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Determinants of bank profitability in transition countries: What matters most?

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ABSTRACT

The aim of this paper is to investigate the determinants of bank profitability in the early transition countries of Central and Eastern Europe (CEE), and in the late transition countries of the former USSR. We apply a GMM technique for the period covering 2000–2013. The results show that profitability persists and the determinants of bank profitability vary across transition countries. Particularly, the banking sector of early transition countries is more competitive. However, the impact of credit risk on bank profitability is positive in early transition countries, but negative in late transition countries. Government spending and monetary freedom negatively influence bank profitability only in late transition countries. Moreover, better capitalised banks are more profitable in early transition countries implying that these banking sectors are more robust. A range of possible approaches that governments can take to further develop banking sectors are discussed.

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1. Introduction

It has now been almost three decades since the collapse of the socialist system, and many previously centrally planned economies have established market-based economies. Most countries have followed a similar approach to overcoming the legacy of the Soviet system. Although the speed and sequence of reform varied across countries, all were influenced by the World Bank and International Monetary Fund, the so called Washington consensus, which focused on liberalisation, stabilisation and privatisation. The soviet-style mono-banks were abolished and restrictions on the internal convertibility of money removed, state control of interest rates was suspended, and the privatisation of state-owned banks took place very early although with varying degrees of success (Fries and Taci, 2002). In addition, transition countries completed two major reforms. The first was the introduction of a two-tier banking system to separate the central bank from the commercial banking sector. This also included the division of large industrial banks into smaller organisations to create competition in the sector. This resulted in a move away from a system where the primary goal of the banks was to transfer state funds to state-owned enterprises for investment projects approved by central planning to a system appropriate to a market economy. The incumbent systems were inefficient in terms of resource allocation and the quality of banking supervision, and risk

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Table 1
Domestic credit provided by banks (% of GDP).

Year	Late Transition countries				Early Transition countries			
	Armenia	Azerbaijan	Georgia	Kazakhstan	Czech Republic	Estonia	Hungary	Lithuania
2013	43.80 (46.00)	25.36 (25.49)	39.83 (42.91)	35.58 (39.08)	55.28 (66.97)	73.67 (71.60)	50.72 (64.69)	46.21 (51.05)

Source: World Bank World Development Indicators 2014. The numbers in brackets show the domestic credit provided by the financial sectors (% of GDP).

assessment was poor. The second was the establishment of a system of financial intermediation to increase saving and investment. The importance of these reforms was recognised by the governments of all the transition economies. However, while the countries of Central and Eastern Europe (CEE) and the Baltic States (the early transition group) began structural reforms in the 1990's, and have to a large extent created efficient banking sectors, in the former Soviet Union states (the late transition group) this process is still not complete.

Although the share of bank domestic credit over GDP is relatively higher in the early transition countries, it can be shown that the banks are universally the most important component of the financial sector (Table 1). Considering the vital role of banking in developing and transition countries, improvement in profitability can have a significant impact on the allocation of financial resources (Sufian and Habibullah, 2010). Moreover, recent studies show that a profitable banking sector better withstands negative shocks and thus contributes to the stability of the financial system (Athanasoglou et al., 2008). Therefore, research that investigates the factors driving bank performance and profitability is important in order to inform strategies for future financial and economic development.

Recent studies largely focus on the determinants of bank profitability in developed and developing countries (Athanasoglou et al., 2008; Dietrich and Wanzenried, 2011; García-Herrero et al., 2009; Trujillo-Ponce, 2013). However, research directed to transition countries, and particularly the countries of the former USSR, is limited. Moreover, banks behave differently under different institutional settings, which implies that the results obtained for developed and developing countries may not apply to those in transition to a market economy (Berger et al., 2001; Berger and Udell, 2002; Haselmann and Wachtel, 2007). In addition, transition countries have a number of unique characteristics, and government policies and regulations can differ from those in developed and developing countries. The relevant studies mostly consider bank-specific, industry-specific and macroeconomic variables as determinants in an investigation of bank profitability. However, these do not take account of environmental conditions, government policy and regulation, and thus it is premature to apply the results to transition country banking sectors. Therefore, this paper also includes national environmental factors such as government spending and fiscal and monetary freedom as they may be important in explaining bank profitability.

The aim of this paper is to investigate the determinants of bank profitability for early (CEE and the Baltic States) and late (former USSR) transition countries for the period 2000–2013. This study is important as it contributes to the existing literature in several aspects. Firstly, it uses a richer dataset that covers the period before, during and after the recent global crisis period (2000–2013) for these countries. Second, it includes the special conditions of early and late transition countries, and allows an examination of environmental factors and their impact on bank profitability. Third, existing studies on bank profitability use either static (Pasiouras and Kosmidou, 2007; Staikouras and Wood, 2011; Sufian and Habibullah, 2010) or dynamic approaches (Athanasoglou et al., 2008; Dietrich and Wanzenried, 2011). However, in this paper robust conclusions can be drawn using both approaches.

This paper builds on research by Athanasoglou et al. (2008), Dietrich and Wanzenried (2011) and Sufian and Habibullah (2010). The results are interesting not only for academics and bank officials, but also for other stakeholders such as policy-makers, central bankers and other financial authorities. The results show that the quality of asset allocation needs further improvement in late transition countries. In addition, better capitalised banks are found to be more profitable in early transition countries. Moreover, indicators of economic freedom, such as government spending and flexible monetary policy, still have a negative impact on bank profitability in late transition countries. This suggests that policy-makers need to consider further reform in these areas.

The paper is structured as follows. Section 2 highlights the difference between early and late transition countries and discusses the relevant empirical literature. Section 3 describes the data and methods used. Section 4 presents the findings from the empirical analysis, and Section 5 concludes and suggests some policy recommendations.

2. Theoretical background

2.1. Economic transition in the countries of the former USSR

Over the last three decades, a plethora of studies have focused on the transition of countries of CEE from a system of central planning to a market economy (Fries and Taci, 2005; Kenjegalieva and Simper, 2011). However, the majority of the former Soviet countries have been largely ignored due to the paucity of reliable information (Djalilov and Piesse, 2011; Schobert, 2006). This is a serious omission as these countries are substantially different from the early transition countries in CEE in a number of important respects. Firstly, the former Soviet countries were controlled by the communist regime for more than seventy years. This resulted in a lack of a national collective memory of any other form of economic organisation, and the institutions in these countries were largely impenetrable. Furthermore, the leadership had no experience of managing a

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