ABSTRACT: This paper investigates the dynamics of the banking environment in early and late transition countries for the period 2000-2012. We consider macroeconomic, governance, economic freedom, financial depth, industrial, bank-specific, and CSR variables to compare the banking environment in transition countries. Our analyses show the presence of differences in the banking environment of two groups of transition countries: however, this gap shrunk over the period 2000-2012. The late transition countries have lower scores in the variables 'Investment' and 'Financial freedom', implying that in the future the governments of these countries may focus on improving the investment and financial climate.

KEY WORDS: Transition economies, bank performance, bank concentration

JEL CLASSIFICATION: G21, O160, P34
1. INTRODUCTION

The presence of a sound banking sector is important for ensuring that the financial system and economy run smoothly and efficiently, as banks play a crucial role in channelling funds from lenders to borrowers for productive investment projects (Djalilov & Piesse 2011; Macit 2012). Over the last 25 years the banking sector in transition countries has undergone significant changes. Particularly, the establishment of a two-tier banking system has been accompanied by consolidation, entry of foreign banks, and strengthening of prudential regulation and supervision. It can be assumed that all of these changes posed great challenges to transition country banks, as the environment in which they operate has changed significantly. Many recent studies focus on various aspects of the banking sector in transition countries (Grigorian & Manole 2006; Peresetsky 2010; Pruteanu-Podpiera, Weill, & Schobert 2008; Weill 2003), but research addressing the dynamics of the banking environment during the post-crisis period is limited. Considering the established link between economic growth and banking sector development (Levine 1997, 1998), investigation of the driving forces of the banking sector in transition countries is important not only for bank managers but also for many other stakeholders such as the governments, policymakers, Central Banks, and academics. Additionally, banks need to generate adequate earnings to maintain solvency, to survive, and to flourish as a sound and profitable banking sector in order to better withstand negative shocks and to contribute to the stability of the financial system (Athanasoglou, Brissimis, & Delis 2008). Moreover, existing studies indicate that bank profitability is an important predictor of financial crises (Demirgüç-Kunt & Detragiache 2000).

This paper is interesting for several reasons. Firstly, transition countries’ political and economic structure, and especially the banking sector, has undergone significant changes during the last 25 years. Many transition countries have achieved significant progress in banking, supervisory, and regulatory reform, and in the implementation of structural reform in order to reduce risks and promote financial sustainability. However, transition countries, particularly the Former Soviet Union (FSU), may still need to further develop their banking environment, including their legal institutions and investment-financial freedom. Secondly, there has been a plethora of research on the progress of the transition in Central and Eastern Europe (CEE) and more recently the Baltic States (Bartlett 2009; Nuti 2009), particularly on the measurement of banking sector efficiency and models to determine the factors that influence best practice. However, the countries of the FSU, especially the Central Asian countries, have been largely
neglected due to lack of data. This paper compares the dynamics of the banking environment in transition countries including those of Central Asia.

The paper divides 14 transition countries into two groups. The first group comprises early transition countries: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, and Poland. The second group comprises late transition countries: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Tajikistan, Ukraine, and Uzbekistan. The aim of this paper is to compare the dynamics of the driving forces of the banking environment in these two groups of transition countries for the period 2000-2012.

The paper is structured as follows. The following Section II discusses why these two groups of transition countries are different and discusses the relevant literature. Section III compares the dynamics of the variables impacting on the banking environment for the two groups of transition countries. Section IV concludes.

2. LITERATURE REVIEW

2.1 Why Transition Countries?

Over the last 25 years a plethora of studies have focussed on the transition of CEE countries from a centrally planned system to a market economy. However, the majority of the FSU countries have been largely ignored due to the paucity of reliable information and these countries differ substantially from early CEE transition countries. The FSU countries were ruled by a communist regime for more than seventy years. This resulted in a lack of national collective memory of any other form of economic organisation or institutions and these countries had no experience of managing a domestic market economy prior to the collapse of the Soviet Union in 1991. During the Gorbachev era in the late 1980s, when reforms to establish a market economy took place in the Baltic states of the FSU and in several CEE countries, the other countries of the former USSR did not follow suit. The latter group of countries provide a sharp contrast to countries such as Hungary, Poland, and the former Czechoslovakia, and even to the Baltic states of the FSU, which only had a system of central planning for the period from the Second World War until the 1990s. This historical legacy has a huge impact on how quickly a market economy can be established and emphasises the importance of historical background and conditions at the beginning of transition on the direction and speed of financial sector development, and its impact on economic growth. Secondly, many FSU countries are rich in mineral
and energy resources that have implications for both economic growth and potential internal conflict associated with resource allocation. Thirdly, some FSU countries, especially those located in Central Asia, are geographically very extensive and border politically unstable countries such as Afghanistan, whose problems can be contagious. For these countries, maintaining economic growth and ensuring financial stability are vital to retain social cohesion and sustained development.

