



The influence of political factors on commercial banks in Central European countries

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ARTICLE INFO

Article history:

Received 9 June 2011

Received in revised form 2 January 2012

Accepted 9 August 2012

Available online 19 August 2012

JEL classification:

G21

G28

Keywords:

Banking

Politics

Banks performance

Post-transition countries

ABSTRACT

This study examines the impact of political factors on the behaviour and performance of commercial banks in 11 Central European countries from 1995 to 2008. Using a unique dataset of commercial banks and political factors, we find that state-owned banks report significantly smaller net interest income ratios during the years of parliamentary elections. The proxy cumulative amount of net interest income lost by state-owned banks during the election years equals, on average, 0.38% of each country's GDP. The decrease in the profitability of state-owned banks is caused primarily by the lower interest rates charged on loans. In contrast, we document that the lending growth of state-owned banks is not affected by the political cycle. Hence, to a certain extent, this study supports the view that state-owned banks constitute a tool that serves political goals in Central European countries.

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1. Introduction

The link between politics and the economy remains strong in post-transitional Central European (CE) countries. On the one hand, this connection is a legacy of the area's former political and economic systems. On the other hand, this relationship reflects the relatively weak institutional framework that emerged after the transformation of CE countries (Pistor et al., 2000). Consequently, it can be assumed that the governments of these countries can influence the activities of state-owned entities, including banks. Because state-owned banks play an important role in the financial system and in the process of economic development (La Porta et al., 2002), the degree of political influence on the banks' performance is important from both a policy and a regulatory perspective.

This study was inspired by the growing literature addressing the problem of political impact on financial systems. State-owned financial institutions, their decisions, and their financial results are at the centre of the discussion, as analysing the vulnerability of

state-owned financial institutions to political pressures constitutes a convenient way of differentiating two competing theories that explain the economic roles of those entities (Sapienza, 2004; Cole, 2009; Braun and Raddatz, 2009). First, the theory of the social welfare goal assumes that state-owned financial intermediaries exist to counter market failures, especially failures concerning socially important projects. Second, the theory of political benefits claims that state-owned financial institutions do not aim to increase social welfare; rather, they are efficient tools for obtaining and maintaining political support.

We provide new evidence to support the second theory by reporting on the impact of political factors on state-owned banks in post-transitional economies with unique, hand-collected data concerning political factors and the ownership structures of 358 banks in 11 CE countries from 1995 to 2008. We document that state-owned banks have significantly lower net interest income ratios during election years and that the proxy for the cumulative amount of net interest income lost by state-owned banks during the election years, on average, equals 0.38% of each country's GDP. *Ceteris paribus*, in our sample, being a state-owned bank in an election year causes the reported net interest income ratio to decline by approximately 19.5% in comparison with the mean value of the net interest income ratio. These observations are robust to various changes in the model specifications. In contrast, when we turn to

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the dynamics of loan volume, we cannot detect statistically significant relationships. Therefore, it seems that political pressures in CE countries manifests through the interest rates charged by the banks.

Our work contributes to existing literature in several ways. First, this study extends the literature by documenting some of the political factors that impact the performance of both state-owned and privately owned banks. Existing studies demonstrate that foreign banks are more efficient and more profitable than private domestic or state-owned institutions (Bonin et al., 2005a; Fritsch et al., 2007); furthermore, foreign banks experience more stable loan growth (Haas de and van Lelyveld, 2006). Second, we employ a set of political factors that, to the best of our knowledge, has not been used previously. This set includes the intensity of political competition, the expectations regarding electoral results, the coincidence of electoral events, and the political orientation of the government. Third, we offer evidence on a relatively large number of post-transitional countries that have not yet been studied thoroughly. Finally, this article contributes to the literature on government control over firms by providing evidence that political connections created through ownership may negatively impact state-owned bank performance and thus the long-term stability of the financial system.

The remainder of the paper is organised as follows. Section 2 reviews the existing literature and presents the hypotheses, and Section 3 describes the model used in this study. In Section 4, we discuss the data. Section 5 provides the main empirical results, and Section 6 presents the results of the robustness tests. Concluding remarks are presented in Section 7.

