REBALANCING FINANCE

Diversifying funding to foster growth

It has been almost a decade since the EBRD last published a *Transition Report* that focused on the financial system. Back in 2006, economic growth in the region was in excess of 6 per cent, several percentage points higher than in the eurozone. The EBRD region was even home to the world's fastest-growing economy: Azerbaijan. The region's strong economic growth was underpinned by large inflows of foreign direct investment and rapid growth in domestic credit. The 2006 report's encouraging conclusion was that economic and institutional reforms were continuing apace across the transition region.

However, it also warned that cross-border capital could be withdrawn very quickly in a crisis and that foreign direct investment, which was underpinning growth and convergence in the region, was more mobile than people generally realised. Two years later, those warnings began to look rather prescient. The global financial crisis and the subsequent eurozone debt crisis have resulted in capital inflows from traditional European sources declining to a mere trickle. The financial world has undergone profound changes, both globally and in the EBRD's countries of operations.

As we publish this year's *Transition Report*, the region's annual growth rate is hovering around zero. In fact, the region's income levels have hardly converged at all with those of advanced economies in the post-crisis period. Russia's economy, which expanded rapidly before the 2008-09 crisis, has experienced a sharp decline in economic growth. Cross-border flows of capital and foreign direct investment have shrunk, while credit growth has been weak (and even negative in some countries). Furthermore, the reform process has stalled across the region, as the 2013 report highlighted.

Although growth has recently picked up among a number of commodity importers in the region, the recession in Russia – which has been exacerbated by declines in commodity prices – has had a negative impact on economies that have close ties with that country on account of trade, investment and remittances. Geopolitical tensions and the expected tightening of monetary policy in the United States are also weighing on the region's economies. As a result, growth in the EBRD region as a whole has virtually ground to a halt in 2015 and is expected to recover only moderately in 2016.

This is a good time, therefore, to look at how the financial sector can act as a stable and robust engine of economic development in such challenging and uncertain circumstances.

The report begins by showing how far the transition region is currently lagging behind in terms of investment. This investment gap is casting a serious shadow over the region's long-term growth prospects – a finding echoed in the last two *Transition Reports*. In order to boost investment and close that gap, new funding sources need to be explored. Indeed, this report suggests that the challenge is not only to increase the quantity of finance that is available to firms and households, but also to rebalance its composition and improve its quality. Such rebalancing and diversification will involve changes in a number of different areas.

First, a key theme of this year's report is the need to reduce the region's overwhelming reliance on debt financing and increase the role played by equity. A combination of economic contractions and unfavourable exchange rate movements have resulted in a situation where the total domestic and external debt of households, firms and governments in the transition region is now *higher* than it was on the eve of the global financial crisis. Despite a decline in the availability of new loans, particularly for small businesses (see Chapter 2), the debt burden has continued to rise.

Against that background, the report highlights the special role that equity financing can play in supporting investment and productivity increases in firms, with a particular focus on private equity. Evidence suggests that private equity investors operating in the region improve firms' access to credit and help companies to scale up capital expenditure and hire new workers, resulting in higher levels of revenue and productivity. However, relatively few firms in the region have attracted private equity investment to date. There are several ways in which policy-makers could help to improve access to private equity, including tightening rules on corporate governance and making it easier for private equity funds to exit investments through public equity markets. The capital markets union that is currently under discussion could play an important role in improving access to equity in central Europe and parts of south-eastern Europe.

Second, there is a need to shift from foreign currency-denominated finance to local currency credit markets. The dollarisation of credit in the region (that is to say, the percentage of lending that is denominated in a foreign currency) remains exceptionally high by global standards and only a few countries in the region have seen noticeable declines in dollarisation levels in the wake of the global financial crisis. As a result, many firms and households remain vulnerable to sudden exchange rate movements, the risk of which has increased in light of the expected monetary tightening in the United States.

Efforts to reduce dollarisation will be dependent on the gradual rebalancing of banks' funding sources, with shifts from foreign to domestic channels. The ability of banks – both foreign and domestically owned – to access abundant cross-border funding played an important role in supporting the strong credit growth and economic convergence that was observed prior to the crisis. However, a more balanced funding model is now needed to ensure that local banking systems become more resilient to shocks in the longer term.

Third, the right balance needs to be struck between public debt, household debt and corporate debt. The analysis in this report shows that firms in many countries – particularly small and medium-sized enterprises – remain relatively underserved by the financial sector. Survey evidence suggests that in many cases these firms are discouraged from applying for credit by cumbersome and lengthy application procedures.

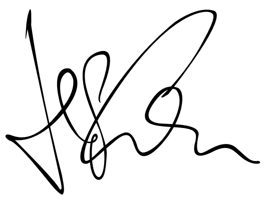
Lastly, rebalancing also involves a shift towards a more diverse network of cross-border investment partnerships, complementing the strong existing links with advanced European economies. There is scope for stronger economic ties between the transition region and both the other emerging markets and non-European advanced economies, which would make overall funding flows more stable. Intra-regional links could also be strengthened.

Rebalancing does not mean shifting from one extreme to the other. Instead, this *Transition Report* calls for the gradual and sustainable optimisation of the financial system structure. Even if more equity financing does become available, debt will continue to play a major role, often helping to leverage the benefits of equity financing. Some lending will always be conducted in a foreign currency – serving the needs of companies with key markets abroad, for instance – but such lending would normally make up a small percentage of total credit in the financial systems of more advanced economies. And economic forces of gravity dictate that advanced European economies will remain important trade and investment partners for the region, even as economic links with other countries multiply and grow stronger.

The optimal situation in terms of debt instruments, currency breakdowns, sources of funding and investment partners will be different in each country, being shaped by local factors, and it will evolve over time. Nevertheless, this report provides general guidance that, taken together, will help to ensure that financial systems offer a diverse range of funding options that meet the demands of small businesses, larger firms and households, thereby helping income levels to continue converging with those of advanced economies. In this regard, this report develops themes highlighted as part of the Addis Ababa Action Agenda that was adopted earlier this year, including the contribution that deeper domestic capital markets and cross-border equity flows can make to sustainable development.

This report does not seek to cover all major areas of finance, as that would be impossible to do in any depth. Instead, it focuses on a few specific issues – the geography of foreign direct investment, small businesses' access to bank finance and the impact of private equity financing – that serve to illustrate its broader arguments.

The report is very much forward-looking. In order to better reflect this approach, this publication has the title *Transition Report 2015-16*, a convention that we intend to follow in the coming years.



Hans Peter Lankes
Acting Chief Economist
EBRD

“” REBALANCING AND DIVERSIFICATION WILL INVOLVE CHANGES IN A NUMBER OF DIFFERENT AREAS.