European Bank
for Reconstruction and Development

Financial structures to promote private sector development in south-eastern Europe

by Francesca Pissarides

Abstract

This paper investigates the extent to which the financial sector in south-eastern Europe (SEE) responds to the needs of the local private sector. It does so through an analysis of the sources of finance used by enterprises when making fixed investments, and by looking at the level of banking intermediation and the (lack of) development of the non-banking financial sector. Enterprises in SEE are found to rely mainly on internal funds to finance expansion. The degree of financial intermediation of which the local banking system is capable is far lower than in Western economies. The paper examines various characteristics of the financial sector to gain an understanding of this poor performance.

Keywords: financial sector, enterprises, south-eastern Europe.

Journal of Economic Literature Classification Numbers: N2, P3.

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An earlier draft of this paper was presented at the Informal Meeting on "Financial Sector Reform" of the Stability Pact Working Table on Economic Reconstruction, Development and Cooperation, in Athens, 2 April 2001. The author is grateful to Elisabetta Falcetti, Kurt Geiger, Maja Parnardzieva, Henry Russell, Peter Sanfey, Jerald Schiff and Anita Taci for comments provided on an earlier version. Nadezhda Aleshina provided conscientious and prompt research assistance, for which the author is also very grateful.

Working Paper No. 64 **Prepared in June 2001**

1. INTRODUCTION

The private sector has grown to become the major contributor to growth in almost all the countries of south-eastern Europe, but it still faces substantial obstacles and a difficult investment climate. Lack of finance, although not the most severe constraint affecting the entry, development and growth of private enterprises, is a particularly acute problem in spite of efforts made to alleviate it by governments, international financial institutions (IFIs) and donors.

Two elements contribute to hinder efforts made in the field of finance. First, finance alone is insufficient to support enterprise entry and growth. To maximise the benefits of financial structures, provision of finance should be accompanied by parallel efforts to improve the investment climate and by the creation of efficient support structures which would provide the much-needed advice to new entrepreneurs. Second, it is possible that the traditional instruments utilised in the past ten years in the region are not the most efficient or sustainable tools to deliver the funds made available by IFIs and donors to the nascent private sector.

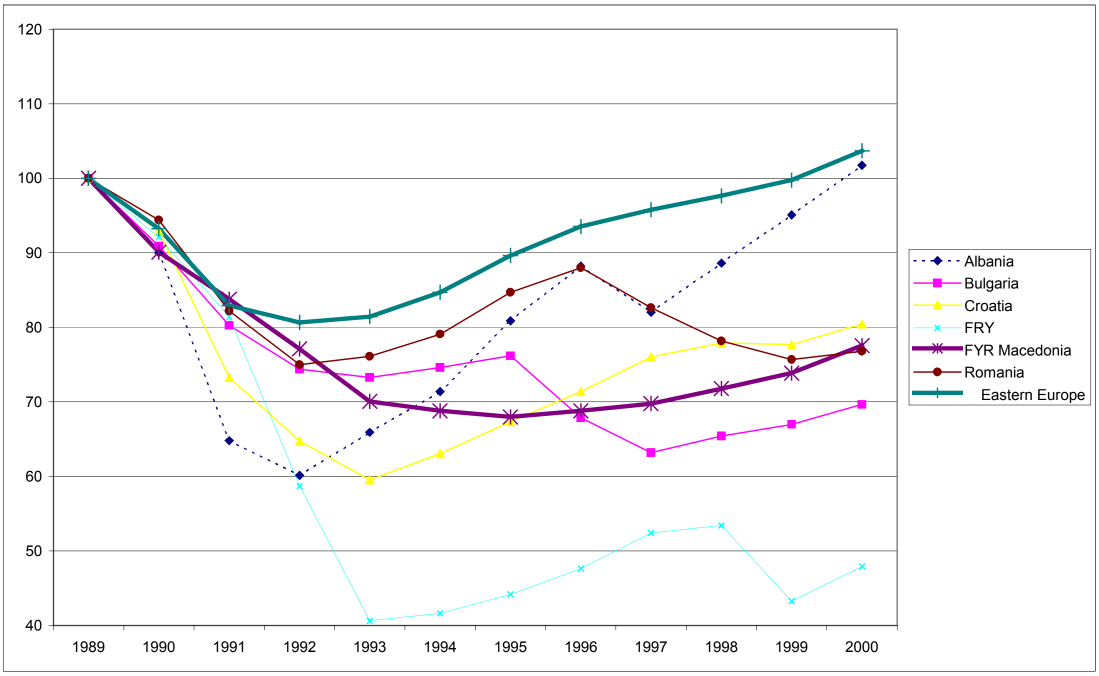
This paper provides an overview of financial structures available in south-eastern Europe to intermediate savings and to alleviate the financial constraint to the private sector. It focuses on Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Federal Republic of Yugoslavia, Former Yugoslav Republic of Macedonia and Romania, and identifies elements of success and areas of concern. The main conclusion is that the financial system in this region is failing to meet the demands of the private sector. Under-developed capital markets in these countries place the burden on banking sectors that in most cases still require significant reforms.

The paper is structured as follows. Section 2 provides an overview of economic developments and progress with structural reforms in the region and relates it to developments in the rest of eastern Europe. Section 3 relates findings of the EBRD/World Bank Business Environment and Enterprise Performance Survey on aspects of the investment climate, which affect enterprise performance and growth and on sources of finance available to the private sector. Section 4 analyses the financial structures currently available in the region. Rather than following a standard country-by-country approach, the analysis presents cross-country comparisons for individual aspects of the banking system. Section 5 concludes. An Annex provides an overview of financial intermediaries funded by IFIs and donors and comments on their effectiveness and sustainability.

2. BACKGROUND INFORMATION ON ECONOMIC DEVELOPMENT IN SOUTH-EASTERN EUROPE

South-eastern Europe is, and has traditionally been, the least-developed region of Europe, and during the past decade has been the slowest region in terms of progress in transition from command to market economy. More adverse initial conditions than in the rest of European transition countries and a highly distorted industrial structure have characterised the entry of each country of SEE in the transition process. The process itself appears to have been slower, more painful and fragile than elsewhere in Europe. From a macroeconomic point of view transition recession (interpreted as the collapse in GDP following the introduction of market reforms) has been twice as severe than in central Europe[1] and recovery has been far more sluggish (see Chart 1). Stabilisation has been a difficult target to achieve and many macroeconomic reversals have characterised the past ten years.

Chart 1. Index of real GDP



Source: EBRD.
Note: Weights are computed in US dollars from GDP in 1989 at PPP exchange rates. Eastern Europe also includes south-eastern Europe.

From a reform point of view the region has undergone a stop-go cycle, partly due to varying levels of governments' commitment to reforms and also to adverse political developments and economic crises. Despite good progress in the areas of liberalisation of trade, markets and foreign exchange systems, which have provided an initial impulse to private sector growth (see Table 1), many of the policy challenges of transition remain to be addressed in an effective manner. These challenges include the privatisation and restructuring of key industries, the imposition of financial discipline on enterprises and banks, and the establishment of legal and social institutions, which would support further private sector development.

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[1] EBRD (1999).

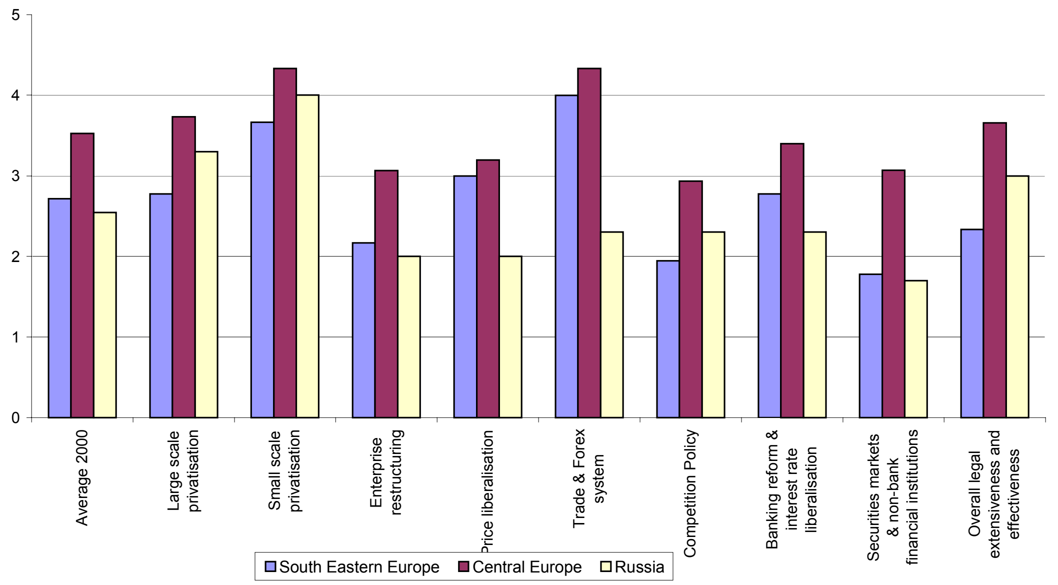
Table 1. Private sector share in GDP

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Albania	5	5	5	10	40	50	60	75	75	75	75
Bosnia and Herzegovina	na	na	na	na	na	na	na	na	na	35	35
Bulgaria	10	10	20	25	35	40	50	55	60	65	70
Croatia	15	15	20	25	30	35	40	50	55	55	60
FR Yugoslavia	na	na	na	na	na	na	na	na	na	na	40
FYR Macedonia	15	15	15	15	35	35	40	50	50	55	55
Romania	15	15	25	25	35	40	45	55	60	60	60

Source: EBRD, *Transition Report* 2000.

Chart 2 highlights the differences in progress of structural reforms between south-eastern Europe (excluding FR Yugoslavia), Russia and central Europe, measured in terms of "EBRD transition indicators". These are scores that the EBRD assigns to each country in which it operates for selected areas of reform.[2] They range from 1, which indicates little or no progress from a rigidly planned economy to 4+ (or 4.3), which represents a standard that would not look out of place in an industrialised market economy. With the exception of the areas of price, trade and foreign exchange liberalisation (where differences between SEE and central Europe are minimal, and where Russia is lagging significantly behind both regions), all other reform areas in SEE lag well behind those of central Europe, and are not too distant (in either direction) from those of Russia.

Chart 2. EBRD 2000 transition indicators



Note: Central Europa consists of the Czech Republic, Hungary, Poland , Slovenia and the Slovak Republic.
South-eastern Europe consists of Albania, Bulgaria, Bosnia, Croatia, FYR Macedonia and Romania

Source: EBRD.

[2] EBRD (2000).

3. INVESTMENT CLIMATE IN SOUTH-EASTERN EUROPE

Slow progress with market reforms is one of the causes of the very poor investment climate. Enterprise entry and development are fraught with difficulties and the private sector in general is facing considerable obstacles in doing business. During the past ten years, a large number of enterprise surveys has been carried out in the region with the purpose of reaching a better understanding of the difficulties met by enterprises in their day-to-day operation and during growth. For consistency's sake, this paper only looks at the results of the EBRD/World Bank Business Environment and Enterprise Performance Survey.[3] This survey has been implemented using the same questionnaire and methodology in all countries of the region (excluding FR Yugoslavia, which at the time was not an EBRD member country) and which was administered in the same recent period in all countries (1999-2000).