The literature exploring banking environment and banking profitability mostly uses four groups of factors: macroeconomic factors, governance factors, financial depth, and industry and bank-specific factors (Beck, Demirgüç-Kunt, & Levine 2010; Berger, Demirgüç-Kunt, Levine, & Haubrich 2004; Levine 1998). Following the relevant studies, we now discuss the various factors in the literature that impact the banking environment.

Macit (2012) investigates the determinants of profitability in Turkish banks and finds that macroeconomic variables, particularly exchange rate levels and real interest rate, have a positive impact on profitability. Analysing structural and cyclical determinants of banking profitability in 16 Western European countries, Beckmann (2007) states that lagged GDP growth has a substantial pro-cyclical impact on bank profits.

Analysing four regional blocks in Sub-Saharan Africa and one comparator block in the Eastern Caribbean using bank-level data, Boutin-Dufresne, Peña, Williams, & Zawisza (2013) find that institutional factors are very important when explaining high interest margins in the East African community. Additionally, Özkán-Günay, Günay, & Günay, (2013) assess the impact of regulatory policy on the efficiency of different sized commercial banks in the Turkish banking sector over the period 2002-2010. Their results indicate that regulatory policies have a positive effect on the efficiency of banks. Particularly, large- and medium-size banks outperform small banks. Moreover, Neyapti & Dincer (2014) provide robust evidence that bank regulations and supervision have significant positive effects on bank deposits and investment rate and significant negative effects on nonperforming loans.

Many existing studies use industry factors to explain profitability in the banking sector. Garcia-Castro et al. (2010) show that a less concentrated banking system increases bank profitability in China. However, Beckmann (2007) finds that industry concentration does not significantly affect the aggregate profitability of banks in 16 Western European countries. Moreover, Berger (1995) finds
that efficiency and market power do not significantly explain the variances of profitability. His results suggest that very large increases in efficiency and market share would be needed to significantly increase bank profits.

Investigating the Armenian banking sector for the period 2002-2006, Dabla-Norris & Floerkemeier (2007) find that bank size, liquidity, market power, and market structure explain a large proportion of cross-bank and cross-time variation in spreads and margins. They also show that the Armenian banking sector has a lot of potential to increase cost efficiency and competition.

Many studies find bank-specific factors important when explaining bank performance and profitability. Analysing the banking sector of China, Garcia-Castro, Ariño, & Canela (2010) show that better capitalised and more efficient banks are more profitable. Additionally, Macit (2012) states that both the ratio of non-performing loans to total assets and the log of real assets have a significant impact on return on assets (ROA) and return on equity (ROE) for Turkish banks.

Fang, Hasan, & Marton (2011) investigate the performance impact of bank diversification on loan and asset portfolios in transition economies. Their results indicate that bank performance is positively associated with asset diversification but negatively related to loan diversification. Additionally, the results show that banking liberalisation and corporate governance restructuring enhance profit gains from loan and asset diversification; however, legal reforms reduce profit gains.

We compare the dynamics of macroeconomic, governance, economic freedom, financial depth, industry bank-specific, and corporate social responsibility (CSR) variables in two groups of transition countries. We consider the data for 254 banks of 16 transition countries obtained from Bank scope. Macroeconomic and financial depth variables are taken from the World Bank Development Indicators 2014. Governance and economic freedom variables are obtained from Kaufmann, Kraay, & Mastruzzi (2011) and the Heritage Foundation, respectively.

