

**JVI Policy Research Conference 2007: “Economic Governance and Sustained Growth in Southeastern Europe”**

**GROWTH, RISKS AND GOVERNANCE: THE ROLE OF THE FINANCIAL SECTOR**

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**Introduction**

Financial sector development has begun to accelerate throughout southeastern Europe. This has the potential, in the right setting, to contribute strongly to real convergence. It is taking place, moreover, against a backdrop of low inflation and several years of sustained growth – signs that the region has exited from a prolonged period of weak performance that reflected intermittent reforms and, in some cases, security tensions. But the lessons of experience from other emerging markets are clear. Financial sector development is no guarantee of sustainable catching-up. It brings opportunities for an acceleration of growth; but it also carries risks that distortions in the economic system, or failures in policy management, may be amplified by financial markets.

Across southeastern Europe, many key reforms already are in place to set the right incentives in this regard. By and large, the macroeconomic policy setting signals an impressive break with the past. Monetary policy frameworks in almost all cases are transparent, and inflation has typically been mastered. Fiscal policy is in most cases strong or strengthening – though concerns remain, and this is one of many fields in which economic performance could benefit greatly from stronger policy frameworks.

The challenge today concerns mainly structural policies and institutional deepening. Here, the state of reforms is far more diverse. The reform and supervision of banking systems has moved ahead decisively, but the regulatory framework for non-bank financial institutions is less advanced. Moreover, the region has tended to lag in restructuring state-owned enterprises and implementing reforms that would enhance competition on domestic markets. Measures are needed also to improve public administration and governance, setting the framework for a vibrant private sector.

Given the pace of financial deepening, this lag in structural policies and institutional deepening is of concern. It could result in a lack of high-return investments to take advantage of the major shift in the supply of foreign and domestic savings. As rapid credit growth continues, and external deficits widen, a lack of commercial outlets

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<sup>1</sup> This paper is based on a pamphlet by Valerie Herzberg and Max Watson, which is to be published by the European Money and Finance Forum in the Spring of 2007. Valerie Herzberg is an economist at the EIB. Max Watson is Economic Adviser to the Director-General, DG ECFIN, European Commission and a Senior Member of St. Antony’s College, Oxford. The views expressed in this paper are those of the authors and do not represent official positions of the EIB or the European Commission.

could lead to an unbalanced pattern of resource allocation which would hamper growth and ultimately raise stability concerns. By contrast, in an environment where monetary, fiscal and prudential policies may have limited traction over credit growth, strong structural policies and institutions can help foster more sustainable patterns of resource allocation, pushing out risk-return frontiers in the economy.

Here, the perspective of EU Accession is a major advantage. Bulgaria and Romania are already Member States, and the economies of the West Balkans are candidates or have accession commitments under the Thessaloniki declaration. This perspective has the potential to accelerate trade and investment integration – in other words, the real sector counterpart to healthy and sustained expansion in the financial sector.

Crucially, too, implementation of the *acquis communautaire* can strengthen economic governance and the working of markets, including through more pervasive financial supervision. But even those economies that became EU members in 2004 are not immune to growth of stability concerns; and southeast European economies typically embarked on Accession facing greater structural challenges. For economies in the West Balkans, there is, too, an inevitable a question whether the Accession anchor is weakening as a result (among other factors) of Enlargement fatigue in the EU15.

Against this background, the present paper explores the challenges associated with rapid financial development in southeastern Europe. It first provides a brief overview of the improved macroeconomic setting, and then suggests a conceptual map to help assess opportunities and risks in using foreign savings. It goes on to discuss the state of the financial sector, and patterns in credit growth. It then asks what structural and institutional reforms are needed to underpin healthy financial expansion. It considers how these elements can interact with macroeconomic policies in fostering growth and embedding stability. In conclusion, it discusses priorities and trade-offs for policy.

### **A macroeconomic snapshot**

Policy-makers in southeastern Europe wrestled with the task of embedding sound fiscal and monetary policies throughout the 1990s, and in some cases well into this decade. The achievements are striking. Monetary frameworks are now transparent in almost all countries; inflation is typically low. Fiscal performance is more varied, but it is strong in some cases, and typically improving over time in others. By-and-large, the design of monetary and fiscal policy has ceased to be a source of instability that would risk undermining any sustained recovery of investment and growth.

Meanwhile, though, the nature of the stability challenge has been evolving. Financial integration has led to the emergence of wide external imbalances in some cases, and it has the potential also to rekindle inflationary pressures (notably under fixed exchange rate regimes). The question now, as the private sector moves into a financial-market supported boom, is what role fiscal and monetary policy need to play in ensuring that real convergence is not interrupted by financial stress. How can fiscal and monetary policy help moderate or counterbalance private sector imbalances as the economy enters a period of accelerating expansion, including notably in domestic demand?

To set the stage, it may be helpful to highlight the key features of macroeconomic performance over the past five years, and its policy foundations.

- Economic growth has strengthened across the region (Table 1). The recovery in most cases has been sustained since 2000, and is continuing. GDP in 2005-6 is rising at rates of 5 to 6 percent in Albania, Bosnia, Bulgaria, Romania and Serbia, and about 4 percent in Croatia and Macedonia.
- The expansion has typically been led by domestic demand, and thus differs somewhat from the pattern in central Europe, where net exports played a stronger role. It has been accompanied by rising inflows of foreign direct investment. Both consumption and investment have increased, with the balance varying. It is hard to disentangle how far investment growth reflects an upswing in residential construction versus productive investment.

<b>Table 2. S.E. Europe: GDP Growth, 2000-06</b>						
<i>(In percent)</i>						
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Albania	7.0	2.9	5.7	5.9	5.5	5.0
Bih	4.3	5.3	4.4	6.2	5.0	5.0
Bulgaria	4.1	4.9	4.5	5.7	5.5	6.0
Croatia	4.4	5.6	5.3	3.8	4.3	4.6
FYROM	-4.5	0.9	2.8	4.1	4.0	4.0
Romania	5.7	5.1	5.2	8.4	4.1	6.5
Serbia	5.1	4.5	2.4	9.3	6.3	6.5
Montenegro	-0.2	1.7	1.5	3.7	4.1	5.5

Source: EBRD

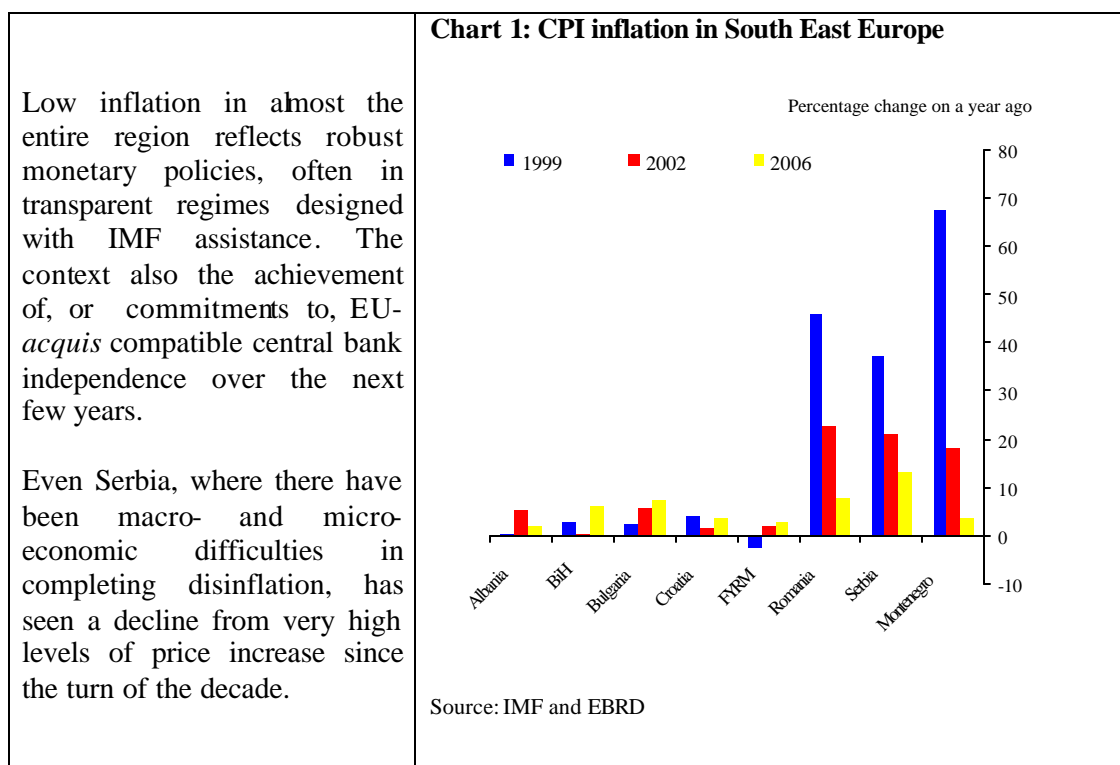
- Export growth has been relatively strong, nonetheless (Table 2). In 2004, Albania, Bosnia, Bulgaria, Croatia, Romania and Serbia all achieved increases in dollar export values of 30 percent or more. Generally slower growth rates in 2005 still saw the region's exports rising by some 18 percent.

<b>Table 2. S.E. Europe: Merchandise export growth, 2000-06</b>						
<i>(In percent)</i>						
	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Albania	19.6	8.1	35.4	34.9	27.0	10.2
Bih	4.6	9.4	36.1	28.3	26.2	17.4
Bulgaria	6.0	11.3	32.5	30.7	18.7	30.0
Croatia	4.2	5.1	26.1	30.1	7.7	-
FYROM	-12.6	-3.6	22.1	23.0	-4.3	12.7
Romania	9.8	21.8	27.1	33.4	17.0	26.0
Serbia & Montenegro	4.2	20.2	26.6	38.1	30.4	Serbia: 29.1 Montenegro 8.5

Source : EBRD

- Inflation had been reduced to low levels in most countries by the end of the 1990s, and in other cases there has recently been a very substantial improvement (Chart 1). Nonetheless, inflation is now a worry again in a few cases, including in some hard peg regimes (such as Bulgaria) as well as flexible regimes (such as Romania). One temporary influence is the impact of

energy prices. But a more pervasive source, actually or potentially, is pressure on non-traded goods prices from a rapid expansion of bank credit.



Low inflation in almost the entire region reflects robust monetary policies, often in transparent regimes designed with IMF assistance. The context also the achievement of, or commitments to, EU-*acquis* compatible central bank independence over the next few years.

Even Serbia, where there have been macro- and micro-economic difficulties in completing disinflation, has seen a decline from very high levels of price increase since the turn of the decade.

- External current account performance has varied widely. Bosnia and Bulgaria have continued to show very large imbalances – 15 and 24 percent of GDP, respectively. Most others recorded deficits in a range of 5 to 9 percent. FDI more than financed the deficits in Bulgaria and Croatia, and covered two-thirds to three-quarters of those in Albania, Romania and Serbia. Only in Bosnia and Macedonia was the FDI cover less than one-third (Table 3).

	2004		2005	
	Current Account	FDI	Current Account	FDI
Albania	-3.8	5.0	-6.9	3.4
Bih	-24.4	6.0	-26.6	8.2
Bulgaria	-5.8	5.1	-11.8	10.7
Croatia	-5.4	2.6	-6.3	3.6
FYROM	-7.7	3.0	-1.3	13.0
Romania	-8.5	6.9	-8.7	8.3
Serbia	-14.8	4.3	-10.0	6.1
Montenegro	-7.8	3.3	-8.6	22.8

- A distinguishing feature in some cases has been a high level of foreign remittances from diasporas, which has represented a stable source of income. Between 2000 and 2003, recorded remittances amounted to four times the value of the current account balance in Albania, double in Bosnia, and more

than half in Croatia and Macedonia. Their true magnitude is estimated to be much larger, suggesting that current account deficits are over-recorded.<sup>2</sup>

- In most cases, external deficits essentially reflected absorption of savings by the private sector, since fiscal balances in many cases showed a modest deficit or a surplus. Moreover, in Bulgaria and Serbia, and to a lesser degree Macedonia and Romania, the last two to three years have seen sizable rises in investment. Where savings fell, this was also typically a private sector development – and was substantial in Bosnia and Romania. A different pattern of imbalances was evident in Albania and Croatia, where the public sectors were in significant, though diminishing deficit.

Eastern Europe, in other words, has bucked the emerging market trend. Where economies in Asia and Latin America run surpluses and build reserves, this region imports savings on a major scale. Geopolitically, that should be no surprise. Eastern Europe is embarked on a historic venture to pool with its neighbours many aspects of economic sovereignty. It is betting on integration, rather than insuring against risks to financial autonomy. As trade and investment links deepened, inward FDI helped drive and finance external deficits. The region's patron has been Schuman, not Guidotti.

### **Assessing the financial sector challenge**

Nowhere is the impact of integration more evident than in the banking sector. A handful of EU-15 banks played a catalytic role in transforming financial systems across eastern Europe. Their contribution was seen as indispensable, importing management techniques and imposing hard budget constraints. Their role in jump-starting the financial sector appears a trump card in eastern Europe's convergence strategy. In parallel with FDI inflows, rising bank credit is also emerging as a key medium-term factors driving the import of foreign savings. As credit growth outpaces money demand, the net foreign liabilities of banking systems expand to finance this.

