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Themes in Southeast European Banking: A Review of Literature

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Abstract
In this paper we review the literature around three main research questions: the impact of foreign bank entry on net interest margins, financial system stability and credit supply. We also motivate the focus on Southeast European (SEE) countries. SEE economies although under the umbrella of European transition economies exhibit different macroeconomic and financial sector features from these countries and as such could benefit from a more focused empirical investigation. This could tailor and improve the recommendations given to policymakers in these countries which will help promote financial and economic development. Other countries in the world that share similar macroeconomic and financial sector features could benefit from the results as well. In addition, it is argued that SEE countries offer a unique laboratory for the proposed research questions because of the dramatic increase of foreign bank presence in these countries and their low level of financial and economic development.
Keywords: foreign bank entry, Southeast Europe, net interest margins, financial system stability, credit supply
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1. Introduction

Commercial banks play an important role in the economy. Their main role is to channel funds from sectors with excess funds to those with lack of funds. In every market economy the financial system has several functions: it facilitates transactions, mobilizes savings, facilitates risk management, allocates resources by selecting firms to finance and monitors firm managers (Caprio and Levine, 1994). Although these functions are taken for granted in most industrialized market economies, in economies transitioning from the centrally planned to the free market economy, not all services of the financial system are provided properly. This lack of financial system development is worrying considering the evidence that links financial development to economic growth (King and Levine, 1993). As most transition economies, South-east European (SEE) countries have bank-dominated financial systems. Analyzing the banking sector of these countries becomes important for promoting economic growth, efficiency and welfare in these countries. Despite the importance of the banking system for these economies banking research is lagging compared to that for advanced economies, partly due to lack of data availability. Previous research on banking in transition economies is segmented in terms of country coverage and time period analyzed. While there are a considerable number of studies on Central and Eastern European (CEE) banking, far less attention has been paid to the SEE region.

The last three decades have been characterized by considerable political, economic and financial sector reforms in SEE countries. The transition period has entailed among others: recapitalizing the banking sector; introducing risk management practices, accounting standards and supervisory regulation; liberalizing interest rates and finally privatizing the state-owned banks and attracting foreign investors (Kager, 2002). In SEE countries this trend has lately accelerated as most of them strive to join the European Union. This poses both challenges and opportunities for these countries making research on this region even more important for guiding and informing policymaking. This aim of this study is to highlight how one aspect of the financial sector reforms, the entry of foreign banks, affects the banking sector of SEE countries. Up to 2009 the increase of foreign bank presence in the region was unprecedented. In 2004 the asset share of foreign-owned banks in SEE countries was 65%, which increased to 90% in 2009. The increase in CEE countries was less dramatic, from 69% in 2004 to 76% in 2009 (Table 1). Low level of financial and economic development together with a rapidly changing financial sector environment make SEE countries a unique laboratory for the proposed study.

The geopolitical term South-east Europe includes Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro. The region has a total population of around 50.3 million people and an area of 613,820 km square (Table 2). Based on macroeconomic and financial development indicators it is safe to conclude that SEE countries are the least developed countries in Europe. The average GDP per capita (Table 3), as an indicator of economic wealth, among SEE countries as of 2011 is 13,129 current international $, (in purchasing parity terms), much lower than that for CEE (22,681 current international $) and EU 15 countries (40,219 current international $). A similar picture emerges on the financial sector front. Financial deepening as of 2011, as measured by the ratio of domestic credit provided by the banking sector to GDP (Table 4), is 63% for SEE countries, while it is 76% and 168% for CEE and EU 15 countries, respectively. In terms of the riskiness of the SEE region, Table 2, gives the Standard and Poor's credit ratings of SEE countries along with those of CEE

and EU 15 countries as of August 2012. Among SEE countries the highest credit rating belongs to Bulgaria (BBB) while the lowest (B) to Bosnia-Herzegovina. EU 15 countries have the highest credit ratings, with CEE countries being in the middle. These characteristics point to the fact that South-east Europe is a unique transition region in terms of both macroeconomic and financial indicators and deserves a separate treatment in the banking literature.

The impact of foreign bank entry on three different aspects of the host country banking system will be reviewed in this study. The first research question looks at the impact of foreign bank entry on net interest margins in SEE countries. Net interest margins are usually interpreted as the cost of financial intermediation (Saunders and Schumacher, 2000). High interest margins may hinder the efficient allocation of resources and reduce the effectiveness with which the financial system channels funds from borrowers to lenders. This is especially prohibitive for SEE countries that have under-developed capital markets and rely mostly on bank financing. A preliminary look at the data shows that on average, interest rate spreads (lending rate minus deposit rate) have slightly declined in the SEE region although they remain significantly higher than in other European countries. In 2004 the average interest rate spread in SEE countries was 8.2% while in 2008 it declined to 6%. The corresponding figures for CEE countries are much lower: 4.2% and 2.6% in 2004 and 2008 respectively (Table 5). Drawing a conclusion as to whether foreign bank entry has driven interest margins requires econometric estimations. There are no studies to date that investigate this issue for SEE economies. Transferable lessons can be drawn for other transition countries that are at the same level of economic and financial sector development.