3. DISCUSSION

3.1 Macroeconomic factors

Recent studies have used macroeconomic variables to analyse bank performance. Among the most popular are interest rates, exchanges rates, GDP growth, and
inflation (Boutin-Dufresne et al. 2013; Dabla-Norris & Floerkemeier 2007). Due to the lack of data for the exchange rate and interest rate variables for the countries under investigation we aim to use only GDP growth and inflation rates.

Figure 1 shows the GDP growth dynamics of early and late transition countries for the period 2000-2012. It indicates that the group of late transition countries had higher GDP growth in the period. Additionally, the early transition countries were more severely hit by the recent global financial crisis, especially in 2008 and 2009 (Figure 1). This is because the early transition countries are EU members and are more integrated in the Western financial system where the impact of the global financial crisis was severe. Additionally, our second macroeconomic variable is inflation, which is measured by the annual growth rate of the GDP deflator.

**Figure 1.** GDP growth (annual, %)

![GDP growth chart](image)

Source: World Bank Development Indicators 2014

**Figure 2.** Inflation, GDP deflator (annual %)

![Inflation chart](image)

Source: World Bank Development Indicators 2014
Figure 2 indicates that the level of price change in these two groups of countries is very different: inflation is much higher in the group of late transition countries. Perhaps the late transition countries’ inflation-targeting monetary policy during this period was unsuccessful. The world’s many advanced economies, including the early transition countries, experienced quite a low rate of inflation during the recent global crisis, while inflation in the late transition countries was quite high (Figure 2). In both figures the early transition countries have a similar trend to that of the advanced Western countries because they are EU members and therefore more integrated into the Western World.

3.2 Governance factors

In this section we use six governance indicators from World Governance Indicators by Kaufmann, Kraay, & Mastruzzi (2011): 1) voice and accountability; 2) political stability; 3) government effectiveness; 4) regulatory quality; 5) rule of law; and 6) control of corruption. Each indicator ranges from -2.5 (lowest) to 2.5 (highest). There is an on-going critical debate among scholars on the use of World Governance Indicators; however, addressing the critics, the authors show that they are comparable across countries (Kaufmann, Kraay, & Mastruzzi 2007).

Table 1 presents the dynamics of governance development in early and late transition countries. ‘Voice and accountability’ captures perceptions of the extent to which a country’s citizens are able to participate in selecting their government. This includes freedom of expression, freedom of association, and a free media. Table 1 shows that early transition countries have a better average score for 2000 than late transition countries, implying the presence of more favourable conditions in the former: however, neither of these groups improved significantly over the period 2000-2012.

The second variable, ‘Political stability’, reflects the perceptions of the likelihood that a government can be destabilised or overthrown by unconstitutional or violent means. Although both groups have improved their scores, the mean for the group of late transition countries remains negative, implying the presence of the threat of political destabilisation in these countries.

‘Government effectiveness’, on the other hand, captures perceptions of the quality of public and civil services and their independence from political pressure. It also includes the quality of policy formulation and implementation. Table 1 indicates that both groups of countries have improved their government effectiveness
scores, implying improvements in the quality of public and civil services as well as in policy formulation-implementation.

Our fourth variable, ‘Regulatory quality’, reflects perceptions of governments’ ability to formulate and implement policies and regulations to promote private sector development. Although early transition countries were in a comparatively favourable position in 2000, the group of late transition countries significantly improved its scores during the period 2000-2012. This implies that their governments have been improving the quality and implementation of policies promoting the private sector.