This survey's results allow us to isolate the areas that appear to be the main constraints to small and medium-sized enterprise (SME) development in south-eastern Europe. Policy instability is considered the most important obstacle to expansion by SMEs (whereas in the whole range of transition countries the main obstacle is considered to be taxes and regulation). Taxes and regulation (and in particular business licensing) are considered the second most important obstacle to doing business. The third most severe constraint is considered to be the lack of access to finance, and lastly, corruption (and slow bureaucratic procedures), one of the main factors contributing to keeping enterprises in the grey economy. In the areas where reforms have been introduced, often the ineffectiveness of the legal and regulatory framework hampers the everyday life of enterprises. Charts 3 to 8 show the relative weight of areas of constraints for SMEs and for large enterprises[4] in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania, as resulted from the Business Environment and Enterprise Performance Survey.

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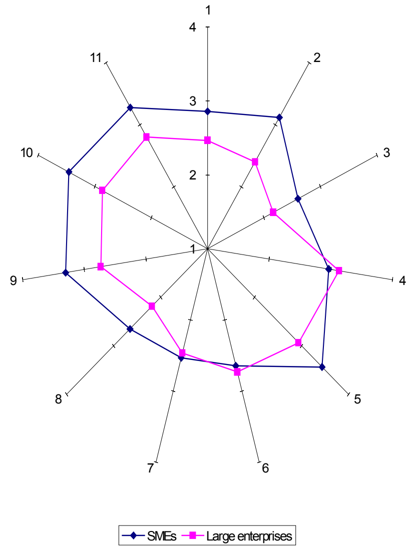
[3] In collaboration with the World Bank, in 1999-2000 the EBRD conducted a major enterprise survey on business environment and enterprise performance. Over 3,000 enterprises in 24 transition countries provided feedback. Samples of firms are stratified to attempt at being fairly representative of the economic structure of each country. Thus industrial and large enterprises are a minority of the enterprises surveyed. Managers of the enterprises were asked to evaluate the extent to which each aspect of the investment climate was an obstacle to operation and growth of their enterprise. A score of 4 represents a major obstacle, while 1 represents no obstacle. Summary scores for each country are calculated as the unweighted average for all firms in that country across all key elements of the investment climate. See EBRD (1999) for a more detailed analysis.

[4] Large enterprises are here defined as those enterprises with more than 200 employees.

ASSESSMENT OF THE INVESTMENT CLIMATE BY COUNTRY AND DIMENSION

Chart 3: Albania



Micro Environment

1 – Finance
2 – Taxes and regulations
3 – Anti-competitive practices
4 - Infrastructure

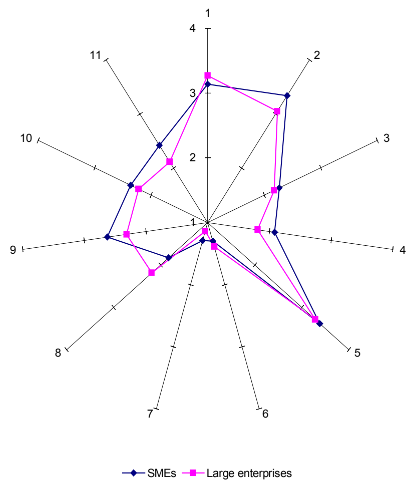
Macro Environment

5 – Policy instability
6 – Inflation
7 – Exchange rate

Law and order

8 – Functioning of the judiciary
9 – Corruption
10 – Street Crime
11- Organised crime

Chart 4: Bosnia and Herzegovina



Micro Environment

1 – Finance
2 – Taxes and regulations
3 – Anti-competitive practices
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Macro Environment

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7 – Exchange rate

Law and order

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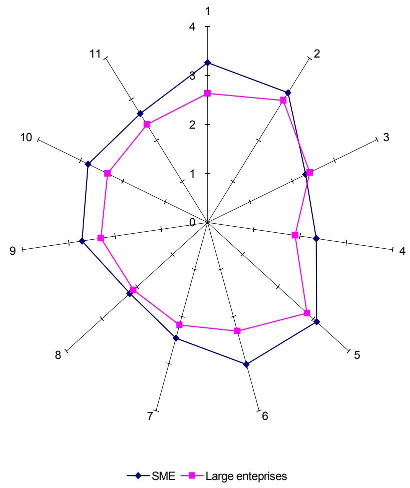
Chart 5: Bulgaria



Micro Environment
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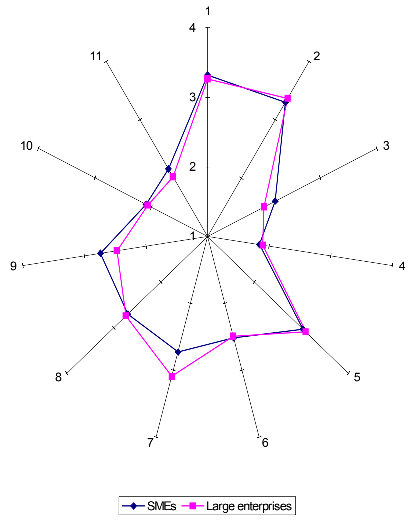
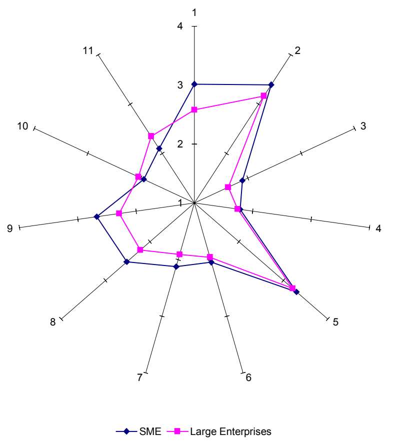
Macro Environment
5 – Policy instability 6 – Inflation 7 – Exchange rate
Law and order
8 – Functioning of the judiciary 9 – Corruption 10 – Street Crime 11- Organised crime

Chart 6: Croatia



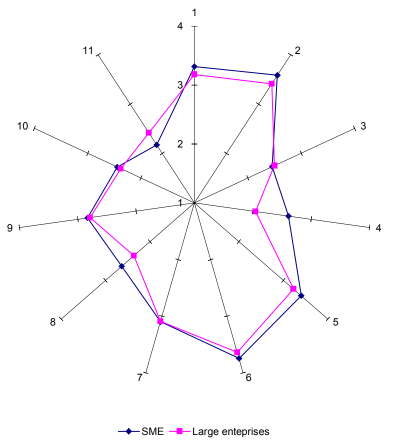
Micro Environment
1 – Finance 2 – Taxes and regulations 3 – Anti-competitive practices 4 - Infrastructure
Macro Environment
5 – Policy instability 6 – Inflation 7 – Exchange rate
Law and order
8 – Functioning of the judiciary 9 – Corruption 10 – Street Crime 11- Organised crime

Chart 7: FYR Macedonia



MICRO ENVIRONMENT
1 – Finance
2 – Taxes and regulations
3 – Anti-competitive practices
4 – Infrastructure
MACRO ENVIRONMENT
5 – Policy instability
6 – Inflation
7 – Exchange rate
LAW AND ORDER
8 – Functioning of the judiciary
9 – Corruption
10 – Street Crime
11- Organised crime

Chart 8: Romania



MICRO ENVIRONMENT
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One of the most important constraints facing enterprises (in relative terms the constraint is more binding for SMEs) in south-east Europe is access to capital. This is a constraint that affects entry, development and growth of small enterprises all over the world. However, a comparative analysis across regions[5] shows clear evidence that the severity of this constraint is much stronger in SEE than in other transition countries, including the Commonwealth of Independent States (CIS), for both private start-ups and state-owned enterprises. As a mirror image of this finding, reliance on own funds is also far greater in SEE than elsewhere in Europe.

The finance constraint affects small enterprises relatively more than it affects larger businesses, with the exception of Bosnia and Herzegovina where large enterprises appear to be affected marginally more by poor access to finance. A comparison among these countries also reveals that the finance constraint is relatively less binding in Albania than in the other economies. This result could most certainly be explained by the fact that Albania has traditionally been the recipient of substantial remittances flows, estimated to be equal to 20 to 40 per cent of GDP, and that its private enterprise sector has largely relied on these inflows to alleviate its financial needs. Charts 9 to 14 illustrate the financing sources used to make fixed investments[6] by enterprises in the countries of south-eastern Europe (except for FR Yugoslavia). Data underlying these graphs are based on the enterprises' responses to the Business Environment and Enterprise Performance Survey.

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[5] See chapter 8, EBRD (1999).

[6] The question asked was, "What proportion of the firm's fixed investment had been financed from each of the following sources over the past year?" The sources listed are: internal funds/retained earnings; equity, sale of stock; local commercial banks; investment funds/special development finance; foreign banks; family/friends; money lenders, traditional or informal sources; supplier credit; leasing arrangement; the state; other.

Chart 9: Albania financing sources for enterprises by size class, 1999.

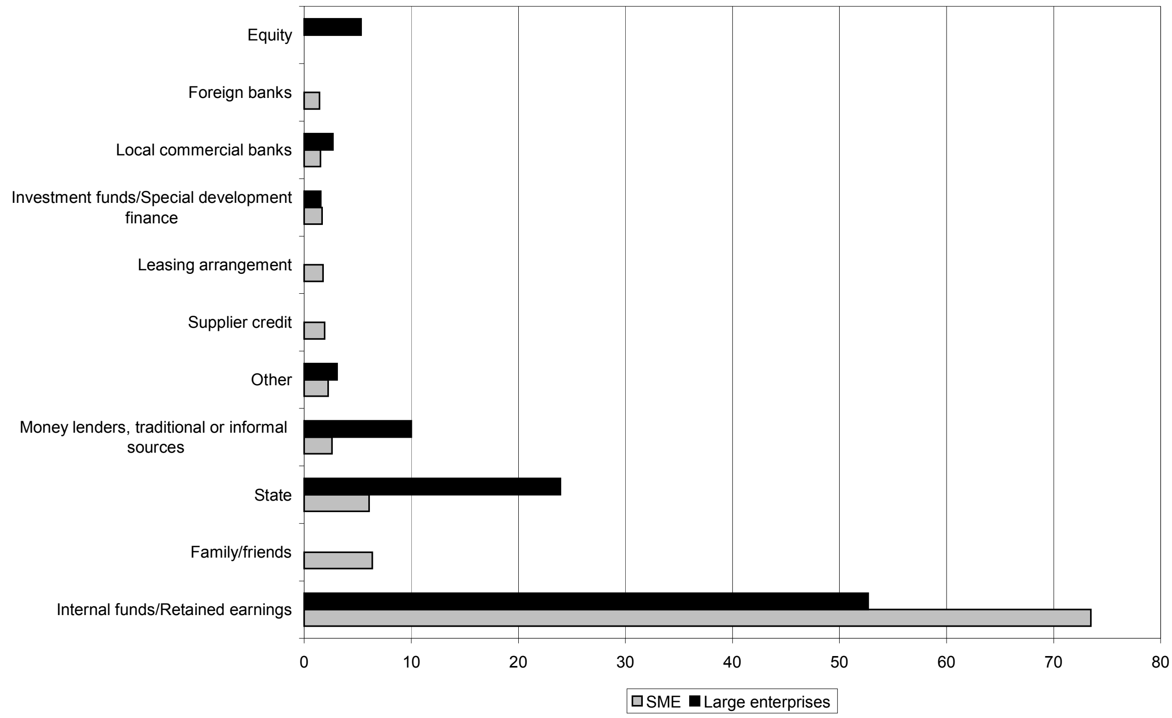


Chart 10: Bosnia and Herzegovina financing sources for enterprises by size class, 2000.

