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Global Uncertainty: The Influence of Monetary Policies Order and Inflation Volatility on Bank Profitability African Bank and Middle East Bank

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ABSTRACT: The objective of this paper is to examine the factors that influence the resilience and adaptability of banks to economic disruption. The aim is to encourage a collaborative and cooperative approach to these challenges. This study analyses the impact of monetary policies, inflation trends, and bank-specific determinants on bank profitability in the African and Middle Eastern regions. A quantitative research approach was used to assess macro and micro factors affecting bank profitability, using secondary data. The macro variables were obtained from the International Monetary Fund (IMF), and the micro variables were extracted from the banks' annual accounts. The research findings indicate that monetary policy and inflation have significant impacts on banks' profitability. Additionally, the System Generalized Method of Moments (GMM) model revealed that the annual interest rate (IR), inflation (INF), capital adequacy ratio (CAR), and previous financial performance (Lagged ROA/ROE) have positive and significant effects on both ROA and ROE. In addition, the loan-to-deposit ratio (LDR) had a significant positive effect on ROE, while the non-performing loan ratio (NPLr) had a significant negative effect. The validity and suitability of the GMM regression model used in this study were confirmed by the AR(2) and Sargan Test results. These findings provide valuable insights for decision-makers in the banking sector to respond to changes in monetary policy and manage risks associated with inflation fluctuations. The study emphasizes the importance of capital management and credit risk management in sustaining bank profitability amidst economic uncertainty.

Keywords: Digital Service Attractiveness, Cash Management System Apps, Mix Method, SWOT Analysis, QSPM

INTRODUCTION

The world has been confronted with a variety of issues in recent years, including COVID19 pandemic. The initial COVID-19 outbreak took place in Wuhan, China in December 2019.WHO issued a Pandemic Alert in respect of the COVID19 outbreak, on 11 March 2020

(Sohrabi et al., 2020; World Health Organization, 2019) COVID-19 pandemic has led to global uncertainty across all sectors, economic sector is among the impacted sectors (Nicola et al., 2020). state COVID-19 could have negative repercussions for the worldwide economy. Loss of income, direct effect on production, disruption of supply chain, market collapse, inflation and GDP contraction (Ozili & Arun, 2023; Priya et al., 2021).