2. Literature review and hypotheses

The relationship between financial intermediaries and the world of politics is complex. On the one hand, financial intermediaries can be subject to political pressures. On the other hand, financial intermediaries can attempt to influence government regulations and supervision processes by exploiting political connections.

Regarding political pressures, several studies have analysed the impact of the electoral cycle. Employing a cross-country sample, Dinç (2005) determined that during election years, loan volume grew significantly more for state-owned banks than for their private-sector counterparts. However, this observation was only valid for his entire sample and his sub-sample of developing countries. In the case of developed economies, Dinç (2005) did not find any signs of political pressure, though his results have been verified with much larger samples by Micco and Panizza (2006) and Micco et al. (2007). In the former, the authors obtained ambiguous results, as the banks in their unrestricted sample appeared to increase lending before elections, but such regularities did not exist in the sub-samples. Additionally, consistent with the results of Dinç (2005), Micco et al. (2007) documented that this finding of politically motivated lending was limited to emerging markets.

In 2009, the existing literature was enriched by two studies that shared an important methodological innovation. Specifically, these studies switched their focus from election years to election cycles. Baum et al. (2009) found that all banks operating in Turkey were sensitive to the phases of the electoral cycle, but this sensitivity did not depend on the ownership structure. In particular, there was no evidence of politically motivated lending activities. Cole (2009) studied agricultural credit in India and found strong evidence of political interference in bank activities. First, Cole discovered that the growth in agricultural credit was higher for state-owned banks during election years than during the other stages of the electoral

cycle. Second, this researcher found that the growth of agricultural credit was more intense in the so-called marginal regions, where election outcomes were uncertain.

The increase in credit supply during election years, as documented by Dinç (2005), Micco and Panizza (2006), Micco et al. (2007), and Cole (2009), can be theoretically explained by referring either to political pressures or to an increase in demand for capital in a fiscally stimulated economy. The second explanation implies that we should be able to observe an improvement in the profitability of banks during election years. However, as Micco et al. (2007) documented, this improvement did not occur. In fact, in emerging markets during election years, the returns on assets for state-owned banks worsened in comparison with the returns for privately owned banks.

Imminent elections are not the sole political factor affecting the behaviour of state-owned banks. Sapienza (2004) found that state-owned entities in the Italian banking sector offered better lending conditions when top managers were affiliated with the leading political parties in a given region, while Khawaj and Mian (2005) studied the significance of the political connections of clients and established that access to bank financing in Pakistan was easier for politically connected firms.

Political pressure is only one facet of the relationship between banks and politics. A second, equally important factor is the possibility that banks will use their political connections to shape their regulatory and supervisory environments. Brown and Dinç (2005) documented that the alignment of managers' objectives and politicians' interests before elections can seriously affect the government's supervisory actions. Focusing on 21 emerging countries, these researchers found that nationalisations and withdrawals of licences were far more likely to occur during the 18-month period following elections and significantly less likely to occur in the year preceding elections. The political nature of the decision to close a bank is also evident in mature economies. Imai (2009) showed that the survival chances of regional and cooperative banks in Japan increased with the strength of the local senior politicians from the ruling Liberal Democratic Party. In contrast to Brown and Dinç (2005) and Imai (2009), Bongini et al. (2000) was unable to establish any relationship between the timing of financial organisation closures and indirect political influence in five East Asian countries. Detragiache and Gupta (2006) demonstrated that political connections did not explain the differences in the performances of Malaysian banks during the Asian crisis. Finally, using data from 150 countries, Braun and Raddatz (2009) found that banking regulations became more manager- and owner-friendly in places where the politician–banker phenomenon was widespread.

Based on the empirical evidence discussed thus far, we develop nine hypotheses. The theory of political benefits assumes that the credit decisions of banks and their price policies are at least partially driven by factors connected to maintaining political support. The veracity of this theory can be verified by analysing the interest margins and loan dynamics during the periods preceding elections and during all other periods. When the group of state-owned banks is compared with the other banks, the pursuit of political targets should result in a decrease in interest margins and an increase in the value of loans. Therefore, the two fundamental hypotheses of the paper are as follows:

- H1.** During periods preceding elections, state-owned banks record lower interest margins than private banks.
- H2.** During periods preceding elections, loan growth is higher in state-owned banks than in private banks.

Offering loans on preferential conditions appears to be a more effective way of gaining political support than offering deposits

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