The second research question analyzes the impact of foreign bank entry on financial system stability in SEE countries. Banking system stability is especially important in SEE countries as memories of banking crises, frozen deposits and bank runs are still fresh among citizens. Numerous reforms were needed to restore confidence in the banking sector and bring deposits back to the banking system. As credit risk is the main risk in transition economies (EBRD, 2012) the main variable of interest will be the level of non-performing loans (NPLs) in the banking system. The level of NPLs in SEE is the highest in Europe. In 2004 the average level of NPLs (as a percentage of total loans) in SEE countries was 9.1%. The corresponding figures for CEE and EU 15 countries were 3.8% and 2.5%, respectively. In 2010 this level increased to 13.4% for SEE countries, 9.7% for CEE countries and 4.3% for EU 15 countries (Table 6). Whether foreign bank entry has a role to play in the increasing trend of NPLs remains to be tested empirically. The novelty in this research question is not only the sample analyzed but also the investigation of the link between foreign bank entry and credit risk in host countries. There have been no rigorous and comprehensive studies to date that look at this dimension of foreign bank entry.
The third research question looks at the impact of foreign bank entry on credit supply in SEE countries. As SEE financial system is bank based, bank credit is the main source of funding for households and firms. Despite the large presence of foreign banks, bank credit to the private sector has been low, albeit showing an increasing trend. In 2004 the average domestic credit flowing to the private sector (as a percentage of GDP) was 25% for SEE countries; 40% for CEE countries and 111% for EU 15 countries. In 2011 the corresponding figures increased to 54%, 70% and 152%, for SEE, CEE and EU 15 countries respectively (Table 7). The main concern in SEE countries was that the 2007/2008 financial crises that severely affected parent banks of SEE affiliates would cause a decline in credit supply as foreign banks were less able (due to reduced parent support) and less willing (due to higher risks) to extend credit. The 2007/2008 crisis provides an opportunity examine our research question in two different macroeconomic settings by splitting the sample into pre and post crisis periods. In addition to focusing on SEE countries, a sample that has not been previously researched in terms of the impact of foreign bank entry on credit supply, the contribution of this study lies in answering a broader question about the role of foreign banks in the credit supply of the least developed transition economies during crisis and tranquil periods.

2. Literature Review

As transition economies attracted an increasing level of foreign ownership, research on the impact of foreign entry on banking institutions and customers in host countries have followed several strands. The impact of foreign bank entry has been examined with regards to several aspects of the host country banking system such as: competition and concentration of the banking system, the supply of credit, bank efficiency, net interest margins as well as the stability of the domestic banking system.

This section will review the literature around three areas, namely, the impact of foreign bank entry on interest rate spreads, the stability of the banking sector and the credit supply.

2.1 Interest rate spreads

An important factor in analyzing the banking system of a country is the cost with which banks channel funds from lenders to borrowers. In order for this intermediation activity to increase social welfare it is important that it is accomplished at the lowest cost i.e. at the lowest level of bank net interest margin (NIM). Several studies have

investigated the determinants of NIMs, however, only recently has research focused on the impact of foreign bank entry on NIMs. The rapid increase of foreign bank presence in transition economies has raised the question of how this development has influenced net interest margins in host countries.

Theoretical studies

The theoretical literature provides some insights as to why and how foreign banks impact net interest margins in host countries. At the center of all theoretical models has been the information asymmetry problem between incumbent banks and new entrants. Incumbent banks have better "soft" information, while foreign banks are better at processing "hard" information (Dell'Ariccia and Marquez (2004). The main channels through which foreign bank entry influences interest margins in host countries are the spillover channel and the competition channel (Lehner and Schnitzer, 2008).

The spillover effect results from the transfer of better screening technology, better utilization of resources and "know-how" from foreign to domestic banks. This will decrease the cost of financial intermediation, hence, net interest margins. Hauswald and Marquez (2003) differentiate between two possible effects of technological progress on interest rates. On one hand, technological progress implies that banks increase their information processing ability. As the scope for information rents improves markets become less competitive which translates into higher interest rates. On the other hand, there may be information spillovers from domestic to potential foreign entrants which erodes the informational advantage and levels the playing field for all banks. This in turn may increase competition and benefit customers in the form of lower interest rates.

The competition channel results from an increase in the number of banks in the domestic banking market as a result of opening up the market to foreign entry. Foreign bank entry will increase the number of banks, if it is done via greenfield investments as opposed to foreign acquisition and will lower net interest margins more strongly. Claeys and Hainz (2007) present a theoretical model of foreign bank entry where foreign banks have better screening technology while domestic banks have better private information about their clients. The model shows that the mode of entry impacts the distribution of information between domestic and foreign banks which in turn influences the degree of competition. The prediction of the model is that if entry occurs through greenfield investment, competition has a stronger impact in reducing lending rates. They find support for this prediction on a sample of ten Eastern European countries and conclude that on average, foreign bank entry reduces interest rates. Similarly, Hauswald and Marquez (2006) present a model where banks enter the loan market and invest resources to collect information about borrowers. Banks can use the acquired borrower-specific information in two ways: they can soften price competition by increasing the adverse selection problem for rival banks and as a way to capture clients and increase market share. In the context of the impact on loan interest rates the empirical predictions of the model imply that new entrants increase competition which in turn reduces the incentive to invest in information acquisition and lowers expected interest rates.

Another theoretical contribution predicting the relation between foreign bank entry and net interest margins is given by the "portfolio composition effect" (Claeys and Heinz, 2007). It states that the average interest rate for borrowers will depend on the banks' portfolio composition of incumbent firms and new applicants. Profitable incumbent firms are more transparent and attract lower interest rates, while new borrowers are characterized by higher information asymmetry and therefore charged higher interest rates. The average interest rate will depend on the proportion of new and incumbent borrowers on banks' lending portfolio.