The rapid development in these largely foreign-owned banking systems is one of the most striking aspects of late transition. Nonetheless, there are potential concerns in this rapid financial transformation. They are well-illustrated by the experience of integration in western Europe itself. Ireland and Portugal, in this regard, represent different ends of the convergence spectrum:

- Ireland attracted foreign savings very strongly to the traded goods sector. This drove productivity growth and underpinned real income increases – powering Ireland's catch-up to EU living standards. This virtuous circle, moreover, was benign for stability as well as growth. It was associated, in early convergence, with shallow external deficits, and a mild net foreign asset cycle. Meanwhile, productivity growth ensured that any external shocks could, if necessary, be met with rapid adjustment of the real effective exchange rate. In other words, sectoral patterns in the absorption of foreign savings led to very favourable outcomes, initially, in terms of real convergence, vulnerability and external adjustment capacity.

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<sup>2</sup> See "World Bank" (2006) and de Luna Martinez, Endo and Barberis (2006).

- Portugal's pattern of real and financial integration was different. The pace of financial integration was even more striking – a main vehicle being heavy interbank borrowing by Portuguese banks. Credit rose steeply relative to GDP. There was a boom in mortgage debt, although the supply response in housing avoided an asset bubble. The public debt, however, continued to rise. Savings were strongly absorbed in the non-traded goods sector. Productivity growth was disappointing, and the external cycle involved large deficits and a steep fall in net foreign assets. When adjustment had to be faced, in the absence of exchange rate flexibility, this implied that wage growth had to bear the brunt of real exchange rate adjustment, while the fiscal position was not able to cushion shocks. After 2002, real convergence in PPP terms went into reverse.<sup>3</sup>

The traded/non-traded goods distinction in this comparison is of course too simple. Non-traded goods that contributed to growth in the productive sector, including the impact of education reforms and infrastructure, played a key role in Ireland's take-off.

The broad lesson, though, is clear and centrally relevant to southeastern Europe today. With declining risk premia and credit constraints, on the back of stabilisation and bank reform, the financial sector is inevitably called on to intermediate a large inflow of savings. How these are deployed will critically affect the longer run outlook for real incomes. It will simultaneously govern the extent of exposure – and indeed of adaptability – in the case of external shocks. These considerations are all the more relevant where, as in southeastern Europe, the nominal exchange rate and national interest rates are not freely available to deal with domestic financial cycles.

This calls for a prudent fiscal policy to limit economic risks and build resilience – a theme discussed later in this paper. But what deserves particular emphasis is the potential role of the lending environment in influencing risk-return trade-offs across the economy. Structural policies move to centre stage in terms of both growth and stability. The quality of reforms, and the effectiveness of supervision, will be pivotal in any assessment of the outlook for growth, risks and governance in the region. To set the stage, it helpful to review briefly the condition of the financial sector today.

### **The state of the financial sector**

During the 1990s, financial systems in Southeastern Europe went through a period of protracted crisis. State ownership and soft budget constraints, coupled with close links to inefficient state-owned enterprises (SOEs), resulted in a build-up of non-performing loans. As monetary overhangs and liberalisation triggered rising price levels, policymakers' attempts to control inflation failed when interest rate hikes put pressure on firms and threatened insolvencies. Renewed rounds of soft lending (or bail-outs of inter-enterprise arrears) often followed, causing further misallocation of credit at a higher eventual cost to society. Meanwhile, liberal bank licensing regimes and weak regulation encouraged the creation of many small banks, often set up by credit-constrained private sector industrialists. Connected lending was widespread.

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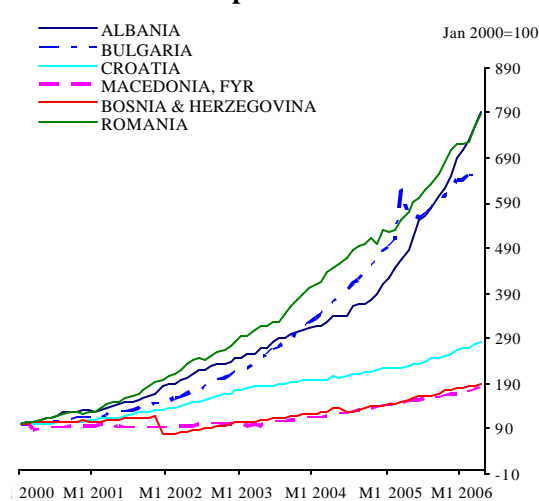
<sup>3</sup> For model simulations and a discussion of convergence in Ireland and Portugal, see the 2006 EU Economy Review, European Commission 2006 (co-edited by Mary McCarthy and Max Watson).

As macroeconomic stabilisation policies eventually prevailed— in some cases, such as Bulgaria or Montenegro, abruptly through currency boards or euroisation – full-blown banking crises frequently followed. This had the potential to trigger disintermediation and heavy financial losses, as in Bulgaria (1997) or Croatia (1998/1999). Montenegro had only one bank operating in late 2002. Albania faced a severe financial crisis in 1997, although this erupted from pyramid schemes in the non-bank financial sector. In Kosovo, as Yugoslav banks left the province during the conflict, the formal financial sector ceased to exist. Given the volatile environment and perceived risks, no private commercial bank, local nor foreign, was willing to open in Kosovo.

Since then, however, the region has made substantial – often dramatic – progress in reforming and modernising financial systems. Growing confidence in banks has been reflected by rising credit penetration and deposit growth (Chart 2). Private sector credit has grown by between 10% and 70% year-on-year since 2003 (Table 4).

More rapid financial expansion can be traced in part to economic stability. Evidence from a panel regression suggests that macroeconomic factors are indeed important in determining banks’ asset allocations in Southeastern Europe (see Annex). Except in Albania, fiscal consolidation has curtailed banks’ exposure to governments (Chart 3). This has increased competitive pressures in private sector lending, put pressure on margins and spreads (Chart 4) and fostered lending to households, where margins are higher. In Croatia for example, interest rate spreads on household loans are double those on corporate loans, even though they are now beginning to decline (Table 4).

**Chart 2: Domestic private sector credit**

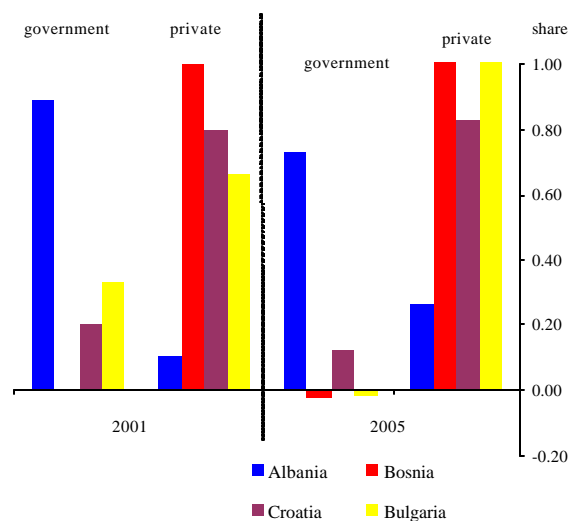


Source: IFS

In addition, monetary stability allowed banks to attract cheap household deposits, as a main funding source. However, as credit growth outpaces money demand, banks are increasingly switching to foreign borrowing and market instruments to sustain asset growth. In Bulgaria, foreign borrowing as a percent of bank assets has risen to around 18%, from some 5% a few years earlier (Chart 5). Also, exchange rate targets, pegs or currency boards have lowered perceived exchange rate risks. With a positive wedge between local and foreign currency interest rates, demand for foreign currency credit has shot up, notably in Serbia, Croatia and Bulgaria. (To some degree this may also reflect implicit hedges, such as remittances.) It is interesting to note that the adoption of inflation targeting in August 2005 in Romania promoted a shift away from foreign currency, but this respite seems to have been temporary (Chart 6).<sup>4</sup>

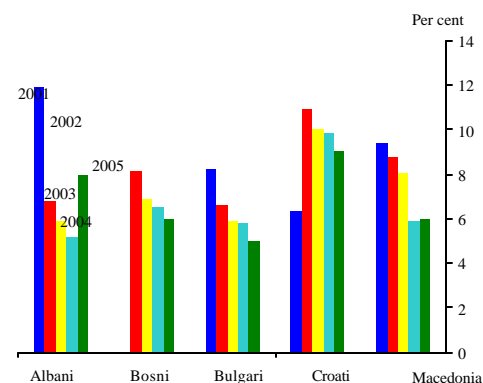
<sup>4</sup> Chart 6 displays local and foreign currency denominated lending. Given the availability of FX-indexed loans, the true size of FX lending is likely to be broader than suggested in the chart.

**Chart 3: Banking sector claims on government and private sector**



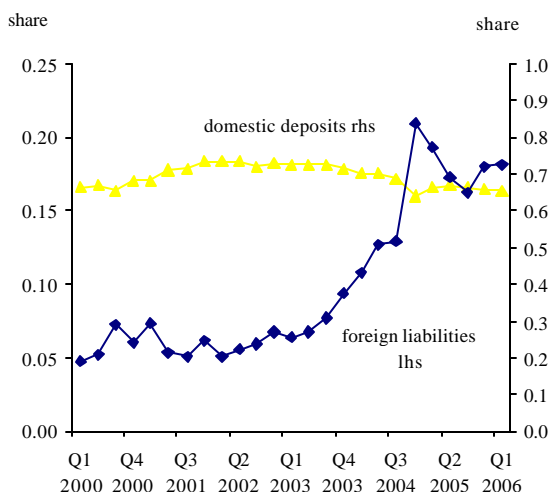
Source: IFS

**Chart 4: Interest rate spreads in South East Europe**



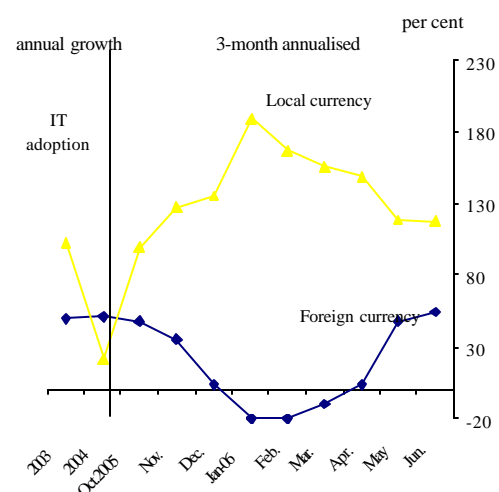
Source: WDI

**Chart 5: Foreign liabilities and domestic deposits as share of banking sector assets – Bulgaria**



Source: IFS

**Chart 6: Credit growth to non-government sector – Romania**



Source: National Bank of Romania

**Table 4: Croatia: Analysis of interest rate spreads, 2001-2003 (Percentage points)**

	2001			2003		
	Total	Enterprises	Households	Total	Enterprises	Households
Interest spreads	9.6	4.8	13.7	7.2	4.9	10.1
Overhead costs	3.5	3.5	3.5	2.5	2.5	2.5
Loan provisioning	0.1	0.1	0.1	0.4	0.4	0.4
Reserve requ.	0	0	0	0.2	0.2	0.2
Deposit protection	0.5	0.5	0.5	0.4	0.4	0.4
Pre-tax profit	5.6	0.8	9.7	3.7	1.4	6.6
Tax	0.2	0.2	0.2	0.1	0.1	0.1
Profit margin	5.4	0.6	9.5	3.6	1.3	6.5

Source: IMF

In most cases, the state privatized banks, and opened the sector to competition (Table 5). The state share declined across the region to around 2-7%. Only in Serbia, the government through its largest bank still controls some 35% total assets. Privatisation involved banks mostly domiciled in the EU (notably Germany, Austria, Greece and Italy), with market shares now of 70-91%. These changes had several implications. They increased efficiency, as new technologies and know-how weeded out inefficient banks, creating economies of scale and reducing overheads. In addition, parent relationships facilitated external borrowing via intra-group funding.

**Table 5. Structure of the banking sectors in South East Europe, 2004/2005**

	Number of banks 2005	Market share % 2005			
		Foreign-owned banks	Private domestic banks	State-owned banks	Top five (2004)
Croatia	34	91	6	3	74
BiH	33	91	5	4	61
Bulgaria	34	75	23	2	55
FRYM	20	51	47	2	76
Romania	33	60	33	7	60
Serbia	40	66	10	24	-
Albania	16	92	0	8	77
Montenegro	10	88	7	5	-

Sources: Mihaljek ; EBRD

In parallel, financial sector regulation and supervision were modernised to provide a stable and efficient framework for privately-owned intermediaries. Payment systems are well-functioning, including in Serbia. Supported by IMF FSAP recommendations, banking laws were modernised in line with best practice, and most countries are increasingly compliant with the Basle core principles of supervision. Prudential rules were tightened, and increasing pressure was placed on banks to build effective risk management systems and monitor credit and market exposures.

Stricter regulation and greater competition, led to closure of poorly managed and often family-owned small banks, enhancing economies of scale. Better governance in some economies also boosted stock markets. In Croatia, for example, the new law on securities markets brought the obligation to list all companies with 100 shareholders or more and at least around euro 4 million share capital. Overall, though, corporate governance remains a major challenge throughout southeastern Europe.

Major progress has clearly been achieved in the last few years. The joint impact of macroeconomic and microeconomic reforms has made the banking sector deeper, more profitable and more resilient (Table 6 and Chart 7). Croatia's banking sector has nearly reached the standards of a fully working market economy (Table 7). Apart from where government ownership remains significant, systems are on the whole well capitalised and able to withstand unexpected adverse shocks. Profitability is strong, thanks also to high asset quality, although increased competition has started squeezing margins, encouraging continuous innovation and market development.<sup>5</sup>

<sup>5</sup> In Serbia, profitability and asset quality is pulled down by the weight of state-owned banks and private domestic banks whose NPLs are between 30-50% of total.

