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Finance–growth nexus in a changing political region: How important was the Arab Spring?

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HIGHLIGHTS

- We examine the growth effects of financial development in MENA countries.
- We use the Arellano-Bond dynamic panel estimation for 2005–2014.
- The impact of finance on growth was positive pre-Arab Spring, but lost significance post-Arab Spring.
- Some macroeconomic indicators improved, while others worsened post-Arab Spring.
- Governance variables show significant improvement post-Arab Spring.

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ABSTRACT

In the context of the Arab Spring, which started in 2011 and overcame the Middle East and North Africa (MENA) countries, this paper examines the growth effects of financial development, controlling for distinct macroeconomic environments, governance levels, and authoritarian regimes across MENA by using the Arellano–Bond dynamic panel estimation for 2005–2014. The results identify mitigating factors in MENA's finance–growth relationships. Moreover, they show that the impact of finance on growth was positive pre-Arab Spring, but lost some of its significance post the Arab Spring, as some macroeconomic indicators improved, while others worsened. However, governance variables show significant improvement post-Arab Spring. These findings suggest that the financial development–growth nexus is contingent on socio-political reforms that shift the paradigm of institutional quality. Finally, this paper also discusses certain policies that may improve the efficiency of financial institutions and the government in generating inclusive economic growth.

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1. Introduction

The recent political crisis that overcame the Middle East and North Africa (MENA) countries since 2011, commonly known as the Arab Spring, took a heavy toll on regional economic development. Considering the Arab Spring's economic consequences, detrimental effects of conflict and instability on growth and development emerged in many MENA countries. The statistics emphasize that the MENA region witnessed deterioration in real gross domestic product (GDP) growth after the Arab Spring. For example, the growth rate in Egypt decreased from 5.1% in 2010 to 2% in 2014 and in Libya from 5%

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in 2010 to −5% in 2014 (World Bank's World Development Indicators (WDI) database (World Bank, 2014c)). Similarly, the data indicate that average growth rate in MENA countries decreased from 5.1% in 2010 to 3% in 2014. Masetti et al. (2013) conclude that the political transformations during and beyond the Arab Spring caused rising public debts, reduced economic activity in the industrial sector, losses at local stock markets, and reduced foreign direct investments (FDI).

The consequences of the conflicts and violence associated with the Arab Spring also raised financial costs significantly and contributed to negative developments for institutional and governance quality. According to economic literature, political instability is detrimental to macroeconomic and financial development (e.g., Abadie and Gardeazabal, 2003; Roe and Siegel, 2011; Pástor and Veronesi, 2013; Francis et al., 2014). As financing conditions were severely affected during this period, the Arab Spring was found to be negatively correlated with bank profitability (Ghosh, 2016) and to have tightened borrowing constraints and impeded capital accumulation (Herrala and Turk-Ariss, 2016), ultimately leading to a reduction in economic growth and development, as suggested in the literature (e.g., Blomberg and Hess, 2006; Blattman and Miguel, 2010; Meierrieks and Gries, 2013). Consequently, this paper aims to better understand the implications of the Arab uprisings by looking at the role of finance in the growth of this politically unstable region, while controlling for macroeconomic, democracy, and governance settings.

Institutional quality is another important element, commonly believed to strengthen or weaken the finance–growth relationship. For instance, Hassan et al. (2011) find that the liberalization of political institutions, property rights, and political pluralism are important factors to enhancing growth in China. They argue that institutional and governance quality can constitute constraints for growth. This is mainly due to high transaction costs and inefficiency in production processes. Levine (1999) shows that legal and regulatory institutions matter for financial development, and are connected through long-run economic growth. Moreover, Acemoglu et al. (2000) show that historically determined institutional quality strongly influences the current levels of income per capita across countries. Similarly, Kaufmann and Kraay (2002) find a strong positive correlation between income levels per capita and governance indicators in 175 countries. Within the same context, Poghosyan (2013) shows that institutional weaknesses (e.g., public governance, control of corruption), lack of competition, and concentrated market structures are the most important drivers to cause high financial intermediation costs in low-income countries. Additionally, Hearn (2014) examines the political, institutional, and governance determinants of liquidity pre- and post-Arab Spring, and finds that less regulated markets lead to an increase in transactions costs attributable to the Arab Spring, thus validating the findings of Hassan et al. (2011) in a North African setting. He also indicates that democratic accountability and the rule of law are important factors in relation to aggregate liquidity.

These institutional and governance qualities are of concern for MENA countries in explaining economic growth (Arayssi and Fakih, 2015), especially in a period of transitions (Henisz, 2000). Here, instances of negative developments in the quality of governance following the Arab Spring abound. Data from the World Governance Indicators (WGI) (World Bank, 2014a) of the World Bank show that MENA countries have generally registered deterioration in public institutions. For example, the *Government Effectiveness* indicator shows a deterioration of this index from 38.76 (2010) to 33.65 (2014) in Algeria, from 43.06 (2010) to 20.19 (2014) in Egypt, from 61.24 (2010) to 47.60 (2014) in Kuwait, and from 12.92 (2010) to 2.88 (2014) in Libya.[1] These indicators are coupled with financial and macroeconomic imbalances. For example, youth and female unemployment rates are the highest in the MENA region compared to all other economic regions (Elder and Rosas, 2015; Fakih and Ghazalian, 2015). Moreover, subsidies and other transfers represent 37% of total government expenses for the MENA countries, compared to 46% worldwide in 2016 (WDI database).

From the financing point of view, the region still faces overall control by a few large banks, poor financial infrastructure, and liquidity and transparency issues (Marrouch and Turk-Ariss, 2014; Arayssi and Fakih, 2015; Cherif and Dreger, 2016). Governments with low institutional efficiency need to attempt attenuating their hindering effect on the design and implementation of financial and economic growth policies (Aisen and Veiga, 2013). This is important for policy makers in evaluating the deregulation process of financial markets, and could especially help with the designing of a dependable, competent financial system that is able to withstand political and social changes. Moreover, such an investigation could potentially validate the popular view that sees the Arab Spring as a catalyst for a change towards more inclusive governments in the region. Regardless of whether these goals can be achieved or not, it would be interesting to determine under which conditions the Arab uprisings could lead to an increase in the financial and economic prosperity of MENA countries. In this context, the role of financial development and the integration of the different financial centers into a homogeneous regional investment strategy becomes of primary importance. As such, new evidence is needed to understand the role of finance in growth in these new challenging scenarios.

The main objective of this paper is to examine the finance–growth nexus, with special emphasis on the role of the macroeconomic environment and government institutions in the politically unstable MENA region. We inquire whether the finance–growth link has changed in the aftermath of the Arab Spring. Consequently, this paper contributes to existing finance–growth nexus literature by considering the recent political reconfiguration of the MENA countries. It also adds to different studies on the MENA region by controlling for a set of macroeconomic, governance, and democracy indicators, in addition to examining the implications of the Arab Spring over 2005–2014. This would be helpful to policy makers in examining whether authoritarian regimes rather implement policies in favor of financial development and/or economic

[1] This index captures perceptions on the quality of public services, of the civil service and the degree of its independence from political pressures, of policy formulation and implementation, and the credibility of government commitment to such policies. It ranges from a 0 (lowest) to a 100 (highest) percentile rank.

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