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Banking Sectors in South-Eastern European Economies

YIWEI FANG[1] – IFTEKHAR HASSAN[2] – KATHERIN MARTON[3]

Abstract

It has been a major achievement that within a decade subsequent to military conflicts, embargo, and crises in the Western Balkan region, a privately owned banking sector developed in SEE that provides financial services similar to those of Western Europe. Rapid privatization ended government interference in the banks and foreign ownership contributed to the build-up of trust of the population that was fractured in several countries through actions of the central bank and other authorities.

The global economic crisis exposed some of the strength and vulnerabilities of SEE countries where mostly during the last decade banking sectors moved from state- and collective ownership to predominantly foreign ownership. Since this is a relatively new phenomenon, government policy makers need to adopt regulations that increase the benefits that foreign banks contribute to the local economy but also reduce some of the adverse impacts that are associated with foreign bank ownership.

Keywords: South-Eastern Europe, banking sector, financial intermediation, foreign banks

JEL Classification: G20, 21

Two decades after the political changes of 1989, the South-Eastern European (SEE) region went through dramatic political and economic transformation. In the formerly centrally planned economies of Bulgaria, Romania and Albania as well as in the successor states of the former Yugoslavia, the transition to market economies is largely completed. Compared to countries of Central and Eastern Europe (CEE), the transition in SEE was accompanied by far more political turmoil and instability. This slowed down the reform process and delayed major economic restructuring during the first decade. With the political stabilization following the

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end of the Kosovo war and democratic changes in the Federal Republic of Yugoslavia in 2000[4], the region experienced sustained economic growth and the pace of economic reforms accelerated. Bulgaria and Romania joined the European Union (EU) in 2007 and are to be followed in the near future by Croatia. Despite such progress, countries of the Western Balkan remain Europe's economically least developed region. Reducing the economic gap with the EU will require concerted and sustained efforts over an extended period. Development of the financial sector will play an important role in this process. In most transition economies capital markets are still in early stages of development, and it is the commercial banking sector that assumes key function in financial intermediation. It is within this framework that this paper aims to assess the state of commercial banking sectors in SEE countries. Though their restructuring in the region began later than in CEE, once the process of privatization of state-owned banks started the transition to a privately owned banking sector took place within a relatively short time. Their stability withstood the test of the recent global financial crisis. This is an opportune time to analyze the major characteristics of the banking sectors that evolved and identify features that may shape future development.

The transition process of banking sectors in CEE countries is covered extensively. Due to its relatively late start, and smaller size, the SEE has region received less research attention. Though the transition experience of the two regions was similar in many aspects, different historical legacies, subsequent political events and timing of reforms also contributed to differences in the two regions. Since the large economic heterogeneity of SEE is an important hallmark of this region, this inevitably affected financial sector development of the countries. Our analysis of the region shows that despite such variations, the banking sectors that evolved in the countries are quite similar in terms of ownership structure and other key financial sector development indicators. We also find that though the arduous process of restructuring resulted in privately owned and rather efficient banking sectors in SEE countries, financial sector development remained at relatively low levels.

The paper is organized as follows: Section 1 presents the process of

[4] In 2000. this included Serbia and Montenegro

transition in SEE countries, including Bulgaria, Romania and countries of the Western Balkan region[5]; Section 2 analyzes the global trend of banking sector internationalization, the broader context for SEE; Section 3 reviews salient literature on the performance of foreign-owned banks in local economies; Section 4 assesses financial sector development in SEE countries by using generally accepted indicators and compares them to other middle income countries as benchmark; Section 5 concludes the paper.

1. The transition process of banking sectors

In Bulgaria, Romania and Albania, the financial sector during socialism followed the Soviet-model of mono-banking system where the state-owned bank performed central banking functions and held accounts of state-owned enterprises. There were also specialized banks such as the national savings bank and foreign trade bank. The function of the system was not financial intermediation in the sense of market economies. Financial needs of enterprises were met largely through the budget and banks had more of an accounting function. The overlaying role of centralized political decision-making characterized allocation of credit throughout the socialist system (Winiecki, 1991). The former Yugoslavia abandoned the mono-banking model in the late 1950s and established a decentralized system of banks under worker management. In 1985, for example, 170 banks operated in the country and it had the most advanced banking sector in the region (Radzic et al. 2008). The former Yugoslavia held also extensive trade relationships with Western Europe. In 1989, it was well placed to move towards a market economy. There were, however, large internal economic differences among regions. Slovenia and Croatia in the north were far more advanced than the Western Balkan region.

