

BANKING REFORM AND FINANCIAL SECTOR DEVELOPMENT IN CENTRAL AND EASTERN EUROPE AND EU ACCESSION COUNTRIES

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Abstract: *From the empirical evidence on the finance-growth-nexus in European transition countries, we conclude that financial sector reform, especially of the banking sector, can contribute to economic growth and speed up transition. Empirical research by Cottarelli, Dell'Arriccia and Vladkova-Hollar (2005) and others has provided evidence that factors originating in the banking system, rather than the corporate sector, were responsible for growth differences in accession and transition economies. In extending the conventional finance-growth framework and based on observations in New EU-Member States (NMS), we suggest that strong foreign bank investment and related cross-border credit from parent banks may have been a substitute for domestic bank growth and thus in supporting real sector growth in South-Eastern Europe (SEE). Given the massive-scale involvement of foreign banks in NMS and SEE, more research is necessary in this area.*

In SEE countries, economic and bank transition started later than in NMS because of political circumstances. As evident from the experience in NMS, financial development is not growth-supportive when the institutional and legal framework given to market participants is not appropriate. Unsound banking intermediation has a direct impact on economic growth as such behaviour perpetuates economic stagnation and inefficient use of resources. Unsound financial sectors in SEE also indirectly hamper economic growth, as they pose serious obstacles to inflows of foreign direct investment which in turn would contribute to economic growth. When financial institutions are subject to poor governance and incentive structures, finance can hardly promote growth. Instead of supporting growth, granting bad loans back to companies of their owners, for example, leads to resource misallocation, reduced private sector confidence and results in lower investment and growth. Policies thus should continue to focus on alleviating the bottlenecks to financial intermediation by guaranteeing stable macroeconomic conditions and a sound institutional legal and supervisory environment. The involvement of foreign banks is found to be a major factor for stabilizing the banking sector and making it fit to support economic growth.

Key words: *banking reform, financial sector, economic growth, transition countries, accession countries*

Introduction

The role of the financial sector for economic growth became a major topic of empirical research in the last decade.¹ The experiences of transition countries showed that faster reform and development of the financial sector can lead to improved economic performance, as measured by GDP growth. Reform policies should first concentrate on ensuring basic property rights and creating a sound legal infrastructure. Banking reform should go hand in hand with enterprise reform. Via financial sector foreign direct investment (FSFDI), hard budget constraints can be imposed on banks, and appropriate incentives for lending on a commercial basis can be created. Investors need to be carefully screened on their intentions and capabilities. Foreign banks are able to bring in modern banking technology. Their entry increases competition in the banking sector and reduces the potential for political infringement on bank lending. Foreign direct investment (FDI) in banking represents a long-

¹ Levine 1997; Wachtel 2001; Fink, Haiss and Mantler 2005

term commitment and may reduce the chances of financial crises. Successful reform of the financial sector in Central and Eastern Europe (CEE) is supporting sustainable economic growth. This involves diverse roles of the sector in mobilizing and reallocating savings, facilitating trading of risk, and through the operation of both banks and capital markets, strengthening corporate governance in the enterprise sector.²

In comparison to EU's New Member States (NMS), financial sector reform has started late in South-Eastern Europe (SEE).³ The establishment of a properly working financial sector has been delayed or jeopardized by a number of adverse developments like war, political instability, hyperinflation and pyramid schemes in the late 1990s in SEE. The financial sector in all countries of the region is dominated by commercial banks. Privatization of the banking sector has advanced during the last years and foreign ownership has gradually increased. New lending has primarily been directed towards households and less to the corporate sector. The banking sector is still relatively small and fragile.

An impressive number of empirical studies relying on large country samples show that financial sector development can have an economically important impact on growth.⁴ Recent studies suggest that the relationship varies with the level of economic development for example between emerging and industrialized market economies.⁵

Apart from sectoral issues, followers of the law-and-finance-view (e.g. La Porta et al., 1998, and Levine, Loayza and Beck, 2000) emphasize the important role of legal and accounting status and reform for economic growth. A related strand of literature, e.g. Baele et al. (2004) and Giannetti et al. (2002), provide evidence that financial deepening and integration can boost economic output. Given the growing level of integration via foreign banks from the EU in the transition economies, this aspect should also be of relevance here.