The global economy could be damaged by the coronavirus by $2.7 trillion (Bloomberg, 2020). Conforming to IMF (International Monetary Fund), In 2020, global GDP growth will slow to -2.8%. This is a significant drop from 2.8% growth seen in 2019 (figure 1). The COVID-19 pandemic has also caused volatile inflation to rise sharply around the globe (Ozili & Arun, 2023). According to WorldBank In 2022, the Gulf Cooperation Council has invested US$8.3 billion in Africa, indicating a strong interest in the region's potential for development (Wong, F., & Xiao, 2020). It is reported that there are 25 digital banks in the MENA region, serving a total of 25 million people, and it is worth noting that fintech investment in the region was US$819 million in the first half of 2022. Additionally, Saudi Arabia aims to triple the number of fintech companies in the kingdom by 2025, according to a new national strategy launched in 2022. However, despite the economic development they have, they are still facing several issues to deal with, such as conflict in the Middle East, and also high volatility inflation. in Africa between 2019 and 2021, the crisis in COVID 19 may result in a decrease by 23 to 33 % of banking revenue. In the same time, African bank
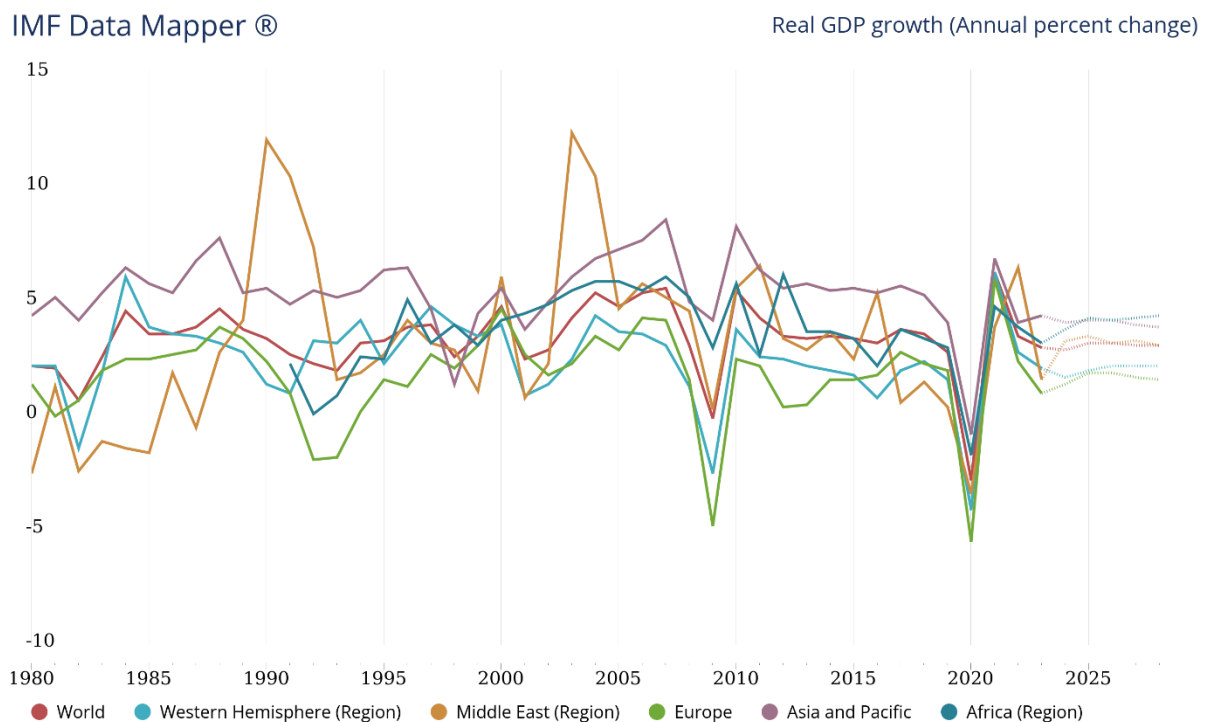
returns on equity may fall by as much as 5 to 15 percentage points due to increases in risk costs and lower margins. (McKinsey et al., 2020). World Inflation rate (Annual percent change) as per IMF, from 2020 to 2022 the world suffered a high volatility inflation rate, 2020 3.2% to 8.7% in 2022 (Figure 2). Based on data that we collected from IMF, the two regions: Africa and Middle East Asia, is the highest inflation rate among other regions. The inflation rate in Africa 2019 9%, 2020 10.6%, 2021 12.8%, 2022 14.3%, whereas the inflation rate in Middle East 2019 6.4%, 2020 9.8%, 2021 12.2%, 2022 14%, the inflation rate of these two regions constantly rising (Figure 2). As a result of high inflation, it led to lower spending power. This prompted African and Middle East Central Bank to develop a new monetary policy. Central Banks utilise monetary policy as a tool to navigate economic volatility and attain price stability (Clarida et al., 2000; Scott, 2005). In many countries, central banks use monetary policy instruments to stimulate growth and achieve the inflation objective. The interest rate, commonly referred to as the policy or cash rate, is one of these key instruments. In order to help maintain (Beck & Levine, 2004). Banks play a crucial part in transmitting monetary policy, a vital instrument employed by the government to attain economic progress without inflation. The national central bank takes charge of managing the money supply, and banks endorse the circulation of money in markets where they function.

Several studies examine bank financial performance determinants (Aebi et al., 2012; Berger & Bouwman, 2013; Cahyaningrum & Atahau, 2020; Kumar & Bird, 2020; Siddique et al.,

2021) Some research examines Monetary Policy on bank financial performance (Kumar & Bird, 2020; Meshack et al., 2022). This paper explores the intricate interplay between adjustments in monetary policy, inflation trends, and the profitability margins of banks that operate in African and Middle East regions. We also add bank specific determinants, it is important to consider the role played by bank-specific

determinants, given that they are important in determining profitability. This paper aims to contribute to a body of knowledge that could inform policy decisions and strategic planning for sustainable banking in the region, examining the interplay of factors that affect banks' resilience and adaptability to economic disruption, to promote a collaborative and cooperative approach to these challenges.