**Table 6: Banking sector robustness indicators in South Eastern Europe**

	Return on assets (before tax)	Net interest margin (% of assets)	CAR %	NPL/Total %	Loan-loss provisioning as % of NPL
Albania	1.3	-	20.8	1.1	
Bosnia	0.6	-	18.5	2-4	Mostly
Croatia	1.7	3.1	15.8	4	58
Bulgaria	2	4.8	15.2	2.2	49.2
Romania	1.7	3.6	20.2	2.6	55.1
Serbia	19.8	6.2	25.2	22.5	47.8
Macedonia	1.6	8.2	20	15	-

Based on a variety of sources and referring of different dates (2002-2006) (IMF, national central banks, EBRD). Detailed comparisons across countries should therefore be avoided.

IMF FSAP stress tests suggest that in most countries banks are able to withstand the direct effects of exchange or interest rate shocks. More questionable, however, is the degree of resilience vis-a-vis the indirect effects of currency shocks through lending to unhedged borrowing. The non-bank financial sector also still stands on more shaky grounds (Table 7), despite some progress made in 2006 in a number of economies, as noted by the 2006 EBRD Transition Report (eg Bulgaria, Croatia and Macedonia). Insurance and pension funds suffer from ongoing governance and supervision weaknesses, insufficient size, lack of competition and openness and skill shortages.

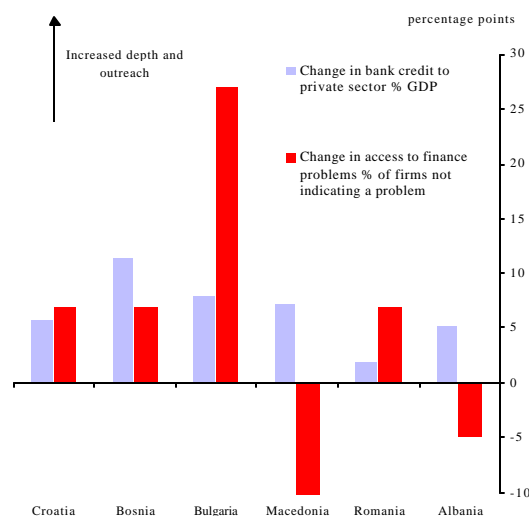
**Table 7. EBRD indicators of financial sector reform 2006**

	Bank	Non-bank
Albania	2.7	1.7
Bosnia & Herzegovina	2.7	1.7
Bulgaria	3.7	2.7
Croatia	4	3.0
FYR Macedonia	2.7	2.3
Romania	3	2
Serbia	2.7	2
Montenegro	2.7	1.7

The transition indicator ranges from 1 to 4+, with 4+ representing the standards of an industrialized market economy and 1 no reform.

Source: EBRD

**Chart 7. Change in financial depth and breath in South East Europe 2002-2005**



Source: EBRD

These advances that have taken place in the reform and supervision of banking systems are a necessary but not sufficient condition for a strong development of the private sector economy. Clearly, there is a pent-up demand for housing and consumer loans. Risk premia have been falling; constraints on credit availability have eased; and on the side of households permanent income expectations doubtless have begun to rise after a period of economic – and in some cases political– instability. Banks have been moving quickly to establish strong market positions in this potentially quite profitable sector. But it is less clear that the shift in credit availability has strongly benefited commercial activities, including development of the traded goods sector.

In the 1990s the contribution of the financial sector to growth was modest. Mehl et al attribute this to numerous banking crises, and poor governance and asset allocation, largely related to weak institutions and rules.<sup>6</sup> 10 to 15 years later, the impact of the sector on activity through lending to households is larger. Weaknesses and constraints in the real economy, however, seem still to constrain the growth of commercial credit.

In the 2005 BEEPS, for example, nearly 70% of responding firms stated that they did not apply for a loan because it “was not needed”. Moreover, despite macroeconomic stabilisation, the cost of financing (eg interest rates and charges) was a problem for over 55% of respondents in southeastern Europe, more than in any other transition region. There is evidence to suggest that financial deepening in some countries, such as Macedonia and Albania, has not been accompanied by greater outreach (Chart 6). The profile of development across the region thus underscores how salient it is to ask whether credit is flowing to uses that will underpin sustained real convergence – and, if not, where policies can be strengthened to foster more favourable outcomes.

### Key features of recent credit growth

A first reality check is to inspect the data across the broader region of eastern Europe, and ask whether rapid financial sector growth and strong imports of foreign savings seem to go hand-in-hand with favourable real sector performance. This may also help place the economies of southeastern Europe in perspective by situating them in relation to EU Member States, where reforms typically moved ahead more quickly. The charts shown below attempt to shed light on this, so far as data limitations allow.<sup>7</sup>

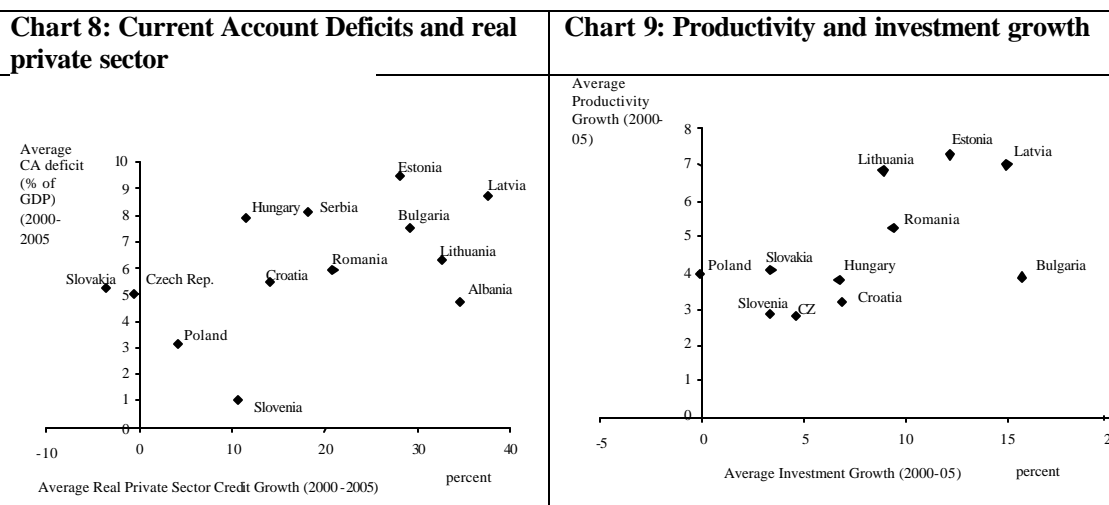


Chart 8 illustrates which countries have experienced particularly rapid credit growth and wide external current account deficits over the past five years. Chart 9 portrays how these same economies have performed in terms of investment and productivity growth. This is a crude approach (including because investment does not distinguish between traded and non-traded goods). But the results are quite suggestive.

<sup>6</sup> See Mehl, Vespro and Winkler (2006).

<sup>7</sup> Charts reproduced from DG ECFIN Occasional Paper 26, with the authors’ acknowledgements to associated research work by Caroline Ko.

The scope for favourable outcomes is evident in some Baltic and central European EU Members. Among these economies, there are examples to show that domestic bank lending can play a greater (Estonia) or lesser (Slovakia) role among financial flows, including foreign direct investment, that support economic development. Overall, though, the eastern Member States that have experienced the highest investment and productivity growth include some of those which also have the widest current account deficits and the most rapid domestic credit expansion.

But there are specific questions about credit growth even in such cases, and these are highly pertinent in southeastern Europe. To what extent is strong investment growth benefiting mainly construction and other non-traded goods, and is this laying a base for sustained growth? Is lending biased toward households (Table 8) or distorted on a systemic scale by poor exchange risk assessments in the case of unhedged borrowers? And could the expansion of mortgage borrowing and consumer debt signal future unsustainable pressure on the balance of payments over the short or medium term?

<b>Table 8: Eastern Europe: Real Change in Credit to Households</b>						
<i>(In percent)</i>						
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
BiH					33.5	29.0
Bulgaria	7.5	40.6	40.2	76.5	64.7	50.8
Croatia	15.6	24.3	38.9	23.7	14.9	17.0
FYROM			34.0	-	62.4	41.6
Romania		56.0	120.4	218.4	49.0	61.0
Czech Rep.	5.0	8.7	26.6	31.9	29.1	30.3
Estonia	22.3	27.0	36.0	52.9	43.7	64.0
Hungary	-	34.5	58.9	53.5	19.5	22.2
Latvia					64.6	72.3
Lithuania	-13.1	24.0	70.2	11.5	94.1	81.9
Poland	14.1	8.9	6.5	12.8	9.3	19.4
Slovakia					27.2	27.4
Slovenia	3.5	-0.3	0.3	5.5	16.8	23.0

There is nothing surprising about a sharp expansion in household debt, accompanied by rising imports and a shift of resources into the non-traded goods sector – especially residential investment. As noted above, the decline of risk premia and the market penetration of EU-15 banks have released financing constraints on households. This amounts to a major and potentially positive convergence shock, involving a rapid adjustment of credit stocks and borrowing levels towards a new equilibrium. Euro adoption had an analogous impact in the converging economies among euro area members, such as Ireland, Portugal and Spain, though the overall pattern of resource flows across sectors led to differing outcomes in terms of real convergence.

In addition to local stabilisation and reform, and the Accession perspective, the effects of the global monetary environment need to be mentioned. As real and nominal yields became compressed in international markets, investors increasingly sought higher returns in more risky markets abroad (the ‘search for yield’), partly explaining easy access by, and sizable flows to, emerging markets. Moreover, Eastern Europe is far from the only area where these shifts in financing conditions have been associated

with a rapid growth in household borrowing, including mortgage debt. To this extent, credit developments across eastern Europe are also part of a global financial pattern.

The pace of lending to firms has been slower across all of eastern Europe, so far as available data allow the composition of credit to be analysed (Table 9).

**Table 9. S.E. Europe: Real Change in Credit to Firms**  
(In percent)

	2000	2001	2002	2003	2004	2005
Bih					28.9	29.0
Bulgaria	5.1	20.5	20.5	21.0	4.4	8.1
Croatia	-2.8	14.9	17.2	0.8	5.5	11.1
FYROM			-8.3	-	15.2	12.7
Romania		10.1	22.5	34.9	24.0	18.8
Czech Rep.	-13.2	-30	-19.4	-1.3	4.7	12.5
Estonia	38	5.4	5.6	22.6	37.7	51.9
Hungary		0.4	0.6	14.4	6.1	10.3
Latvia					29.6	39.0
Lithuania	-3.9	17.7	23.0	50.9	25.2	39.2
Poland	1.5	-1.6	-0.9	1.8	-7.2	-1.5
Slovakia					13.3	37.9
Slovenia	10.7	13.5	3.8	10.8	15.7	19.1

Source: Central bank reports; IMF

The picture is more complex than it seems, however. Credit to firms has often been growing from a higher base, so it has been more important economically than the growth rates suggest. It is also misleading to evaluate domestic bank credit in isolation from cross-border flows and non-bank interlediation. In some cases, cross-border credit flows have also been very sizable relative to GDP, and these are mainly allocated to firms (Table 10). The scale of jumps in cross-border lending to firms in some cases – Bulgaria in 2004, Croatia in 2005 – also illustrate the scope for resourcing credit in response to measures to restrain domestic borrowing.

**Table 10. Eastern Europe: Cross-border loans to non -banks, stocks, 2000-05**  
% GDP

	2000	2001	2002	2003	2004	2005
Bulgaria	2.7	1.7	2.3	2.2	6.3	7.1
Croatia	11.0	8.4	11.4	12.2	13.1	21.4
Romania	4.4	4.8	5.0	4.7	5.8	5.7
Czech Rep.	6.0	6.3	6.2	7.3	6.7	6.9
Estonia	5.3	5.9	6.8	6.0	6.6	8.9
Hungary	7.8	7.1	6.4	7.2	6.9	8.3
Latvia	1.6	1.4	1.8	2.4	2.2	3.5
Lithuania	4.7	3.6	2.9	2.9	2.7	2.7
Poland	3.5	3.5	4.0	4.8	4.4	4.4
Slovakia	8.3	6.6	5.6	4.4	3.7	4.6
Slovenia	7.3	7.3	8.7	8.0	7.2	10.5

Source: BIS

It is therefore instructive to compare the pattern of domestic and cross-border bank loans, by sector, scaled relative to GDP. This is a major corrective to the pattern that emerges from domestic claims alone. Currency adjustment is not possible, but a simple presentation can illustrate how the sectoral allocation of bank loans differs if

cross-border loans to non-banks are added to domestic corporate lending. These data, scaled relative to GDP, are shown in Table 11. Croatia is a particularly striking case.

<b>Table 11. Eastern Europe: Credit to firms and households, stocks, 2005</b>				
<b>% GDP</b>				
	<b>Households</b>	<b>Firms</b>	<b>Crossborder (C/B)</b>	<b>Firms plus C/B</b>
Bulgaria	16.5	26.4	7.1	33.5
Croatia	35.4	30.2	21.4	51.6
Romania	7.5	12.4	5.7	18.1
Czech Rep.	14.1	17.9	6.9	24.8
Estonia	32.8	30.5	8.9	39.4
Hungary	17.4	26.2	8.3	34.5
Latvia	32.4	27.5	3.5	31.0
Lithuania	13.2	22.5	2.7	25.2
Poland	14.6	13.1	4.4	17.5
Slovakia	11.5	11.9	4.6	16.5
Slovenia	15.0	38.7	10.5	49.2

Source: BIS

These figures illustrate that country experience has varied very considerably, and that the scale of bank lending to corporations is easy to underestimate. In addition, direct cross-border flows to non-banks include foreign direct investment, which has been strong in some cases. So resource flow to firms have been larger than it may seem.