In conclusion, the theoretical relation between foreign bank entry and net interest margins in host countries is ambiguous and it therefore remains to be examined empirically. There are numerous studies that investigate empirically this issue. The following section will present some of them.

Empirical studies

The impact of foreign bank entry on host country net interest margins have only recently started to draw theoretical and empirical research. As foreign bank entry has been more pronounced in transition economies, such studies have mostly focused on these countries.

For Latin American countries, Martinez Peria and Mody (2004) investigate the effect of foreign bank entry and the level of bank concentration on bank spreads in a sample of Latin American countries. They find that foreign banks are able to charge lower spreads and have lower costs than domestic banks. Those foreign banks that entered emerging markets by means of acquiring domestic institutions charged higher spreads than those that established de novo operations. They do not find consistent evidence regarding the direct impact of foreign bank participation on domestic bank spreads. The impact is only indirect through its effects on costs. The level of bank concentration is positively related with the level of spreads and costs.

For CEE countries, Drakos (2003) is the first study to apply the Ho and Saunders (1981) model to analyze bank interest margins in these countries. They assess the extent to which foreign bank entry, the transition process and ownership status impact net interest margins using a panel of banks from 11 CEE countries over the period 1993-1999. They find that net interest margins have declined over time, with state-owned banks setting

lower margins. In addition, they show that foreign bank entry has contributed to the reduction of margins. Overall, they find evidence that the transition process has been successful in the sense that it has lead to lower net interest margins. Subsequent studies have also focused on CEE countries. Claeys and Vander Vennet (2008) investigate whether the relatively high interest margins in Central and Eastern European countries are driven by low bank efficiency or a lack of competition in the market, while controlling for macroeconomic factors and the influence of bank ownership on bank interest margins. They find that the presence of foreign banks reduces the bank interest margin. Higher level of efficiency reduce interest spreads for CEE countries that are part of EU, while for non-EU countries higher efficiency has not yet translated into lower interest margins. Bank market structure does not significantly influence interest margins. Capital is shown to have a significant impact on bank margins. Higher capital ratios indicate stability of the banking system and ensure depositor trust.

Other studies such as Claessens et al (2001), have examined a large number of countries. Using bank level data from 80 countries for the 1988-1995 period they examine the impact of the foreign bank presence on domestic banking markets. They study how net interest margins, profitability and taxes paid are affected by the presence of foreign banks. The results show that foreign banks in developed countries have lower interest margins, overhead expenses and profitability than domestic banks. The opposite is true for foreign banks in developing countries. With regards to the impact on the operations of domestic banks, the increase in foreign bank ownership is associated with reductions in profitability, lower non-interest income and lower overall expenses of domestic banks. Overall, the findings suggest that banking customers of host countries may benefit in the long-run from the improved functioning of national banking markets as a result of foreign bank entry.

SEE countries have generally been neglected in this empirical literature. Some SEE countries such as Croatia, Bulgaria and Romania have been included in the sample of CEE countries while others like Albania, Bosnia and Herzegovina, Serbia, Montenegro and Macedonia have in most cases been left out. Given that SEE countries present an interesting opportunity to examine the impact of foreign bank entry on net interest margins, more empirical literature in this region is warranted.

2.2 Stability of the banking system

Another important strand of literature in the context of transition economies is the impact of foreign bank presence on the stability of their banking systems. Ensuring financial system stability is important not only for the well-functioning of the banking system but also for ensuring depositors' trust. Banks are exposed to different kinds of risks which if not managed properly can be a cause for financial instability. The type of risks faced by SEE banks are different from risks faced by banks in developed countries. The main kind of risks in the banking system of SEE countries are mainly related to operational and credit risk and not to financial instruments, securitization or sophisticated market trading risk as was the case in most developed countries (EBRD, 2012). Investigating risks faced by banking systems is an important issue for regulators dealing with financial stability as well as for banks' management.

Theoretical literature

Theoretical studies regarding the impact of foreign bank presence on the financial system stability of host countries are limited. Dell'Ariccia and Marquez (2004) model a loan market where informed (incumbent) and uninformed (new entrants) lenders compete for borrowers. They show that if a strong negative correlation between the degree of information asymmetry and borrower quality exists, an increase in the competitiveness of uninformed lenders worsens the overall portfolio quality of informed lenders. Similarly, Detragiache et al (2008) model the impact of foreign bank entry on the financial sector of poor countries. One of the predictions of their model is that domestic banks have a riskier loan portfolio than foreign banks. A different approach is taken by Schmidt (2008), who presents a model of the impact of foreign bank's mode of entry on the stability of the domestic financial sector. Results show that entry via greenfield investments compared to acquisitions has a stronger impact on lowering the credit quality of the domestic banks' loan portfolios. The channel through which this effect arises is the link between competition and incentives to undertake costly screening. Higher competition erodes profit margins and reduces banks' incentive to screen borrowers. Domestic banks' under-provision of effort is more severe following greenfield entry than following acquisitions. This happens since competition is more aggressive following greenfield entry (due to their higher lending capacity). Theoretically the link between foreign bank entry and financial stability is seen as a complement to the literature that investigates the link between competition and financial stability. As such, it offers ambiguous predictions on the impact of foreign bank entry on financial system stability. The following section presents some empirical evidence on the impact of foreign banks on the financial stability of host countries.