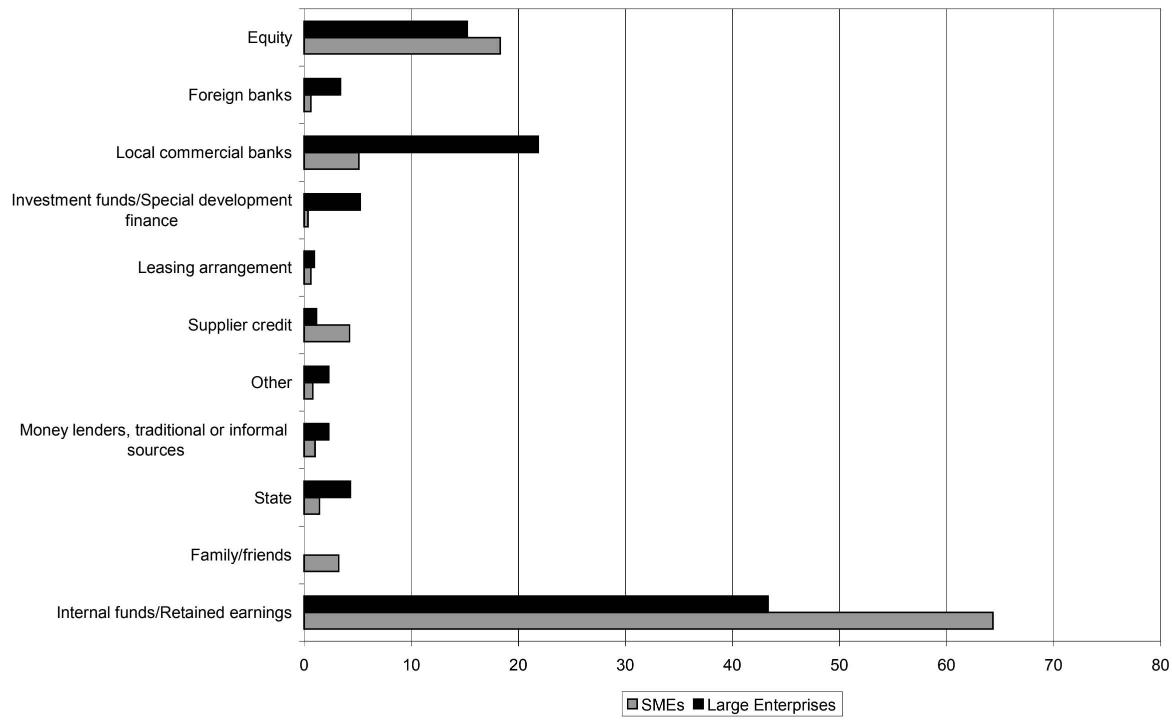


Chart 11: Bulgaria financing sources for enterprises by size class, 1999.

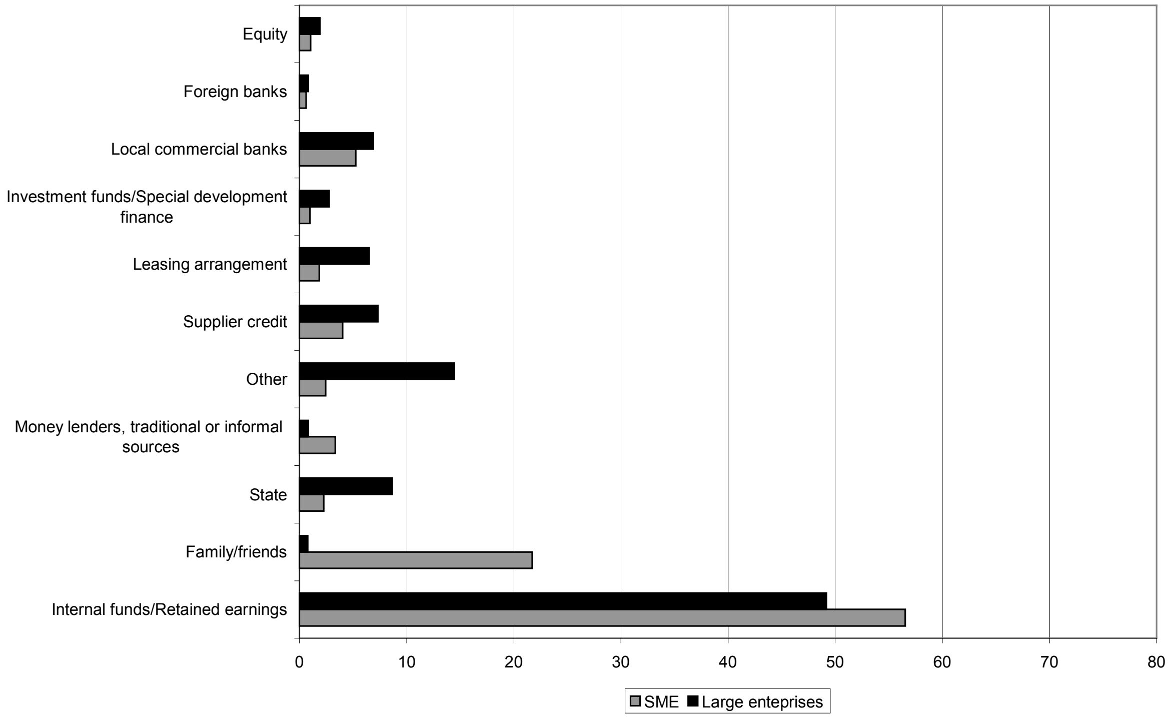


Chart 12: Croatia financing sources for enterprises by size class, 1999.

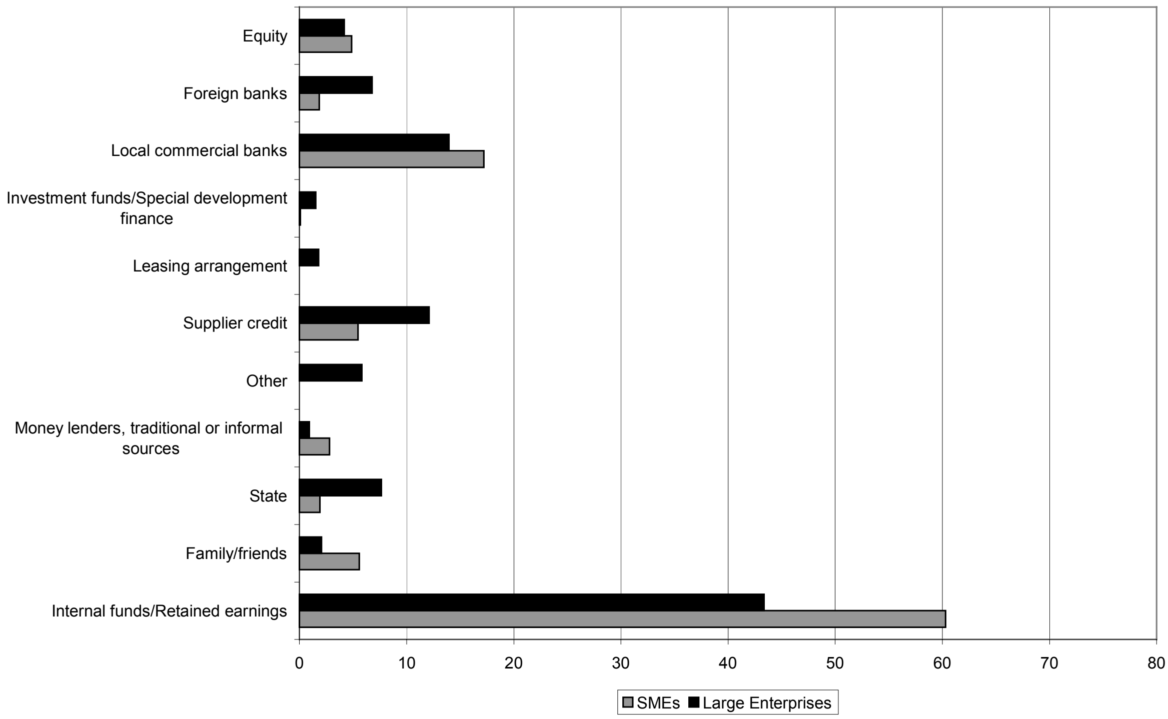


Chart 13: FYR Macedonia financing sources for enterprises by size class, 1999.