In some cases, nonetheless, the recent trajectory of loan growth to households remains a striking feature (as per Table 4). This suggests also a possibility that the strong investment data shown in Chart 8 could in some cases reflect high levels of residential investment, which is socially desirable but does not directly build the productive base of the economy. This split in investment is often not available in national data, however. One interpretation (Kraft 2005, Wachtel 2006) might be that EU-15 banks, in their eastward expansion, are seeking strategic stakes in market segments that are ripe for development. Where business environments are not attractive, mortgages and consumer credit will *de facto* dominate. This bias may be replicated in cross-border flows, if direct investment opportunities are unappealing.

Microeconomically, such a pattern could make sense, though with some question whether exchange risk assessments may be blunted by fixed or steadily appreciating nominal exchange rates. But at the macroeconomic level, a pattern of financial development strongly biased to households could fail to build the productive base of the economy in line with rising income expectations, competitiveness needs, or debt servicing commitments. Banks might end up with concentrated sectoral risks, and there could be a risk of asset price bubbles where housing supply responses are weak.

Moreover, in the event of problems in one country, there would be the potential for these to spread through (“common lender”) contagion among the EU-15 banks that are the majority lenders in the region. Financial trends in Eastern Europe have led to warnings about potential risks (Cottarelli et al 2004, Lane and Milesi-Ferretti 2006).

Such risks might not emerge as a foreign exchange market or banking crisis. They could take the form of balance sheet stresses that weigh on the process of real convergence. The experience of aborted financial development in Portugal illustrates this type of “growth crisis.” The fact that stress takes the form of slow growth, rather

than a market crisis, in no way allays concerns about damage to real convergence, even though risks of contagion and loss of credit market access may be lower.

In sum, the recent data on domestic credit growth in southeastern Europe raise at least as many questions as they answer. The apparent dominance of household lending is misleading to some degree, once cross-border and non-bank flows are taken into account. But the extent of flows to productive activities is hard to determine from the data, and probably varies considerably in light of opportunities for private sector development. Romania, for example, emerges as experiencing a combination of rapid financial expansion, high investment and strong productivity growth. But this trend remains to be confirmed, and the data in most cases in southeastern Europe do not yet indicate as clear a favourable picture.

Meanwhile, the role of the financial sector during convergence in EU Member States such as Ireland and Portugal confirms the wider global experience with the impact of financial development. The balance of opportunities and risks has depended on the extent to which resources flow to productive sectors of the economy. In this, the effectiveness of structural reforms and, particularly, the depth of institutions, have been key. For the recently joined Member States in southeastern Europe – Bulgaria and Romania – and for actual or potential candidates in the region, this underscores the need not only for macroeconomic stability but for adequate structural reforms.

### **The lending environment**

In terms of headline GDP growth, southeastern Europe appears to have reached a turning point in the first half of this decade. Qualitatively, however, some economies display features that need to be addressed to assure sustained catch-up. Productivity gaps, except in Croatia, are large; and in Macedonia, Albania or Romania they may not be offset by lower real wages (Charts 10 and 11). Moreover, productivity growth appears to be, apart from Romania, relatively modest (Chart 10). The private sector is less developed than in central Europe and the Baltic states – its share fluctuating around 50-60%, compared with around 80% in these EU Member States (Chart 12).

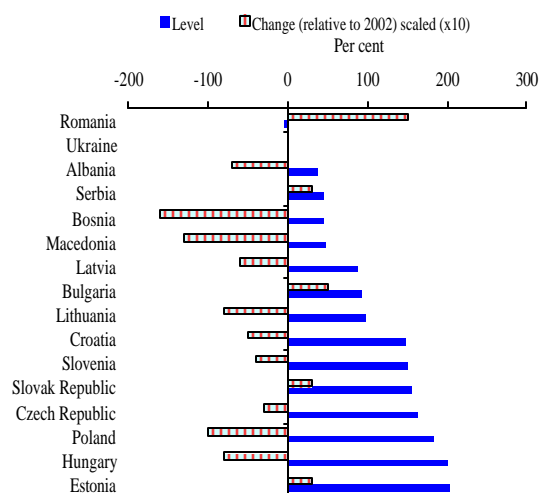
Recent progress notwithstanding, the network of SMEs appears to be growing only slowly. Data 2001/2 showed a density of SMEs per 1000 inhabitants from 7 in Bosnia to 27 in Bulgaria. This compares with some 80 in the 3 largest economies in central Europe (Chart 11). Informal sectors, which tend to limit bank lending, are large in the region, estimated at over 30% of GDP.<sup>8</sup> FDI has been quite heavily concentrated in the financial sector. Despite the small size of economies, intraregional trade is underdeveloped. In 2003, only 7% of trade in the Balkans was regional, compared with 14% in the Mercosur area or 20% among ASEAN economies.

What factors are constraining the attractiveness of the region as a production centre, and hence the transfer of capital and know-how to stimulate growth (Table 12)?

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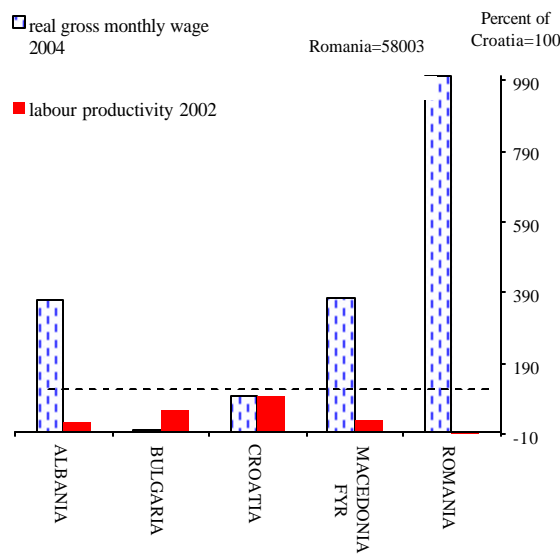
<sup>8</sup> See EBRD (2006). Including agriculture tends to even increase the overall estimate of informal sectors.

**Chart 10. Labour productivity (sales per worker) relative to the Ukraine (in ascending order)**



Source: EBRD Transition Report 2005

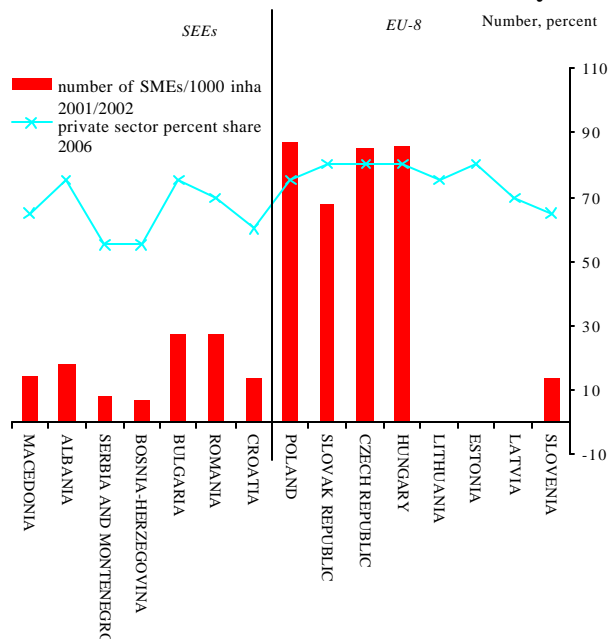
**Chart 11. Labour productivity and real wage costs in South East Europe\***



Source: EBRD, UNDP and own calculations

\* Data for other countries in the region unavailable.

**Chart 12. Private sector share and SME density**



Source: EBRD (2005) and (2004)

Data unavailable for the three Baltic states. 2006 data indicate a private sector share of 65% for Montenegro and 55% for Serbia.

**Table 12. S.E. Europe: Scoring on EBRD transition indicator for enterprise reform and privatization, 2006**

	Large-scale Privatization	Governance Enterprise Restructuring
Albania	3	2+
Bih	3-	2
Bulgaria	4	3-
Croatia	3+	3
FYROM	3+	2+
Romania	4-	3-
Serbia	3-	3-
Montenegro	3+	2

Source: EBRD

Indicators range from 1 to 4+. 4+ represents standards of industrialised market economies; 1 represents no change from centrally planning

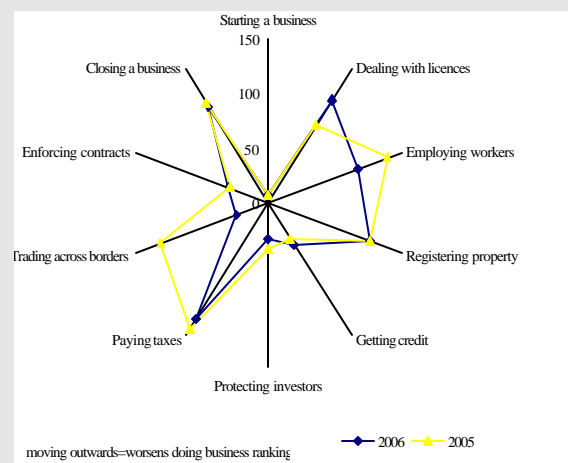
Despite past reforms, the weakness of private sector activity is still partly due to unrestructured SOEs that continue to capture and waste resources. Except for Bulgaria and Romania, the shedding of productive assets held by the public sector remains incomplete, notably for large enterprises (Table 8). Even Croatia is still endowed with some non-negligible loss-making SOEs, for example in heavy industries such as steelmaking and shipyards, which benefit from state guarantees. In Bosnia around 60% of SOEs and a similar share of voucher-privatised firms report losses.<sup>9</sup>

Moreover, fundamental restructuring and the introduction of best-practice corporate governance in the non-financial sector has been slow to proceed (Table 8), resulting in weak financial discipline and the risk of a further non-performing loans (NPLs) down the line. Meanwhile, scarce resources are being diverted away from potentially more productive, fast growing and profitable private enterprise. During 2006 however, some improvements were recorded in Romania (passing of corporate governance legislation) and Macedonia (approval of new bankruptcy legislation). A review of the impact of recent structural reforms in Romania is contained in Box 1.

### Box 1: Structural reform issues in Romania

According to the World Bank Doing Business 2007 Report, Romania was among the top reformers in 2005/2006.<sup>10</sup> Out of 175 countries, it jumped from the 71<sup>st</sup> to the 45<sup>th</sup> place in a comparative ranking across countries. What does this actually mean? And what are the strength and weaknesses of Romania's business climate? The aim of this box is to provide an overview of Romania's structural reform issues. Most recent progress in improving the business climate in Romania was achieved in facilitating trade across borders and in the labour market (Chart A). On the former, Romania improved from the 121<sup>st</sup> to the 35<sup>th</sup> place. Trading has become more speedy and the number of documents needed to export and import have been drastically reduced. In the labour market, the labour code has been reformed, facilitating the hiring and firing of workers.

**Chart A: Doing Business in Romania (0-175)**



Source: World Bank

While only implicitly addressed in the doing business assessment, company level surveys designed and

<sup>9</sup> See Bosnia's IMF Article 4 (2005).

<sup>10</sup> See World Bank Doing Business 2007.

evaluated by the World Bank/EBRD in the Business Environment Enterprise Performance Survey (BEEPS) suggest that between 2002 and 2005 firms also perceived bribe and kickback taxes and their frequency to have markedly declined.<sup>11</sup> Interestingly, and easily forgotten in the ‘lumping’ of country characteristics, Romania already scores quite well in a few areas: ‘starting a business’ and the provision of infrastructure. On the former, Romania ranks 7<sup>th</sup> out of 175 countries. It takes for example only 11 days to set up a business, compared with 32 in the rest of the region and close to 17 in the OECD. This is particularly striking given that corruption is considered to still be a major business problem. Regarding infrastructure, while there are still some issues regarding service delivery (eg delays in obtaining electrical connections), the actual quality of infrastructure appears satisfactorily. Increased competition in the telecommunications sector for example is improving quality and reducing prices.

Yet, despite these favourable aspects, the Romanian economy still faces important structural challenges. Despite recent reforms, the labour market continues to perform poorly. A reflection of this is that labour force participation has declined by over 5 pp from close to 62% ten years ago. In contrast to Poland and Slovakia, firms’ perceptions of labour regulations in Romania have become more negative between 2002 and 2005. 16% of firms identify labour regulation as a major constraint. According to the IMF, the still obligatory nature of collective wage agreements for non-signatory parties represents a key constraint and should be urgently addressed. Further weaknesses represent dealing with licences, registering property, closing a business and the administration of taxes (Chart A).

While some economic indicators taken together are unambiguous in their message, there are others that are more ambiguous. These relate to access to finance and the protection of creditor rights. Regarding access to finance, while credit bureaus have relatively low coverage, the scope, access and quality of credit information is relatively good (Romania scores 5 out of 6). Moreover, according to the company surveys, while the value of collateral needed for a loans is less than in other countries in the region (142% instead of 154%), more loans actually require collateral (93% instead of 83%). Overall, about 20% of firms consider access to finance as a major constraint, compared with 15% in Europe and Central Asia and 26% in other Lower Middle Income Countries.

