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# Determinants of bank interest margins in Central and Eastern Europe: A comparison with the West

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**Abstract**

We investigate the determinants of bank interest margins in the Central and Eastern European countries (CEEC). We assess to what extent the relatively high bank margins in CEEC can be attributed to low efficiency or non-competitive market conditions, controlling for the macroeconomic environment and the influence of foreign and state-owned banks. We systematically compare CEEC banks with Western European banks. Our results indicate that banking in the CEEC is on a virtuous path, at least in the EU accession countries: Increased efficiency benefits customers, while capital adequacy supports systemic stability. In the non-accession countries, important policy actions are required.

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## 1. Introduction

Financial intermediation is essential for economic development. Some authors have provided evidence of a causal link between the degree of financial intermediation and subsequent economic growth (Levine and Zervos, 1998). This issue is particularly important for the Central and Eastern European Countries (CEEC), where the financial infrastructure had to be reconfigured after the collapse of the centrally planned system. The consensus is that these

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countries need a stable and efficient banking system, next to the gradual development of financial markets, in order to finance both private and public investment and expenditures. The effectiveness of the banking system in channelling funds from surplus to deficit actors is often gauged by examining the spread between lending and deposit rates and by assessing the degree of operational efficiency of the banking industry.[1] Although the CEEC have made some progress since the deregulation of their banking systems, interest margins remain relatively high and the gap with Western bank markets remains substantial.[2]

However, the interpretation of relatively high interest margins involves a trade-off. On the one hand, high margins are often associated with a low degree of efficiency and non-competitive market conditions. On the other hand, high margins may be a reflection of an inadequate regulatory banking environment and a high degree of information asymmetry. In such circumstances, high margins are indicative of high risk premia. If, in this type of environment, competition increases, it might induce gambling behavior by banks, causing financial instability (Hellman et al., 2000). Beck et al. (2003), for example, conclude that highly concentrated banking systems are less likely to suffer from crises. Therefore, in less developed economies relatively high bank margins may be necessary, at least temporarily, to sustain bank franchise value and avoid financial instability (Gorton and Winton, 1998).

First, we analyze whether the relatively high interest margins of banks operating in the transition economies of Central and Eastern Europe are caused by a low degree of efficiency (scale and X-efficiency) or by non-competitive market conditions (structure-conduct-performance), while controlling for macroeconomic factors.

Second, we examine to what extent bank behavior in the CEEC is similar to that observed in Western Europe. This is especially important for the group of countries that recently joined the European Union, but also for those that are expected to enter in the future. The so-called 'accession countries' have made considerable efforts to adapt their legal and financial infrastructure to ensure eligibility for EU accession. The expectation is that this process of regulatory and economic harmonization will spur macroeconomic and financial convergence with the EU. In that framework it can also be expected that bank behavior will converge. We systematically compare the determinants of interest margins of banks in Western Europe, the new EU member states and the other CEEC banks to investigate this hypothesis.

Third, we investigate how the presence of foreign and state-owned banks influences the differences that still persist between bank interest margins in accession, non-accession and Western European banking markets. If high margins were caused by market power or operational inefficiency, promoting more local competition would be desirable. If high margins are sustained through barriers to entry, actions in terms of bank reform would be a more pressing avenue of public policy. Hence, different causes call for different policy actions.

In what follows, we use panel data estimation techniques to analyze bank interest margins for 31 countries in Western and Eastern Europe. In Section 2 we briefly review some studies on the determinants of bank interest margins. Section 3 describes the estimation methodology and the data. Section 4 presents and interprets the main results of the regression analysis. Section 5 concludes and provides a number of policy implications.

[1] See Fries and Taci (2004), Weill (2003), Grigorian and Manole (2002) and Yildirim and Philippatos (2007).

[2] See Berglöf and Bolton (2003) and Riess et al. (2002).

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