Empirical literature

Empirically the link between foreign bank entry and financial system stability has been researched more extensively. Uiboupin (2004) analyzes the impact of foreign bank entry on the stability of the banking system of

10 CEE countries. They find that the foreign share in the total number of banks have a negative impact on loan loss reserves in banks operating in CEE countries. The overall conclusion of the paper is that foreign banks contribute to financial stability in CEE countries. Cull and Martinez Peria (2010) explores the drivers and consequences of increased foreign bank participation in developing countries. They conclude that the presence of foreign banks has been shown to exert a positive influence on banking sector efficiency and competition and that foreign bank presence enhances banking stability. O'Sullivan and Ozsoz (2010) using data from 32 emerging countries over the period 1999 to 2005 investigate whether the presence of foreign banks promotes or hinders banking system stability. They find that foreign bank presence does not harm banking system stability. De Nicolo and Loukoianova (2007) use bank level data and ownership information for 133 non-industrialized countries over the period 1993-2004, to investigate the relationship between banking system stability, bank ownership, market structure and banks' screening and bankruptcy costs. They find that the positive relationship between bank concentration and bank risk of failure is stronger when bank ownership is taken into account. Furthermore, they find that foreign banks are significantly riskier than private domestic banks conditional on country and firm bank specific characteristics.

The empirical literature examining the impact of foreign bank entry on financial system stability has generally neglected using the non-performing loans ratio as a measure of ex-post credit risk. We have shown in the previous section that NPL ratios are an important concern for financial system stability in transition economies. This was especially pronounced in SEE countries. Therefore, investigating the link between foreign bank entry and NPLs is important for these countries and provides useful information to regulators and banks' risk managers.

2.3 Supply of credit

The importance of credit supply for SEE economies is great because of their reliance on bank credit as a dominant form of household and corporate financing. As discussed in the previous section despite the increasing presence of foreign banks in SEE countries credit supply to the private sector has remained low, albeit increasing. Investigating the impact of foreign bank entry on credit supply is therefore important for understanding the reasons for the low level of financial deepening in SEE countries. Furthermore, the previous discussion showed that there was a structural break of the credit supply curve for SEE countries before and after the 2007/2008 crisis. This offers an interesting opportunity to test whether the impact of foreign bank entry on credit supply is the same in two different macroeconomic settings. This will also shed light on whether credit supply is driven by different factors in crisis as well as tranquil periods. The importance of this exercise is to be able to alter policy reactions appropriately in different macroeconomic environments so as to support a sustainable credit supply to the private sector. The following section will review the theoretical literature of foreign bank presence on the credit supply of host countries.

Theoretical literature

Theoretical studies dealing with the impact of foreign bank entry on credit supply and credit allocation has usually started from the premise that foreign and domestic banks possess different informational advantages. Foreign banks are better at selecting good borrowers based on "hard information" because of their better screening technology. Domestic banks have superior local knowledge and better "soft" information.

Dell'Ariccia and Marquez (2004) present a model where an informed lender competes for borrowers with an outside lender who has a cost advantage in extending a loan but worse information. They show that the informational advantage of informed lenders enables them to capture borrowers as they find it difficult to obtain outside lending due to adverse selection. This basic intuition leads to the following results: First, informed lenders are able to capture borrowers more in markets with larger information asymmetries. The implication is that informed lenders end up with allocating more credit to more informational opaque borrowers. Second, when informed lenders are faced with an increased competition from outside lenders they allocate more credit to opaque sectors where outside lenders face greater adverse selection problems, referred to as the 'flight to captivity' effect. The tendency of foreign banks to lend more to transparent firms while leaving the worst risks for domestic banks is known in the literature as "cherry-picking" or "cream-skimming".

Sengupta (2007) models foreign entry and bank competition as an interaction between asymmetrically informed principals: the incumbent bank has complete information regarding the credit risk of the borrower, while the entrant does not, and uses collateral as a screening device to contest the incumbent's informational advantage. Three important results emerge from the theoretical model: first, for small cost advantages the entrant cannot attract both risk type borrowers, it attracts the high-risk borrowers only. Second, the entrant's profits from pooling borrowers is increasing in its cost advantage. Third, entry into sectors characterized by stronger information asymmetries requires a sufficiently large cost advantage so that the entrant can successfully sort borrowers. The results of the paper support the evidence suggesting that foreign banks are inclined to lend to large rather than small and medium enterprises. In the theoretical model provided by Sengupta (2007) different

equilibria are given for different levels of entrant's cost advantage. The cost advantage of entrants is sufficiently large in developing countries so in equilibrium foreign banks will dominate its domestic counterpart, more so in sectors in which the domestic bank's clients are of low risk. As pointed out by Detragiache et al. (2008), from a social welfare perspective this is not necessarily a negative phenomenon, as long as domestic banks keep lending to less transparent companies. However if "cream-skimming" by foreign banks forces domestic banks out of the market, small and opaque companies may become credit constrained and the total volume of lending may decline.

In the theoretical model presented by Detragiache et al (2008) foreign banks are better at monitoring "hard" information but not "soft" information. Depending on parameter configurations foreign bank entry may either increase or decrease overall lending, efficiency and welfare. A decrease in overall lending may result from "cream-skimming", whereby soft information borrowers find themselves in the worst pool where they have to pay such high interest rates that they decide not to borrow. The empirical prediction is that in countries with a larger foreign bank presence less credit goes to the private sector. The authors find empirical support for the model. In a sample of lower income countries they find that countries with a larger foreign bank presence have shallower credit markets. These findings raise concerns regarding the ability of foreign banks to contribute to the economic development of poor countries. This is not surprising, however, as recent research in banking suggests that lending to SMEs which are informational opaque businesses is not something large banks are good at.