Regarding the protection of creditor rights the messages are also conflicting. In terms of transparency, the country scores relatively highly in the Doing Business Assessment (Disclosure Index 9 out of 10). The same holds for the Investor Protection Index (same score as OECD countries). According to the EBRD Legal Indicator Survey however Romania shows low compliance with international standards for corporate governance. Moreover, unlike in some of the central European economies, minority shareholders have no access to company books, nor can they call in an independent audit. A new bankruptcy code notwithstanding, the recovery rate on an insolvent firm is estimated at 19.9%, well below the OECD with 74%, but also a touch lower than other countries in the region (29.5%). This is despite a respectable outcome on enforcing contracts (it takes less time and costs less than in OECD countries, despite a greater number of procedures).

Overall, this suggests that the analysis of countries’ business climate is complex and requires in depth analysis. In addition, simple indicators – if taken in isolation and out of context - could be abused to misrepresent a more nuanced picture of a fast evolving and hence hard to capture economy.

Business constraints are typically more serious than in Central Europe and the Baltic States – inhibiting private sector development, especially smaller firms. According to the EBRD 2005 Business Environment and Enterprise Performance Survey (BEEPS), and despite recent reforms, more firms in southeastern Europe complain about problems of doing business. Corporate complaints range from insufficiencies in infrastructure (transportation, power and telecommunications) to burdensome regulations and red tape, and high corruption costs. Poor infrastructure is partly a legacy of recent wars; but even outside former Yugoslavia, networks and supplies are

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<sup>11</sup> For these and following references, see EBRD Transition Report 2005.

deficient and unreliable. There is only one bridge linking Bulgaria to Romania. Albania still faces frequent electricity shortages. In 2006, however, a good deal of progress was achieved in telecoms, largely through stronger competition in the mobile phone market. As a further illustration, Box 2 reviews these issues in Albania.

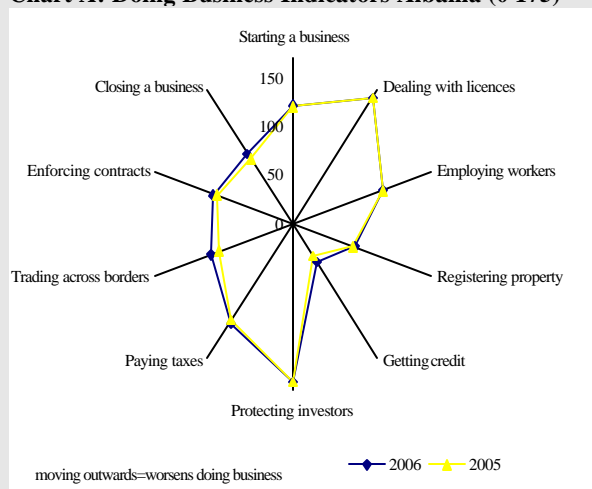
### Box 2: Structural reform issues in Albania

In relative terms, Albania's business climate has worsened slightly in recent years. According to the Doing Business 2007 Assessment, Albania fell back from 115<sup>th</sup> rank to 120<sup>th</sup> rank out of 175 countries. The deterioration was across the board, and greatest for "trading across borders" (Chart A). The recent change is worrying in the context of already low structural performance. There appears to be consensus that corruption, taxation, infrastructure and the working of the judiciary represent key areas of concern.

Some 80% of firms in 2005 considered taxation to be a problem, against around 55% in South East Europe as a whole. Tax administration is also perceived more cumbersome. The significance of the informal economy – estimated at 33% of GNP – is therefore not surprising. Another constraint still in Albania represents the lack of adequate infrastructure and poor delivery. Over 60% of surveyed firms considered the provision of electricity to be problematic, compared with 20% in other parts of the region. The EBRD Infrastructure reform indicator suggests substantial problems in the provision of water. Another major issue is perceived to be corruption. Over 60% of firms indicate this as a problem and 45% of firms say they have to give gifts to obtain import licences. Conflict resolution and the working of the courts is also perceived to be a major issue. Only 20% of firms have used courts, against double that in South East Europe as a whole (Chart B).

That said, on these latter issues, conditions have been improving more recently. Bribes as percent of sales have plummeted in the three year period 2002-2005, and the reduction has been found to be statistically significant.<sup>12</sup> The Millennium Challenge Account finances measures to reduce corruption in tax administration and the recent introduction of a Large Tax Payer Office should improve transparency and encourage compliance. Organised and street crime have both declined markedly. But whether this represents an underlying improvement in political governance and law and order or just a reflection of a more prosperous macroeconomic environment remains to be seen.

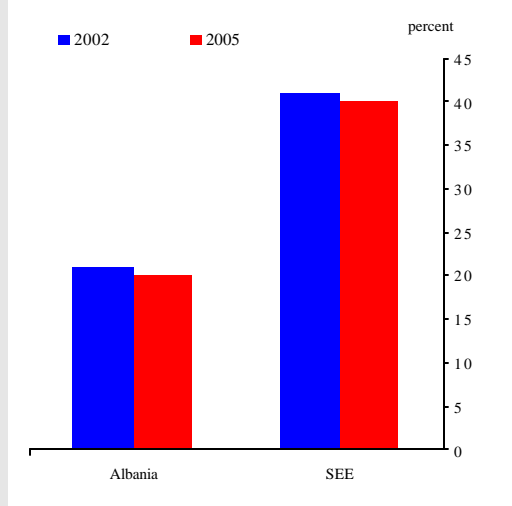
**Chart A: Doing Business Indicators Albania (0-175)**



Source: World Bank

<sup>12</sup> See EBRD Transition Report 2005.

**Chart B: Per cent of firms that have been to court over the past three years**



Source: World Bank/EBRD

The least constraint for businesses appears lie in the financial sector (rank 48<sup>th</sup> out of 175 – see Chart A). Given the considerable reforms and overhaul of the system – as discussed in this paper – this does not come as a surprise. According to the BEEPs, loan negotiations have become less lengthy and more new investments are indeed being financed by formal borrowing. It is interesting that despite all the other more significant business constraints, access to finance is somewhat easier in Albania than elsewhere in the region. Thus, also viewed from this angle, one might wonder to what extent the current credit expansion is sustainable and healthy.

Finally, it is interesting to flag again discrepancies in messages provided by different analyses. According to the Doing Business 2007 Assessment, Albania scores amongst the worst in investor protection- it ranks 162<sup>nd</sup> out of 175 (Chart A). Disclosure for examples is considered dismal. On the other hand, research by the EBRD suggests that compliance with international standards for corporate governance is not too bad (medium rated) for Albania – better than for example in Bosnia or Romania.<sup>13</sup> Moreover, minority shareholders have considerable rights to access company information – something that is not the case in many other countries in the region and even in the CEEs.

Regulatory uncertainty is cited as another major obstacle to private sector activity. Examples of this range from delays and uncertainties about privatisation (eg Kosovo, Bosnia) to the handling of war restitution claims (eg Bosnia). Bribes and red tape represent a major constraint – 25% of firms in South East Europe say that bribes are frequent compared with slightly over 10% in the EU-8.<sup>14</sup> As a result of ongoing corruption problems, enforcement remains a major difficulty for firms.

In a global perspective, businesses in Southeastern Europe (apart from Croatia) face higher enforcement costs than 25% out of 155 countries surveyed. Macedonia and Albania score worse than 50% of such countries (Chart 12). About half of surveyed firms under the BEEPs consider the functioning of the judiciary as a problem in doing business, against only around 27% in the CEEs. These phenomena may have political roots (see Box 7). In any case, weak enforcement seems to affect banks'

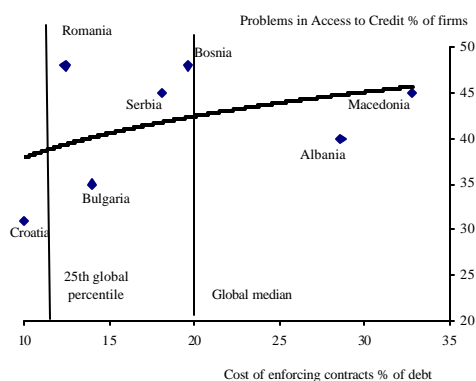
<sup>13</sup> Ibid

<sup>14</sup> Progress on corruption has been made, notably in tax and customs administration. See EBRD (2006)

willingness to lend. Empirically, there is a relation between the cost of enforcement and banks' loan to asset ratios (Chart 13 and Annex).<sup>15</sup>

Among other factors constraining credit availability, unresolved property issues and lack of collateral are particularly important in the region. These factors directly affect the ability of banks to lend, notably to small-sized firms with less of a track record and reliable company information. This is of course a problem in all countries that experienced forced population movements, such as the Former Yugoslav Republics. Finally, weak political parties and governments in a number of countries and constant renewals weaken the quality and efficiency of bureaucracies, as discussed further below.

**Chart 13: Problems in access to credit and cost of debt enforcement**



Source: EBRD BEEPS 2005 and World Bank Doing Business 2005

Official labour markets are relatively rigid especially in the Western Balkans, but also in Romania. Research suggests that job creation and destruction rates are low compared with the EU-8, including compared to those expected at a similar stage of transition.<sup>16</sup> Except in Macedonia, where reforms have been introduced in 2005, and Kosovo which has no law, employment protection laws continue to be stringent, pushing up labour costs, preventing industrial and managerial change, while promoting informal enterprise.<sup>17</sup>

Finally, political issues, as mentioned earlier, are probably constraining private enterprise as well as intermediation (Box 3). This has three dimensions. First, political uncertainty and/or potential ethnic/community unrest increase business risk and hence the required rate of return, constraining private sector investment and hence effective intermediation. The same holds for local discrimination of minority ethnic groups and their limited access to resources and institutions. This applies mainly to the Western Balkans, though all countries are considered higher political risk than the EU-8.

In sum, while country-specific readings of investment climate indicators do at times appear counterintuitive and hard to reconcile with other facts, the overall general pattern of failings matches well with concerns that have become apparent at the more macroeconomic level, notably the orientation of credit to perhaps less productive sectors, rather than to smaller sized firms. The ensuing microeconomic reform priorities need therefore also be placed into a broader financial stability context. In this regard, effective financial supervision is crucial.

<sup>15</sup> It is worth noting that Hungary where SME lending is becoming increasingly widespread ranks 12<sup>th</sup> on the global enforcement scale, ahead of a number of Euro-area economies.

<sup>16</sup> See Slay, (2006).

<sup>17</sup> While Croatia scores better on most BEEPs than other SEEs, the World Bank Doing Business score – which is based on a more factual analysis of regulations and laws ranks Croatia at the bottom of the region, together with Albania. Bulgaria and Romania perform best, while the latter on a number of criteria does worse on the BEEPS.

### Box 3: Politics in the Western Balkans and how they matter for the investment climate

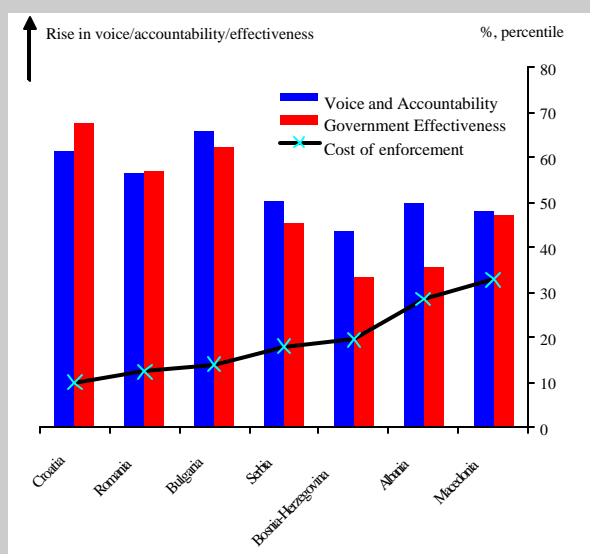
Survey results and studies suggest that a large part of the region is still characterised by significant political weakness.<sup>18</sup> Political parties and elected governments are held in low esteem by the public at large in contrast to say non-elected institutions such as the church (in Serbia for example) or the European Commission (in Albania for example).

In addition, electoral cycles are relatively short and changes in power are typically accompanied by complete renewals of administrative bureaucracies. Political funding is considered opaque. In some countries political power is being increasingly devolved to local levels. Finally, the region continues to be influenced by a nationalistic mindset (as reflected by non-negligible support for radical parties), flaring tensions between different communities.

The channels through which political fragility affects the investment climate are numerous. The perceived limited legitimacy of current elected leaders and bureaucracies weakens their ability to enforce rules and regulations (Chart A). It also has the potential to encourage corruption as administrators know that their position is likely to be short-lived.

The trend to decentralise power could also in some instances contribute to a greater incidence of bribe-taking and bending of rules: decision-making local officials often find it more difficult to resist pressure by local monopolies to abuse power than their peers in a more centralised and thus 'distant' political system. Finally, nationalistic ideas have the potential to trigger discriminatory treatments of local citizens, be it by government officials or private persons. As a consequence, access to resources and the market and hence the investment climate is significantly impaired for concerned firms and entrepreneurs.

**Chart A: Voice and accountability, government effectiveness and cost of debt enforcement**



Source: World Bank

<sup>18</sup> Also see 2005 World Bank Governance indicators.

## Structural reform priorities

The lending environment in southeastern Europe illustrates the scope for continuing reforms to raise the returns on productive ventures and help ensure balanced financial development. Issues of financial system efficiency, and ultimately stability, cannot be divorced from market processes in the real economy – including the effectiveness of judicial systems and insolvency procedures. Given limited implementation capacity, policymakers need to develop a sharply focused diagnosis in each case, but the broad lines of structural policy priorities can be inferred from the discussion above.

