EBRD Transition Report 2015-16: Rebalancing Finance

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On January 28, 2016, the Oesterreichische Nationalbank (OeNB) welcomed Ralph de Haas, Director of Research at the European Bank for Reconstruction and Development (EBRD), to present the main findings of the latest EBRD Transition Report. The event was opened by Doris Ritzberger-Grünwald, Director of Economic Analysis and Research at the OeNB.

In her welcome address, Ritzberger-Grünwald stated that this year's report is the first EBRD Transition Report in nearly a decade to focus on the financial sector, a topic of utmost importance for countries in transition. She explained that research has indeed established a positive nexus between financial deepening and economic growth but that more recent debates have questioned the sustainability of debt-financed growth given the deleveraging process that began after the onset of the crisis. Against this background, the report is highly relevant according to Ritzberger-Grünwald, as it provides ideas on how to restructure and develop financial systems in order to make them more resilient in the future. It also explores ways to utilize financial systems to overcome the large investment gap in the EBRD region and to deepen domestic capital markets. With respect to the latter, she pointed out that the formation of local capital markets is a long-term project that requires appropriate institutions. Even in countries with well-functioning institutions people often prefer to hold their cash in euro, as observable in many countries of Central, Eastern and Southeastern Europe (CESEE).

After the introductory remarks, Ralph de Haas, the EBRD's Director of Research, outlined the most important messages of the EBRD Transition Report 2015-16. Above all, he highlighted that the economies where the EBRD operates (EBRD region) are currently facing the challenge of rebalancing and strengthening their financial sectors to boost economic growth and innovation.

Part 1: large investment gaps in the EBRD region

One of the key topics of the report is the emergence of an investment gap in the EBRD region. Prior to the crisis, convergence was largely driven by economic integration, high FDI and other capital inflows. With the onset of the crisis, external finance stopped being the motor of convergence in the EBRD region. De Haas pointed out that limited fresh debt funding has led to large post-crisis investment gaps in the region. Investments would need to be scaled up by USD 75 billion a year to bring investment back to the levels expected of economies at this stage of development. He also showed that the stock of outstanding debt as a percentage of GDP is still rising at close to pre-crisis speed. Also, the composition of this debt is suboptimal: Too much domestic debt is still denominated in foreign currency and the level of nonperforming loans (NPLs) is persistently high. Thus, there is the need for developing local-currency financial markets and for concerted action to reduce NPLs.

De Haas suggested that the countries need to find alternatives beyond debt funding in the medium term. More precisely, countries of the EBRD region should build stronger links with other advanced and emerging markets to use the potential of diversifying FDI inflows. This recommendation should be seen against the background that FDI inflows have been below their estimated potential since the crisis and that 60% of investments originate in EU-15 source countries.

Part 2: better access to finance for SMEs

According to de Haas, firm-level credit constraints have increased almost everywhere in the EBRD region, calling for a more resilient allocation of credit to firms, in particular SMEs. De Haas went on to explain that institutional improvements can have a powerful impact, in particular if credit registries and collateral regimes function well. Institutional aspects aside, credit is more likely to flow to SMEs where application procedures are appropriately streamlined and where relationship lending is more prevalent than transaction-based lending. Looking at the liability side of the banking system, de Haas called for more diverse funding sources.

Part 3: private equity as an alternative funding source

In the last part of his presentation, de Haas argued that more emphasis should be put on private equity as an alternative funding source. Private equity, a financing instrument that has been rarely used in transition countries so far, is characterized by a medium-term investment horizon (between 3 to 5 years). De Haas showed that private equity can have a high impact on the economy. According to the EBRD, private equity investments on average add 30 jobs over a five-year period, increase labor productivity and profitability. As mentioned before, the unused potential of private equity is large. In order to make use of this potential and to attract more private equity, the protection of investors and the development of capital markets need to be improved.

Discussion

The discussant Harald Waiglein, Head of the Directorate-General Economic Policy and Financial Markets at the Austrian Federal Ministry of Finance, argued that many EU countries are facing challenges similar to those experienced by countries in the EBRD transition region: debt overhang, high levels of NPLs, scarce liquidity and credit-constrained SMEs. Waiglein offered two explanations for such malfunctioning of financial sectors: First, legacy issues (high levels of NPLs) and second, legal issues (e.g. related to intangible property rights and to deficits in insolvency law). Concerning financial constraints for SMEs, he drew attention to an initiative of the Austrian Federal Ministry of Finance and the World Bank which aims at improving accountability and regulatory oversight. Furthermore, the role of private equity was discussed, as private equity is not secure in times of crisis and can decline rapidly. In the course of the discussion, it was argued that this holds true for new lending or new investments. However, investors that do not withdraw – as it is also difficult to sell in crisis times – can be seen as a cross between FDI and private equity investors.

For further information, please read the *EBRD Transition Report 2015-16*.