IMF Data Mapper ®   Real GDP growth (Annual percent change)

©IMF, 2023, Source: World Economic Outlook (October 2023)

Figure 1

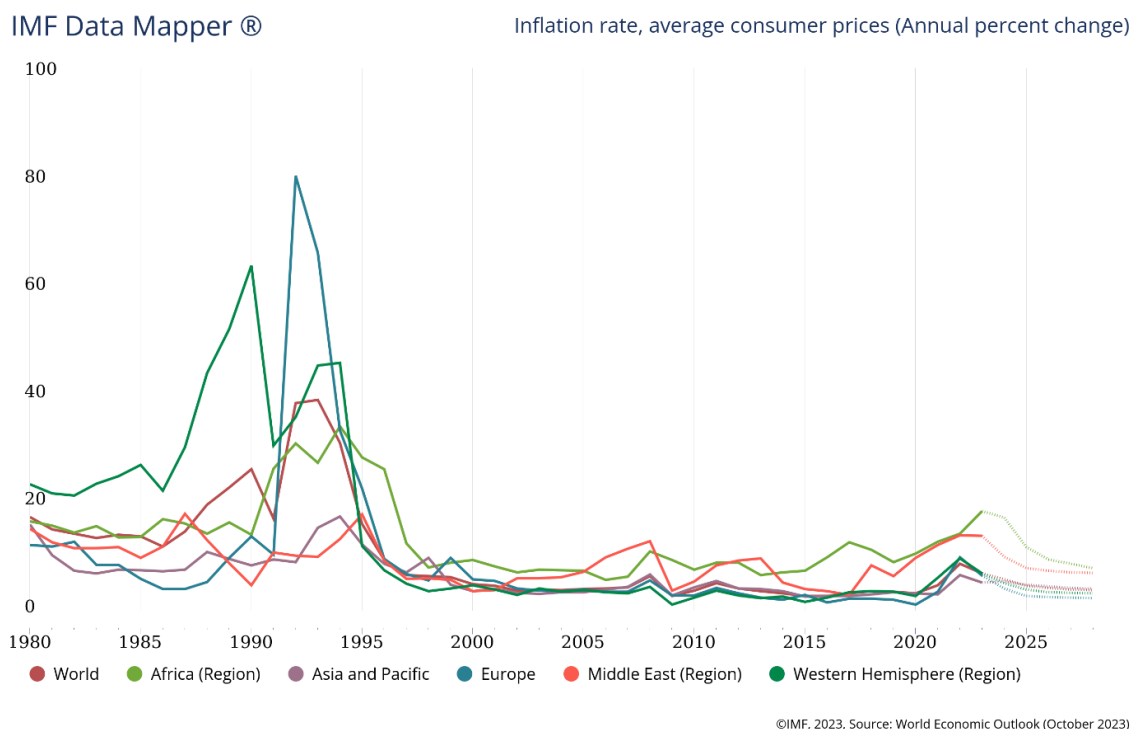©IMF, 2023, Source: World Economic Outlook (October 2023)

Figure 2

Literature Review :
Macroeconomic factors
Monetary Policy

(Borio et al., 2017) A study of 109 banks in 14 developing countries between 1995-2015 finds a positive correlation between bank profitability and monetary policy-induced short-term interest rates. As a result, our paper proposes the development of the initial hypothesis.

H_1 : *Monetary policy has a positive correlation with bank profitability.*

Inflation

(Tan & Floros, 2012) To see how inflation affects bank profits, the test was carried out on 101 banks in China, the study found a positive correlation between inflation and the profitability of Chinese banks. (Tan, 2016) examines the effect of inflation on the profitability of Chinese banks in the period 2003 to 2011 which shows the results that inflation has a positive significant effect on the profitability of Chinese banks. Thus, we develop a second hypothesis:

H_2 : *Inflation has a positive correlation with bank profitability*

Bank Specific Determinant
CAR

(Zou & Li, 2014) State the capital adequacy requirement represents the minimum capital that a bank must hold according to regulatory guidelines. Banks are more likely to be profitable if they have a higher CAR (Karim et al., 2014). A number of studies have examined the correlation between CAR and Bank profitability as measured by ROA ROE (Adeyanju, 2011; Hussain & Hassan, 2005; Menicucci & Paolucci, 2016) found that Capital adequacy ratio has a positive significant correlation with bank profitability.