First, *improvements to infrastructure and networks* are key, notably in the Western Balkans. The scale and quality of transport systems, and the provision of power, water and telecommunications, all require major enhancement. Given budget constraints, governments need to think how better to involve the private sector in financing and managing infrastructure, while controlling contingent liabilities. A prerequisite is the creation of independent regulatory agencies as well as incentive-compatible tariff and pricing schemes for private operators. The efficiency of ports and customs requires review to lower transport costs and facilitate exporting activities by small firms – thus also reducing vulnerability to exchange rate shocks. Romania, for example, made progress on this front in 2005 by easing trading across borders (see Box 1).<sup>19</sup>

*Labour market reforms are also a key priority.* As discussed earlier, in many countries this would cover social contributions and income tax levels and excessive labour protection and could play a significant part in reducing the size of the informal sector. Efforts need to be intensified to bring long term unemployed back into the labour force, through retaining and potentially tax incentives, while cutting the duration of unemployment benefits and being stricter on abuse.

A further key element to reduce frictions in the financial sector is to improve the effective working of the *legal and judiciary environment*. Policy-makers need to take action to ensure not only that bankruptcy laws are adequate but that the legal process operates in a reasonably efficient manner – facilitating an orderly resolution of claims. Property rights need to be redefined and clarified to facilitate the use of land and housing as collateral. Judges require commercial training, and their numbers increased to speed up procedures and lower costs. To the extent feasible, out of court settlements could be facilitated. This is part and parcel of strengthening the benefits for firms to accept operating in the formal sector: the protection of property rights and low cost access to an even-handed judiciary is thus crucial.

In addition to removing distortions, are *more activist policies* needed? Possible justifications lie in the small size of firms and of markets; the lag in institutional reforms; and continuing political uncertainty in some cases. Examples of such policies include the setting up of development banks and microfinance banks (see Box 4). Codes of conduct to facilitate debtor-creditor relations are another possibility. Guarantee funds or subsidised credit lines for SMEs are also sometimes advocated.

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<sup>19</sup> See World Bank Doing Business 2007.

#### **Box 4: The creation of Micro Enterprise Bank of Kosovo and its early challenges**

As Yugoslav banks fled the province during the Serbo-Albanian conflict in 1998/1999, the formal financial sector had ceased to exist. Given the volatile environment, small size of economy and low expected returns, no private commercial bank, neither local nor foreign, was willing to operate in Kosovo.

Asked by UNMIK to swiftly advance the establishment of a financial institution to improve access to financial services in Kosovo, IFC, EBRD, KfW and FMO joined forces. In autumn of 1999, the group selected the Frankfurt based consultant IPC (Internationale Projekt Consult) to help establish a fully-licensed bank with the aim to offer a range of financial services adapted to the demand of the target group, especially micro and small entrepreneurs.<sup>20</sup> In order to set incentives for the consultant, IPC was asked to take a minority 17% stake in the EUR 2.3 million equity of the institution. IPC invested via IMI (Internationale Micro Investitionen), a stockholding company it had founded for this purpose. In addition, the public development finance institutions looked for a private commercial bank as an investor and provider of relevant know-how in money transfer and cash management.

In December 1999 the Microenterprise Bank of Kosovo (MEB) was formed. Commerzbank, IMI and FMO invested directly into the equity of the bank. IFC and EBRD could not invest directly as Kosovo was not an officially recognized country. As KfW was using Financial Cooperation funds provided by the German government their challenge was similar. The solution was to fund MEB through warehousing arrangements via the Albanian FEFAD-foundation and the Micro Enterprise Bank of Bosnia which then bought equity shares in MEB, Kosovo, on behalf of IFC, EBRD and KfW.

*“On 24 January 2000, the Micro Enterprise Bank of Kosovo was opened. Staff, management and owners were stunned by the volume of activity from the very first day and the pace with which it kept accelerating. Farmers in worn-out clothes, small traders and employees of NGOs queued to open accounts. Lending had to be delayed because of the overwhelming demand for deposits and money transfers. During February more than 2,000 money transfers were processed amounting to 100 million Deutschemark (EUR 50 million). Accounts were opened at a rate of 100 a day. The minimum deposit to open an account was EUR 12. Three quarters of the deposits were held in small personal accounts. Close to 25 % of the deposit accounts were owned by legal entities that had an incentive to minimize the use of cash for security and control reasons. These included UNMIK and many NGOs.*

*By June 2000, MEB had more than 8,000 clients. A second branch was opened outside Pristina in Prizren. Further branch openings were planned for Peja and Gjakova. The challenges then were:*

- (1) Given the immense demand for services from the start of operation of MEB, how could the bank attract the numbers of sufficiently qualified staff needed? Finding university graduates who could be trained was difficult as the government in Belgrade had closed universities in Kosovo in 1994 in order to disenfranchise Kosovars. Furthermore, there were no banking training facilities or courses available in Kosovo.*
- (2) How would MEB manage to expand the branch network to other cities and to rural areas beyond Pristina when physical were hard to come by? Many buildings in central locations had smashed windows or gaping holes in their façade. The renovation was costly. Moreover, property titles were not verifiable.*
- (3) What contributions could the owners of MEB make to the reconciliation in a divided Kosovo? They were eager to contribute to whatever possible. One issue was to find staff willing to serve Serb clients in the region around Mitrovica.*
- (4) What would make cash handling manageable and safe? Almost all deposit account transactions involved physical exchange of cash. Guaranteeing that MEB always had sufficient cash was a huge challenge. The Deutsche Mark notes and coins had to be brought in from Germany while the airport in Pristina was closed. Cash transports by land were too risky given the security situation of Kosovo’s neighbours.*
- (5) How could the volume of cash transactions be further increased without increasing the strain on MEB’s systems? How might new technologies help?”*

Source: KfW

Microfinance banks have been developing rapidly over recent years- boosted by significant foreign donor and IFI support. Most microfinance banks in South-eastern Europe operate on the basis of market principles, comply with banking supervision, cover costs and increasingly approach full sustainability, but still benefit from low cost long term IFI refinancing. Their integration into the ‘traditional’ financial sector has progressed and hence their ability to channel local savings. But penetration rates are still low (less than 0.3% of population).<sup>21</sup> Despite this, the challenges to improve access without sacrificing sustainability are considerable. These are capacity constraints in human resources, the ability to monitor clients as networks grow, trade-offs between ‘mission drift’ (ie a tendency to grow the loan balance at the detriment of smaller borrowers) and profitability.<sup>22</sup>

Another angle of approach is to try to improve working relations between small firms and banks. Appropriate standards may need to be elaborated that meet the need of the creditor, while minimising the burden on firms. This requires a close collaboration between central banks and trade associations. The formulation of a code of conduct between banks and SMEs might raise awareness of mutual concerns and priorities, facilitating access for smaller firms. The government may also want to foster consultancy services for small firms to facilitate interaction with banks, provide market research, and strengthen their systems and skills, all with the aim to facilitate the creation and presentation of bankable projects. Credit registers (*centrales des risques*) may also help increase transparency in the lending market.

Credit guarantee programmes (CGP) are another tool that is at times advocated to facilitate small firms’ access to capital.<sup>23</sup> These programmes jointly provide collateral and insurance, and exist in various configurations in developed and developing countries. In South East Europe, most countries dispose of SME guarantee funds or other subsidised SME lending schemes. Criticism of traditional government credit schemes has pointed to their “second best” nature, and failure to address underlying distortions. If the lack of collateral represents the underlying problem then it is optimal to unlock collateral through say clarification of property rights.

In addition, CGPs risk creating new distortions. For example, given limited funds, guarantees could crowd out viable projects and SMEs. Moreover, it is not clear that CGPs become self-sustaining given the high administrative costs of servicing SMEs. Finally, government funds raise issues of political interference, corruption and accountability. But evidence on the quality and quantity of guarantee funds and subsidised SME schemes through development banks in South East Europe is sparse. An in-depth examination would thus be welcome – notably in light of current significant credit misallocation risks.

In ***financial regulation and supervision***, crucially, a very sound basis has been laid to support the development of the financial sector. Nonetheless, further challenges need to be addressed. In most cases, a key priority lies not in formal frameworks but in issues of implementation – particularly risk-based supervision, credit assessment and consolidated oversight. Better information is needed for banks and supervisors concerning the financial health of households and corporates. There are differing

approaches to the implementation of Basle II, with a key factor being the approach to risk assessment taken by foreign banks.

Supervision of non-banks has lagged, but is receiving greater attention – including where administrative controls have diverted credit outside the banking system. Much remains to be done in the field of non-bank supervision, including in the field of disclosure and governance rules. In Bulgaria for example, self-standing leasing companies report statistical information to the central bank, but are not supervised. The oversight of financial markets also needs to be strengthened, with issues of transparency and governance (including minority rights) a high priority.

An important and controversial issue is the role of supervision in addressing rapid credit growth. At the micro level, the priority is clear: to ensure the capacity of banks to screen credit and manage the risks involved in new segments of the market, where track records are not available to help in assessing risk levels. The more difficult issue concerns possible action to moderate aggregate credit growth. The appropriate question is whether banks and supervisors are internalising systemic risk in their evaluation of credit and market risk – and how this might imply re-designing or recalibrating supervisory tools. One route could be more onerous stress-tests (including of indirect foreign currency exposure). Another tool is anti-cyclical loan provisioning of the type applied in Portugal and Spain; but this may run into tax and accounting obstacles. A further approach lies in imposing or adjusting minimum loan-to-value or loan-to-income ratios, which may moderate exuberance in mortgage lending.

A related prudential challenge is co-operation with foreign supervisory authorities. From a stability perspective, one key issue is prevention. In particular, it is not clear how a meaningful cross-border dialogue is to be conducted with regard to systemic credit risk. For example, foreign subsidiaries may have large and growing exposures to the real estate, including via mortgages. But each bank may be globally well-diversified. (They may also have an option of converting to branch status.) What is the basis for supervisory concern about such local risk concentrations? Should home supervisors enter into a dialogue on this with local supervisors and their own banks?

The assessment of liquidity is complex also, in terms of prevention. Should short-term intra-group liabilities of foreign banks be regarded as akin to direct investment, or are they a source of funding vulnerability from a macrofinancial perspective? Here, the dominant position of a few foreign banks in eastern Europe could pose contagion risks, as highlighted in some local Financial Stability Reports. “Common lender” issues are familiar from Asia, though the strategic engagement of EU banks, and the institutional setting, to some degree qualify these concerns.

Complementing these issues of prevention are well-known dilemmas concerning crisis resolution, and in particular burden-sharing. It is in some circumstances unclear which authorities would bear the costs in the event of a crisis, or how these costs would be shared among them. Arguably, it is very hard to sort out issues of prevention effectively if the incentives resulting from resolution costs are unclear.

These issues can – and should – be kept distinct from any argument to use supervision as a surrogate macroeconomic policy tool, to help cope with constraints on monetary policy and/or tensions surrounding fiscal policy. Such a role for supervision is open to

well-recognised objections. While this might look tempting to macroeconomic policy-makers during a boom, the countervailing danger of pressure on supervisors to ease prudential requirements in a downturn – thus reducing incentives to resolve bank problems and undermining confidence – should need no underscoring.

Nonetheless, faced with limitations affecting monetary, fiscal and local supervisory instruments, policy-makers in southeastern Europe have made considerable use of administrative controls over credit to the private sector, citing monetary reasons among others. Bulgaria imposed stricter standards on provisioning and loan classification, and the central bank also put in place ceilings on credit growth and deposit penalties if banks exceed them. The National Bank of Romania imposed limits on foreign currency lending to unhedged borrowers (at 300% of bank equity).

A major difficulty with such approaches is that they have limited purchase with an open capital account, especially where banks are foreign-owned and major investors include international firms. Cross-border flows to firms can free up domestic capacity for lending to households. BIS data on cross-border credit to non-banks illustrates how sharply this can rise in response to domestic credit conditions. There may also be scope for credit to flow through alternative non-bank channels (as with leasing companies in Croatia, for example). Credit may indeed be diverted to intermediaries that are less supervised, causing negative spillovers for growth and stability.

Empirically, experience with administrative controls has been mixed. As suggested by trends in Chart 5, the jury is still out regarding the effectiveness of such measures. They may mainly provide a brief respite during which other policies can take effect, but they do not appear viable for a medium-term dampening of credit growth. Over time, they may well lead to the diversion of credit to other routes – including direct cross-border lending and intermediation by less supervised domestic institutions. Policy practitioners in the region give some credence, however, to certain measures that are more-or-less market-based and prudential in intent: centrales des risques; limits on loan-to-income or loan-to-value ratios; and capital ratio charges for banks with high foreign currency loan exposure to unhedged borrowers. Such measures, which can be fully justified in prudential terms, may indeed have welcome macroeconomic spillover effects by avoiding distortions that swell credit growth.

As noted above, authorities across the region have therefore stepped up regulation of leasing companies and sought greater coordination with other authorities regarding cross-border flows, as tightened regulation encouraged circumvention and alternative credit supplies. This has been one factor encouraging co-ordination or mergers among supervisory agencies. In 2006, for example, Croatia merged the supervision of all non-bank intermediaries. There has been some tendency across eastern Europe to unify authorities; but the key operational concern is that, under all institutional options, there is a major effort to overcome barriers to information flows and co-ordination, either across supervisory bodies or between them and central banks.

Nothing in this section should be read to deny the wide diversity of structural features in southeastern Europe, or the varying degrees of advance with institutional reforms. Among other things, this variety is reflected in the different Accession status of countries – with Bulgaria and Romania already members, and others still on the

threshold of Stabilisation and Association Agreements. But, across this diversity, patterns are evident in the structural and institutional challenges facing the region.