Bank efficiency (measured by the net interest margin) showed a significantly positive and causal impact on growth, while this was not the case for credit volume. The latter finding can be attributed to the inclusion of laggard reformers from the Commonwealth of Independent States (CIS). Drakos (2003) provided an alternative explanation by arguing that high bank market concentration is negatively associated with economic growth in transition economies. For SEE, the empirical findings of Mehl and Winkler (2003) fail to support the hypothesis of positive and causal link between financial development and economic growth. They explain this as a failure of the reforms in the first half of the 1990s in SEE to prevent inflationary finance and financial crises.⁶ In some of these SEE countries the financial development, by introducing new reform steps,⁷ has just started so that the banking sector could not yet contribute to economic growth.⁷

Foreign bank entry in South-Eastern Europe

The creation of a full-fledged financial system is an integral and important part of a typical accession strategy. The financial sector has a special role, as it mobilizes resources and allocates them to those investments that are capable of generating the highest returns on capital. The better the financial sector can perform this role, the better the economy will perform in the long term. A sound financial sector improves the screening of fund-seekers and the monitoring of the recipients of funds, which improves allocation of resources. It encourages the mobilization of savings by providing attractive instruments and savings

² See in the following: Fink, G., Haiss, P. and von Varendorff, M. 2005, Foreign Bank Market Entry and Economic Development: The Case of Serbia, in: Chadraba, P. and Springer, R. (eds), Proceedings of the 13th Annual Conference on Marketing and Business Strategies for Central and Eastern Europe, Vienna

³ Penev and Rojec 2004

⁴ For recent reviews, see Blum et al. 2002 or Wachtel 2003. Lead effects of financial markets on economic growth were identified in several countries with Granger causality tests by Fink, Haiss and Hristoforova 2005. For a critique, see Rousseau and Wachtel 2005.

⁵ Rousseau and Wachtel 1998; Fink, Haiss and Vuksic 2004

⁶ For a deeper discussion of transition-specific effects in analyzing the finance-growth nexus, see Mehl and Winkler 2003, 4

⁷ Mehl and Winkler 2003

vehicles. This may also increase the savings rate. In the medium term, economies of scale in financial institutions lower costs of project evaluation and origination, and facilitate the monitoring of projects through corporate governance. Financial intermediaries provide opportunities for risk management and liquidity. They promote development of markets and instruments with attractive characteristics that enable risk sharing.⁸

The quickest way to bring the necessary management changes is to give the bank independence from the government through FDI in the banking sector. Privatization of state owned banks together with opening of banking institutions to foreign investors improves the performance of banking sectors in transition countries. A crucial element of the effective transition of SEE countries' banking systems is the privatization of state owned banks. Delays in the privatization process are due to government policy reluctance.⁹ There are several strategies to privatize banks: outright trade sales, sale by voucher, initial public offerings. Foreign banks bring with them stability and rapid improvements because of their know-how in marketing, risk management and information technology.¹⁰

Bonin, Hasan and Wachtel (2005) and Fries and Taci (2005) find that foreign owned banks are more cost-efficient than domestic banks in emerging markets. Besides providing stability and bringing „fresh money“, credit risk management techniques and improved corporate governance to these markets,¹¹ the strong involvement of foreign banks in the NMS, mainly from the old EU-15, also implies a growing integration of these financial markets into the EU-15's financial markets. Theory and empirical findings¹² suggest that integration of financial markets contributes to economic growth, which should equally apply to Turkey and the other Accession Countries.

The majority of cross-border Mergers & Acquisitions (M&A) in NMS's banking sectors took place between 1999 and 2002 with the peak reached in 2001. Since 2002 only very few primary M&A were registered in the NMS, reflecting the fact that most banks are now privatized and have a stable shareholdership.¹³

Now banks are increasingly looking at SEE. The banking sector in SEE 7¹⁴ is with total assets of EUR 100 bn about one-quarter the size of NMS's banking sector. GDP in SEE 7 (2005: EUR 165 bn) is about one-third of GDP of NMS. Foreign banks hold 72% of the SEE 7 market, a share overall similar to that in the NMS. Bank consolidation has not progressed as far as in the NMS. This is indicated by the higher number of banks in the region (224) compared to NMS (205), while having a smaller number of inhabitants and a lower volume of banking transactions.¹⁵ Foreign banks investing in SEE 7 are mainly from Europe. The top three in terms of market share are neighboring countries Austria, Italy and Greece. That suggests a similar strategy compared with foreign bank entry in NMS, namely to establish an ever-wider regional network.¹⁶