In Bulgaria, Romania and Albania, unstable and weak macroeconomic conditions during the first decade of transition delayed privatization of banks. During the early 1990s, however, governments promoted the entry of domestic banks through very liberal policies, such as low mini-

[5] Though Slovenia was part of former Yugoslavia and geographically is part of South-Eastern Europe, in 2007 it joined the Organization of Economic Co-operation and Development and has a developed country status. Due to this difference from other parts of the region we did not include Slovenia in our analysis. Due to limitations of data we also omit coverage of Montenegro and Kosovo.

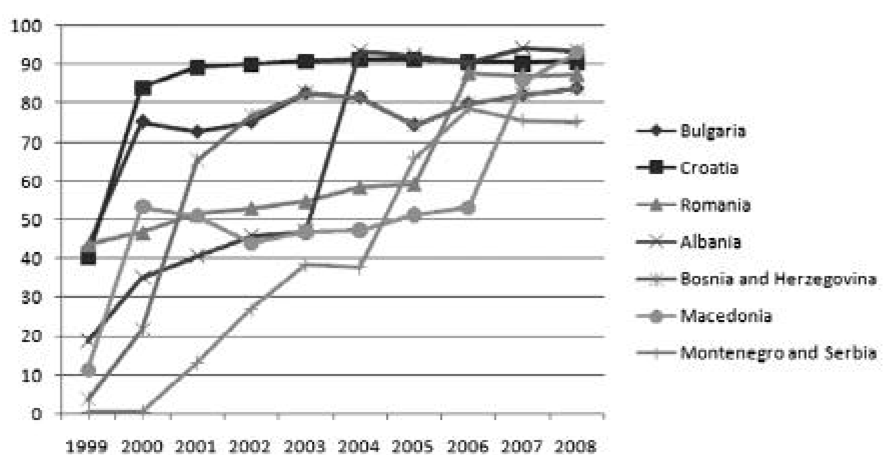
mum capital requirements. Regulations for entry of foreign banks were restrictive. Under weak bank regulatory systems and government intervention in bank management state-owned banks continued to lend to ailing state-owned enterprises which led to the accumulation of large non-performing loans. In 1996, for example, about 60 % of Bulgarian assets were non-performing and the estimated non-performing loans of the three major Albanian state-owned banks amounted to 90% of the assets (Backe et al. 2006). These problems led to banking sector crises in 1996-97 in Bulgaria, and in the late 1990s in Romania and Albania. Clean-up of the banking sectors by the respective governments was costly and time-consuming. It also underlined the importance of a rapid privatization through foreign investors. In the late 1990s, all three countries started major privatization programs, with the pace in Bulgaria more rapid than in Romania and Albania.. By the early 2000s the banking sector privatization was largely completed.

In 1989, the socially-owned banks in the former Yugoslavia were transformed to joint stock companies, and in 1991 their privatization began. Banks had to submit a privatization plan to the government. If the government did not approve it, the bank became state-owned. During this process, the ownership of many banks reverted to the state. Consequently, following the break-up of Yugoslavia, and the independence of Croatia, Macedonia and Bosnia and Herzegovina in 1991, a relatively large number of banks operated in these countries. Many of them, including newly formed private domestic banks, were undercapitalized and managed inefficiently. At the end of the 1990s, all three countries experienced banking crisis and many of the small banks went bankrupt. Subsequent to the crises the privatization process accelerated.

As a result of over a decade of military conflict, political and economic isolation, and hyperinflation, restructuring of the financial sector started later in Serbia than in other SEE countries. During the Balkan wars the central bank confiscated the foreign exchange reserves of the banks, which affected adversely the trust of the population towards financial institutions. In 2000, the newly elected government improved the banking regulatory system and began privatization of state-owned banks. By 2009, about 70 % of the sector's assets were privatized through foreign banks.