Among the key priorities are the working of formal labour markets; the problems of remaining state-owned or supported institutions; frameworks for competition; the judicial system; and financial supervision. Addressing these institutional challenges effectively is essential to unlock high medium-term growth potential. Moreover, by helping to foster a balanced pattern of financial flows, this can contribute crucially to ensuring macrofinancial stability over the medium term.

### Macroeconomic frameworks, institutions and governance

The priority of deepening institutional reform concerns macroeconomic governance as well as frameworks to enhance the working of private markets. The encouraging economic performance of recent years – resumed growth with low inflation – already evidences greatly improved macroeconomic management. But important challenges remain, especially in the public finances. The challenge now is, to an important degree, to improve macroeconomic governance and related institutions.

In the case of the **public finances**, it is true that headline fiscal deficits and debt ratios have been declining, despite the impact of bank and real sector restructuring (Table 13). Great improvements have been made also in fiscal measurement: off-budget funds have increasingly been incorporated, and sound public accounting practices have been adopted. Transparency has thus made a leap forward, reflecting the impact of international standards and codes, and the *acquis communautaire*.

	Fiscal Balance		Public debt	
	2000	2005	2000	2005
Albania	-9.2	-4.7	71.3	55.0
Bih	-3.1	0.0	-	30.0
Bulgaria	-1.0	+2.3	89.3	29.9
Croatia	-6.5	-4.2	51.1	45.6
FYROM	+2.5	-1.5	53.2	44.0
Romania	-3.8	-0.8	22.7	15.2
Serbia & Montenegro	-0.9	+0.2	-	53.0

Source: IMF and National Publications

But the relative weakness of fiscal frameworks is evident, first, in that fact that fiscal consolidation is incomplete in several cases. Retrenchment in Croatia has proved troublesome, and the high level of public investment expenditure only partially mitigates this concern. Public debt dynamics in Bosnia remain a major challenge. In Serbia, there is important real sector restructuring still to be completed, and this may throw up further significant costs to the budget. In Romania, 2006 has seen an ill-timed easing of the fiscal stance against the background of a strong private-sector boom. There are still cases where off-budget funds have yet to be fully incorporated. This typically means that deficits in such cases are somewhat under-recorded. And strategies usually are not yet in place to address population ageing.

Second, fiscal policy now faces the challenge of supporting macroeconomic stability in a setting of strong credit expansion and growing private sector saving-investment imbalances. Here, the capacity of fiscal institutions to ensure that “good times” are well used will be crucial. This depends also on accurate measurement of underlying fiscal balances during financial booms, an area in which advanced as well as emerging market economies in other regions have experienced serious problems.

Fiscal positions tend to be overestimated in an environment of credit and asset price booms for several reasons. Asset price rises can provide a sizable, but reversible, boost to revenues. Moreover, the composition of GDP during credit booms may initially show strong consumption growth, with weak net exports, but over time this tax-rich composition will tend to reverse. Finally, it is easy to overestimate potential growth when a credit boom is underway. At a minimum, a sizable safety margin must be allowed in estimating the underlying fiscal position during financial booms.

Domestic fiscal institutions matter crucially in an environment of strong credit expansion and large private sector imbalances, because they are a vital complement to externally set rules such as the Maastricht criteria for membership of the euro area. It is particularly important, in this setting, to treat the 3 percent Maastricht deficit reference value as a ceiling, not a target. Experience in Spain, and a comparison with Portugal, illustrates the stabilizing influence of a fiscal policy that moves to surplus during real convergence alongside the process of euro adoption.

If credit booms continue, and growth in southeastern Europe remains strong over the next few years, it will be prudent to allow the public sector to move to balance or surplus. This will help preserve macroeconomic balance; limit real appreciation; and build in additional flexibility for the challenges that may surface as credit booms come to an end. But if the public sector’s support for growth is not to be diminished, then structural reforms in taxation and in public expenditure are a high priority, so that adequate consolidation can go hand-in-hand with growth-supportive spending.

In other words, the institutional and structural features of fiscal policy need to move to centre stage. This is essential in order to combine support for stability with support for growth, and to ensure that sound fiscal institutions help to preserve time consistency in policy and to steer expectations:

- Well-targeted reforms hold the key to reconciling support for growth with a pace of consolidation adequate that can safeguard macroeconomic stability. Key steps to raise public saving can also improve allocative efficiency – for example, removing subsidies to consumption and real estate, and making budgets more supportive of growth in the productive sector.
- In this context, there needs to be a review of tax burdens and social charges. While tax rates are not out of line internationally, top brackets often start at low monthly incomes, e.g., less than 500 euros. Moreover, social contributions amount to a non-negligible further 40%. In Albania, the top bracket rate of 30% yields revenue collections of less than 1% of GDP. Excessive taxation encourages firms to misreport information or opt for the informal sector, tending to distort credit away from potentially profitable firms.
- From a financial stability perspective, microeconomic aspects of fiscal policy deserve much more attention. Key priorities here include public debt strategies

(as these affect funding and exchange risks); and the allocative impact of taxes and subsidies, including the treatment of interest on real estate borrowings.

- Reforms to the civil service and bureaucracy constitute a major policy priority, especially for small firms, to get rid of corruption, burdensome regulations and red tape. Again these encourage informal sectors – and hence render formal financial intermediation more difficult. This is indeed a key issue – and one where the EU accession perspective can most help in its resolution.
- In the broader public sector, the restructuring of state-owned firms and hardening of budget constraints remains incomplete in some cases, especially in the Western Balkans. This is crucial in order to cut back budgetary subsidies – and in a few cases to help avoid a build up of further NPLs in the banking system, as well as a diversion of credit away from private firms.
- There is important scope to strengthen fiscal institutions, thus helping to embed stability more firmly and to influence market expectations (Box 5). In particular, strategic medium-term frameworks for public spending can help support a reorientation toward productive goals.

#### **Box 5. Fiscal Institutions – Lessons from the “2004 Wave” of EU Member States**

There are interesting lessons to be learned from fiscal experience in eastern EU Member States. A key insight is that the institutional setting of policy can influence expectations favourably through sound governance, transparency, credibility and time-consistency – thus enhancing stability. There are several facets to this issue, and they are relevant to southeastern Europe.

For many of the Member States that joined the EU in 2004, a key challenge is to build credibility with markets that they can hold firm to **budgetary commitments**, overcoming the “common pool problem.” Fiscal institutions can be designed in ways that help limit expenditure bias – a topic examined in European Commission Public Finance Report for 2005. There are different approaches. One is to delegate formation, monitoring and implementation of the budget to a single body – for instance, a finance minister with a leading role in the budgetary process. A further approach is to address fragmentation of the process by increased co-ordination among spending ministers and different levels of government through formalised rules and procedures. Most of the Member States that joined the EU in 2004 have embarked on reforms in their fiscal institutions that embody elements of the latter approach.

In recent years, most of these countries also introduced **multi-year budgetary frameworks** to internalize medium-term consequences of decisions on spending, and improve ex-post monitoring. Many also moved to integrate activities of **extra-budgetary funds** in the budget process, and to increase co-ordination of spending decisions across levels of government (Gleich, 2003, Yaoutinen, 2004). It is important not to create sources of public debt outside the budget through a failure to control tightly the incurring of contingent liabilities through public-private partnerships.

The ending of regulatory uncertainty was identified as a major constraint for example in relation to privatisation. It is thus important to draw up a credible **medium term reform plan** to anchor expectations – this would encourage firms to borrow for investment and productive activity. Independent councils could be called on to prepare the macroeconomic assumptions used in budgetary projections. Effective regulatory frameworks can allow the private sector to play a role in providing infrastructure.

Continued/...

Nonetheless, there is still room to strengthen fiscal governance in these countries, particularly in light of the “reform fatigue” which (as in the Czech Republic, Hungary and Poland, for example) can easily set in after periods of strong adjustment effort. For example, agreement how to use better than expected **budgetary outcomes in “good times”** will be helpful to avoid loosening the stance of fiscal policy during periods of strong growth. Such a rule might be to dedicate all over-budget revenues to deficit and debt reduction, thus building a buffer during good times.

Strengthened practices for **evaluating expenditure** (e.g., via cost-benefit analysis techniques in the selection of projects, periodic reviews of programmes, establishment of selected output-based indicators) also contribute to increase the effectiveness of expenditure and to achieve cost savings.

A key element of all such approaches is **sound and transparent fiscal data**, following ESA 95 principles, provide policy-makers and markets with a reliable basis for assessment. Effective fiscal management needs to rely on a range of indicators, not just a few headline numbers, and to incorporate key consistency checks in accounting areas such as stock-flow adjustments – as well as economic areas such as the compatibility of projections for sector balances in the economy.

In **monetary policy**, strong and transparent institutional frameworks (hard pegs or inflation targeting) are in place in several cases, while others have intermediate approaches. This reflects in part the diverse approaches adopted during stabilization episodes, which tended to move countries towards the two ends of the floating/hard peg spectrum.

A first group (Bosnia and Herzegovina, Bulgaria, Kosovo and Montenegro) opted for deutsche mark/euro-based stabilization strategies through hard pegs or introduction of the euro without a formal arrangement, and are continuing with this. A second group also used the exchange rate as the main instrument to stabilize prices, but without a hard peg: Croatia and Macedonia remain in this category. A third group (Albania, Romania and Serbia) pursued eclectic strategies – informal inflation targeting (IT), managed floats or monetary targeting. Romania has now moved to a pure form of IT, and Albania has been moving pragmatically and prudently in this ultimate direction. There has thus been some tendency to move further toward “corner solutions,” though not all cases fit into this pattern.

But in the case of monetary policy, quite complex structural and institutional challenges remain, over and above the attainment of fully transparent policy regimes. As well as their effectiveness in containing inflation, all of the prevailing monetary regimes also have important risk characteristics, in terms of overall economic and financial management. It is essential for fiscal and structural policy-makers to internalise fully the implications of these regimes and institutions for risk management and policy co-ordination, if financial development is to be sustainable.

These risk characteristics are well illustrated in the present environment of rapidly growing domestic credit and widening private sector imbalances. There are difficult questions how monetary policy can or should respond, within the limits of each regime type, to the impact of expanding credit on the external accounts and on asset

prices. These problems take somewhat different forms depending on the monetary regime:

- Under pegged regimes, with an open capital account, there is little scope to influence credit growth through interest rates. Moreover, the fixed exchange rate setting may contribute to a willingness among firms and households to take on unhedged foreign currency debt, facilitating more rapid credit growth. Hard peg strategies may thus encourage, overall, an acceleration of financial dynamics. The influence of the exchange regime should not be exaggerated, since expectations of medium-term nominal appreciation could have similar result. And there are deeper processes of financial integration at work. But patterns of credit growth lend some plausibility to this view (Table 14).
- Fixed and floating strategies channel shocks to different markets, so the resilience of the economy will vary according to the flexibility and rigidity of those markets. Under pegs, real sector markets need to be flexible (labour markets, and other mechanisms that reallocate resources, such as insolvency procedures). Under flexible rates, financial markets need to adjust flexibly to avoid major and durable losses of output – and this will not be the case if firms and households have large unhedged balance sheet exposures.

**Table 14. Eastern Europe: Monetary regimes and credit developments**

<i>(In percent)</i>				
	<b>Monetary regimes</b>	<b>Real credit growth (2005)</b>	<b>Foreign currency credit % (2005)</b>	<b>Credit/GDP (2004)</b>
Albania	Float	70.6	80	9
Bih	CBA	27.6	Indexed	45
Bulgaria	CBA	27.6	45	37
Croatia	Rigid	14.3	65	62
FYROM	Peg	20.0	40	23
Romania	Float	55.0	65	18
Serbia & Montenegro	Rigid	41.0	70	17
Czech Rep.	Float	19.6	11	32
Estonia	CBA	57.5	73	42
Hungary	Rigid	14.7	39	44
Latvia	Hard Peg	35.5	60	51
Lithuania	CBA	52.5	58	29
Poland	Float	8.5	24	31
Slovakia	Float	21.8	38	24
Slovenia	Rigid	20.2	32	48

Sources: IMF; National Publications

- The time-profile of adjustment to shocks is different. Under flexible exchange rates, monetary policy has the freedom to puncture a credit boom. Under hard pegs, country-specific booms lead to adjustment through an extended process of real appreciation, which over time slows the boom. There is a perverse effect, initially, as inflation rises and real interest rates fall – amplified by asset prices. So the boom may be protracted. There is a question whether such extended periods of perversely low real interest rates may cause a distortive shift of resources to the non-traded goods sector, also retarding adjustment. And there is also a concern that periods of inflation in such booms could postpone a “euro exit” just when external vulnerabilities are largest.

- These regime differences are important, but the degree of policy flexibility under floating rates should not be exaggerated. Monetary sectors in the region are quite small and euroised, so the impact of interest rates may be modest, and unsterilised inflows may dilute their impact. The response of the economy to exchange rate shifts is also complicated by unhedged currency exposures (depreciation becomes potentially contractionary, and appreciation can be expansionary due to balance sheet effects). This means that puncturing a boom may involve a sharp adjustment in interest rates, exchange rates and output.

In the setting of southeastern Europe, with credit accelerating and private saving-investment imbalances widening, these risk characteristics of monetary regimes take on key importance. Flexible regimes with rising levels of foreign currency debt offer only qualified monetary autonomy, and provide only a limited “safety valve” for policy errors. Hard pegs initially proof the economy against speculative attacks. But they may accelerate the growth of credit and unhedged exposures; and their inflation dynamics could delay euro adoption – factors that leave these regimes exposed to a small risk of a major crisis, were a peg to fail amid heavy balance sheet exposures.