Overall, theoretically the impact of foreign bank presence on credit supply depends on the degree of the cost advantage of foreign entrants and the degree to which they are able to alter their portfolio composition in favor of low-risk companies in host countries. In theoretical models, the ultimate impact on the total level of credit supplied by banks will depend on these parameter values. The following section will review the empirical literature on this issue.

Empirical studies

Empirical evidence focusing on the impact of foreign bank entry on credit supply in emerging countries is inconclusive. Central and Eastern European countries seem to contradict the view that foreign banks decrease private sector lending. De Haas and Naaborg (2006) conduct interviews with managers of parent banks and their affiliates in Central Eastern European countries and find that the acquisition of local banks by foreign banks has not shifted lending in favor of large, transparent companies. On the contrary, foreign banks have gradually expanded lending to smaller companies. Giannetti and Ongena (2009) analyze the extent to which foreign bank lending can benefit small and young firms using a large dataset of listed and unlisted companies in Eastern European countries. They find that foreign lending is associated with higher growth in firm sales, assets, and use of financial debt but the effect is weaker for small firms. They also find that businesses connected to the government or to domestic banks benefit the least from foreign bank entry while young firms benefit most. This suggests that foreign banks are more likely to base their lending decisions on economic criteria rather than on connections, thereby mitigating the connected-lending problem and improving capital allocation.

As foreign bank penetration has been high in Latin American countries, they have also been studied in terms of the impact of foreign banks on credit supply. Berger et al (2001) using Argentinean data, examine the impact of foreign ownership on lending to small and opaque firms. They show that large foreign-owned banks have difficulty lending to informationally opaque borrowers. For Pakistan, Mian (2006) shows that cultural and geographical distances can make banks avoid lending to soft information businesses because of agency and informational costs. For India, Gormley (2010) shows that foreign banks financed a small number of very profitable firms upon entry and that on average firms were eight percentage points less likely to obtain a loan after the entry of foreign banks due to an overall decline of domestic bank loans.

Clarke et al (2006) using survey data of firms operating in 35 transition and developing economies analyze whether foreign bank presence improves access to external finance for firms. They find that both small and large firms report facing lower financing constraints in countries with a large foreign bank presence. Another study using survey data is from De Haas et al (2010). Using data from the EBRD Banking Environment and Performance Survey (BEPS) they investigate how bank and institutional characteristics impact the composition of bank loan portfolios. They show that bank size, ownership and creditor protection are important determinants of the composition of bank loan portfolios. Foreign banks are more focused on mortgage lending and lending to subsidiaries of international companies. Degryse et al (2009) explore how foreign bank entry determines credit allocation in emerging markets. They investigate the impact of the mode of foreign entry on credit allocation to borrowers with different levels of information transparency. They find that the portfolio allocation of banks is mainly driven by the information transparency of borrowers, which they refer to as the "portfolio composition" hypothesis.

3. Conclusion

Banking sector reforms encouraged foreign bank entry in many emerging countries with the hope that this will

reduce interest rates, enhance financial system stability, introduce fresh capital to the banking sector and increase credit supply. In this paper we review the literature around three main themes: the impact of foreign bank entry on net interest margins, financial system stability and credit supply, respectively. We motivate the focus on SEE countries as an interesting laboratory to test these research questions as a region with one of the highest presence of foreign banks. Even after many years of financial sector reforms in this region, interest rate spreads are prohibitively high, the level of non-performing loans is high, the supply of credit to the private sector is limited. Examining the impact that one aspect of the financial sector reform – foreign bank entry – has had on the banking sector of these countries will expand our understanding on the reasons behind the sluggish trend of the above mentioned indicators and will provide policy recommendations for the future. Results can be applied to other countries with similar macroeconomic and financial sector environments and will contribute to the foreign bank entry literature by furthering our understanding of the impact of foreign bank entry on host country banking systems.

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Table 1. Asset share of foreign-owned banks (in%)

	2004	2005	2006	2007	2008	2009
SEE						
Albania	93.3	92.3	90.5	94.2	93.6	92.4
Bosnia and Herzegovina	80.9	90.9	94.0	93.8	95.0	94.5
Bulgaria	81.6	74.5	80.1	82.3	83.9	84.0
Croatia	91.3	91.3	90.8	90.4	90.8	91.0
FYR Macedonia	47.3	51.3	53.2	85.9	93.1	93.3
Montenegro	31.0	87.7	91.9	78.7	84.6	87.1
Romania	58.5	59.2	87.9	87.3	87.7	84.3
Serbia	37.7	66.0	78.7	75.5	75.3	
Average SEE	65.2	76.7	83.4	86.0	88.0	89.5
CEE						
Slovenia	20.1	22.6	29.3	28.8	31.1	29.5
Estonia	98.0	99.4	99.1	98.8	98.2	98.3
Hungary	63.0	82.6	82.9	64.2	84.0	81.3
Poland	71.3	74.3	74.2	75.5	76.5	72.3
Slovakia	96.7	97.3	97.0	99.0	99.2	91.6
Latvia	48.6	57.9	63.3	63.8	65.7	69.3
Lithuania	90.8	91.7	91.8	91.7	92.1	91.5
Average CEE	69.8	75.1	76.8	74.5	78.1	76.3