The brief review above shows that despite differences in initial condi-

tions and subsequent political events in countries, the process of restructuring of the banking sector and its outcome were similar. Liberal entry policies for new banks, inadequate bank regulatory and supervisory legislation, delays in the privatization of state-owned banks amidst deteriorating conditions of the real sector of the economy contributed to banking crisis in Bulgaria in 1996-97, in Albania in 1997, Croatia in 1998-99, Romania in 1999-2000, Bosnia and Herzegovina in 2001, and



Source: based on EBRD, Transition Report, London, various issues

Chart 1. Foreign ownership in the banking sector, percentage of assets

in Serbia until 2004. The high costs of bailouts for governments underlined the urgency of rapid privatization and the need to recapitalize the sector through foreign investors. International lending institutions that provided financial assistance and advice to countries during the banking crises also supported rapid privatization through foreign banks. Implementation of these programs also coincided with the initiation of negotiation for accession to the EU by Bulgaria, Romania and later Croatia. Under the terms of the accession agreement governments committed themselves to major revision of their banking regulation and to full opening of the sector to investors from the EU. These agreements, together with the political and economic stabilization of the region, improved the investment

climate of the region for foreign banks. As can be seen in Chart 1, and Appendix 1, with the completion of the privatization of banking sectors in SEE countries became largely foreign owned.

2.1. Internationalization of banks

Large-scale entry by foreign banks to SEE followed the trend of the past two decades marked by the global expansion of banks. Traditionally, two major theories addressed internationalization of banks. On the macro level, foreign direct investment (FDI) in the banking sector was linked to bilateral trade flows between two countries (Grosse and Goldberg 1991, Williams, 1998; Yamori, 1998). On the micro-level, expansion of banks was explained by the motivations of banks to follow their customers to foreign markets that they can provide them financial services (Caves, 1971; Dunning, 1993; Rodriguez-Clare, 1996). Foreign expansion of U.S. banks during the 1970-1980 period found empirical support for this theory (Markusen and Venables, 1997).

During the past two decades, with increase of FDI flows in the global economy, the traditional pattern of such flows changed in the banking sector. Clarke et al. (2003), for example, argue that while the "follow the customer motivation" may explain expansion of banks to developed markets, presently, it is less relevant to developing countries. Entry of banks to high-growth emerging markets is primarily motivated by local profit opportunities and the competitive advantage that they enjoy vis-à-vis domestic banks (Focarelli et al. 2000). Since the 1980s, in Latin American and East Asian countries, increase in foreign ownership of banking sectors was also associated with financial crises. During such episodes, governments lifted former restrictions on foreign ownership in the financial sector and allowed foreign banks to acquire ill-performing domestic banks. International lending organizations that gave financial support and advice to countries in crises also advised governments to liberalize the financial sector and reduce or eliminate restrictions on foreign ownership. Most of the recent growth in foreign expansion of the banks took place in developing countries. Though there have been a number of large mergers and acquisitions in developed countries, overall the share of foreign-owned banks remained relatively low. Table 1 shows that the during the last 1995-2005 period the largest increase in foreign bank ownership took

place in Latin American and Caribbean countries and to a lesser extent in Asian countries.

Table 1. Foreign share of total banking assets, %, 1995 and 2005

Region	1995	2005
East Asia	7	3
Latin America and the Caribbean	11	37
Middle East and North Africa	7	15
South Asia	0	6
Sub-Saharan Africa	20	9

Source: Claessens et al. 2008.

The exceptionally high share of foreign ownership that characteries CEE and SEE regions is unprecedented in contemporary times[6]. Only a few, mostly tax haven island economies such as Barbados and Madagascar have banking sectors with similarly high foreign ownership.