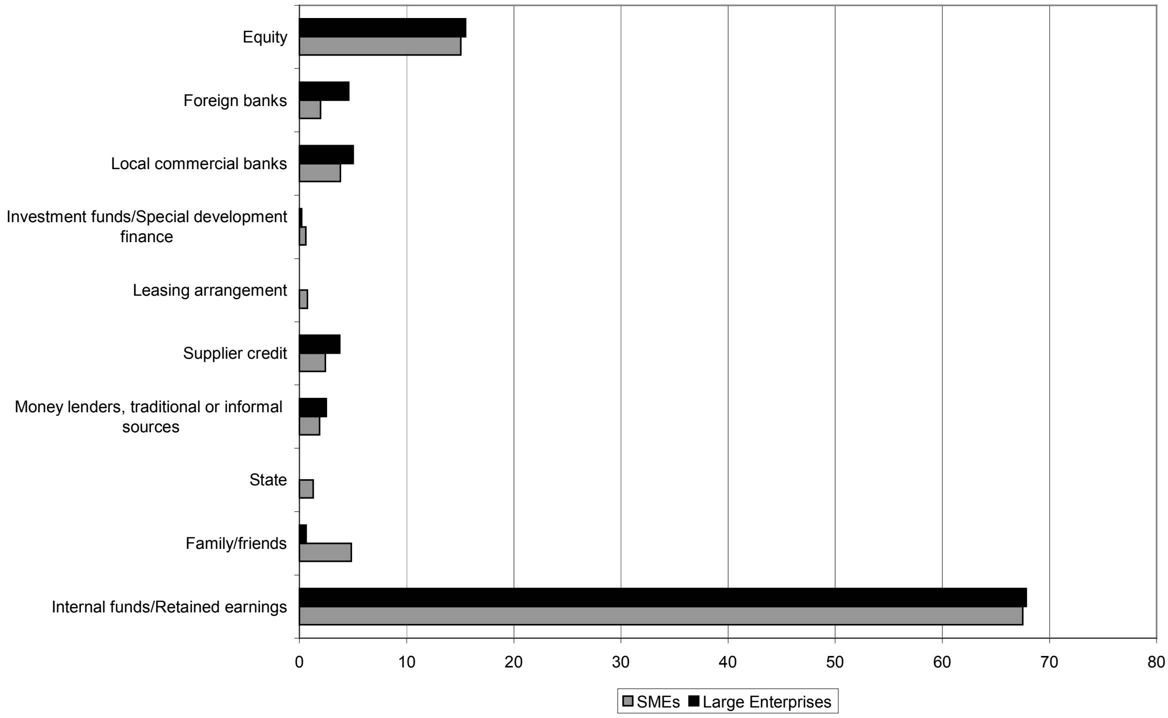
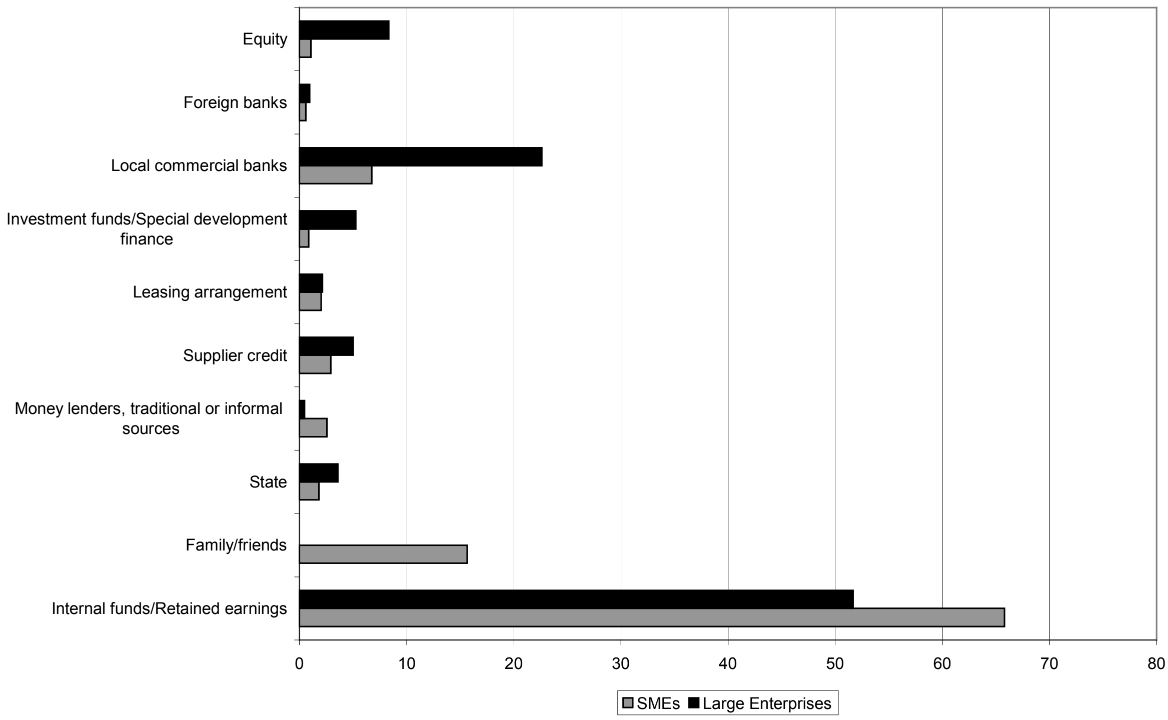


Chart 14: Romania financing sources for enterprises by size class, 1999.



Internal funds appear to be the main source of finance throughout the region for the enterprise sector, more in relative terms for the lower end of the enterprise size spectrum than for the upper end. In Albania and FYR Macedonia they appear to have a stronger role than in other countries of the region. The role of funds from family/friends appears to be relevant only for small enterprises. The role of local commercial banks is modest (and in Albania and FYR Macedonia almost irrelevant), and relatively more important for large than for small enterprises. This intuitive result does not hold for Croatia, where the reverse is true. Possibly this could be explained by the significant role that foreign banks have in Croatia in financing large enterprises. On the other hand, state financing in Albania is still an important source of funds for large enterprises (still all state-owned). Foreign banks appear to play no role in financing large enterprises in Albania and play only a very modest role in financing small enterprises. To a lesser extent large enterprises also rely on state financing in Bulgaria, Croatia and Romania. Equity also has a modest role and again is relatively more prominent for large enterprises, except once again for Croatia. Money lenders are relatively more important in Albania, where informal financial structures have always thrived (culminating in the development of the pyramid schemes, which collapsed in 1996-97). Finally, leasing arrangements are only relevant, albeit modestly, in Bulgaria.

4. FINANCIAL STRUCTURES IN SOUTH-EASTERN EUROPE

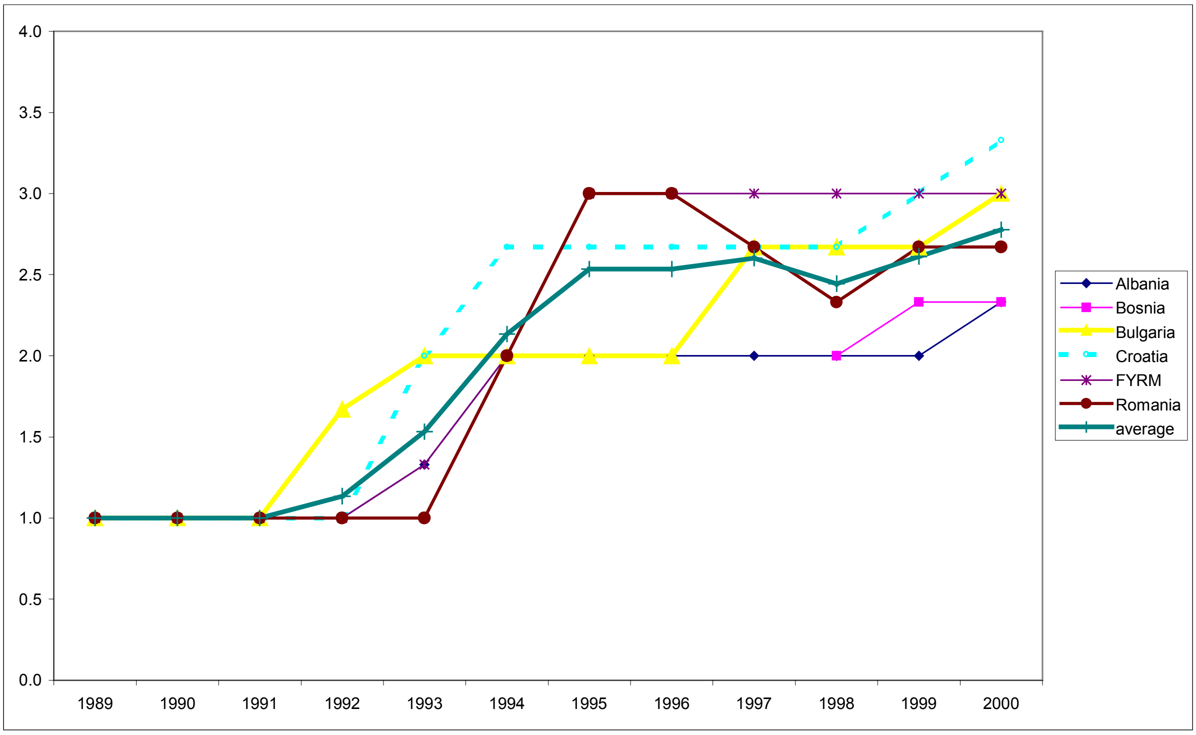
A common feature that characterises the financial sector in the region is the dominance of the banking system. Capital markets are still in their infancy and limited to equity markets.

4.1 THE BANKING SYSTEM

The pattern of reform and development of the banking sector has not been homogeneous. There are few elements which are common across the board. This makes attempts at generalisations rather arduous and common prescriptions in terms of policy recommendations inappropriate. In particular, different historical circumstances between the former Yugoslav republics and the remaining countries in the group are still evident in the persisting strong links existing between banks and enterprises in the former Yugoslav republics. Such links, which are not present in the remaining countries of the region, have not necessarily been effectively dealt with by the privatisation process and are in some cases still evidenced by the high level of related party lending. Chart 15 provides an attempt at summarising progress with reform in the banking sector, as interpreted by the EBRD Transition Indicators.[7] Transition Indicators have not been provided for FR Yugoslavia, which has only recently become a member of the EBRD. However, from preliminary analysis it would be fair to assume that the transition indicators for the Yugoslav banking system are lower than those of other countries in south-eastern Europe. The reform status for the banking sector of Croatia, FYR Macedonia and Bulgaria is above the average for the region and that of Romania, Bosnia and Herzegovina and Albania below the same average. It is also interesting to note that Romania experienced a reversal in its reform path during 1996-98, whereas the remaining countries appear to have never backtracked on reforms during the transition period. Table 2 provides some descriptive statistics for the banking sector in the region at the end of 1999. The text provides more up to date information, where available.

[7] In particular in the area of Banking reform and Interest rate liberalisation the scores can be read as follows. 1 = little progress beyond establishment of a two-tier system. 2 = significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings. 3 = substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks. 4 = significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises and substantial financial deepening. 4+ = standards and performance norms of advanced industrial economies; full convergence of banking laws and regulations with BIS standards; provision of a full set of competitive banking services. See EBRD (2000).

Chart 15: Pattern of reform in the banking sector



Source: EBRD.

Concentration

The local banking system in the countries of south-eastern Europe is generally characterised by a large number of banks, few of which clearly dominate the market. The assets of the top five banks in each country account for between 60 and 87 per cent of total banking sector assets. Bosnia and Herzegovina,[8] FR Yugoslavia[9] and FYR Macedonia[10] are still characterised by the presence of a number of either old "socialist" banks, or spin-offs from these (although some have been, or currently are, in the course of being privatised), and by a number of relatively new private banks set up during the 1990s. Of these new private banks, some were set up by groups of enterprises to respond to their specific financial needs and are still affected by interlocking ownership or financial linkages with these enterprises. Only a very small minority of these new banks have very diluted ownership structures, and attempt to provide banking services following market-based criteria. The rest can be classified as "agent banks" in that they mainly operate as treasury divisions of single enterprises (or groups of). Moreover, all the former Yugoslav Republics started their transition to a market economy endowed with a "centralised payment system" which relegated most payments functions and services, normally in the realm of banking, to special bureaux. In FR Yugoslavia these payments bureaux are still operational and in Bosnia and Herzegovina they have only recently been dismantled.[11]

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[8] IMF (2000a).

[9] Developpement et Finance International (2001).

[10] Drummond (2000).

[11] EBRD (2001).

Table 2. Descriptive statistics of the banking sector, end-1999.

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	FR Yugoslavia	FYR Macedonia	Romania
Number of banks	13	62	27	40	81	23	34
Of which majority foreign owned	8	3	14	13	0	5	19
Total bank assets (US$ billion)	1.8	3.1	4.2	10.6	11 (official exchange rate)	1.2	10
Assets of top five banks (% of total bank assets)	87	Na	63	62	60	71	67
% of bad loans (total loans)	51	Na	12	10.3	40-90	43	52.2
% of state assets (total bank assets)	81.6	77	48.9	39.6	> 80	23.2	50.3
Domestic credit (% of GDP)	45.3	45	18.6	39.2	19.3	22.2	19.4
Credit to enterprises (% of GDP)	3.6	3.6	14.6	22	19	11.3	10.5
Total bank deposits (% of GDP)	41.9	21.5	21.7	30	27	16.7	22.4
Equity (% of total assets)	6.6	Na	Na	11.2	< 0	20.7	21.4
Required capital adequacy ratio	12	8	12	10	8	8	12

Source: official estimates, as reflected in publications from the national authorities, IMF, and EBRD evaluations partly based on information from these sources.

