

Foreword by the EBRD's Chief Economist



Better access to finance fuels growth and improves livelihoods.

The transition region as a whole is gradually catching up with western Europe and other mature market economies. Economic growth, at 5.7 per cent in 2005 and around 6.2 per cent in 2006, is several percentage points higher than in the eurozone. Following the opening of the Baku-Tbilisi-Ceyhan oil pipeline, Azerbaijan has become the fastest growing economy in the world. High prices and demand for oil and gas, metals and agricultural commodities are the reasons for the strong performance of many resource-rich countries but economic growth across the transition region has mostly been driven by domestic consumption.

Nevertheless, the transition countries still face risks as global imbalances persist and interest rates in the main OECD economies increase, diminishing the appetite for investment in emerging markets. While countries with weaker macroeconomic foundations may be the first to feel the pressure, the experience of the Asian and Russian crises in the late 1990s has taught us that a poor institutional framework also deters

inward investment. Capital may be withdrawn very quickly in a crisis, and in this respect the increasing level of short-term debt, particularly in central eastern Europe and the Baltic states, is a cause for concern. We have also learned that foreign direct investment is more mobile than conventional wisdom suggests. Although foreign investors have so far kept faith in the transition region (with net inflows of foreign direct investment estimated at US\$50 billion in 2006), they are likely to discriminate between strong and weak reformers.

Encouragingly, the reform process in the transition region as a whole is continuing apace. Our annual assessment of progress in transition – outlined in the EBRD's transition scores – reveals a similar rate of progress to the last few years. Increasingly, transition is driven by markets rather than governments. We see this market pressure particularly in the mobile phone sector and in the financial sector, where lending continues to grow and new products, such as mortgages, are being introduced at a remarkable pace. Increasingly, institutional change is also bringing about the

growth of other financial services, such as stock markets, leasing and insurance activities.

The extraordinary transformation of the financial sector is the focus of this year's *Transition Report*. In a little over a decade this sector has moved from a state-controlled system to one in which a diverse range of financial institutions increasingly provides finance to aspiring entrepreneurs, larger firms striving to enhance their competitiveness and households wishing to improve their living conditions. Despite considerable variation in the approaches to financial sector reform, the key driving forces across the region have been broad improvements in the institutional environment, privatisations and market entry by foreign banks.

From the early 1990s, privatisations ended the system of state-owned banks lending exclusively to governments and public enterprises. New banks also started to enter the market throughout the region. By the mid-1990s, basic regulatory and supervisory frameworks were in place, allowing a steady increase in the availability of finance, particularly in central eastern Europe and the Baltic states. At the end of the decade, however, growth in bank credit mostly involved lending to large enterprises and in a significant number of countries – particularly in south-eastern Europe and the Commonwealth of Independent States – the financial sector continued to be underdeveloped.

Nevertheless, a number of key changes had taken place. Most striking was the emergence of foreign banks as major players, either through the acquisition of existing banking assets or as new entrants. Indeed, the entry of foreign banks in the transition region is unique in both its scale and coverage. These changes have increasingly been associated not only with improvements in bank performance but also with widening access to banking services and greater diversity in the types of services being offered to customers. This Report charts the financial development that has occurred and highlights the large variation across the transition countries in terms of how credit is provided to the private sector.

The institutional framework affects both access to finance and the services that banks provide to their clients. Better institutional quality increases lending to small businesses and households and broadens the range of services provided by banks.

Most strikingly, lending to households, particularly through mortgage loans, has grown rapidly throughout the region. This reflects not only the emergence of private housing markets but also the increasing ability of the financial sector to take collateral and to rely on legal systems for effective enforcement. Improvements in the quality of the legal system have resulted in greater lending to households while better regulatory quality is associated with more lending to small businesses (as regulators require banks to have lower exposures to large firms).