Table 1. Dynamics of Governance Indicators

<table>
<thead>
<tr>
<th>Years</th>
<th>Voice and Accountability</th>
<th>Political Stability</th>
<th>Government Effectiveness</th>
<th>Regulatory Quality</th>
<th>Rule of Law</th>
<th>Control of Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>-0.9108</td>
<td>-0.7282</td>
<td>-0.7679</td>
<td>-0.7913</td>
<td>-0.9896</td>
<td>-0.8482</td>
</tr>
<tr>
<td>2002</td>
<td>-0.9668</td>
<td>-0.6181</td>
<td>-0.8262</td>
<td>-0.7856</td>
<td>-0.9642</td>
<td>-0.9535</td>
</tr>
<tr>
<td>2003</td>
<td>-0.9558</td>
<td>-0.5375</td>
<td>-0.7391</td>
<td>-0.7010</td>
<td>-0.8886</td>
<td>-0.8448</td>
</tr>
<tr>
<td>2004</td>
<td>-0.9620</td>
<td>-0.6500</td>
<td>-0.7196</td>
<td>-0.6494</td>
<td>-0.8586</td>
<td>-0.9523</td>
</tr>
<tr>
<td>2005</td>
<td>-0.9227</td>
<td>-0.6529</td>
<td>-0.7295</td>
<td>-0.7308</td>
<td>-0.8640</td>
<td>-0.8626</td>
</tr>
<tr>
<td>2006</td>
<td>-0.9319</td>
<td>-0.6943</td>
<td>-0.7003</td>
<td>-0.6539</td>
<td>-0.9196</td>
<td>-0.7473</td>
</tr>
<tr>
<td>2007</td>
<td>-0.9616</td>
<td>-0.3326</td>
<td>-0.7064</td>
<td>-0.5385</td>
<td>-0.8510</td>
<td>-0.7934</td>
</tr>
<tr>
<td>2008</td>
<td>-0.9793</td>
<td>-0.3067</td>
<td>-0.6311</td>
<td>-0.4583</td>
<td>-0.7905</td>
<td>-0.7943</td>
</tr>
<tr>
<td>2009</td>
<td>-0.9562</td>
<td>-0.3295</td>
<td>-0.5930</td>
<td>-0.4544</td>
<td>-0.8178</td>
<td>-0.8664</td>
</tr>
<tr>
<td>2010</td>
<td>-0.9554</td>
<td>-0.3766</td>
<td>-0.5889</td>
<td>-0.4442</td>
<td>-0.8223</td>
<td>-0.8865</td>
</tr>
<tr>
<td>2011</td>
<td>-0.9170</td>
<td>-0.4556</td>
<td>-0.5530</td>
<td>-0.4374</td>
<td>-0.8149</td>
<td>-0.8666</td>
</tr>
<tr>
<td>2012</td>
<td>-0.8911</td>
<td>-0.4250</td>
<td>-0.5297</td>
<td>-0.4635</td>
<td>-0.7565</td>
<td>-0.7871</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Years</th>
<th>Voice and Accountability</th>
<th>Political Stability</th>
<th>Government Effectiveness</th>
<th>Regulatory Quality</th>
<th>Rule of Law</th>
<th>Control of Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>0.8892</td>
<td>0.4456</td>
<td>0.5376</td>
<td>0.8920</td>
<td>0.5098</td>
<td>0.3108</td>
</tr>
<tr>
<td>2002</td>
<td>0.9954</td>
<td>0.8796</td>
<td>0.7124</td>
<td>1.0973</td>
<td>0.6296</td>
<td>0.2966</td>
</tr>
<tr>
<td>2003</td>
<td>0.9579</td>
<td>0.8904</td>
<td>0.7919</td>
<td>1.0557</td>
<td>0.6738</td>
<td>0.4429</td>
</tr>
<tr>
<td>2004</td>
<td>0.9596</td>
<td>0.5865</td>
<td>0.7758</td>
<td>1.0886</td>
<td>0.6878</td>
<td>0.4208</td>
</tr>
<tr>
<td>2005</td>
<td>0.9339</td>
<td>0.7256</td>
<td>0.7685</td>
<td>1.0596</td>
<td>0.6948</td>
<td>0.4701</td>
</tr>
<tr>
<td>2006</td>
<td>0.9017</td>
<td>0.7779</td>
<td>0.8258</td>
<td>1.0502</td>
<td>0.7578</td>
<td>0.4027</td>
</tr>
</tbody>
</table>
‘Rule of law’ captures perceptions of the quality of the law, particularly contract enforcement, property rights, the police, and the courts. Early transition countries have increased their scores; however, late transition countries have struggled to improve the quality of the law. Our last governance variable, ‘Control of corruption’, considers perceptions of the extent to which public power is exercised for private gain. Neither group of countries made significant improvements in this variable during the period 2000-2012. EBRD’s Life in Transition survey indicates the major reasons for corruption in transition countries. The people in these countries mostly make unofficial payments to get better public services. Thus the governments in these countries need to develop a strategy to overcome corruption in organisations providing public services. Overall, the scores for governance variables in Table 1 show that early transition countries had better scores in 2000; however, both groups of countries have only been improving slowly.