As most of the transition countries Bulgaria suffered from an economic and financial crisis in 1996/97.¹⁷ The crisis was a consequence of lending to essentially bankrupt state owned enterprises in the early 1990s, as well as a regional and sectoral focus, which reduced the banking industry's capacity to absorb shocks. Prior to the crisis the National Bank of Bulgaria was very restrictive concerning licensing foreign banks. First branches of foreign banks were

⁸ Wachtel 2001; Levine 1998

⁹ Stubos and Tsikripis 2004, 6

¹⁰ OECD 1993

¹¹ Buch, Kleiner and Zajac 2003

¹² e.g. Baele et al 2004; Giannetti et al 2002

¹³ ECB 2005, 17ff

¹⁴ SEE 7 countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and Serbia

¹⁵ Bruckbauer 2005, 6ff

¹⁶ Bastian 2003, 97

¹⁷ Gronkiewicz-Waltz 2006, 46

allowed only in 1994/95 and thus the banking market was opened very slowly to foreign competition initially.¹⁸

To overcome problems of corporate governance, inject managerial and technical know how and prudent bank management, majority bank ownership was also chosen as solution in the AC once initial hesitance was overcome, with market concentration remaining high. The market share of state owned banks in Bulgaria was above 50% until 1999; already in 2000 it fell under 20%. Market share of foreign owned banks grew steadily and reached a level of 70% in 2001 and is above 80% since 2003.

Croatia's state owned banks had a market share of almost 80% in 1996. Already the following year the share fell under 50%. Noteworthy is the development from 1999 to 2000. The share of foreign owned banks in Croatia grew from around 40% to 84%, while the share of state owned banks fell under 6%.¹⁹

In addition to a reform-reluctant political regime conflicts in the aftermath of Yugoslavia's disintegration hindered Croatia's banking sector from development and restructuring. Yugoslavia introduced a two-tier banking system already in the 1960s within the context of its special economic concept of market socialism. Unlike other transition countries Croatia already possessed a basic institutional and legal framework and market-like banking practices. But due to the political environment during the military conflicts on the Balkan Croatia was not able to leverage these advantages. First steps to restructure the banking sector, merely of a financial nature though, were taken within the framework of a linear rehabilitation program as a reaction to the National Bank of Yugoslavia freezing private foreign currency deposits.

These measures neglected the need to implement effective corporate governance structures. Soft budget constraints, moral hazard and bad debt legacy were some of the following problems. A second round of restructuring measures was launched by the Croatian National Bank. Continued difficulties in banking sector reforms, economic slowdown and a loss of confidence in emerging markets following the Asian and Russian crisis accumulated in a major banking crisis in 1998/99. As indicated in tables 5 and 6 only then the state withdrew from the banking sector.²⁰

Privatization of banks in FYR Macedonia is almost completed. Only 1.9% (2004) of the banking sector is state owned. Unlike in other AC (except from Turkey) the asset share of banks in foreign hands is low. FYR Macedonia is overbanked, that is indicated by 21 banks that are servicing a population of 2.1 mn. The banking sector is highly concentrated. Two banks (Komerrijalna banka a. d. Skopje and Stopanska banka a. d. Skopje) are controlling over 50% of total assets. Alike the situation in Croatia FYR Macedonia inherited a two-tier banking system. But the country's four commercial banks suffered from poor corporate governance. Due to banks' ownership structures connected lending and continued funding of loss-making enterprises was encouraged.²¹

In Romania reform of the banking sector started late compared to other transition countries in the region. The process of transition to a market-oriented banking system included an undercapitalized sector, bad debt problems and lack of market discipline. The following banking crisis was accompanied by the collapse of numerous banks. Only in 2003 the market share of state owned banks was under 40% for the first time.²² Market share of foreign owned banks was slightly above 60% in 2004 and generally grew slower than in Bulgaria and Croatia.²³

¹⁸ Gardo 2005a, 27f

¹⁹ Gardo 2005b, 34ff

²⁰ Gardo 2005b, 34f

²¹ Perrin 2005, 41ff

²² Gardo 2005c, 47f

²³ Gardo 2005a, 31ff

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