Access to finance for small businesses, a crucial engine of growth in the transition economies, is still lower than expected. There is a concern that foreign banks lack local market knowledge and are reluctant to lend to small businesses. Smaller local banks have to some extent filled this vacuum with what appears to be highly profitable financing. Survey evidence from four transition countries presented in this Report indicates that access to bank credit has a positive impact on the performance and growth of small businesses.

The main focus of this Report is on the banking system, reflecting the dominance of banking within the financial sector in the transition region. However, it is also interesting to observe the strong, parallel growth in other areas of finance. These developments are highly inter-connected. For example, the improved functioning of stock markets brings transparency and better valuation to financing activities, and bond markets help to develop inter-bank markets which are critical to the liquidity of the financial system. Corporate bond markets are much harder to develop and have generally only emerged in response to failures in the banking system. In the long term, they serve as an important check on the dangers of excessive lending by banks to client companies.

Another development is the gradual emergence of the private equity industry in the transition region. The share of total assets held by local private equity firms remains small and the volumes provided by firms operating in the advanced market economies are modest. Nevertheless, private equity is becoming an important source of financing and means of restructuring that is not provided through the banking system. Unique data available from EBRD investments are used

in this Report to document the evolution of private equity in the transition region.

A better institutional framework has helped to improve the performance of private equity funds, which have also learned from experience. The time taken to break even and exit from investments has diminished significantly since the early 1990s. Improvements in the functioning of equity markets have increased the exit options for funds. The study in this Report also provides insight into the process of corporate restructuring. In the early and intermediate stages of transition, for example, the main priority is to improve the quality of general management. The study also reveals that diversified funds seem to do better than funds specialising in individual industries. As the institutional environment improves and individual firms restructure, however, industry-specific funds are likely to become more effective.

The increasing availability of finance for the private sector raises the obvious issue of its impact on growth. This relationship has been widely studied, with very mixed results. Evidence from the 1990s suggested that the link between financial development and economic growth was not strong in the first decade of transition. This link appears to have strengthened as the general institutional framework has improved. Nevertheless most countries, even the advanced countries of central eastern Europe and the Baltics, have lower levels of financial development than their levels of income would imply. This suggests that financial systems must develop further before the full growth potential of these economies can be exploited.

Investment in improving the functioning of the financial system is likely to accelerate growth. This potential is present even in the most advanced transition countries. For example, Slovenia, which was recently admitted into the European Economic and Monetary Union in recognition of its strong macroeconomic performance, still has a comparatively opaque financial system.

Considerable challenges remain for the transition countries. This Report shows that, despite rapid financial development, most firms in the region still rely on internally generated funds and contributions through informal channels – for example, loans from friends and relatives of the

owner/entrepreneur. A large number of firms, even in some of the most developed transition countries, have no link whatsoever to the formal financial system. Improving access to financial resources for these enterprises and for new businesses is still a fundamental challenge for the transition countries. Widening financial access requires a variety of measures, such as improving the quality of supervision of the banking system, enforcing competition policy and encouraging the growth of other financial services. As the transition region develops, growth will increasingly need to stem from innovation, requiring riskier and longer-term investments from financial institutions.

The experience of the transition region offers a fascinating insight into the broader aspects of financial development, clearly demonstrating how changes in the institutional environment are the driving force for both financial and economic growth. This Report highlights the remarkably positive impact of foreign commercial banks in the region but the evidence also shows that micro and small enterprises do not benefit to the same degree.

Moreover, as the foreign-controlled banks become integrated into their parent institutions, their impact on financial access and the development of the financial sector in the transition countries looks uncertain. There are also broader concerns that activities such as research and product development will be centralised in corporate headquarters in the world's financial capitals, leaving local institutions with less demanding tasks and a less dynamic local workforce. In the long term, this may slow down growth in the transition region. Maintaining skill levels will require investment in improving the business climate, including development of higher education and improvements to social infrastructure. Addressing these weaknesses will be key in sustaining the strong growth performance of the region.



Erik Berglöv

Chief Economist of the EBRD

1 October 2006