Consolidation trends

Consolidation of the banking sector has been initiated, but it still has a long way to go. Through further privatisation, mergers and liquidation the number of banks is expected to reduce much further. A proper framework for the banks' exit is essential in this respect. In Bosnia and Herzegovina, where at the end of 1999 62 banks were operating, there were 57 banks left in March 2000, of which six were in receivership.[12] As part of the ongoing privatisation programme, a number of bank liquidations are expected as of mid-2001. Moreover, the increases in net capital requirements for banks scheduled in June 2001 for the Federation and in June 2002 for the Republika Srpska will provide a further impulse to consolidation of the sector.

In Croatia, with the expansion of its powers under the new Banking Law (in effect from December 1998), the central bank has overseen a period of bank consolidation. Bankruptcy procedures have been initiated against eleven banks and temporary administrators have been

[12] EBRD (2000).

placed in three others. Consolidation is also taking place through mergers and acquisitions. Erste Group of Austria has added to its initial investment in Bjelovarska Banka with recent acquisitions of Trgovacka Banka and Cakovecka Banka. Erste Group is now finalising the merger of these three banks, while Zagrebacka Banka acquired Varazdinska Banka in June 2000. The sector is now dominated by eight banking groups and they account for more than 80 per cent of total banking assets. In FYR Macedonia moves towards consolidation of the banking sector are expected to increase this year following the increased minimum capital requirements, which came into force in April 2001.

Entry of foreign banks

The south-east European economies have failed to attract substantial strategic foreign involvement during the past ten years. In Croatia and Bulgaria the recent spur of reforms managed to attract foreign investors and foreign-owned banks, which now account for 76 and 70 per cent respectively of total bank assets. However, the slow and cautious entry of foreign banks into the Croatian market has only produced small changes.[13] Competition has increased only mildly, and very few new products and services have been introduced by foreign banks.

In Bosnia and Herzegovina entry of foreign banks is continuing slowly with the total number of foreign banks reaching five in 2001. Their role in terms of intermediation of savings has so far been minimal. Following the entry of new foreign shareholders in the largest and third-largest Macedonian banks, Stopanska Banka a.d. Skopje and Tutunska Banka a.d. Skopje, the share of foreign capital went up from 19.3 per cent at the end of 1999 to 40.6 per cent at the end of 2000. The impact of foreign entry was immediately reflected in increased competition, with lending rates dropping from the high levels at which they had been in the past few years (20 to 25 per cent) by 5 to 7 percentage points.[14]

In Romania, majority foreign-owned banks now account for 44 per cent of sector's assets. Those foreign banks that have managed to enter the market, either by opening local branches or by investing in existing banks during their privatisation, show a tendency to favour extending credit to non-financial firms from their own countries. In the best of cases these banks serve the local blue chip companies. Mostly they concentrate efforts in expanding those areas of banking that generate fees and commissions, previously unexplored by domestic banks. The major extension of credit to the new private sector, and in particular to SMEs, derives not by using the banks' own funds but by managing credit lines of donors or IFIs. (See the Annex for an analysis of the impact of credit lines on provision of finance to the private sector.)

Ownership and progress with privatisation

A high degree of concentration was, until 1999, accompanied by a still high degree of state control in the sector. Privatisation and restructuring of the local banking sector, which, at the beginning of 1999 was still largely in state hands, is progressing well, with one exception, Romania. In 2000 Bulgaria and FYR Macedonia became the first countries of the region to virtually complete privatisation. In Albania, one of the two remaining state-owned banks, the National Commercial Bank, was privatised in June 2000. Privatisation of the largest bank, endowed with the widest branch network, the Savings Bank, is scheduled to commence in mid 2001. A privatisation advisor was appointed and the bank was fully recapitalised with treasury

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[13] Dolenec, et al. (2000).

[14] Inflation on an annual basis was 9% at the end of 2000.

bills at the end of 2000.[15] In Bosnia and Herzegovina, privatisation of the banks was first initiated in the Federation,[16] but needs to be replicated in the Republika Srpska (RS). By the end of October 2000 five banks had been offered for sale in RS and two in the Federation.

In Bulgaria, bank privatisation is almost complete, following the sale of 98 per cent of Express Bank to Société Générale and of 98 per cent of HebrosBank to the Regent Pacific Group in 1999, and the sale of Bulbank to a consortium led by Unicredito and Allianz in 2000. Completion of the ongoing sale of Biochim Bank would leave only the State Savings Bank in public ownership. In Croatia, the privatisation of the banks that have been taken into rehabilitation between 1996 and 1998 is almost complete. The share of assets of state banks and of private banks with more than 20 per cent state ownership dropped from 45.5 per cent in 1999 to 12 per cent in mid-2000. Remaining banks to be privatised are Dubrovačka Banka and Croatia Banka, for which privatisation plans have been prepared and Hrvatska Postannska Banka, for which recapitalisation is needed.[17] The privatisation of these large banks to foreign strategic investors is likely to further strengthen the system.

In FYR Macedonia the state sold its remaining shares in the largest bank, Stopanska Banka, in April 2000 to the National Bank of Greece, EBRD and IFC. At the end of 2000, 84 per cent of banking sector assets were in private hands. The sector is very concentrated, with some of the smaller banks unlikely to meet the new capital requirement, which came into force in April 2001. Privatisation in the banking sector in Romania has proceeded more slowly than in the rest of the region: around 40 per cent of the total assets of the Romanian banking system is still in state hands. The new government has, however, defined as priority the privatisation of two of the four existing state-owned banks, Banca Agricola and Banca Comerciala Romana. Banca Agricola has been recapitalised through the issuance of treasury bills and plans to privatise Banca Comerciala Romana have been announced for 2002.[18]

Soundness and financial performance

Restructuring of banks is progressing but the banks' financial performance is still very mixed, with the share of bad loans in total loans still very high (except for Bulgaria). Aggregate financial indicators frequently overestimate the soundness of the banking system, either because banks reporting is poor, or because valuation of assets is inflated, or because insufficient attention is paid to market risk, or because the level of required provisioning is below Western standards. Aggregate financial indicators also hide a degree of variance within the system, which, if exposed, would highlight further fragilities.

In Albania progress with restructuring has made headway with the accomplishment of the re-capitalisation of the Savings Bank, covering its negative capital, estimated at 2 to 2.5 per cent of GDP.

In Bulgaria following the 1996 financial crisis, with the introduction of stringent regulations which forced banks towards more conservative lending practices, the banking sector became liquid, solvent and profitable,[19] and the share of bad loans is now the lowest in the region. Total risk-weighted capital adequacy increased from 10.2 per cent in mid-1997 to 35.4 per

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[15] EBRD (2001).

[16] IMF (2001b).

[17] IMF (2001c).

[18] EBRD (2001).

[19] Ulgenerk and Zlaoui (2000).

cent by September 2000. However, the aggregate data for the sector as a whole hide a high variance in the financial performance of individual banks. As at the end of September 1999 nine banks recorded losses of various sizes. Also, loan-loss provision is not as high as required, which implies that profit data for the sector might be inflated.

In Croatia, an analysis of aggregate financial indicators indicates that the soundness of the banking system has improved since the 1998-99 financial crisis. This improvement is the fruit of a substantial reorganisation and recapitalisation of the system. Liquidity has improved and the system as a whole is profitable. The five largest banks all reported pre-tax profits in mid-2000. The ratio of non-performing loans to total loans has dropped only slightly from 10.3 per cent at the end of 1999 to 9.3 per cent at the end of 2000. Recovery of corporate debt remains difficult.[20] Over 90 per cent of all lending is indexed to the rate of depreciation against the Deutsche Mark. On the hypothesis that these borrowers are unhedged, the Croatian banking system may be vulnerable to a depreciation of the currency.[21]

In FR Yugoslavia the banking system used to be an important source of revenue for the government; directly, through extremely high taxes on banking services and profits, and indirectly through financial mechanisms such as high minimum reserve rates. Moreover, it was used to provide quasi-fiscal subsidies to loss-making enterprises. Not surprisingly, the financial performance of the sector as a whole suffered. The August 2000 report of the FR Yugoslavia Banking Association describes "an extremely dynamic and high growth of irrecoverable receivables and expenditures of indirect write-offs of bank investments".[22] Official figures place 29.5 per cent of all outstanding loans in FR Yugoslavia as in arrears, with provisions only sufficient to cover under 60 per cent of their amount. However, it is likely that the loan-quality issue is much more severe than official data indicate. It is believed that between 40 and 90 per cent of all outstanding loans are irrecoverable. This means that the capital base is much thinner than the capital adequacy ratio indicates in the FR Yugoslavia banking system. The Banking Association, based on its calculations of underprovisioning, considers 30 per cent of the equity as at risk. Yet, if the quality of assets were properly accounted for, it is likely that the banking system as a whole would turn up as having negative equity, as the required level of provisioning is far higher than what the banks have been reporting.

In FYR Macedonia, despite the advanced stage of privatisation, corporate governance in banks is not satisfactory. As a legacy of a past which saw the banks supervised by Boards on which the largest borrowers were represented, the banking system is affected by a large amount of related party lending and large exposures to single debtors. Regulations are not sufficiently tight to effectively contain net lending to shareholders. As a result, the quality of the loan portfolio is very poor with non-performing items (loans classified as C, D and E) standing at 37.3 per cent of total loans at September 2000. The quality problem is much higher for a group of seven banks, which had more than 50 per cent of their credit exposure classified at the end of September 2000. Total loan loss provisions accounted for 40 per cent of total classified exposure at the time, down from 50 per cent at the end of 1998 and 65 per cent in 1997.[23] This reflected underprovisioning by some banks (the large Stopanska Banka and the smaller Almako Banka). Moreover, allocated provisions being calculated on the basis of

[20] IMF (2001c).

[21] IMF (2000c).

[22] Developpement et Finance International (2001).

[23] Drummond (2000).

collateral are likely to be inadequate, given that market value of collateral is likely to be lower than its book value. Measured capital asset ratios overestimate the true level of capitalisation of the system. The high capitalisation ratio points at unallocated provisions due to the misclassification of credit exposures.

In Romania, with the closure of Bancorex in July 1999 and the restructuring of Banca Agricola, the financial performance of the banking system has improved,[24] with the share of non-performing loans falling by one half in 1999 to (the still high) 37 per cent of total loans of the banking system. As a consequence of the increased minimum capital adequacy requirements being reduced from 8 to 12 per cent in 1999, the resolution of a large share of existing non-performing loans and a significant recapitalisation effort, the ratio of bank capital to assets increased from 10.3 per cent in 1998 to 21.4 per cent in 2000. However, these ratios overstate the solvency of banks, as banks' assets are improperly valued and not enough attention is paid to market risk.[25]

Intermediation

The average degree of monetisation of the SEE economies, as can be seen in Table 3, is extremely low, roughly half of the US level and 45 per cent of the European level. The banking system of SEE provides respectively about one-third and one-fifth of the credit provided by the US and Euro area banking systems. These two sets of indicators portray a very underdeveloped banking system.

[24] EBRD (2000).

[25] IMF (2000f).

