observations)					
BB/GDP	-3.00	-3.73	4.15	-9.38	4.49
CR3	0.73	0.75	0.80	0.63	0.06
CREDIT/GDP	36.14	35.85	47.00	25.50	6.96
RGDPG	3.81	3.70	7.50	-0.20	0.30
INFLATION	0.05	0.2	1.9	-1.2	0.92
HHI	2432.70	2461.13	28822.24	2102.35	196.78
Panel E: Qatar (10 observations)					
BB/GDP	1.01	-0.45	18.95	-9.33	8.99
CR3	0.93	0.93	0.96	0.92	0.01
CREDIT/GDP	32.33	31.80	39.50	27.20	4.54
RGDPG	8.50	7.30	25.40	2.90	6.19
INFLATION	3.1	2.3	8.8	1	2.46
HHI	4554.34	4667.94	5178.17	3668.74	473.31
Panel F: Kuwait (10 observations)					
BB/GDP	1.78	5.49	17.01	-13.55	10.70
CR3	0.62	0.62	0.34	0.60	0.01
CREDIT/GDP	54.93	57.75	67.80	35.40	11.20
RGDPG	3.74	4.20	13.40	-2.00	4.45
INFLATION	1.88	1.4	3.9	0.6	1.21
HHI	1965.78	1929.58	2075.28	1902.04	67.41

Appendix II: List of Banks

Panel A: UAE (16 Banks)
National Bank of Abu Dhabi
National Bank of Dubai
Abu Dhabi Commercial Bank
Emirates Bank International
Mashreq Bank
Union National Bank
First Gulf Bank
Commercial Bank of Dubai
Arab Bank for Inv. & Foreign Trade
National Bank of Ras Al-Khaimah
National Bank of Fujairah
Invest Bank
Commercial Bank International
Bank of Sharjah
United Arab Bank
National Bank of Umm Al-Qaiwain
Panel B: Bahrain (7 Banks)
Gulf International Bank
Arab Banking Corporation
Ahli United Bank
Bank of Bahrain & Kuwait
National Bank of Bahrain
United Gulf Bank
Bahrain Saudi Bank
Panel C: Saudi Arabia (9 Banks)
Natioanl Commercial Bank
Samba Financial Group
Riyad Bank
Arab National Bank
Banque Saudi Fransi
Saudi British Bank
Saudi Hollandi Bank
Saudi Investment Bank
Bank Al-Jazira

Continued

Panel D: Oman (6 Banks)
Bank Muscat
National Bank of Oman
Oman International Bank
Bank Dhofar
Oman Arab Bank
Oman Housing Bank
Panel E: Qatar (4 Banks)
Qatar National Bank
Commercial Bank of Qatar
Doha Bank
Ahli Bank
Panel F: Kuwait (8 Banks)
National Bank of Kuwait
Gulf Bank
Commercial Bank of Kuwait
Bank of Kuwait & Middle East
Burgan Bank
AlAhli Bank of Kuwait
Kuwait Real Estate Bank
Industrial Bank of Kuwait

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