Source: EBRD

Table 2. Population, Surface Area and S&P Credit ratings

	Population, total	Surface area (sq. km)	S&P Credit Ratings
SEE			
Albania	3,204,284	28,750	B+
Bosnia and Herzegovina	3,760,149	51,210	B
Bulgaria	7,534,289	111,000	BBB
Croatia	4,418,000	56,590	BBB-
FYR Macedonia	2,060,563	25,710	BB
Montenegro	631,490	13,810	BB-
Romania	21,438,001	238,390	BB+
Serbia	7,291,436	88,360	BB
Total	50,338,212	613,820	
CEE			
Slovenia	2,048,583	20,270	A
Estonia	1,340,161	45,230	AA-
Hungary	10,000,023	93,030	BB+
Poland	38,183,683	312,680	A
Slovakia	5,430,099	49,040	A
Latvia	2,239,008	64,560	BBB-
Lithuania	3,286,820	65,300	BBB
Czech Republic	10,519,792	78,870	AA
Total	73,048,169	728,980	
EU 15			
Austria	8,389,771	83,870	AA+
Belgium	10,895,785	30,530	AA
Denmark	5,547,683	43,090	AAA
Finland	5,363,352	338,420	AAA
France	65,075,569	549,190	AA+
Germany	81,776,930	357,120	AAA
Greece	11,315,508	131,960	CCC
Ireland	4,474,356	70,280	BBB+
Italy	60,483,385	301,340	BBB+
Luxembourg	506,953	2,590	AAA
Netherlands	16,615,394	41,540	AAA
Portugal	10,637,346	92,090	BB
Spain	46,070,971	505,370	BBB+
Sweden	9,378,126	450,300	AAA
United Kingdom	62,231,336	243,610	AAA
Total	398,762,465	3,241,300	

Source: World Development Indicators and Standard and Poor's

Table 3. Gross Domestic Product (GDP) per capita, PPP (current international $)

	2004	2005	2006	2007	2008	2009	2010	2011
EU 15								
Austria	32,846	33,626	36,583	38,074	39,783	38,824	40,007	42,122
Belgium	31,177	32,189	34,238	35,655	37,026	36,718	37,665	38,633
Denmark	32,281	33,193	36,047	37,713	39,830	38,292	40,158	41,015
France	28,090	29,453	31,315	33,025	34,041	33,545	34,107	35,194
Finland	29,863	30,708	33,140	36,167	38,080	35,693	36,477	37,581
Germany	29,679	31,115	33,547	35,557	37,119	36,036	37,402	39,414
Ireland	36,769	38,896	42,530	45,506	42,741	39,832	40,470	41,642
Greece	23,861	24,348	26,803	27,709	29,568	29,381	28,410	26,892
Spain	25,957	27,392	30,373	32,230	33,157	32,161	31,889	32,701
Italy	27,528	28,280	30,399	32,056	33,372	32,247	31,895	32,569
Luxembourg	64,956	68,320	78,500	84,525	89,056	82,892	86,132	88,787
Netherlands	33,185	35,104	38,076	40,727	42,915	41,078	42,166	43,339
Portugal	19,854	21,369	22,967	24,201	24,939	24,935	25,432	25,444
Sweden	32,496	32,703	35,704	38,478	39,615	37,337	39,325	41,447
United Kingdom	31,752	32,738	34,992	35,735	35,885	34,473	35,687	36,511
EU 15 Average	32,020	33,296	36,348	38,490	39,808	38,230	39,148	40,219
CEE								
Czech Republic	20,063	21,264	23,262	25,429	25,885	25,625	25,239	25,949
Estonia	14,773	16,548	19,163	21,594	22,159	19,791	20,382	22,406
Latvia	11,731	13,040	14,995	17,178	18,091	15,992	16,284	17,692
Lithuania	12,968	14,197	16,057	18,191	19,559	16,915	18,158	20,374
Hungary	16,188	16,975	18,299	18,933	20,432	20,154	20,545	21,738
Poland	13,009	13,784	15,073	16,757	18,019	18,925	19,899	21,281
Slovenia	22,270	23,476	25,456	27,228	29,074	27,176	26,931	27,570
Slovakia	14,654	16,175	18,381	20,873	23,210	22,577	23,251	24,434
CEE Average	15,707	16,932	18,836	20,773	22,054	20,895	21,336	22,681
SEE								
Bulgaria	8,870	9,809	11,082	12,366	13,916	13,718	13,944	14,603
Romania	8,731	9,361	11,136	12,688	14,670	14,365	14,531	15,163
Montenegro	7,650	8,238	10,325	12,265	13,650	12,845	12,877	13,612
Croatia	14,440	15,332	16,820	18,721	20,310	19,820	19,339	20,031
Macedonia	7,020	7,872	8,774	9,500	10,723	11,233	11,249	11,666
Albania	5,628	6,102	6,807	7,191	8,179	8,635	8,651	8,944
Serbia	7,798	8,517	9,447	10,124	11,531	11,087	11,360	11,919
Bosnia and Herzegovina	5,844	6,341	7,174	7,913	8,688	8,606	8,728	9,089
SEE Average	8,248	8,947	10,196	11,346	12,708	12,539	12,585	13,129

Source: World Development Indicators

Table 4. Domestic credit provided by banking sector (% of GDP)