This assessment carries a strong twin message as regards economic governance and institutions. First, it is crucial to assure transparent and credible macroeconomic policy frameworks, to maximize their role in steering expectations and safeguarding stability. Second, this monetary environment implies a very heavy discipline on the robustness of fiscal policy and the effectiveness of structural reforms. Risk management in the economy has to be broadly shared across policies.

### **Concluding remarks: policy priorities and trade-offs**

The discussion so far suggests a number of key medium-term challenges relating to financial development and stability in southeastern Europe. In some cases it is quite complicated to map these to policy prescriptions. But perhaps the most difficult challenge is to form a balanced assessment – regionally, or on a case-by-case basis – how deep a concern is warranted that the financial sector might fail to deliver.

The upside possibilities are clear, and represent a historic opportunity for the region, even if formal enlargement progresses more slowly than planned. These lie in accelerated trade and investment integration with the EU, and more broadly with global markets. A countervailing concern lies in very strong financial sector dynamics, which appear promising but could give rise to medium-term vulnerabilities.

The heart of the question is whether today's strong financial expansion might end up delivering too little productive investment; too much unhedged borrowing in foreign currencies; and too strong a real appreciation, which then proves hard to reverse. In institutional terms, it is that foreign banks and corner-solution monetary regimes might shield economies initially from market shocks, but eventually expose them to a sudden stop of capital flows, amid balance sheet constraints that impede the use of the exchange rate to reorient economic activity. The economies with less flexible exchange regimes are perhaps particularly at risk of long-drawn out adjustment dilemmas. For inflation targeters, the same issues could pose acute market risks.

Such a scenario could develop in part because of troubling incentive problems. An environment of financing ease and well-buffered institutions could lull policy-makers to avoid tough choices, allowing long-run stresses gradually to build up. Specifically, monetary authorities may feel their hands to be tied; fiscal authorities may enjoy favourable revenue surprises during extended booms; and supervisors may see little choice but to rely on home authorities that are uninterested in local systemic risks and face unclear incentives with regard to liquidity support and burden-sharing risks.

This is where international surveillance can make a decisive difference. Strong traditions of IMF involvement, coupled with an expanding EU policy dialogue, could help highlight risks and pinpoint key policy options. Close regional co-operation and exchanges of experience can contribute greatly, including through outreach to share the experience of adjustment fore-runners among the EU's eastern members.

The basic priorities are clear. They are, first and foremost, to improve market structures and frameworks, and institutional depth, in the real economy, thus opening up high risk-adjusted returns in productive activity. Only good productivity growth can validate rising income expectations, ease adjustment tensions, and ensure the international liabilities are serviced without domestic strains. It is infinitely more effective to strengthen market incentives, thus harnessing the capital flow tide productively, rather than construct administrative sea-walls that may only distort its impact.

However, given the current institutional weaknesses in these economies, some more activist policies may at times prove unavoidable. It needs to be borne in mind that these may come at a cost. There needs to be a searching examination whether they truly fill market gaps, or whether they risk distorting the allocation of resources? This is relevant in relation to administrative controls over credit, but it also applies to schemes to jump-start financing for small enterprises. Meanwhile, local supervisors will ensure that banks internalise systemic risks, and they will require full-bodied support from home supervisors in so doing.

Alongside effective structural measures, macroeconomic policies must be provide a bed-rock of stability for the economy. More than in the past, policy-makers will need to be attentive to the risk-characteristics of policy regimes, and their interaction with financial markets. Well-designed fiscal reforms and institutions will be key in moderating pressures on the economy and unlocking supply-side opportunities; but the fiscal stance also needs to be prudently evaluated for the transient impact of strong financial booms. Monetary authorities either need to embrace flexible strategies that allow true variability, and trigger sharp adjustments where needed in the short run. Or, where pegs are retained, they need to make clear the need for exemplary fiscal and structural policies over a long period, since the timing of euro exits may depend on price developments that they cannot entirely influence.

In pursuing reform priorities over the medium term, policy-makers inevitably will face complex trade-offs and complementarities. It may be helpful in conclusion to explore what light is shed on these by the assessment in this paper.

The most fundamental issue explored in this paper is whether policy-makers face trade-offs or complementarities between *financial expansion and financial stability*. Should one imagine the relation between these as an inverted U, in which countries are best placed for sustained real convergence if they experience intermediate credit growth and current account deficits? Is very rapid financial expansion to be contained at all costs? That may be the implicit image in the mind of macroeconomists as they worry about high headline numbers for bank lending and private sector imbalances. It would be a very troubling conclusion in southeastern Europe, where macroeconomic and financial policies, it appears, have limited traction over aggregate credit growth.

Here, the assessment in this paper points strongly towards complementarities between financial expansion and financial stability, but subject to actions that will strengthen the structural setting and institutional framework for private sector development. For the range of values observed in eastern Europe, there is no intrinsic reason to fear rapid financial growth – and the capacity to unlock this is indeed a major plus of the EU Accession process. But these gains are far from automatic. Strong increases in cross-border flows and domestic credit raise the stakes for policy makers, since they amplify both the favourable aspects of business environments and the distortions.

This helps to clarify a further issue, concerning the *overall macroeconomic stance*. A key question is whether authorities should tighten the stance of monetary and fiscal policies in the face of widening private imbalances, appreciating real exchange rates, strong credit growth, or asset price increases;

- A first answer to this must lie in a careful analysis that places financial developments in their real sector context, factoring in the overall resilience of linkages in the economic system. At any point, this may reveal that serious distortions or balance sheet stresses are building up, and that it is better to cut off the expansion through tight monetary or fiscal policy, even at the expense of a short, sharp cycle in the real exchange rate and output. Under a pegged regime, this would raise fundamental questions about sustainability.
- A more forward-looking answer, but one which would need to be embraced urgently to be still realistic, is that the *boundary of macroeconomic and structural trade-offs* in the economy can be pushed out over time. Through forceful structural and institutional reforms, policy-makers can make it safer to run the economy at high growth rates of domestic demand, with rising external liabilities, since sound market structures and institutions should elicit a swift and sustainable supply response. A central concern is that resources flow to efficient uses in the productive base of the economy, including crucially the traded goods sector. Through strong productivity growth this can enhance competitiveness, underpin income expectations, facilitate real exchange rate adjustment, and ensure that international liabilities are smoothly serviced. Careful analysis of the business environment is thus a key priority, since only this can provide a basis for policy-makers to press through targeted reforms.

For any state of reforms in the business environment, key issues arise in the *design of fiscal frameworks*. Here, a number of key conclusions have been gaining wide recognition among economists. In essence, fiscal policy-makers usually face opportunities which, while politically difficult, can support the twin objectives of growth and stability. Well-targeted reforms can enhance public sector support for

growth while facilitating consolidation. Strong fiscal institutions, meanwhile, can help buttress decision-making and guide expectations in ways supportive of stability. This will be particularly important when revenues are swollen by financial booms, further complicating the task of pursuing consolidation in “good times.” Overall, the fiscal story is more of complementarities than of trade-offs, and institutions matter greatly.

The trade-offs relating to *monetary frameworks* are more complex. Experience in the region confirms that alternative monetary and exchange regimes, given adequate policy support, can perform very well in assuring low inflation. Much harder to evaluate are the risk characteristics of these regimes. This paper has argued that, in southeastern Europe specifically, proponents of both fixed and floating regimes can easily underestimate the hazards facing monetary policy along the Accession road.

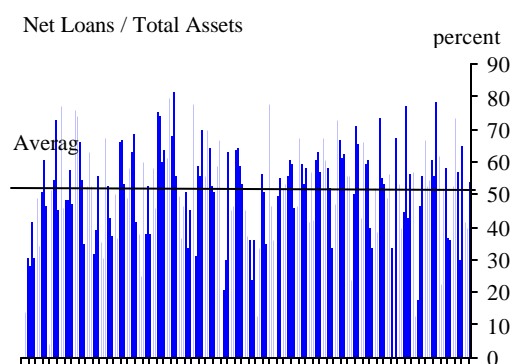
Hard pegs insulate the economy from nominal exchange rate shocks, but they may accelerate the expansion of unhedged borrowing in foreign currencies, and they put a high premium on real sector flexibility in the case of shocks. Inflation dynamics, meanwhile, can raise questions about early euro adoption as an exit strategy. Flexible exchange rates facilitate adjustment; and – as part of a co-ordinated policy effort – they may help to slow the growth of balance sheet risks. But to the extent such risks build up nevertheless over time, then these regimes offer no more than a qualified safety valve in the event of exogenous or policy-induced shocks.

In sum, as the literature makes clear, the support of rapid financial development for sustainable growth is not automatic. Market distortions can be amplified, and policy errors can cause severe setbacks for growth. Such setbacks may take the form of a crisis or, at least as likely in this region, they may emerge as stresses that stall real convergence. So accelerated financial integration – a hallmark of the EU Accession process – places strong demands on policy-makers to ensure that institutions and market structures keep pace. Across southeastern Europe there are encouraging signs in this regard. But there are also many watchpoints that deserve close policy attention.

### Loan to asset ratios of banks in southern eastern Europe

While averaging around fifty percent, casual observation shows large discrepancies in loan to asset ratios across banks in South East Europe (Chart A). Loan to asset ratios show banks' propensity to engage in traditional financial intermediation towards the domestic private sector.<sup>24</sup> In that, akin to credit to GDP ratios at an economy-wide level, these data - for countries at an early stage of development - provide insights about financial deepening: to what extent it can be explained by fundamentals and is hence sustainable; whether it suggests potential for catch-up and what the fundamentals behind it are, for example macroeconomic or bank-specific.

**Chart A: Net loan over asset ratios for 150 banks in South East Europe.**



Source: Bankscope

To analyse this, a regression of pooled data of net loans over asset ratios of 150 individual banks from 2000-2004 in Albania, Bosnia, Bulgaria, Romania, Croatia, Serbia and Macedonia was run on indicators of bank health such as the net interest margin, the level of capitalisation, loan-loss reserves and the bank's market share over the same time period. The effect of the latter on the propensity of banks to lend could be positive or negative, depending if economies of scale and hence lower interest rates or effects of diminished competition and hence higher interest rates dominate. The choice of macroeconomic variables was inspired from past research on financial deepening<sup>25</sup>. The fiscal balance and a dummy for high inflation episodes should pick up respectively public sector crowding out (and resulting in banks lending less) and macroeconomic instability. GDP per capita was used to proxy for the availability of collateral and general economic development. Finally, the World Bank Doing Business cost of contract enforcement measure was included in the regression.

We find the following results:

- Given the amount of idiosyncratic factors that such a regression cannot pick up, the fit of the regression is relatively low, but is reasonable if we include only banks with market share of at least 2% (n=74) (R2 of 0.4) (Table A). This suggests that there are a number of small institutions with possible reporting issues; run by non-market considerations; and/or are very specialised niche operators.
- The larger the bank's market share, the smaller the loan to asset ratio, suggesting that economies of scale effects may be outweighed by increased monopoly power.

- As expected, the higher the debt enforcement cost, the lower the propensity to lend. Also, high inflation and fiscal deficits discourage lending. As nearly all countries now pursue stability-oriented policies, sustainable further development of lending activities will need to be driven by bank-specific factors or improvements in the institutional environment.
- In-line with theory, the higher the interest margin, the more banks lend. Interest margins are driven by structural (reflecting lending technology, management) and cyclical conditions. Privatisation and FDI into banking sectors in 2005 and its effects since, which are not picked up in these estimations, are likely to raise profit margins and possibly imply a higher desired loan to asset ratio in the future.
- GDP per capita, the capitalisation of banks and loan loss reserves have no significant effect in the regressions. The latter is interesting; it might suggest that loan-loss reserves are inadequate and/or mis-specified.
- The residuals pattern is suggestive that loan-to-asset ratios are below equilibrium in Bosnia and Romania, but above in Serbia and Croatia (Table B and Chart B).<sup>26</sup> Indeed private sector loan growth has indeed picked up in Bosnia since 2004, but also in Croatia – and massively in Albania. Conversely, Bulgaria has seen a fast decline in private sector credit growth – plausibly driven by central bank tightening of administrative measures.

**Table A: Regression results of pooled estimation of 62 banks' loan to asset ratios in South East Europe**

Dependent Variable: Net loans over asset ratio  
Method: Least Squares  
Date: 07/06/06 Time: 14:47  
Sample: 1 74  
Included observations: 62

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	64.95964	5.544277	11.71652	0.0000
Net interest margin	1.299516	0.706223	1.840094	0.0713
Capital ratio	0.113463	0.178805	0.634566	0.5284
Fiscal deficit	2.806032	0.662777	4.233749	0.0001
Enforcement costs	-0.367810	0.226568	-1.623397	0.1103
High Inflation dummy	-8.242240	3.604610	-2.286583	0.0262
Market share	-0.402710	0.183784	-2.191219	0.0328
Loan-loss reserves	-0.091905	0.153880	-0.597251	0.5528
R-squared	0.490156	Mean dependent var	50.82613	
Adjusted R-squared	0.424065	S.D. dependent var	14.61103	
S.E. of regression	11.08837	Akaike info criterion	7.769585	
Sum squared resid	6639.408	Schwarz criterion	8.044054	
Log likelihood	-232.8571	F-statistic	7.416382	
Durbin-Watson stat	1.991273	Prob(F-statistic)	0.000003	

**Table B: Average residuals for different countries**

AL	BO	BU	SE	CR	MC	RO
-0.3	-2.6	0.4	1.7	1.35	0.1	-2.8

**Chart B: Actual and fitted observations of loan to asset ratios in South East Europe**

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