H₃ : Capital adequacy ratio has a positive correlation with bank profitability

NPL

NPL is a measure commonly used to assess the credit quality of a bank, and measures cases of default or late payment of at least 90 days by the borrowers. A higher NPLs ratio for banks indicates that banks are less healthy, or tend to have lower profitability (Arping, 2017; Hakim, 2017; Khan et al., 2020; Somoye, 2010) In previous research (Ekinci & Poyraz, 2019; Kumar & Bird, 2020; Laryea et al., 2016; Menicucci & Paolucci, 2016) Examined of the correlation between non-performing loans (NPLs) and bank profitability, as measured by return on assets (ROA) and return on equity (ROE), provides evidence that NPLs have a significant negative impact on bank profitability.

H4 : NPL has a negative effect on bank profitability

LDR

The loan-to-deposit ratio (LDR) is a measure of a bank's liquidity in terms of the amount of loans or credit extended to customers; a high LDR ratio may be an indication that a bank is financially unsound (Adebayo & Oluwaremi, 2017; Adeyanju, 2011; Boďa & Zimková, 2021; Murphy, 2020) Various studies (Menicucci & Paolucci, 2016; Rengasamy, 2014) show that LDR is positively and significantly related to bank profitability (ROA & ROE).

H5 : LDR has a positive effect on bank profitability.
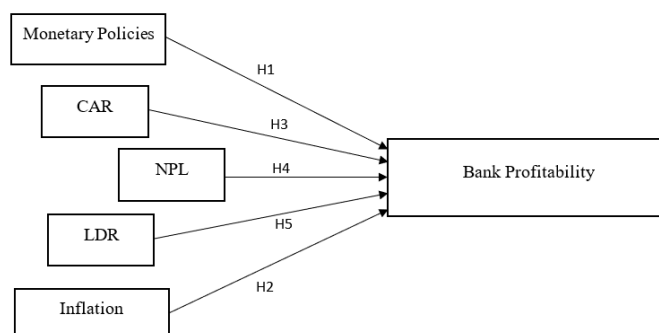
RESEARCH METHOD

A quantitative research approach is used to assess macro and micro factors affecting banks' profitability, using secondary data, with macro variables obtained from International Monetary Fund and micro variables obtained from banks' annual accounts. We chose 37 banks in Africa and the Middle East for the 2018-2022 period of time. Return on assets (ROA) and Return on equity are indeed widely recognised profitability indicators for banks, prior empirical studies had ROA and ROE as indicators for bank profitability (Al-Homaidi et al., 2018; Hanim et al., 2009). ROA assesses the effectiveness of a bank's asset utilization in generating profit, while ROE measures the profitability generated by equity investments. Interest rates and inflation

play a pivotal role in shaping the financial landscape, hence we utilise Interest rate and Inflation as macroeconomic variables. We employ CAR, NPLr, LDR as microeconomic variables.

Variables		Symbol	Measurement
Dependent	Return on Asset	ROA	Profit before tax/Total Assets (%)
	Return on Equity	ROE	Profit before tax/Total Equity (%)
Independent	Monetary Policies	IR	Short-term Interest rate
	Inflation	INF	Annual year Percentage from IMF
	Capital Adequacy Ratio	CAR	Tier 1 Capital + Tier 2 Capital / Risk-Weighted Assets (%)
	Non-Performing Loan	NPLr	Non-performing Loans/Total Loans (%)
	Loan-to-Deposit Ratio	LDR	Total Loans/Total Deposit %

This study examines the impact of monetary orders, high inflation volatility and bank-specific determinants on bank profitability. Panel data regression is the methodology of choice in this study. Prior research (Lassoued et al., 2018) faces two issues, autocorrelation and endogeneity. In order to overcome these problems, we use the GMM method of estimation. (Arellano & Bover, 1995). To determine the optimal choice, the model was tested using fixed effect, random effect and GMM analysis methods.

$Prof_{i,t} = \alpha + \beta_1 Prof_{i,t-1} + \beta_2 IR_{i,t} + \beta_3 INF_{i,t} + \beta_4 CAR_{i,t} + \beta_5 NPLR_{i,t} + \beta_6 LDR_{i,t} + \beta_7 SIZE_{i,t} + \varepsilon_{i,t}$

$Prof_{i,t}$ is the profitability of bank i in year t as measured by ROA and ROE, $IR_{i,t}$ is interest rate of bank i in year t, $INF_{i,t}$ is inflation rate bank i in year t, $CAR_{i,t}$ is Capital Adequacy Ratio bank i in year t, $NPLR_{i,t}$ is Non-Performing Loan ratio bank i in year t, $\beta_6 LDR_{i,t}$ is Loan to Deposti ratio bank i in year t.