	2004	2005	2006	2007	2008	2009	2010	2011
SEE								
Albania	45.4	48.6	54.5	62.1	66.1	68.0	67.1	69.1
Bosnia and Herzegovina	33.9	39.9	55.7	61.9	67.2	52.9	65.0	57.7
Bulgaria	34.5	40.2	40.7	55.6	64.3	69.6	70.9	71.4
Croatia	57.6	63.7	69.4	71.6	74.5	76.4	82.2	88.5
FYR Macedonia	20.3	19.4	22.8	33.4	41.3	43.5	48.5	46.7
Montenegro	17.0	17.5	35.9	78.2	88.0	76.2	67.9	61.0
Romania	16.9	20.8	24.1	35.0	47.4	52.7	54.9	55.0
Serbia	25.2	29.1	25.7	31.7	40.3	48.0	57.6	55.0
Average SEE	31.4	34.9	41.1	53.7	61.1	60.9	64.3	63.1
CEE								
Slovenia	56.1	65.4	73.1	81.8	87.1	93.4	97.4	94.7
Estonia	60.2	68.3	81.2	90.3	95.9	105.4	98.9	85.7
Hungary	58.1	62.3	68.4	75.7	80.9	81.4	81.7	75.7
Poland	37.6	37.4	42.0	46.3	59.7	61.4	63.5	66.2
Slovakia	42.9	48.1	49.8	51.6	54.1			
Latvia	53.9	71.9	89.7	89.5	89.4	94.3	89.6	79.3
Lithuania	30.5	43.1	48.9	59.9	64.2	70.0	64.6	57.5
Czech Republic	43.0	41.7	46.7	51.3	55.6	60.5	62.9	68.0
Average CEE	47.8	54.8	62.5	68.3	73.4	80.9	79.8	75.3
EU 15								
Austria	122.3	130.3	129.6	126.9	130.8	140.9	137.5	135.1
Belgium	102.2	103.4	108.6	111.7	113.1	118.8	117.0	117.3
Denmark	164.8	178.2	190.0	205.2	209.6	221.9	215.3	206.0
Finland	69.5	77.5	82.4	85.1	87.9	98.0	100.8	100.4
France	106.1	109.0	115.1	122.0	124.3	128.8	132.9	133.5
Germany	138.7	137.2	131.7	124.7	126.6	133.1	132.0	125.9
Greece	95.4	106.6	108.9	113.8	115.9	115.6	145.5	148.5
Ireland	133.1	159.0	179.1	195.0	207.4	223.8	233.2	225.7
Italy	102.9	107.4	111.6	128.2	132.0	141.6	154.9	157.0
Luxembourg	98.1	127.4	151.6	182.9	183.6	189.8	185.9	171.6
Netherlands	169.7	176.6	177.7	197.6	196.0	224.1	212.1	211.1
Portugal	139.2	144.0	155.2	165.6	177.7	195.1	209.1	204.0
Spain	140.0	159.2	177.2	197.7	214.5	229.1	233.9	228.8
Sweden	108.2	117.5	122.2	130.4	134.6	144.1	142.3	142.7
United Kingdom	153.3	161.9	171.6	187.5	213.5	229.2	222.6	213.8
Average EU 15	122.9	133.0	140.8	151.6	157.8	168.9	171.7	168.1

Source: World Development Indicators.

Table 5. Interest rate spread (lending rate minus deposit rate, %)

	2004	2005	2006	2007	2008	2009	2010
SEE							
Albania	5.2	8.0	7.7	8.4	6.2	5.9	6.4
Bosnia and Herzegovina	6.6	6.0	4.3	3.6	3.5	4.3	4.7
Bulgaria	5.8	5.6	5.7	6.3	6.4	5.2	7.1
Croatia	9.9	9.5	8.2	7.0	7.2	8.4	8.6
FYR Macedonia	5.9	6.9	6.6	5.4	3.8	3.0	2.4
Montenegro	6.1	4.1	5.4	5.5	5.8		
Romania	14.1	13.2	9.2	6.6	5.5	5.3	6.8
Serbia	11.9	13.1	11.5	7.1	8.8	6.7	6.0
Average SEE	8.2	8.3	7.3	6.2	5.9	5.5	6.0
CEE							
Slovenia	4.8	4.6	4.6	2.3	2.6	4.5	
Estonia	3.5	2.8	2.2	2.1	2.8	4.6	6.7
Hungary	3.7	3.4	0.6	2.3	0.3	5.2	2.7
Slovakia	4.9	4.2	4.1	4.3	2.0		
Latvia	4.2	3.3	3.8	4.8	5.5	8.2	7.7
Lithuania	4.5	2.9	2.1	1.5	0.8	3.6	
Czech Republic	4.7	4.6	4.4	4.5	4.6	4.7	4.8
Average CEE	4.3	3.7	3.1	3.1	2.7	5.1	5.5

Source: World Development Indicators

Table 6. Non-performing loans (%of total loans)

