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Role of bank credit on local growth: Do politics and crisis matter?

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ABSTRACT

Although state-owned banks are expected to promote the growth of less-developed regions, especially in developing economies, several cross-country studies report that lending by state banks is associated with the inefficient allocation of credit and low levels of development. Further, state banks have been found to lend to their cronies, especially around elections. In this paper, we study the lending activities of state-owned and private banks during the period 1992–2010 and analyze the relationship between the credit these banks provide and local economic growth in Turkey during crisis periods and in election years. We find that the share of state-owned banks in the credit market in crisis periods and local election years is significantly higher than their share in non-crisis and non-election periods. The per capita real credit that state-owned banks provide during crisis years is found to be positively associated with local growth in all provinces. Our results suggest that although state-owned banks might issue loans for political reasons in election periods, they also seem to play an important role in offsetting the adverse effects of economic shocks, especially in developed provinces.

1. Introduction

The 2007–2008 financial crisis restarted the long-standing debate on the role of state-owned banks.[2] Those in support of state-owned banks claim that the banks play an important role in expanding access to financial services for small businesses[3] or for socially desirable projects that private banks ignore. Despite the theoretical advantages of these banks in broadening access to credit, they are generally regarded as inefficient and vulnerable to political interferences. For example, La Porta et al. (2002) report that government ownership of banks could have harmful effects on productivity, economic growth, and the development of financial systems. Micco et al. (2007) document that state-owned banks in developing countries have lower profitability ratios than their private counterparts, and that the gap in their performances increases during election years. Cornett et al. (2010) find that state-owned banks are generally less profitable, have greater credit risk than privately owned banks, and finance the government to a greater degree. Several other studies examine state-owned banks in a single country and present evidence that these banks provide more funding or charge lower interest rates to politically connected firms or individuals (for example, see Sapienza (2004) for Italy, Leuz and Oberholzer-Gee (2006) for Indonesia, Khwaja and Mian (2005) for Pakistan, and Imai (2009) for Japan).

While most of the previous studies report a negative or insignificant effect of state-owned banks on growth, a few recent papers document their positive association with it. Andrianova et al. (2012) examine more than 100 countries during 1995–2007 and show that government ownership of banks was associated with higher long-run growth when controlling for regulatory quality. Similarly, Körner and Schnabel (2009) observe the positive effects of state ownership of banks on the average growth rate of per capita GDP in countries with well-developed financial systems and better-quality political institutions. Önder and Özyıldırım (2010) analyze the effect of state-owned bank credit on local growth in Turkey and show that the loans provided by state-owned banks are associated with higher economic growth in the country's developed provinces. However, this relation is not observed in Turkey's poor provinces,

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[2] For the most recent discussion about the role of the state-owned banks, see the blog maintained by Demirguc-Kunt (http://blogs.worldbank.org/allaboutfinance/the-aaf-virtual-debates-join-charles-calomiris-and-franklin-allen-in-a-debate-on-state-owned-banks).

[3] Beck and Demirguc-Kunt (2006) highlight that access to and the cost of finance are often ranked as the most constraining features of the business environment by small and medium enterprises (SMEs) and that state-owned banks are expected to solve their financing problems. However, empirical studies have yielded mixed evidence in favor of state-owned banks. For example, Clarke et al. (2005) show that state-owned banks do not necessarily outperform private banks with respect to small business lending in Latin America (Argentina, Chile, Colombia). Beck et al. (2011) document that there is no significant association between greater state ownership of banks and financial access of SMEs across a sample of 38 developing countries. On the other hand, Burgess and Pande (2005) find that a 1% increase in the number of rural banking locations in India reduces rural poverty by 0.34%.

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which suggests that the role of state-owned banks might depend on the existence of institutional quality even at the micro level.

In general, empirical studies seem to have no standard answer that is valid for all countries and for all situations regarding the role of state-owned banks. Do these banks provide funding for political reasons or to reduce market failures? To contribute this literature, we study the lending behavior of state-owned and private banks during crisis and election years and analyze whether credit provided by these banks in these years affects output growth at the provincial level in Turkey. As highlighted by Levy-Yeyati et al. (2007), private banks might overreact to recessions and amplify the business cycle. Thus, public banks can be used as a crisis resolution vehicle to distribute subsidies to some sectors or regions. Obviously, regions are affected by financial crises with varying severity; developed areas might be hit harder than less-developed areas.[4] However, to the best of our knowledge, no study in the literature examines how lending by state-owned and private banks varies during crisis periods, whether the loans provided by state-owned banks in these periods have any welfare effect, or whether these effects differ for developed and less-developed regions. Thus, our first aim in this paper is to test whether these banks have any beneficial role during economic slowdowns.[5]

Several empirical studies have examined the lending activities of state-owned banks during election years. For example, Dinç (2005) analyzes lending by banks in 36 countries and reports an increase in lending by state-owned banks during election years, mainly in emerging markets. Similarly, Micco et al. (2007) find that state-owned banks in developing countries increase their loans in election years. Cole (2009) shows that state-owned banks lend more agricultural credit in election years in India but that this extra credit has no significant effect on agricultural revenue or crop yield at the district level. Previous findings suggest that public sources, including state-owned bank funds, are used more for the advancement of governments' ambitions in election periods. However, the important question is whether funds used for political reasons benefit the well being of local people as well. Thus, the second aim of this paper is to provide the answer to this question. By comparing the welfare implications of loans issued by state-owned and private banks on per capita provincial income in election years, we try to understand how a political event might change local prosperity when both state-owned and private banks have access to the same local information.