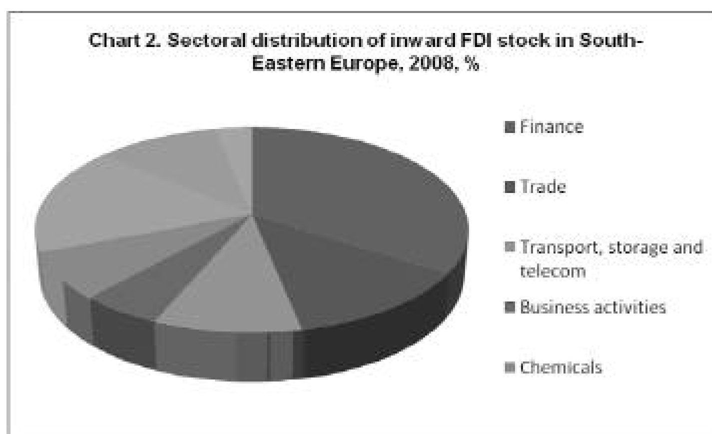
2.2. Foreign banks in SEE

A few banks from the EU dominate banking sectors in SEE. Most of these are based in the neighboring countries, with the largest presence of Austrian, Italian, and to a lesser extent, French, Greek and Turkish banks. Appendix 2 shows the branch network of these banks in SEE countries. It is interesting to note the all the countries are dominated by a relatively few foreign banks. These banks also held large market shares in most CEE countries, markets that they entered during the privatization process of the 1990s. With changing regulations in the Commonwealth of Independent States, these same banks are currently expanding to countries of that region. With few exceptions, the largest European banks have limited presence in SEE. Most of the banks that operate in the region are medium-sized and liberalization of Eastern Europe presented them opportunities for growth. Since many of the state-owned banks were privatized subsequent to major banking crises, foreign banks acquired assets at favorable prices and also ensured guarantees from the government related to potential non-performing loans that originated prior to privatization. Foreign

[6] High foreign ownership of the banking sector was prevalent, for example, in several Central and South Eastern European countries around the turn of the 20th century.

banks also entered SEE countries through de novo formation. This form was used mostly by Greek and Turkish banks, while Austrian and Italian banks established their operations mostly through the privatization process (UNCTAD, 2010).

A distinct feature of FDI inflows to SEE, and particularly to the Western Balkan region, is the dominance of such flows by the financial sector. As can be seen in Chart 2, FDI in the financial sector accounted for 32 % of total inflows, the largest share among sectors. With the exception of Croatia and Romania, a hallmark of FDI inflows to the SEE region is its high concentration to a few services sector, primarily finance, real estate, and telecommunications and it's their relatively low share in the manufacturing sector. This contrasts with the sectoral distribution to most CEE countries, where FDI inflows are more evenly distributed among the services and manufacturing sectors. In these countries FDI played an important role in establishing export-oriented manufacturing. This phenomenon, with the exception of Croatia, is largely absent in SEE countries. Foreign banks' motivation to enter SEE was not to "follow the customer" rather, it was the local market opportunity and their strong competitive advantage vis-à-vis domestically-owned banks. The concentration of



Source: UNCTAD, World Investment Report, 2010

Chart 2. Sectoral distribution of inward FDI stock in South-Eastern Europe, 2008, %

banks to a few neighboring source countries is consistent with gravity models assuming that geographical distance of two countries is major determinant of FDI flows (Guimaraes et al. 2000).

3.1. Performance of foreign-owned banks in the host country

Internationalization of the banking sector and its implications for the host economies were researched extensively. Within this context, it was investigated whether foreign-owned banks behave differently than their domestically-owned counterparts. Generally, the positive contribution of foreign-owned banks to the host economy received support in the literature. Foreign-owned banks were found to mobilize low cost funds and improve allocation of resources (Goldberg and Saunders, 1981; Gelb and Sagari, 1990, Terrell, 1986; Bhattacharaya, 1993). In several country case studies, mostly undertaken in developing countries, foreign owned banks were found to be more cost efficient than domestically-owned ones. This was largely attributed to the ability of the local subsidiaries to access lower costs funds and technology of the parent company. Study of banks in 80 countries during the 1988-1995 periods by Claessens et al. (2001), however, resulted in more differentiated findings. Their research found that in developed countries foreign owned banks operated with lower interest margins and profits than domestic banks but in developing countries, the opposite was true. Their findings draw attention to the importance of local economic conditions on the performance of foreign banks.