RESULT AND DISCUSSION

Table 1 provides descriptive statistics of variables that we use in our research. ROA (Return on Assets) indicates the average profitability relative to total assets. The mean ROA is 0.016, which suggests modest profitability. The standard deviation is 0.013, indicating slight variability in profitability across the banks. ROE (Return on Equity) reflects the average profitability relative to shareholders' equity. The mean ROE is 0.139, which is higher than ROA, an indication that banks have a better return on equity. The high standard deviation of 0.980 suggests significant differences in ROE among banks. The mean of the IR is 0.073, with a standard deviation of 0.053. The mean value of INF is 0.109, with a relatively low standard deviation of 0.023. The mean CAR is 0.186, with a standard deviation of 0.042. The mean NPLR is 0.064, with a standard deviation

of 0.079. The mean LDR is 0.777, with a standard deviation of 0.233.

Table 1 Descriptive Statistic

Variable	Obs	Mean	Std. dev.	Minimum	Maximum
Roa	185	.016	.013	-.045	.07
Roe	185	.139	.980	-.458	.381
IR	185	.073	.053	01	.172
INF	185	.109	.023	.064	143
CAR	185	.186	.042	.116	373
NPLr	185	.064	.079	.007	.69
LDR	185	.777	.233	.29	1.279

We first used a fixed effects model to determine the most appropriate model for analysing bank profitability in Africa and the Middle East **Table 2**. The statistical model shows a significant positive correlation between IR and both ROA and ROE at the 0.01 level. This indicates that higher interest rates are linked to increased profitability for banks in these regions. INF, CAR, NPLr, LDR According to this model, there is no significant influence on bank profitability. However, this model shows the results of the Wooldridge Test and Modified Wald Test. Both P-values are less than 0.05, indicating that the null hypothesis should be rejected. This suggests that the fixed effect model has autocorrelation and heteroskedasticity. To ensure the validity and reliability of the regression results, we subsequently utilized the System Generalized Method of Moments. **Table 3** The model uses instrumental variables to address potential endogeneity and enhances the reliability of the estimates by employing lagged values of the dependent variables as instruments. The AR(2) test and Sargan test p-values in our sysGMM

model were both higher than 0.05, indicating that our model is not affected by second-order autocorrelation and that our instruments are valid. This enhances the reliability of our results.

Lagged ROAs and ROEs are positive and highly significant, indicating that past profitability has strong predictive power of current profitability. This demonstrates the persistence of profitability over time for banks. Higher interest rates are associated with higher profitability, as indicated by the positive and significant coefficient for interest rate in both the ROA and ROE equations. This may be due to the increased income from loan interest, which contributes to the banks' profitability. Inflation (INF) has a positive, significant coefficient in both equations, implying that higher inflation can lead to higher profitability. A possible explanation for this is that banks may be able to adjust the interest rates they charge on loans to compensate for inflation and thus maintain or increase their profit margins.

Table 2 Regression Result Fixed Effect Model

	ROA				ROE			
	Coefficient	Std. error	z	p-value	Coefficient	Std. error	z	p-value
Variable								
Constant	-.0055441	.0105253	-0.53	0.599	-.0116661	.0889653	-0.13	0.896
IR	.098742	.0297006	3.32	0.001***	.7939566	.251045	3.16	0.002***
INF	-.0263973	.0235037	-1.12	0.263	-.0085655	.1986659	-0.04	0.966
CAR	.0567557	.0365205	1.55	0.122	.3319708	.3086907	1.08	0.284
NPLr	.0028381	.0084838	0.33	0.738	-.0513464	.0717093	-0.72	0.475
LDR	.0087422	.0086376	1.01	0.313	.0445185	.0730098	0.61	0.543
Observation	185				185			
Group (*ID*)	37				37			
Adjusted R^2	0.184				0.186			
Wooldridge Test *P-Value*	0.000				0.000			
Modified Wald Test *P-Value*	0.000				0.000			

*Notes : *** *P-Value* > 0.01, ROA = Return on Asset, ROE = Return on Equity, IR = Annual Interest Rate, INF = Inflation, CAR = Capital Adequacy Ratio, NPLr = Non-Performing Loan ratio, LDR = Loan to Deposit ratio. Wooldridge Test *P-Value* = Autocorrelation test *P* < 0.05 (Autocorrelation Problem), Modified Wald Test *P-Value* = Heteroscedasticity test *P* < 0.05 (Heteroscedasticity Problem).