3.3 Economic freedom

In a society with economic freedom and equality, resources and their consumption are distributed on the basis of open market competition. A society with a high level of economic freedom provides a fair chance of succeeding and energises people to achieve their goals. In this section we discuss the dynamics of the Heritage Foundation’s economic freedom variables: ‘Monetary freedom’, ‘Trade freedom’, ‘Investment freedom’, ‘Financial freedom’, and ‘Business freedom’. These variables range from 0 (no freedom) to 100 (very free).
Table 2. Economic Freedom Variables

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Observations</td>
<td>435</td>
<td>457</td>
<td>386</td>
<td>447</td>
<td>193</td>
<td>224</td>
</tr>
<tr>
<td>Mean</td>
<td>80.06</td>
<td>67.79</td>
<td>77.25</td>
<td>69.47</td>
<td>77.87</td>
<td>70.56</td>
</tr>
<tr>
<td>Monetary freedom</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade freedom</td>
<td>435</td>
<td>457</td>
<td>386</td>
<td>447</td>
<td>193</td>
<td>224</td>
</tr>
<tr>
<td>Mean</td>
<td>78.43</td>
<td>70.84</td>
<td>86.49</td>
<td>78.34</td>
<td>87.36</td>
<td>80.67</td>
</tr>
<tr>
<td>Investment freedom</td>
<td>435</td>
<td>457</td>
<td>386</td>
<td>447</td>
<td>193</td>
<td>224</td>
</tr>
<tr>
<td>Mean</td>
<td>67.89</td>
<td>37.09</td>
<td>68.90</td>
<td>37.64</td>
<td>72.85</td>
<td>39.02</td>
</tr>
<tr>
<td>Financial freedom</td>
<td>435</td>
<td>457</td>
<td>386</td>
<td>447</td>
<td>193</td>
<td>224</td>
</tr>
<tr>
<td>Mean</td>
<td>74.28</td>
<td>42.69</td>
<td>67.18</td>
<td>45.19</td>
<td>65.96</td>
<td>41.65</td>
</tr>
<tr>
<td>Business freedom</td>
<td>435</td>
<td>457</td>
<td>386</td>
<td>447</td>
<td>193</td>
<td>224</td>
</tr>
<tr>
<td>Mean</td>
<td>71.08</td>
<td>54.98</td>
<td>68.25</td>
<td>66.67</td>
<td>70.67</td>
<td>71.51</td>
</tr>
</tbody>
</table>

Source: Heritage Foundation

Table 2 presents the scores for the economic freedom variables for the periods 2000-2006 (pre-crisis), 2007-2010 (during-crisis), and 2011-2012 (post-crisis). The variable ‘Monetary freedom’ captures the stability of a currency and market-determined prices. The score for the late transition countries is much smaller over the period 2000-2006; however, it improved over the entire 2000-12 period. The reverse is the case for the early transition countries. Although the data period does not include the adoption of the euro in some countries (Lithuania, Latvia), a possible reason for the decrease in the score might be the instability of the euro during and post the crisis period, as the EU member states are strongly integrated. ‘Trade freedom’ considers free inflows as well as outflows of goods and services. Although early transition countries have a higher score for the period 2000-2006, this gap has been significantly shrinking over time. ‘Investment freedom’ assesses the degree to which there exists a free and open investment environment. Neither group of countries significantly increased their scores and thus the difference in scores remains largely unchanged.

An efficiently functioning financial system environment provides more opportunities for people to succeed by offering diversified funds and resources. ‘Financial freedom’ captures how efficiently a country’s financial system functions. Although this score has been decreasing for the early transition countries the gap remains significant, as the late transition countries’ score has not improved. The variable ‘Business freedom’ captures the right to establish and run a firm without onerous state interference. The early transition countries have a much higher score for the period 2000-2006. However, the late transition countries
‘scores have improved significantly and by the period 2011-2012 their score has surpassed that of the early transition countries.

Both groups of countries have improved their economic environment over the period 2000-2012. However, the late transition countries need to improve both their investment climate and their financial systems.