Several studies investigated the relationship between performance and ownership of banks in transition economies. Country case studies, for example, for Croatia (Jemric and at al., 2002), Poland (Nikiel et al., 2002), and Hungary (Hasan et al., 2002) and for a sample of 20 transition economies (Fries et al., 2005), found that foreign owned banks were more efficient than domestic private- or state-owned banks. These studies covered the 1990s, the first decade of the transition when problems of the real sector impacted state-owned banks adversely and the initial weak regulatory systems allowed entry of undercapitalized small private banks. A number of recent studies that investigated the second decade of transition found a different landscape. Subsequent to the banking crises that all countries experienced, weak domestically owned banks exited the market. Those that survived the instabilities of the first decade of transition, over time, gained

experience, and improved their technological and managerial know-how. In the 2000-2007 periods domestically-owned banks, on average, operated with similar cost efficiencies than foreign- owned banks. Two important comprehensive studies analyzed banking sectors in the post 2000 period. Firstly, Zajc et al. (2009) studied performance of banking sectors during the 1996-2006 periods in 8 ECE countries that in 2004 joined the EU. Cost-efficiency of banks during the ten-years was not related to their ownership; rather, market concentrations explained differences among countries. Similarly, the recent study of Yiwei et al. (2010) of banking sectors in 6 South-East European countries during the 1998-2008 periods found no significant cost efficiency differences between foreign- and domestically owned banks. Their findings were, however, consistent with earlier literature, that foreign owned banks were significantly more profit efficient than domestically owned banks.[7] They attributed the higher profitability of foreign owned banks to their competitive advantage in offering a wider range of products than domestic companies and their ability to extract higher rents on those products.

As can be seen in Table 2, the rates of return on investment in SEE countries are significantly higher than in Western European countries, home countries of the banks. Though rates of returns had declined from the much higher levels of the late 1990s, they remained well above that of other European countries.

3.2. Lending practices

Research on the role of ownership on lending practices addressed two major issues. Firstly, do foreign- and domestically-owned banks have different customer base? Secondly, does ownership influence lending behavior during periods of financial crisis? Research on the allocation of credit by banks in Latin American and Asian developing countries found some evidence that foreign banks cater primarily to large firms, and those located in urban areas (Berger et al. 2001). Small companies which are often "informationally opaque", and require 'relationship banking' and firms in rural areas were found to be served mostly by domestically owned banks

[7] Profit efficiency refers to a bank's ability to earn higher profit with the same bundle of inputs.

Table 2. Bank return on assets, percentage, in SEE and selected EU countries

Country/Year	**2005**	**2006**	**2007**	**2008**
Albania	1.4	1.4	1.6	0.9
Bosnia&Her.	0.7	0.9	0.9	0.4
Bulgaria	2.1	2.1	2.4	2.1
Croatia	1.6	1.5	1.6	1.6
Macedonia	1.2	1.8	1.8	1.4
Romania	1.9	1.7	1.3	1.6
Serbia	1.1	1.7	1.7	2.1
EU				
Austria	0.6	0.7	0.8	0.1
France	0.6	0.6	0.4	0
Germany	0.4	0.4	0.3	-0.3
Italy	0.7	0.8	0.8	0.3
Portugal	0.8	0.9	1.1	1

Source: International Monetary Fund, Global Financial Stability Report, 2010

(Mian, 2006). Foreign-owned banks in Poland in the mid-1990s were found to prefer to lend to large commercial firms while domestically-owned banks catered mostly to smaller companies (Nickiel, et al.2002). A study undertaken in 2005 on the lending practices of 220 banks in 20 transition economies concluded that foreign-owned banks lent a higher proportion of their assets to consumer mortgage loans and foreign subsidiaries than did domestically–owned banks (DeHaas et al. 2007). The study also identified a significant relationship between bank size and customer base; smaller banks were found to provide financial services mostly to small- and medium-sized companies and large banks to large companies.