We study the lending activities of Turkish state-owned and private banks during the period 1992–2010. Turkey is an interesting country in which to analyze the association between lending by these banks and local growth in crisis and election periods. First, over the sample period, the Turkish economy was hit by three crises, and state-owned banks are considered to be among the prime contributors to one of these crises (Steinherr et al., 2004; Alper and Onis, 2004). Second, these banks are the main providers of access to financing in the lagging areas of Turkey. Although several state-owned banks have been privatized since the 1980s, three state-owned banks are still available to allocate funds to investment projects in poor regions. Third, control of state-owned banks is very important for political parties, which suggests that they might provide funding for political reasons.[6] Hence, comparing the economic significance of state-owned and private banks, especially at the provincial level, contributes to the literature on understanding the role of institutional frameworks for regional development, mainly during crisis or election periods.

Our results indicate that the credit market share of state-owned banks in crisis and local election years is significantly higher than their share in non-crisis and non-election years in all provinces, and in less-developed provinces. We find that state-owned and private bank credit per capita alike are positively and significantly associated with the well-being of people in all Turkish provinces. Moreover, credit provided by state-owned banks during crisis years is found to have a significant and positive effect on local growth in all provinces and in developed provinces, but credit granted during election years does not have a significant effect. These results suggest that although state-owned banks might issue loans for political reasons during election periods, they might also play an important role in offsetting the adverse effects of economic shocks, especially in developed regions.

The paper is organized as follows: Section 2 provides information about banking in Turkey. Section 3 summarizes the hypotheses. Section 4 presents the empirical model and the data. Section 5 reports the results and several robustness checks. Section 6 concludes the paper.

2. The Turkish banking sector

The Turkish banking sector consists of deposit banks, development and investment banks, and participation banks that operate according to the profit/loss-sharing principle. In 2010, of the 48 banks in the Turkish banking sector, 31 were deposit banks, 13 were development and investment banks, and four were participation banks. The number of state-owned banks was eight in 1990 and three since 2001 (Table 1). As in most other developing countries, state-owned banks in Turkey originated with a clear mandate to finance specific sectors of the economy.[7] They held 31% of the total assets of the Turkish banking sector at the end of 2010.

State-owned banks have created a fair amount of price distortion in the Turkish banking sector for years. Their revenues did not reflect real income, as interest earnings on uncollected "duty losses" accrued as income and were reported on the balance sheet as receivables from the treasury. However, they carried out their tasks of extending subsidized credit in the market with short-term financing at higher costs. Eventually, the losses of these banks made them an instability factor in the financial sector (BRSA, 2010).[8] With the Turkish banking crisis in 2001, the government realized that the current public banking practices could no longer continue. In the second quarter of 2001, the government financially and operationally restructured state banks: preferential credit as part of support programs ceased, and state-owned banks became

[4] The more modernized areas of Indonesia (Java and urban areas) were hit harder by the Asian crisis than less modernized or agriculture-dominated areas (Brodjonegoro, 2002). After the recent crisis in 2007–2008, disposable income decreased more than 5% in the northern provinces of Italy but decreased only by about 1.4% in the southern part (Rizzi and Dallara, 2011).

[5] In the literature, choosing the best way of resolving economic shocks and accelerating economic recovery is still a debated issue. There is evidence that governments may create large fiscal outlays in resolving a banking crisis with the objective to accelerate recovery. For example, Laeven and Valencia (2008) examine 42 crisis episodes during 1970–2007 and present that state-owned banks may be causing large fiscal costs and encourage unproductive risks to be taken at government expense. Although growth and fiscal issues are intertwined regarding the role of state-owned banks, due to data constraints at the provincial level, in this study we only concentrate on the growth issue.

[6] For example, during the 1997–1999 coalition government period, control of the existing public banks was distributed among three parties in the coalition according to their voting shares.

[7] Ziraat Bank was established in 1863 to offer mainly agricultural credit; Emlak Bank was founded in 1927 to provide mortgage loans; Etibank (1935) helped the development of mining and power supplies through credit and Halk Bank (1938) has supplied specialized credit to small businesses and craftsmen.

[8] During the week of February 19, 2001, the two largest state-owned banks, Ziraat Bank and Halk Bank, had losses that amounted to \$2.5 billion, or about 2% of the GDP (BRSA, 2010).