Table 3. Monetary and banking intermediation indicators, 1999.

	M3/GDP, in per cent	Domestic credit / GDP, in per cent
Albania	57.9	45.3
Bosnia and Herzegovina	26	45
Bulgaria	32.3	17.4
Croatia	39.7	39.2
FR Yugoslavia	46.1	19.3
FYR Macedonia	21.5	22.2
Romania	25.7	19.4
SEE	35.6	29.7
USA	70.3	83
Euro Area	78.2	138

Source: IMF (2000b) and EBRD.

The impact of the backwardness of the SEE banking system on the real economy is actually even worse than is depicted in Table 3. Credit to the enterprise sector in SEE accounts, on average, for 12 per cent of GDP versus 105 per cent of GDP in the Euro area. Even where privatisation and restructuring have made headway, the capacity of intermediation of the banking system in the region is poor, with credit to the enterprise sector ranging from a meagre 4 per cent to 22 per cent of GDP. Even where some modest growth of bank credit to the enterprise sector has been recorded, rarely do banks manage to meet enterprise needs in terms of maturity and collateral requirements. Shortage of funds, lack of credit skills, unavailability of good lending opportunities, poor and/or deteriorating loan portfolios are among the many factors responsible for a low level of bank credit to the private sector. Sometimes a relatively high level of bank credit to enterprises, with respect to GDP, hides a high level of insider or related party lending. Moreover, enterprises at the very low end of the size class spectrum are rarely recipients of bank credit outside very specialised programmes funded by IFIs and donors. Banks exercise resistance to entering what is generally perceived as the riskiest segment of the enterprise sector.[26]

The low level of confidence in the banking sector in SEE partly accounts for the low degree of lending to the private sector. A poor deposit base, as measured by total bank deposits as a percentage of GDP, of 26 per cent on average badly compares with the Euro Area 84 per cent.

The Albanian banking sector only provides very minor loan finance to SMEs outside dedicated credit lines. Overall, the enterprise sector only benefits from a very small amount of bank loans (3.6 per cent of GDP at end 1999). What is provided is mainly working capital finance, on the back of very high collateral.

In Bosnia and Herzegovina, domestic banks, apart from the management of dedicated credit lines, suffer from an acute shortage of funds. Credit to the enterprise sector in relation to GDP is as low as it is in Albania, at the very bottom of the countries of the region. Traditionally banks offer short-term working capital loans at relatively high interest rates, with loan terms of 3 months or less, and real interest rates as high as 2-3 per cent per month. The high levels of political risk, shortage of bank equity capital and very low levels of consumer term deposits

[26] See the Annex for a discussion of the merits and limitations of micro-finance activity in the south-east European region.

are among the most important factors underlying the inability of domestic banks to serve the financial needs of private enterprises.

Although the health of the banking sector has improved substantially since the crisis in 1996, Bulgarian financial institutions are not yet fulfilling their function as financial intermediaries.[27] The management of much of the banking sector is inexperienced in the core activities of making credits within a market economy (in the areas of project evaluation, risk assessment and monitoring) and the sector has been experiencing excess liquidity and falling economy-wide investment levels. In addition, the collateral law and its conservative interpretation by the Bulgarian National Bank, while altogether ruling out unsecured lending, have also prevented the development of mainstream forms of lending such as receivable financing. The resolution of financial disputes is frequently very slow and contract enforcement is weak. The banks operate in a difficult environment; good lending opportunities appear to be limited and the competition from foreign banks for the best customers is increasing. This has resulted in excess liquidity in the system with banks investing surplus funds in government securities and short-term placements. It is likely that increased intermediation will take hold once creditors' rights are more firmly established and corporate governance improved.[28]

In 1999 lending had come to a virtual halt in Croatia, following the 1998/1999 banking crisis. As a result domestic credit fell from 43.2 per cent of GDP in 1998 to 39.2 per cent of GDP in 1999. At the end of 2000, domestic credit as a percentage of GDP was still below 1998 levels. Credit to enterprises dropped also from 26.5 per cent in 1998 to 22 per cent of GDP in 1999. Croatian banks face significant information problems that affect their ability to assess the creditworthiness of their clients. They still do not know whether their clients have loans from other banks and, if so, whether they repay them. The 1998 Banking Law provided for a central credit register to be set up, but this has not yet materialised. A recent survey[29] on banks lending policies reveals that 77 per cent of banks believe that households are better repayers of loans. Moreover, over 40 per cent of Croatian banks do not yet have either risk management or quality control.

In FR Yugoslavia, credit to the enterprise sector as a percentage of GDP is relatively high at 19 per cent, if compared with the other countries in the region. However, there are signs to indicate that credit to enterprises is dominated by insider lending and fiscal adjustments (subsidised loans to socially owned enterprises disguised as credits). Despite the presence of a rule which decrees that the total volume of all large loans (i.e., all loans greater than 10 per cent of the bank's equity) must not exceed 80 per cent of the bank's equity, in September 2000 this amounted to 313 per cent of bank equity. The rule is much stricter than the corresponding rule in EU countries, where the limit on large loans is 800 per cent of a bank's equity. However, in contrast to EU standards, there is no rule limiting insider loans, which in EU countries must not exceed 25 per cent of bank equity.

In FYR Macedonia in 1999, domestic credit to the enterprise sector amounted to 11.3 per cent of GDP. The poor quality of the loan portfolio resulted in very high costs of intermediation. The risk burden has therefore been shifted into higher interest rates, penalising new and good

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[27] Lending to the private sector in 1995 used to be relatively high at 20% of GDP. Currently it amounts to 14% of GDP. This is low compared with the average for all transition countries, 17% of GDP, to that of USA, 49% of GDP, and UK, 120%.

[28] IMF (2001d).

[29] Kraft et al. (2000).

borrowers and distorting credit allocation. Moreover, the banks have provided credit at preferential rates to bad debtors. This constitutes an effective tax on viable enterprises and *de facto* reduces the number of total loan applications. Official data for the period 1997 to 1999 shows an increased share of assets as being allocated to credit for non-banks. This however is mostly due to accounting changes.[30] Banks have extended credit to enterprises in the past few years mostly through off-balance-sheet activities that have come on balance. These activities include denar and foreign currency advances for letter of credit transactions issued in previous periods, or receivables from payments made on behalf of banks' clients stemming from banks' guarantees. Increased competition from foreign-owned banks is expected to have a beneficial impact on intermediation levels.[31] Interest rates for corporate loans have dropped already since significant foreign entry in the sector in 2000.

The Romanian economy has been characterised by an excess of liquidity in banks and a shortage of liquidity in the real sector. Excess liquidity has been traditionally drained from the system by the central bank (National Bank of Romania - NBR) in the form of highly priced short-term deposits. These short-term deposits earned a yield far above that of bank's lending rate to enterprises. Faced with much higher returns on NBR deposits and Treasury securities, banks have substantially reduced new lending. Liquidity has also been concentrated in some banks, (e.g., Banka Comerciala Romana and Romanian Development Bank) while others have suffered from chronic liquidity shortage (e.g., Bancorex and Banca Agricola). Given the status of financial markets and intermediation, it is not easy to find opportunities to raise capital in Romania. SMEs are affected by the lack of funds even more than large enterprises, as banks prefer to lend to the latter from a risk consideration. At the end of March 1999, only 20 per cent of local currency credit to non-government economic agents (including households) was of medium- and long-term tenor. Meanwhile non-government credit in local currency represents an estimated 35 per cent of total non-government credit; the balance being credit denominated in convertible currencies. Total indebtedness of the Romanian enterprise sector (defined as the sum of their foreign indebtedness and indebtedness to domestic banks) in 1998 was equivalent to 29 per cent of GDP, and only 20 per cent of the population have bank accounts.

Banking supervision and legal and regulatory environment

Despite improvements in the legal and regulatory environment and in the field of banking supervision, which, almost everywhere, followed financial sector crises, there is still a long way to go in order to reach acceptable Western standards and eliminate the spectre of further crises, which would inevitably undermine the already weak confidence in the local banking system.

In Albania, the legal and regulatory environment was substantially strengthened following the conclusion of civil unrest which stemmed from the 1997-98 collapse of the pyramid schemes. The establishment of an information credit bureau has been postponed until the end of 2001, reflecting delays in finding a consultant. A new law on deposit insurance is expected to be approved in early 2001.[32]

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[30] Drummond (2000).

[31] IMF (2000e).

[32] IMF (2001a).

In Bosnia and Herzegovina, banking supervision is improving,[33] thanks to the substantial technical assistance provided mainly by USAID. The banking supervision agency in the Federation is very active in closing insolvent banks and intervening in banks facing problems. As a result, the licences of several privately owned banks have been withdrawn. The independence of supervising agencies in both entities has been improved by granting immunity to their staff from prosecution for actions related to the conduct of their official duties. A new deposit insurance scheme was started in four banks in the Federation in February 2001.[34]

In Bulgaria, since the introduction of the 1997 banking law and its related prudential requirements, violations of major prudential requirements (capital adequacy, loan concentration to single borrowers, open foreign currency position) have been far rarer than in the past. A central credit registry started operating in October 1999. Bulgarian banks are in full compliance (in some cases largely compliant) with 23 out of 25 Basle Committee Core Principles.[35] Since January 1999 a self-financing deposit insurance system has been in place (it funds itself by collecting a levy of 0.5 per cent of end-year deposits of the banking system).[36] However, links between this fund and the central bank are not transparent and as the Deposit Insurance Fund does not have supervisory powers, it cannot refuse entry to any bank to the scheme. A draft law on bank bankruptcy which clarifies the Fund's powers with respect to bank liquidation has recently been submitted to parliament. Areas for further improvement include: consolidated reporting of certain prudential ratios; adoption of IAS standards by all banks; stricter rules for valuation of some types of collateral; rules and capital charges for market risks; policies for country risk exposure of banks. Technical assistance is supporting improvements of off- and on-site supervision capability. Bankruptcy and liquidation procedures remain hindered by ambiguity and uncertainty.

In Croatia, following the 1998 crisis, a new banking law strengthened the central bank's enforcement and regulatory powers and increased the responsibility of the banks' supervisory boards. It also introduced a mechanism for timely response to failing and insolvent banks and established the institution of a temporary administrator. This regulatory framework allowed the Croatian central bank to deal with problem banks,[37] which at the time of introduction of the law accounted for 25 per cent of total banking sector assets. It also allowed the central bank to take preventive action in the case of weak but solvent small banks. Three important issues remain to be dealt with. First, accounting and prudential rules need to be further developed and enforced, (such as is *fit and proper*, *know your customer* and *value at risk* rules). Second, banking supervisory capabilities need to be further strengthened. Lastly, the deposit insurance system needs to be improved.[38]

In FR Yugoslavia regulatory standards are sometimes stricter than in western economies, however, compliance with statutory ratios is very poor. In some cases even when it appears that regulations are being adhered to, weaknesses in other banking rules makes compliance

[33] IMF (2001b).

[34] EBRD (2001).

[35] Ulgenerk and Zlaoui (2000).

[36] World Bank (2001).

[37] IMF (2000d).