Access to credit by various types of enterprises was studied in a comprehensive study of over 8000 firms in 20 transition economies by Brown et al (2010).[8] Their research found that in Eastern European transi-

[8] Among the countries the following SEE countries were included: Albania, Bulgaria, Bosnia, Croatia, Macedonia, Romania and Serbia

tion economies the high interest rates of loans, the collateral requirement and the cumbersome conditions of loan application discouraged a very high percentage of small firms to apply for loans. The proportion of discouraged small firms increased with the higher share of foreign ownership in the sector.

With the growing participation of foreign owned banks in several developing countries the issue of the relationship between bank ownership and lending practices during episodes of financial crisis gained importance. Such research was motivated by the concern that foreign- owned banks may cut back their lending in the local market during financial crisis and thus, affect financial stability adversely. Research on lending behavior during the financial crises of the 1980s and 1990s in Latin American and East Asian countries resulted in inconsistent findings. Peek and Rosengreen (2000), for example, found that during the financial crisis in Argentina in the early 2000s, foreign banks did not curtail their local lending. In Malaysia, on the other hand, during the Asian crisis, a sharp drop in foreign bank lending took place (Detragiache and Gupta, 2004). Comparing pre- and post crisis lending by foreign banks in 10 CEE countries that experienced financial crises during the 1990s, De Haas et al. (2006) found no significant curtailing of loans during the crisis period. They concluded that foreign banks, by maintaining lending levels, contributed to the stabilization of the economy. Lending by foreign banks was, however, subject to economic conditions in their home country. For this reason, De Haas et al. (2006) suggested governments in transition economies that they diversify the sources of country origin of foreign banks.

Due to the high concentration of foreign banks in SEE from a few EU countries, vulnerabilities of these countries became a major concern during the recent global financial crisis. Sudden stops in credit flows to the local economy could have greatly aggravated the crisis. Risks for the banks was also high since for some of them loans to the region accounted for a major share of their assets and profits. The gravity of this problem, both for parent companies and their local subsidiaries in SEE (and CEE) and their respective economies, required a concerted effort by all major constituents involved. This action, referred to as the Vienna Initiative, brought together representatives of home and host governments of the banks, bank regulators, and representatives of major parent banks with extensive subsidiary network in the CEE-SEE region.

3.3. The Vienna Initiative

By the late 2008, the global financial crisis hit CEE, and somewhat later SEE, strongly. During the credit boom of 2004-2007, there were large cross border inflows to SEE through the banks. Several countries had major current account deficits and relied on outside financial flows not only for credit but also for support of their foreign exchange system. A sudden stop of credit flows from parent banks could have had serious regional implications. Losses from the region also created major vulnerabilities for Austrian, Italian, Greek and Turkish banks that were exposed heavily to the region. Since the mandate of the European Bank for Reconstruction and Development (EBRD) has been to ensure successful transition of former socialist countries to market economies, it assumed a leading role in co-ordination of rescue effort. The concerted international intervention involved provision of financing by the International Monetary Fund (IMF) to governments where current account deficits and foreign exchange system support required access to foreign loans. In 2009, IMF granted loans to Romania, Serbia, Bosnia and Herzegovina, and Kosovo. The conditions of IMF loans, and of other European Union support programs, included commitment by parent banks to maintain their existing exposure in SEE and CEE countries and recapitalization of their subsidiaries. Such commitments sought to avoid potential home bias on the part of major banks and their withdrawal of funding from subsidiaries in SEE (and CEE countries). Though the initial agreement involved only commitments in countries that received IMF support, subsequently it was extended to the entire SEE region (EBRD, 2010). As part of the agreement, governments in SEE (as well as in CEE) committed themselves to provide local currency liquidity to banks, irrespective of their ownership. This concerted effort was successful in preventing large outflows of funds from the region. During the last quarter of 2008 and the first quarter of 2009, BIS reporting banks in transition economies reduced their assets by 4 percent (EBRD, 2010).