3.4 Financial depth

Financial depth compares the financial sector to the economy. There are two commonly used variables, banks’ domestic credit to the private sector and domestic credit to the private sector. The first indicates total credit to the private sector by banks only, while the second shows total credit to the private sector by the financial sector: both are usually compared to GDP. This percentage is usually high in high-income countries with advanced financial sectors, sometimes reaching 100% or even more; however it is low in low-income countries with poorly developed financial sectors.

Figure 3 compares domestic credit to the private sector by banks (as a percentage of GDP) in early and late transition economies. It shows that both groups have a similar dynamic, which increases towards 2009 and decreases thereafter, perhaps due to the impact of the recent global financial crisis (2007-2010). However, the variable is much higher in the group of early transition countries, showing that they have more advanced banking sectors.

**Figure 3.** Domestic credit to private sector by banks (% of GDP)

The second proxy variable of financial depth, domestic credit to the private sector, compares the size of all credits issued by the financial sector to the private sector.
with GDP. Figure 4 compares the size of domestic credit to the private sector in early and late transition countries. It shows that the dynamics of the variable is similar for both groups of countries over the period 2000-2012; however, financial depth is much stronger for the group of early transition countries.

**Figure 4.** Domestic credit to private sector (% of GDP)

![Figure 4. Domestic credit to private sector (% of GDP)](image)

*Source:* World Bank Development Indicators 2014

### 3.5 Industry factors

The next group of variables used in the analyses are industry and market structure variables comprising the Z-score and Herfindahl-Hirschman Index (HHI). Recent studies have used different risk measurements for the banking sector (e.g., credit risk, default risk). We use Z-scores as the measure of bank risk as it is monotonically associated with the measure of a bank’s probability of failure. The Z-score is expressed as ROA plus equity-asset ratio divided by the standard deviation of ROA. Since the Z-score indicates the distance to insolvency, a higher Z-score implies that a bank is less risky. This represents a more universal measure of bank risk-taking and has been extensively used in the literature of finance and banking.

**Figure 5.** Z-score in Early and Late Transition Countries

![Figure 5. Z-score in Early and Late Transition Countries](image)

*Authors’ calculations using data from Bank scope*
The trend of the Z-score is higher in the group of late transition economies, but banks in the group of early transition countries take more risks, as their Z-scores are lower (Figure 5). This is consistent with economic theory that banks in more advanced markets have better risk assessment expertise and are able to take more risks and still survive and flourish. However, the Z-score levels in both groups of countries increased substantially over the period 2008-2012 compared to the previous years, implying that the banks tended to take less risks during the turbulent period.

Our HHI is equal to the squared sum of each banks’ market share and thus a higher value implies a higher level of concentration. These are reported in Figure 6, where it can be seen that the HHI is higher in the group of late transition economies, indicating a more concentrated market. Additionally, Figure 6 shows that the concentration levels in both groups of countries decrease during the period 2000-2012.

**Figure 6.** HHI in Early and Late Transition Countries

![HHI in Early and Late Transition Countries](image)

Authors’ calculations using data from Bank scope

**3.6 Bank-specific factors**

In this section we discuss the dynamics of various bank-specific variables such as Overheads, Loan Loss Provisions (LLP), and Equity to Total Assets (ETA) in early and late transition countries. The Overheads variable is defined as the ratio of bank overhead expenses to total assets. In Figure 7 the vertical axis shows overheads in percentages and the horizontal axis indicates the year. The results show that overheads are lower in early transition countries, indicating that they have more expertise in using resources. However, this variable dramatically increased in 2009, 2011, and 2012 in the early transition countries, perhaps because of the impact of the recent global financial crisis.
The next bank specific variable is LLP, defined as the value of a bank’s loan-loss provisions expense as a share of its total assets. In Figure 8 the vertical axis shows the share of LLP to total assets in percentages while the horizontal axis indicates the year. Although both groups of countries have a similar LLP dynamic, the share is much higher in the group of late transition countries, implying that the banks of early transition countries have better expertise in efficiently allocating their resources.