[38] Unfunded deposit insurance liabilities from the banks that failed during the 1998/99 crisis amounted to 2% of GDP. The government took over these liabilities and honoured the obligations.

irrelevant. This is the case with the capital adequacy ratio. Figures appear very good, but the reliability of this ratio as an indicator of soundness of the banking system is virtually unimportant given that provisioning requirements are poor and their monitoring is weak. Banking supervision is lacking. During the past few years, central bank decisions against intervention, even in cases in which commercial banks clearly violated existing banking regulations, highlighted its complete lack of independence from the government. However, the situation is expected to improve significantly now that a reformist government and central bank governor are in place.

In FYR Macedonia, despite recent steps to improve the legal environment and strengthen supervision capacity, weaknesses still exist in ensuring timely compliance with banking laws and regulations. Off-site monitoring and supervision still require substantial efforts. The existing legal framework for creditors' rights needs amending in order to foster the development of banking sector intermediation. Under current bankruptcy legislation, courts can delay the start of bankruptcy proceedings and enforcement of collateral requires prior court approval. Mortgage legislation does not facilitate foreclosure in those cases where real estate is used as collateral. Also, under collateral legislation, security cannot be given over a changing pool of assets such as inventories, and accounts receivables based on a general description of assets. These elements make it very difficult for small enterprises to meet the collateral requirements for banking finance. A Deposit Insurance Fund was set up in 1999 and new legislation passed in 2000 made it state-backed.

In Romania, the significant improvements in the regulatory system over the last three years constitute only the very first steps in the right direction. In particular, the legislation on problem banks is still inadequate. It is the courts which determine the insolvency of a bank rather than the central bank. Procedures to initiate bankruptcy are cumbersome and ineffective. As a result banks' exits have been slow. Regulations targeting the management of the exchange rate risk are still under preparation. Current regulation takes into account the overall position, but disregards intra-day positions and limits on specific currencies. Related reporting requirements are also below international standards. More work is also needed on the regulation of bank liquidity. The Deposit Guarantee Fund, set up in 1996, before the banking system had been cleaned-up, has proven to be a financial disaster.[39] Its funding base has been insufficient to repay depositors of failed banks and the Fund had to resort to borrowing from the central bank. It is estimated that even in the absence of more banking closures, it will be years before the Fund completes repaying its debt to the central bank and starts accumulating reserves again.

4.2 NON-BANKING FINANCIAL SECTOR

Non banking financial markets in the region are still at a very early stage of development, both from an institutional and regulatory point of view and from an asset volume point of view. Their role in intermediation of savings is virtually irrelevant. Progress with reforms has been slower and far more patchy than in the banking sector. Chart 16 describes the reform pattern as measured by the EBRD Transition Indicators. Scores assigned to each country range from 1 to 4+, with 1 indicating little or no change from a rigidly planned economy and a 4+

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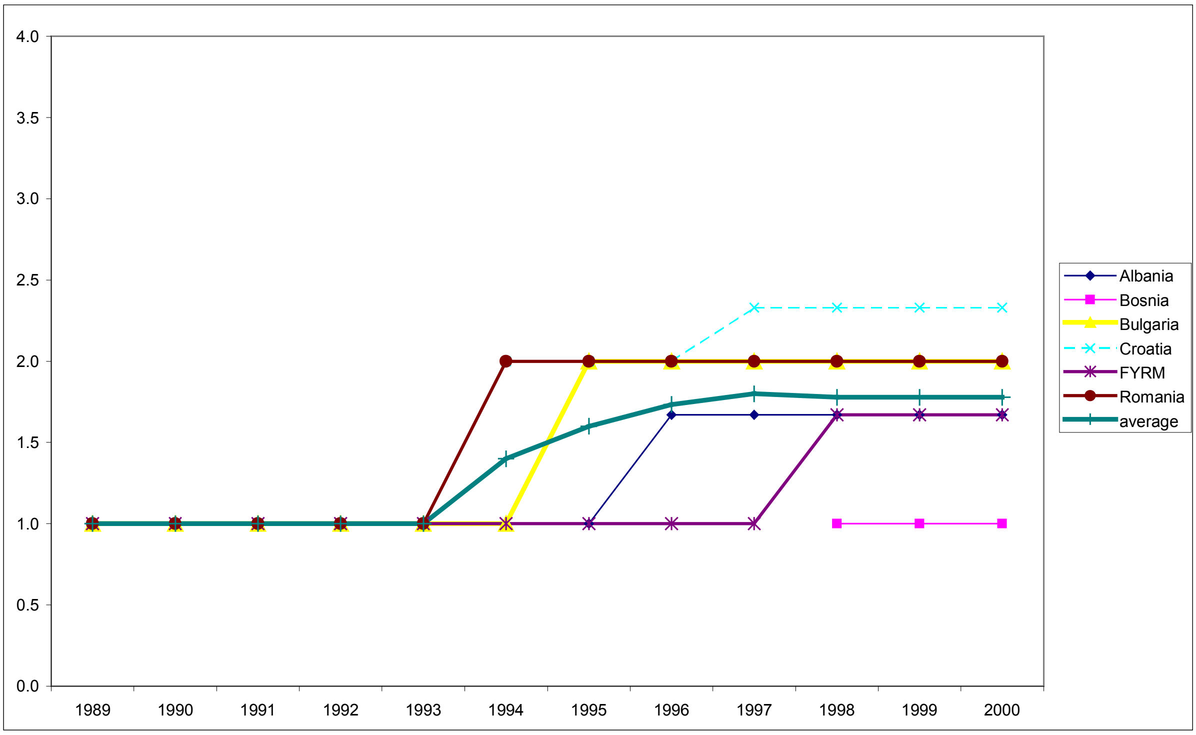
[39] IMF (2000f).

representing a standard that would not look out of place in an industrialised market economy.[40]

In 1996 a stock exchange was established in Albania. Trading has been negligible and only treasury bills and government bonds are traded.

In Bosnia and Herzegovina the insurance sector is characterised by a large number of severely undercapitalised players and dominated by a large state-owned company. The insurance companies' past record of honouring their obligations is poor and risk management is inadequate. Supervision is lacking. There is no stock exchange. However, some companies undergoing privatisation issued shares. These need to be reported to the Federation Securities Commission.[41]

Chart 16: Progress of reforms in the non-banking financial sector



Source: EBRD.

[40] Particularly in the area of securities markets and non-bank financial institutions, the scores can be read as follows: 1 = little progress. 2 = formation of securities exchanges; market-makers and brokers; some trading in government paper and/or securities; and rudimentary legal and regulatory framework for the issuance and trading of securities. 3 = substantial issuance of securities by private enterprises; establishment of independent share registries; secure clearance and settlement procedures; and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework. 4 = securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation. 4+ = standards and performance norms of advanced industrial economies; full convergence of securities laws and regulations with IOSCO standards; and fully developed non-bank intermediation.

[41] Gomel (2001).

In Bulgaria a stock market was set up in 1997 during the first wave of mass privatisation. A large number of companies are listed on the BSE, but many of the small companies are not traded at all. Total market capitalisation is low and estimated at BGN 1.1 million (US$ 0.6 million). Only half of these shares are not held by the government. High commission rates for trading and unfavourable capital gains taxation on privately held securities have resulted in a 30 per cent higher volume in trading of listed companies outside the stock exchange. The presence of off-exchange trading raises serious issues about transparency of market pricing. Turnover is very low and managed by a handful of intermediaries. The first corporate bond issue was offered in 1999. On 1 January 2001 the new law on Public Offerings of Securities became effective and brought the regulation of securities markets in line with EU standards.

The insurance sector is undergoing consolidation and is subject to new and more stringent regulations. It is still dominated by the state-owned insurance company. Activity in the sector is low due to poor past performance, in terms of honouring obligations, and low income levels. The sector has started to become attractive to foreign investors, following the introduction of the new regulatory system.[42]

Bulgarian accounting principles are being reformed to meet EU-IAS requirements. Bulgarian banks are also in the process of adopting IAS accounts and standards. The framework for external auditing of public companies is in place.

The supervision of pension funds, whose assets are estimated at US$ 15 million, has started to be addressed by the 1999 legislation on supplementary voluntary pension insurance. However, a large number of still unregulated financial companies operate in the fields of portfolio management, investment advice, investment holding and leasing.

In Croatia the insurance sector has been growing fast, dominated by the state-owned insurance company. Competitiveness of the market is good, despite this company's dominant position, and four foreign-owned insurance companies are also operating in Croatia.

The Zagreb Stock Exchange has been in place since 1991, but has not developed significantly. 89 stock (all of privatised companies), 10 preferred equity issues, 1 corporate bond (of a large bank) and 38 deep discount bonds are listed on the ZSE. Trading volume is very small and concentrated on 10 listed companies. The market is lacking good quality financial products. Capitalisation was around US$ 2.4 billion in September 2000. The securities market infrastructure and regulatory system are in place. The Securities Depository Agency has recently been set up to handle clearing and settlement transactions. The Croatian Securities and Exchange Commission (CROSEC) has been established to provide prudential regulatory oversight for the development of the securities markets as an outlet for the shares of privatised companies. Markets have so far been able to attract only primary trading. Secondary market trading is low. Regulatory enforcement needs to be constantly upgraded. There are a few concerns on the property ownership rights and their definition in the laws, especially under the company laws.[43] Enforcement authority is one of the most important areas for improvement for CROSEC.

In FR Yugoslavia the consolidated balance sheet of all commercial banks accounts for 78 per cent of the balance sheet total for the commercial banks, the central bank and all other financial institutions. Bond markets and stock exchanges are severely underdeveloped.

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[42] Ulgenerk and Zlaoui (2000).

[43] USAID/Croatia (2000).

The Yugoslav insurance sector is predominantly based on motor, third party, fire & theft, with little life business. The market is by and large controlled by two large state-owned companies. The state pension fund is estimated to be bankrupt.

The Macedonian Stock Exchange was set up in 1995.[44] It is still largely irrelevant for trading companies as an institution through which they may raise additional capital.[45] It is regulated by the Security Exchange Commission, set up in 1997. A new legal framework for securities was enacted in July 2000. There are eight brokerage houses active in FYR Macedonia and five insurance companies, supervised by the Ministry of Finance. There are no other financial intermediaries in the country, such as investment funds or private pension funds.

In Romania, serious issues affect the non-banking financial sector. In particular, despite some progress made in improving supervision of credit cooperatives and popular banks, the mutual funds sector has been seriously marred by the collapse of Fondul National (accounting for 90 per cent of the market, and extremely visible due to a very effective marketing campaign) in May 2000. The latter had behaved like a pyramid scheme,[46] proving the safety measures and their enforcement as entirely ineffective. The National Securities Commission, which is the institution in charge of supervising these funds, dismally failed to perform its role and unhealthy relationships with the state-owned savings bank were unveiled following the collapse of the fund. The government has initiated work on the issue of governance, regulation and supervision in the sector with the support of the World Bank.

[44] Macedonian Stock Exchange (1999).

[45] Data for 2000 show a very significant sudden increase in turnover. This is the result of the government's issue of bonds in lieu of old foreign currency deposits.

[46] IMF (2000f).

5. CONCLUSIONS

This paper has investigated the extent to which the banking system and other financial structures and instruments targeted to serve the financial needs of the local private enterprise sector are succeeding. It has done so both by looking at the sources of finance used by the enterprise sector when making fixed investments and by looking at the level of banking intermediation and the (lack of) development of non-banking financial products.

