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Obstacles to a global banking system: "Old Europe" versus "New Europe" ☆

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Abstract

"Old Europe" – the developed nations of continental Europe – averages only about 15% foreign bank ownership, whereas "New Europe" – the transition nations of Eastern Europe – averages about 70%. Similar findings hold elsewhere in the world – developed nations tend to have much lower foreign bank ownership shares than developing nations. We examine the causes of the differences within Europe with an eye toward more general conclusions. Our findings suggest that the low foreign bank shares in "Old Europe" – and perhaps developed nations more generally – may primarily result from net comparative disadvantages for foreign banks and relatively high implicit government entry barriers. The high foreign penetration in "New Europe" – and perhaps developing nations more generally – may be due to net comparative advantages for foreign banks and low government entry barriers, particularly in nations that reduced their state bank ownership.
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1. Introduction

"Old Europe" – the developed nations of continental Europe – tends to have relatively low foreign bank ownership, whereas "New Europe" – the transition nations of Eastern Europe – often has most of its banking services provided by foreign banks. To illustrate, the three largest developed economies in continental Europe – Germany, France, and Italy – each have less than 10% of assets owned by other European-based foreign banks and less than 15% foreign bank penetration overall. In contrast, three of the largest transition economies – Poland, Czech Republic, and Hungary – each have more than 50% of assets owned by banks headquartered in other European-based foreign banks alone. In this paper, we focus primarily on the causes of the differences in foreign bank ownership between "Old Europe" and "New Europe" with an eye toward drawing more general conclusions about the connections between the level of development and foreign bank ownership.

The differences in foreign bank ownership between "Old Europe" and "New Europe" may seem surprising. Most of the "Old Europe" nations – including the three nations cited – are long-term members of the European Union (EU), which has explicitly tried to create a single banking market. These countries in most cases share a common currency and close geographic proximity, reducing the costs consolidating across borders. The "New Europe" nations, in contrast, often had state domination of banking fewer than 20 years ago. Most have now significantly reduced state ownership of banks have lowered other explicit and implicit barriers to entry and allowed foreign banks to control most of their banking assets. In some extreme cases – such as Estonia, Czech Republic, and Croatia – state bank market shares are less than about 5% and foreign bank shares are about 90% or more.

The experiences of "Old Europe" and "New Europe" are not atypical of developed and developing nations, respectively, elsewhere in the world. Foreign banks control only about 10% of banking assets in most developed nations in North America and East Asia. While there are exceptions, foreign bank penetration in developed nations is generally quite low relative to many developing nations. To illustrate, the average foreign bank share in the developing nations of Latin America is over 40% and foreign shares are well over 50% in some individual developing nations in Asia and Africa. In a few developing nations – e.g., Belize in Latin America, Macau in Asia, Lesotho in Africa – foreign banks have virtually taken over the banking markets, with market shares of about 90% or more.

The relatively low foreign penetration in developed nations may seem surprising. Most of these countries have removed many of the explicit government regulatory barriers to foreign bank entry. The nations of "Old Europe" have adhered to the Single Market Programme (SMP) designed to make the EU as close as possible to a single banking market with a single banking license that may be used across the member nations. Technological advances have also encouraged globalization of the banking system. Improvements in information processing, telecommunications, and financial technologies have all facilitated greater reach across borders. The newer technologies allow banks to manage information flows from more locations and to evaluate and manage risks at lower cost without geographic proximity. In addition, globalization of trade and enlarged cross-border activities of nonfinancial companies have increased demand for banks that can provide services across international boundaries.

The low foreign shares in developed nations relative to developing nations may also be surprising because the latter more often have high explicit barriers to foreign entry. In