4. Financial sector development in SEE

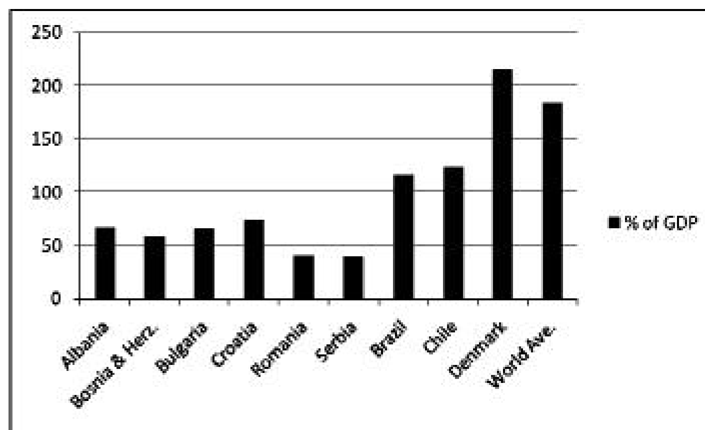
The role of financial sector in economic development is well-documented (Greenwood and Jovanovic, 1990; King and Levine, 1993; Levine, 1996). There is substantial research evidence that even after controlling

for per capita GDP, countries with well-developed financial sector experience higher growth rates. Private sector credit, (measured as percentage share of GDP), was found to be a good predictor of subsequent economic growth (Levine et al. 1999). Relatively easy availability of credit was also found to encourage development of capital-intensive industries (Rajan et al. 2004). Ease of access to credit by the small- and medium-sized companies was also related positively to income distribution and poverty rates (Beck et al. 2004).

The commonly used indicator of financial sector development is the share of domestic credit to the private sector in relation to GDP (Levine et al., 1999; Berglof and Bolton, 2002). In transition economies, both in SEE and CEE, prior to privatization of state-owned banks credit expanded rapidly, mostly to finance the loss making state-owned enterprises. The financial crisis that ensued in all countries ended the credit expansion. With the privatization of banks, the new foreign owners assumed initially very risk averse posture. In 1999, with the exception of Croatia, domestic credit to the private sector was very low, ranging from 3 % in Bosnia and Herzegovina to 12 % in Bulgaria EBRD, 2000). Many banks held most of their assets in government bonds or other securities. In Albania, for example, in 2004, 70 percent of the banks assets were invested in treasuries (EBRD, 2006)

With high global liquidity in the 2003-07 period countries in SEE experienced very high growth rates of credit expansion, although from a very low base. In 2008, the range of private sector credit among countries was quite large, ranging from 39 % of GDP in Serbia to 75 % in Croatia. Following Serbia, the share of private credit to GDP, with 40.9 %, was the second lowest in Romania. In 2008, with the global financial crisis, the credit expansion came to a sudden halt.

Though countries of SEE experienced a credit boom in the 2003-07 periods, in 2008 with an average share of the private sector credit to the GDP of 57 %, financial sector depth is comparatively underdeveloped. Private sector credit to GDP ratios in other middle income countries are around 100 percent and the ratios are above 200 percent in developed countries. In 2008, the world average of private sector credit ratio to GDP was 185 % (World Bank, 2010).



Source: World Bank, Indicators database

Chart 3. Domestic credit to the private sector 2008

Banking sector assets in countries of SEE are very small, both in absolute terms and as percentage share of GDP. As can be seen in Table 3 with 85 billion euros, total banking sector assets are highest in Romania, to be followed by 49 billion euros in Croatia. In 2008, total banking sector assets in 5 SEE countries, for which data was available, amounted to 203 billion euros, about 6 % of the 31,363 billion euros for the Euro region (Bank Austria, 2009). In terms of percentage share of GDP, banking sector assets for the euro area were 346 %, while in SEE countries only in Croatia and Bulgaria exceeded 100 %. With a ratio of 67 percent to GDP, the lowest share of banking assets to GDP was in Romania.

Table 3. Banking Sector Assets, 2008

Country	Total Bank Asset	
	in bil. Euro	% of GDP
Bulgaria	37	108
Bos.&H.	11	86
Croatia	49	106
Romania	85	67
Serbia	21	70
Euro Area	31,631	346

Source: Bank Austria, 2009

5. Conclusions

It has been a major achievement that within a decade subsequent to military conflicts, embargo, and crises in the Western Balkan region, a privately owned banking sector developed in SEE that provides financial services similar to those of Western Europe. Rapid privatization ended government interference in the banks and foreign ownership contributed to the build-up of trust of the population that was fractured in several countries through actions of the central bank and other authorities.