These are the main findings. Enterprises in south-eastern Europe mainly rely on internal funds to finance expansion. Among the external sources of finance, large enterprises in Albania, and to a minor extent in Bulgaria, still rely on state funding and in Romania on local banks. As far as smaller-sized enterprises are concerned, the only country in which the banking system is playing some role is Croatia. Overall, the local financial system in south-eastern Europe fails to respond to the demand for finance by the local private sector. With capital markets being extremely underdeveloped, the burden of intermediation of savings to finance the enterprise sector is fully on the shoulders of the banking system. However, with the local banking system still largely in need of significant reforms and in a state of poor capitalisation, at times low liquidity, poor profitability, overall poor financial health and low provisioning levels, the resulting degree of financial intermediation of which it is capable is inevitably far lower than in Western economies. Poor attention to market risk, the often-inadequate legal and regulatory environment, and in most cases poor effective supervision do nothing to dispel the danger of further financial crises. Even where financial indicators appear to have significantly improved, banking sector soundness might be inflated due to poor reporting, low required provisioning, inadequate accounting for market risk or inflated asset valuation. A high degree of variance behind the financial indicators hides further vulnerabilities.

In conclusion, the substantial improvements and reforms which have often followed the resolution of financial crises are a very significant first step in the right direction. If efforts are not maintained towards furthering and deepening of reforms, independence from donors and IFIs funded credit lines, micro-finance banks and equity funds will not be automatically reached.

ANNEX: CREDIT LINES, MICRO-FINANCE AND EQUITY FUNDS

CREDIT LINES

The traditional instrument used by donors and IFIs in their efforts to alleviate the financial constraint to the private enterprise sector is the extension of a credit line through a local bank. In the past ten years this instrument has been used extensively in the region. Funds from sources such as the World Bank/IFC, EIB, Phare, EBRD, as well as from bilateral donors such as the American, Dutch, Swiss, Austrian, Italian, German, Greek and Taiwanese governments, have been channelled through credit lines managed by local banks or by NGOs to the enterprise sector. Using a local financial intermediary in "less advanced transition countries" required the provision of significant technical assistance to the intermediary. This would pay for the work of credit advisors who would improve the local banks credit skills, local experts who would assist the credit advisors at branch level and IT experts to adapt (or create) the local banks management information system to effectively manage their loans to private enterprises.

Most of these credit lines have been designed to target small and medium-sized private enterprises, but their performance in terms of reaching the target has varied greatly. In most cases the local financial intermediaries have disbursed also to large private enterprises, thus diluting the scope of their work. In other cases disbursements have not occurred due to competition on pricing from alternative funding sources.[47] In other cases, the intermediary failed to disburse due to exogenous developments that disintegrated its willingness to enter this riskier segment of the market.

The issue of sustainability is an important one. The rationale behind extension of credit lines through local financial intermediaries is that of creating a channel of finance to the enterprise sector. By providing funding to a bank that was not previously versed in lending to private enterprises, and thus allowing it to engage for the first time in this activity (with all the support technical assistance funds can provide), donors hope to lower the bank's perception of risk linked to the sector and improve its credit skills. Once the credit line funds run out, it is hoped that the bank will be prepared to use its own funds to continue lending to these enterprises. The sustainability objective should, in theory, be more easily attainable if the intermediary is an institution whose mandate is that of intermediating savings between households and enterprises (i.e., a commercial bank) rather than an NGO that will always have to rely on the availability of credit lines from donors and IFIs. However, there have been cases in which the donor, at the time of addressing the task of providing finance to enterprises, could not find any suitable local financial intermediary who could accomplish that objective. In those cases NGOs were selected to channel the funds to the enterprises. In retrospect, very few of the NGOs active in financing private enterprises have done more than "delivering finance" to the target group. In most cases funds get "delivered" very fast, very little of them

[47] This has been a problem for some EBRD credit lines, priced commercially. Given the limited number of local banks deemed suitable for the management of credit lines, situations in which the same local bank was in charge of managing a number of differently priced credit lines have not been infrequent.

can be recycled to more borrowers and once the funds have run out the NGOs have gone out of business.[48]

MICRO-FINANCE

The primary purpose of micro-finance is to provide access to finance for very small, private sector entrepreneurs who otherwise have little opportunity of securing debt financing on acceptable terms. Commercial banks often view micro-lending as labour-intensive, risky and therefore unprofitable. They are more inclined to concentrate on the provision of finance to medium and large enterprises and of banking services that generate fees and commissions. These factors make it very difficult for micro businesses to obtain access to finance at a reasonable cost and on reasonable terms. In a way this could be seen as a paradox. As a result of lack of banking finance, micro-enterprises are those with the highest equity ratio, relying predominantly on internal funds. Micro-enterprises are therefore financially strong companies. However, they are seriously affected in their attempts to access loan finance by asymmetric information problems. Being small, new and unknown, frequently in the black economy, often unable to provide tax returns or to prepare business plans, they do not manage to communicate to lenders about their creditworthiness if the lenders avail themselves of traditional credit techniques.

Micro-finance techniques are, in these cases, the best way to address distortions created by asymmetric information. Rather than taking a traditional project approach, a micro-finance provider follows a "personality approach" and concentrates on cash flows. Micro-finance providers mostly (at least in the initial phase of their operations) address working capital demand rather than investment needs. They rely on cashflow-based loan analysis, the build up of a large volume of loans and a critical mass of the portfolio. This can only be achieved by reducing transaction costs through the use of what is known as MIS (management information system) and powerful software packages. These instruments allow for intensive monitoring of loan performance from the beginning of the loan (avoiding grace periods). As these techniques fundamentally depart from the traditional project-based approach followed by commercial banks, it is often necessary to convince these of the opportunities associated with high-volume micro lending. There are two main approaches that can be used to target the micro-enterprise market. The EBRD has implemented both in its countries of operations.

The first approach is that of using local commercial banks, and is known as the "downscaling approach". It involves providing hands-on technical assistance by western specialists in order to promote institution building and to train loan officers. Donor funds are also used to cover administrative expenses. The approach takes a very realistic and "on the ground" view of the business environment in each specific country, and takes into account issues such as vague financial reporting, lack of credit histories, taxation and collateral registration. The institution building component of this approach is essential and is a primary goal of the program. It aims at increasing technical expertise to conduct profitable micro lending, with the expectation that the commercial banks will continue to make MSE lending an integral part of their business strategy. One programme of this type is currently being implemented in Romania via Banca Transilvania (signed in 1999) and Banca Comerciala Romana (signed in 2001), using funds

[48] Exceptions are few and the most notable in the region are Moznosti in Macedonia, some NGOs operating under the World Bank sponsored LIP Programme and LOK, World Vision and Mikrofin in Bosnia.

from the EU-EBRD SME Finance Facility, and another one in Bulgaria via Union Commercial Bank (signed in July 2000).

Although the approach includes a generous technical assistance component it is usually still necessary to convince commercial banks to participate in a micro-finance programme. This is partly due to the view that micro lending is riskier and costlier than other types of activities. In the case of Romania, where funds from the EU-EBRD SME Finance Facility are utilised, an incentive is provided to participating banks in the form of a "performance fee". This incentive *de facto* reduces the cost of funds to the bank, if the bank meets the targets set in the programme in terms of the numerical reach of MSEs and of loan quality. The banks' interest level is supposed to increase once the banks recognise that the arrears rate in MSE portfolios is well below the average rate for commercial credits and that profitability is acceptable. For this reason the "performance fee" is structured along a decreasing scale over time.

In addition to the uncertainty of some participating banks' commitment, key weaknesses of the downscaling approach are the potential fragility of the local banks participating in the programme (and of the sector in which they operate), and governance problems experienced by the banks. Furthermore, the local banking sector thinks that there is insufficient critical mass to make engagement commercially viable. The availability of extensive donor/soft funds may distort and delay the sustainability of such efforts. Both can deeply affect the performance of micro-finance programmes following the downscaling approach.

A second approach, known as the "greenfield approach" has been developed in recent years. It exists in the establishment of new institutions, "micro-banks", which focus solely on micro lending. The EBRD participates in providing the capital to new institutions and invests together with other IFIs, bilateral agencies and micro specialist institutions, and in some cases local commercial banks. These micro-finance institutions are recipients of substantial grant and subsidised donor funding, which supports start-up costs and constitutes the initial funding base for lending activities while the institution becomes locally known and starts building up its own deposit base. Governance and own financial fragility problems are obviously overcome through this approach.

Despite the merits of this approach and the impressive results achieved in its implementation, two issues constitute a potential source of concern. First, greenfield micro-finance banks are sometimes seen as unfair competitors of local commercial banks, in that they benefit from grants and subsidised credit lines that are rarely available to the local banking system. There is no doubt that competitive pressure by greenfield banks is exerted on the system. However, this is supposed to be only temporary as micro-finance banks are meant to eventually "graduate" from soft funding. Second, there is doubt that the target of sustainability of these banks can be achieved. The risk that these banks do not put necessary efforts in building up a deposit base, because of the availability of soft funding, is real. If the banks' liabilities fail to grow alongside the growth of the loan portfolio, there is little hope that self-reliance and sustainability can be reached and consequently that the element of unfair competition be phased out. It is impossible to provide a clear-cut response to these doubts as the "greenfield approach" started being implemented only recently and in very adverse environments. However, even so, there are elements which lead us to believe that graduation of micro-finance banks might not be so far away in time. The example of the Micro Enterprise Bank

(MEB) in Bosnia and Herzegovina is quite striking in this respect, with its deposit base increasing from US$ 180,000 in December 1998 to US$ 2.6 million in October 2000.[49]

Currently four micro-finance banks have been established in south-eastern Europe in Bosnia and Herzegovina, Albania, FR Yugoslavia and Kosovo.[50] Their performance, in terms of number and quality of loans and of meeting the target group of enterprises, is staggering. On the back of these successes, more countries in the region are being targeted for setting up similar banks.

EQUITY FUNDS

The vast majority of private enterprises in transition economies have very low debt-to-equity ratios, due to the lack of loan finance in these markets. Their financial needs would generally be satisfied by loan finance, if this were available. However, a small subset of the private enterprise sector, generally composed of relatively older and larger companies in the formal economy, which have already benefited from bank finance and which are planning expansion and investment, find their plans severely constrained by the acute scarcity of equity finance. To address the need for equity finance of companies that are planning investments and restructuring, equity funds can be utilised. Equity funds in transition countries tend to concentrate on the group of relatively more advanced countries and, due to the high transaction costs, target investment in large companies or, at best, in small companies with rapid growth and profit potential, such as companies in the new economy. During the past ten years south-eastern Europe has been served by very few equity funds, most of which have been concentrated in Bulgaria and Romania. They are mostly donor-sponsored funds, benefiting from substantial technical assistance grants and tend to target deals of an average size of less than US$ 1 million. Under the umbrella of the Stability Pact, small equity funds have attracted donor support totalling US$ 20.2 million. The Albanian Reconstruction Equity Fund (US$ 14 million), enjoying substantial support from Italy, has recently expanded its operations into Kosovo.

[49] After the closure of ZPP, the Payments Bureaux’, in January 2001, bank deposits are expected to increase at an even faster pace.

[50] A fifth micro-finance bank is about to be set up in Bulgaria.

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