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Corruption, soundness of the banking sector, and economic growth: A cross-country study

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ABSTRACT

This paper explores the impact of corruption on both the banking sector and economic growth; we determine the impact using 76 macroeconomic data from various countries over the period 2002–2004. The results of various cross-sectional regressions provide substantial evidence that corruption significantly aggravates the problems with bad loans in the banking sector. In this study, we also find some evidence of a new channel through which corruption lowers economic growth: Corruption distorts the allocation of bank funds from normal projects to bad projects, which decreases the quality of private investments, hence it decreases economic growth.

1. Introduction

The consequences of corruption[2] (Mauro, 1995; Lambsdorff, 2005) have been a hot issue that has attracted many academics as well as many policymakers. The main focus has been placed upon corruption's impact on economic growth; numerous studies have investigated the channels through which various economic forces such as private investment, public expenditure, and other factors affect economic growth (Murphy et al., 1993; Shleifer and Vishny, 1993; Mauro, 1995; Tanzi and Davoodi, 1997; Wei, 2000).

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[2] Corruption in general is defined as *the abuse of public office for private gain*. Among many definitions of corruption, this definition seems to focus on *political corruption*–corruption of a political system where *public officials* seek illegitimate personal gain through actions such as bribery, extortion, cronyism, nepotism, patronage, graft, and embezzlement—which is considered to prevail among some types of corruption. In this paper, corruption refers to political corruption unless otherwise noted.

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Meanwhile, extensive evidence suggests that corruption was a contributing factor to the worldwide financial crises via its adverse impact on the banks' balance sheets.[3] In particular, through the incidents during the 1997–1998 East-Asian financial crises, it was revealed that the prevalent corruption contributed to the financial crises. The case involving the Hanbo corporation in South Korea is a typical example that the strong ties between firms and politicians have led to the serious deterioration of the banks' asset quality and ultimately to the financial crisis.[4] However, the description of the relationship between corruption and the banks' performance has mainly relied on anecdotal evidence, and very little academic effort has been made so far.

The goal of this paper is to provide rigorous empirical evidence of the impact of corruption on the soundness of the banking sector. We also attempt to verify whether an accumulation of bad loans adversely affects a country's economic growth because the banking sector, in general, plays a pivotal role in a country's economy.

The corruption affecting a bank's performance could arise for several reasons: firms may bribe politicians (e.g., to secure loans by bypassing the loan review processes), banks may bribe politicians[5] (e.g., to gain regulatory forbearance), and so on (see Munshi (1999) for examples of corruption that affect bank performance.) Presumably, one possible result will be the misallocation of loanable funds from normal projects to bad projects,[6] which typically ends up with an increase of non-performing loans.[7] As a result, increasing the amount of bad loans may lead to the reduction in the productivity of private investment[8] finally, it may lead to lower economic growth.

Although it is highly likely that a country with highly corrupt public sector usually has a highly corrupt banking sector, corruption does not necessarily lead to bad loans in the banking sector. For example, a borrower who has a good project may bribe a loan officer to save time by bypassing the usual loan review process. In this case, the probability of success may increase due to the timely implementation of the project (see Mauro (1995) for a similar "speed money" argument). Even when a borrower with a bad project receives funds via corruption, nobody knows if the funded project will fail or succeed in the end, though the probability of success will be relatively low.

Moreover, corruption measured by the Corruption Perceptions Index (CPI) has little to do with the corruption of the banking sector, which is explained further in Section 2.2. Even if CPI is related to the corruption of the banking sector, bad loans may not be a relevant issue when CPI is created. Their concern in the survey is not related to the bad loans, but it is related to the behavioral aspects of corruption. For example, they may ask questions like "Have you experienced any *bribery* during bank transactions?" but they may not ask questions like "Have you seen any bad loans during bank

[3] Literature on bank crises shows that the deterioration of the balance sheet is one of main symptoms of a financial crisis.

[4] Hanbo Corporation, a business conglomerate, financed enormous amounts of funds using its strong ties to high ranking officials, politicians, lawmakers, and even the then-president's son. The secret relationship revealed during the prosecution in 1997 had been maintained by bribes that Hanbo provided to them.

[5] Among many causes of corruption (Mauro, 1995; Lambsdorff, 2005), government regulation is regarded as one of the most important forces. Glaeser and Saks (2006) state that great numbers of regulations increase the opportunities for helping private sectors evade these regulations, therefore they increase the possibilities for bribe taking. Indeed, the banking sector is more regulated than other sectors in the economy; thus, the banking industry is more vulnerable to the public officials' influence than other industries. Dinç (2005) shows that a bank's lending behavior is affected by a politician's influence using the loan data of government-owned banks around election years. Charumilind et al. (2006) find that firms with ties to banks or politicians had better access to bank loans and even financed without collateral using data on firm from Thailand before the IMF crisis.

[6] In general, the main source of loanable funds in banking institutions is deposits. These funds may also come from foreign countries or international organizations such as the World Bank, IMF, ADB, etc. The main concern of the international organizations regarding corruption is the misuse of their funds in injected countries.

[7] Park (2004) shows that a bank's asset quality may deteriorate through bargaining between the politician and the bank manager: The politician, bargaining with the bank manager who seeks his private benefit as well as the maximum profits of shareholders, may secure loans for a firm with bad projects by using his influence on banks in exchange for the political money or electoral votes from the firms.

[8] Considering the central role of banks as a financial intermediary, the misallocation of bank funds may result in an adverse change in the composition of private investment, i.e., an increase of the portion of bad investments whose productivity is very low compared to that of normal projects.