Foreign Bank Participation in Selected ECA Countries, 1995 and 2002

	1995	2002
Europe & Central Asia	**13.0%**	**35.7%**
Bulgaria	8.2%	51.7%
Croatia	9.8%	42.1%
Czech Republic	14.2%	58.7%
Estonia	80.7%	72.7%
Hungary	22.4%	58.7%
Kazakhstan	12.6%	20.0%
Latvia	17.8%	38.8%
Lithuania	18.9%	91.3%
Macedonia, FYR	28.4%	41.8%
Poland	3.7%	49.3%
Romania	0.0%	26.5%
Russia	2.0%	15.6%
Slovak Republic	8.7%	81.5%
Slovenia	6.8%	25.8%
Ukraine	0.0%	6.8%

Source: Micco, Panizza, and Yanez (2006)
Note: Table shows the share of assets (% of total banking sector assets) held by foreign banks

could be acquiring cheap —most probably distressed — domestic banking assets as a result of crises, which could be viewed as beneficial by regulators.

Lower Private Credit Levels

Did greater participation of foreign banks coincide with increased provision of credit to the private sector? We find that in the aftermath of crises, high foreign bank participation levels are associated with lower private credit levels. Does this imply that foreign banks pull back from lending as a result of crisis? This is not necessarily the case because, as noted above, it could be that foreign banks are acquiring distressed banks with relatively weak loan portfolios. Many of those loans are written off in restructuring exercises prior to the sale of banks to foreign investors, and thus the reduction in private credit is a mechanical accounting exercise rather than a reflection of slow post-crisis credit growth.

We cannot, however, rule out the possibility that new entrants are simply poor intermediaries for the private sector. In environments where foreign banks are better established, there is no such reduction, and private credit is at higher levels before, during, and after crises. Our results support the idea that, in the aftermath of crises, better established foreign banks provide more credit to the private sector than recent foreign entrants, which have acquired distressed banks. One might also expect that the competitive pressure stemming from stable foreign participation would enhance banking sector efficiency.

Robert Cull and Maria Soledad Martinez Peria are Senior Economists at Finance and Private Sector Development Research Group, the World Bank, Washington, DC. Full text of their paper can be viewed at: http://go.worldbank.org/2DQT70LK00 (WPS No. 4128). **BT**

Financial Sector Development in South Eastern Europe

In transition countries in general and in South Eastern Europe (SEE) in particular, financial markets are substantially smaller than in established market economies, as measured by the financial intermediation ratio. Nevertheless, if regulations were appropriately set, effects on growth could be expected. We examine whether the development of financial markets has played a significant role for real GDP per capita growth in four SEE countries — Bulgaria, Croatia, Romania and Turkey — during 1995-2005, using a production function approach. The influence of the financial sector on the economy can be measured via total domestic financial intermediation (TFI), defined as the sum of domestic or private credit, market capitalization of domestic shares and outstanding domestic bonds.

Compared to neighboring Greece, the level of financial intermediation is still low in the four countries, with the highest level achieved by Croatia (see Table). Stock market capitalization contributes very little to financial intermediation in all countries.

The results of our estimations show that the potential contribution of the financial sector to economic growth in the four countries has not been fully used. As TFI showed rather negative effects in the short term and with lags was only mildly positive, we suggest that the different financial segments play different roles at the stage of development that these SEE countries are in. Domestic bonds stand out as maybe playing an important role in economic development for the SEE countries over the last ten years, whereas private credit and the stock market had no significant influence on growth.

Financial Intermediation 2005, in % of GDP

	Domestic credit	Private credit	Stock market	Bonds	TFI
Bulgaria	43.62	44.49	5.12	22.21	71.82
Croatia	73.54	60.80	35.25	55.36	151.40
Romania	19.29	11.50	19.82	9.12	40.44
Turkey	56.55	26.15	44.60	50.77	121.52
Greece	113.65	84.84	67.97	99.48	252.30

Source: IFS, BIS, BSE, World Federation of Exchange, SSE

The fact that government issues dominate bond markets is a salient structural feature of these markets. As previous research indicated, governments may play an important role in developing financial markets at an earlier stage of a country's development, when capital is scarce.

The insignificance of private credit might be due to the high level of bad loans to the private sector, while for the stock markets this is most probably due to their underdevelopment; both suffered from a prolonged weak legal environment during the transition years.

As for non-financial intermediation variables, only capital stock growth proved to be significant and positively related to economic growth. This could be explained by the large capital scarcity in transition countries. These capital flows stem mainly from FDI, with foreign bank entry playing a major role, and also some portfolio investment.

Peter Haiss is a lecturer at the Europa Institute, Vienna University of Economics and Business Administration and is with Bank Austria Creditanstalt; Bettina Hagmayr is a graduate student at Vienna University of Economics and Business Administration. The opinions expressed are the authors' personal views and not necessarily those of the institutions the authors are affiliated with. For related research by the authors, see http://www.wu-wien.ac.at/europainstitut/forschung/nexus **BT**