Our next bank-specific variable used in the analyses is ETA. In Figure 9 the vertical axis shows the share of equity of total assets in percentages while the horizontal axis indicates the year. The results show that the banks in both groups of transition countries have a similar equity-to-total-assets dynamic, but the banks of late transition countries have a much higher equity share, implying that they rely more on their equity resources and have a lower level of liability.
Figure 9. Equity to Total Assets in Early and Late Transition Countries

![Equity to Total Assets in Early and Late Transition Countries](image)

Source: Bank scope

### 3.7 Corporate Social Responsibility

Over recent decades, CSR and its relationship to corporate performance has been the subject of an interesting and continuous debate among researchers. According to Wu & Shen (2013), companies are usually encouraged to adopt CSR because of its benefits to micro- and macro-performance, where the first is generally related to the reputation of companies and retaining and recruiting highly qualified workers, while the second refers to environmental improvement and reduction in social inequality. However, banks’ level of social engagement varies across countries and this may come from different perceptions of the impact of CSR on bank performance.

Recently, various indicators to proxy CSR have been used in related studies, as there is no unanimously accepted indicator to quantify corporate social activity. However, there is limited data and research that addresses CSR in transition economies. Additionally, various formats were used to publish the banks’ reports, which made it difficult to count (either manually or using content analyses software) the numbers of keywords used. We use a binary variable of CSR, where CSR takes the value of 1 if a bank publishes CSR reports (or uses CSR-relevant keywords in annual reports) and 0 when it does not. Following the study by Gamerschlag, Möller, & Verbeeten (2011), we searched for the keywords of the Global Reporting Initiative (GRI) framework, referring to it as the global standard. In addition to the environmental and social keywords derived by Gamerschlag et al. (2011) from the GRI (Table 3), we searched for the two philanthropic keywords, ‘sponsorship’ and ‘charity’.
Table 3. Keywords of the GRI framework

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recycled; energy consumption; biodiversity; emissions; effluents; waste; spills; environmental impacts</td>
<td>Employment; employee turnover; collective bargaining; collective agreements; occupational health; occupational safety; training; diversity; equal opportunities; human rights; discrimination; freedom of association; child labour; forced labour; compulsory labour; community; corruption; public policy; compliance; fines; sanctions; product responsibility; customer health; customer safety</td>
</tr>
</tbody>
</table>

We used singular and plural forms of the keywords as well as British and American English.

Table 4 shows the means of CSR for the two groups of transition countries during the periods 2000-2006, 2007-2010, and 2011-2012. Initially, CSR reporting was much higher in the banks of the early transition countries; however, the gap has been significantly decreasing. This implies that the banks in both groups of transition countries have been significantly improving their CSR reporting and commitments over time.

Table 4. Corporate Social Responsibility

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Observations</td>
<td>435</td>
<td>457</td>
<td>386</td>
<td>447</td>
<td>193</td>
<td>224</td>
</tr>
<tr>
<td>Mean</td>
<td>0.49</td>
<td>0.20</td>
<td>0.55</td>
<td>0.39</td>
<td>0.59</td>
<td>0.55</td>
</tr>
</tbody>
</table>

Sources: Annual reports of banks.

4. CONCLUSION

In this paper we analysed and compared banking environments in early and late transition countries. In particular, we explored the dynamics of the variables considered to significantly impact banking sectors in the relevant literature. They are macroeconomic, governance, economic freedom, financial depth, industrial bank-specific, and CSR variables.

Our analyses of macroeconomic variables indicate that late transition countries have been enjoying higher rates of GDP growth; however, early transition countries have been experiencing lower rates of inflation. Overall, governance
variables are lower in value in late transition countries, implying that early transition countries have better governance. The variables of economic freedom showed that early transition countries have managed to establish market economies with higher levels of economic freedom. Additionally, early transition countries have higher rates of domestic credit to the private sector, implying that they have greater financial depth.

Although the banking sectors of early transition countries are more risky (lower Z-score), the level of loan-loss provision is higher in the late transition countries. This implies that early transition countries have better expertise in allocating resources and managing risk. Even though many banks in early transition countries have been publishing separate CSR reports, our content analyses results show that CSR reporting rates are similar in both groups of transition countries.

In sum, our analyses show the presence of differences in the banking environment of two groups of transition countries; however, this gap got smaller during the period 2000-2012. The late transition countries had lower scores in the Investment and Financial freedom variables, implying that in the future the governments of these countries should focus on improving their investment-financial climate.

REFERENCES:


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