The salient feature of banking sectors in SEE countries is the very high share of foreign ownership and the very limited role that domestic private and state-owned banks play. As discussed in the paper, this development was driven by serious banking crises that required rapid privatization. The urgency left few alternatives for governments than foreign buyers. (An exception from this path was followed in Slovenia). Since in present times such high foreign ownership of the banking sector is a new phenomenon, its long- term benefits and costs to the countries are hard to assess. The literature, discussed above, gives a differentiated picture, higher efficiencies of foreign banks tend to show trade-offs with higher profits by such banks, and some evidence suggest that foreign banks are less inclined to service smaller companies than do domestic banks. The validity of these findings for SEE countries would need to be monitored over time. Limited access to finance by small- and medium sized companies would impact especially adversely countries of the Western Balkan where most of the firms are relatively small and job creation and growth will depend on access to credit by these firms.

High foreign ownership in an industry is associated generally with high dependency on foreign decision makers and their profit objectives. Operations of foreign banks in SEE reflects the strategic importance of these markets. During the 2003-07 periods, banks increased sharply their lending at interest rates that were far above levels in western European countries. In SEE countries, the costs of financial intermediation were very high. For foreign banks an important source of profits was their ability to obtain funds at low costs from their parent company. Since these funds were in foreign currency, to avoid foreign exchange exposure, banks matched their position by lending in foreign exchange to local consumer. In the 2005-2008 periods, for example, over 60 percent of the loans in SEE

were in foreign exchange (EBRD, 2010). This shifted the foreign exchange risk from the banks to unhedged borrowers. When in the wake of the recent global financial crisis foreign exchange rates were devalued in several SEE countries, substantial costs were imposed on local borrowers.

Though the Vienna Initiative was successful in preventing a large scale withdrawal of funds by foreign banks from SEE countries, the credit boom of the 2003-07 periods was followed by a major drop in new lending. These large swings in boom and subsequent drying up of loans were more pronounced in SEE countries than in Latin American and Asian developing countries (Kamil et al. 2010). The large fluctuation in credit availability imposed high adjustments costs on local economies.

The global economic crisis exposed some of the strength and vulnerabilities of SEE countries where mostly during the last decade banking sectors moved from state- and collective ownership to predominantly foreign ownership. Since this is a relatively new phenomenon, government policy makers need to adopt regulations that increase the benefits that foreign banks contribute to the local economy but also reduce some of the adverse impacts that are associated with foreign bank ownership.

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Appendix 1. Characteristics of banking sectors in South-Eastern Europe, 1999-2008

Country	No. of total banks		Market share of the top 5 banks		% Asset share of foreign-owned banks		% Asset share of state-owned banks	
	1999	2008		2008	1999	2008	1999	2008
Bulgaria	34	29		57	42.8	83.9	50.5	1.8
Croatia	53	34		76	40.3	91.2	39.8	4.7
Romania	34	31		54	43.6	87.9	50.3	5.9
Albania	13	17		15	78.2	94.2	81.1	0
Bosnia&Her.	91	32		22	76.0	95	75.9	3.2
Macedonia	23	18		>80	2.5	93.1	2.5	1.4
Montenegro	n.a.	10		>80	n.a.	91.9	na	0
Serbia	75	37		46	0.4	78.7	8.9	14.9

Source: EBRD, Transition Report, various issues.

Appendix 2. Total number of branches in SEE countries, 2008

Bank/Country	BG	RO	Croatia	Albania	Serbia	BH	Total SEE
Raiffeisen Int.	197	557	79	102	103	100	1,185
UniCredit	269	259	140		72	161	901
Société Générale	142	932	117	40	88		1,413
Erste Bank		641	119		68		828
Intesa Sanpaolo		92	230	33	230	52	637
OTP	379	105	105		95		724
KBC	139				65		204
EFG	223	293			123		639
N. B. of Greece	280	149		29	104		628
ING	2	120					122
Volksbank		246	28		26	50	350

Source: Bank Austria Market Research, 2009.