The capital adequacy ratio (CAR), which measures a bank's financial strength, is positively and significantly related to the profitability of a bank. This may reflect the fact that well-capitalised banks are better able to take advantage of profitable lending opportunities and may also be perceived by depositors and investors as more stable and trustworthy. NPLr in our ROA is not statistically significant, Non-performing loan ratio (NPLr) has a negative coefficient on ROE, indicating that an increase in NPLR is associated with a decrease in ROE. This is due to the fact that non-performing loans represent a cost to the bank and can reduce profitability, which in turn can reduce the return on equity. Loan to Deposit Ratio (LDR) has a positive coefficient in the ROA equation, indicating that a higher ratio of loans to deposits is associated with higher asset returns, this is in line with the assumption that credit is typically the most profitable asset category of a bank. The loan-to-deposit ratio (LDR) has a negative coefficient on ROE, indicating that an increase in the LDR is associated with a decrease in ROE. This suggests that banks that have more loans relative to deposits are likely to have lower ROEs, this may be due to the increased risk associated with a larger loan portfolio, which may lead to higher provisioning for impairment losses and thus lower net income and return on equity.

Table 3 Regression Result System GMM

	ROA				ROE			
	Coefficient	Std. error	z	p-value	Coefficient	Std. error	z	p-value
Variable								
Constant	-.023016	.0020091	-11.46	0.000***	-.0136802	.0155792	-0.88	0.380
Lagged ROA	.3656871	.0178416	20.50	0.000***				
Lagged ROE					.3404777	.026112	13.04	0.000***
IR	.0511407	.0038729	13.20	0.000***	.3872008	.039511	9.80	0.000***
INF	.0255315	.0049131	5.20	0.000***	.3541276	.049455	7.16	0.000***
CAR	.0962803	.006305	15.27	0.000***	.288976	.0460966	6.27	0.000***
NPLr	.0040741	.0061322	0.66	0.506	-.1805069	.0663877	-2.72	0.007***
LDR	.0096812	.0011651	8.31	0.000***	-.0105841	.0126899	-0.83	0.404
Observation	148				148			
Group (*ID*)	37				37			
AR(2) *P-Value*	0.102				0.095			
Sargan Test *P-Value*	0.971				0.985			

*Notes : *** *P-Value* < 0.01, ROA = Return on Asset, ROE = Return on Equity, IR = Annual Interest Rate, INF = Inflation, CAR = Capital Adequacy Ratio, NPLr = Non-Performing Loan ratio, LDR = Loan to Deposit ratio. AR(2) *P-Value* = Autocorrelation test at Lag 2 *P* > 0.05 (No Autocorrelation), Sargan Test *P-Value* = Overidentifying restriction *P* > 0.05 (Instrumen Validity).

CONCLUSION

The research findings showed that monetary policy and inflation had significant impacts on bank profitability in the African and Middle Eastern regions. This was evidenced in the fixed effect regression model where the annual interest rate (IR) variable showed a positive and significant influence on the financial performance indicators, Return on Asset (ROA), and Return on Equity (ROE). Furthermore, based on the System Generalized Method of Moments (GMM) model, it was observed that the annual interest rate (IR), inflation (INF), capital adequacy ratio (CAR), and previous financial performance (Lagged ROA/ROE) had positive and significant effects on both ROA and ROE. Additionally, ROE was significantly and positively influenced by the loan to deposit ratio (LDR), while it was significantly and negatively affected by the non-performing loan ratio (NPLr). Moreover, the AR(2) and Sargan Test results indicated the validity and suitability of the GMM regression model in this study. These findings provided valuable insights for decision-makers in the banking sector to respond to changes in monetary policy and manage risks associated with inflation fluctuations, emphasizing the importance of capital management and credit risk management in sustaining bank profitability amidst economic uncertainty.

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