	2004	2005	2006	2007	2008	2009	2010	2011
SEE								
Albania	4.2	2.3	3.1	3.4	6.6	10.5	13.9	14.4
Bosnia and Herzegovina	6.1	5.3	4.0	3.0	3.1	5.9	11.4	11.7
Bulgaria	2.0	2.2	2.2	2.1	2.5	6.4	11.9	13.5
Croatia	7.5	6.2	5.2	4.8	4.9	7.8	11.2	11.5
FYR Macedonia	17.0	15.0	11.2	7.5	6.7	8.9	9.0	9.1
Montenegro	5.2	5.3	2.9	3.2	7.2	13.5	21.0	
Romania	8.1	2.6	1.8	2.6	2.8	7.9	11.9	13.4
Serbia	22.2				11.3	15.5	16.9	18.6
Average SEE	9.0	5.6	4.3	3.8	5.6	9.6	13.4	13.2
CEE								
Slovenia	3.0	2.5	2.5	1.8	1.8	2.3	3.6	
Estonia	0.3	0.2	0.2	0.5	1.9	5.2	5.4	5.2
Hungary	2.7	2.3	2.6	2.3	3.0	6.7	9.7	10.4
Poland	14.9	11.0	7.4	5.2	4.5	8.0	8.8	8.4
Slovakia	2.6	5.0	3.2	2.5	2.5	5.3	5.8	5.8
Latvia	1.1	0.7	0.5	0.8	3.6	16.4	19.0	18.4
Lithuania	2.2	0.6	1.0	1.0	4.6	19.3	19.7	19.1
Czech Republic	4.0	3.9	3.6	2.7	3.2	5.2	6.2	5.6
Average CEE	3.9	3.3	2.6	2.1	3.1	8.6	9.8	10.4
EU 15								
Austria	2.7	2.6	2.7	2.2	1.9	2.3	2.8	2.7
Belgium	2.3	2.0	1.3	1.2	1.7	3.1	2.8	
Denmark	0.7	0.4		0.6	1.2	3.3	4.1	4.4
Finland	0.4	0.3	0.2	0.3	0.4	0.6	0.6	0.5
France	4.2	3.5	3.0	2.7	2.8	3.6	4.2	
Germany	4.9	4.0	3.4	2.7	2.9	3.3		
Greece	7.0	6.3	5.4	4.5	5.0	7.7	10.4	11.5
Ireland	0.8	0.7	0.7	0.8	2.6	9.0	8.6	9.2
Italy	6.6	5.3	4.9	4.6	4.9	7.0	7.8	
Luxembourg	0.3	0.2	0.1	0.4	0.6	0.7	0.2	0.3
Netherlands	1.5	1.2			1.7	3.2	2.8	2.7
Portugal	2.0	1.5	1.3	1.4	1.8	2.8	3.3	3.2
Spain	0.8	0.8	0.7	0.9	2.8	4.1	4.6	
Sweden	1.1	0.8	0.8	0.6	1.0	2.0		
United Kingdom	1.9	1.0	0.9	0.9	1.6	3.5	4.0	
Average EU 15	2.5	2.0	2.0	1.7	2.2	3.7	4.3	4.3

Source: World Development Indicators

Table 7. Domestic credit to private sector (% of GDP)

	2004	2005	2006	2007	2008	2009	2010	2011
SEE								
Albania	9.4	14.9	21.8	30.0	35.2	36.7	37.7	39.3
Bosnia and Herzegovina	36.9	43.1	49.5	61.8	67.4	54.4	63.8	54.8
Bulgaria	35.4	41.0	44.9	62.8	71.7	75.5	74.1	72.1
Croatia	48.5	52.6	59.2	62.3	64.4	65.9	70.1	72.2
FYR Macedonia	21.5	24.4	29.3	35.7	42.4	43.9	45.5	46.3
Montenegro	14.6	18.0	36.3	80.3	87.0	76.5	66.9	55.1
Romania	15.7	20.0	25.9	35.1	46.0	47.1	46.1	45.2
Serbia	23.0	29.0	29.2	35.2	40.2	45.2	51.3	49.1
Average SEE	25.6	30.4	37.0	50.4	56.8	55.6	57.0	54.3
CEE								
Slovenia	47.9	56.3	65.9	78.8	85.3	92.9	94.4	91.4
Estonia	60.8	69.7	82.8	91.3	96.0	107.4	98.5	84.6
Hungary	45.9	51.2	55.6	62.6	69.8	69.5	68.8	65.0
Poland	28.1	28.9	33.3	39.4	49.6	50.4	51.9	54.9
Slovakia	30.4	35.1	38.7	42.4	45.0			
Latvia	50.8	68.2	87.5	88.7	90.5	104.6	99.3	82.7
Lithuania	28.8	40.9	50.1	60.0	62.7	70.1	63.9	53.7
Czech Republic	31.3	35.4	39.4	46.3	50.6	52.3	53.3	55.8
Average CEE	40.5	48.2	56.7	63.7	68.7	78.2	75.7	69.7
EU 15								
Austria	106.0	115.6	116.4	115.4	120.3	126.6	122.4	119.6
Belgium	71.2	73.8	82.0	90.9	93.9	97.5	94.8	93.0
Denmark	158.2	171.8	185.7	202.5	216.3	223.5	216.4	209.0
Finland	67.6	75.1	78.8	81.5	86.0	93.8	95.2	95.6
France	90.6	92.7	98.4	105.6	108.8	111.5	114.2	116.2
Germany	112.9	112.6	109.6	105.3	108.6	113.4	107.8	105.4
Greece	70.8	79.6	85.1	94.1	97.5	94.1	115.9	118.2
Ireland	133.0	159.5	180.5	198.9	220.3	234.5	215.0	207.6
Italy	84.8	89.0	94.5	100.6	104.8	111.0	122.2	122.3
Luxembourg	106.1	129.0	154.6	184.8	183.6	187.3	185.4	169.9
Netherlands	157.8	165.0	167.2	188.1	193.2	214.9	199.3	198.1
Portugal	135.9	140.7	151.9	162.5	173.7	186.8	190.9	192.2
Spain	124.9	145.7	167.0	187.9	202.8	212.2	213.9	204.0
Sweden	101.3	107.9	112.8	121.5	127.6	136.2	135.7	136.2
United Kingdom	150.8	159.6	170.7	187.2	212.5	213.8	202.9	187.9
Average EU 15	111.5	121.2	130.4	141.8	150.0	157.1	155.5	151.7

Source: World Development Indicators