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WESTERN BALKAN COUNTRIES AND THE EUROPEAN FINANCIAL SYSTEM: ANALYSIS FROM THE FINANCIAL REPORTING PERSPECTIVE

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ABSTRACT

The impact of international financial reporting of SMEs on economic performance continues to be one of the most debated issues among international economists. Theoretical models have identified a number of channels through which international financial reporting of SMEs can promote economic growth and economic development in developing countries and countries in transition. However, in spite of its benefits, financial reporting of SMEs can also be dangerous, as it has been witnessed in many recent financial crises. In fact, there are some evidences that financial globalisation leads to better macroeconomic outcomes only when certain "threshold conditions" are met. Therefore, this paper discusses the potential benefits and potential costs of financial reporting, which could face transition countries from Western Balkans while integrating their financial systems into the European financial system. Since the financial sector of Western Balkan countries is characterised by an increasing presence of foreign bank, this paper points out the potential advantages and a possible "danger" of the excessive presence of foreign banks in the host-country. This paper concludes with the idea that it is important to determine the optimal level of foreign banks participation in local banking sector and that financial reporting of SMEs should be approached cautiously, with good institutions and macroeconomic frameworks viewed as important preconditions.

KEYWORDS: *Small and Medium Sized Enterprises, Economic growth, Balkan countries.*

1. INTRODUCTION

The idea of European integration is not a new one; it was stimulated by the Marshall Plan. The preamble to the Economic Cooperation Act voted by the American Congress in 1948 invites Europe to follow the example of the United States and to form a common economic market spanning the continent. The first tangible element of the European integration in the aftermath of the Second World War was the formation of the European Coal and Steel Community (ECSC), which was created by the Treaty of Paris (1951), following a proposal from French foreign minister Robert Schuman. Six countries (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany) signed the Treaty of Paris, pooling their coal and steel resources. For half a century, the European Union (EU) has pursued everdeeper integration while taking in new members. The number of Member States has increased since the signing of the Treaty of Rome (March 1957).

Recently, the governments of the EU Member States have agreed to extend the EU perspective to countries in South East Europe – Croatia, the Former Yugoslav Republic of Macedonia, Albania, Bosnia and Herzegovina, Montenegro and Serbia. At present, among these countries, there are only two candidates for EU membership – Croatia and FYR of Macedonia. Other countries of the region are considered as potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia). The EU integration process implies legally binding, sweeping liberalisation measures – not only capital account liberalisation, but investment by EU firms in the domestic financial services and the maintenance of a competitive domestic environment, giving this financial liberalisation process strong external incentives (and constraints).

The integration of potential candidate countries into the enlarged Europe is currently realised through Stabilization and Association Process (SAP) which aims to bring these countries progressively closer to the EU. The centerpiece of the process is a Stabilisation and Association Agreement (SAA), which represents a contractual relationship between the EU and each potential candidate country, entailing mutual rights and obligations. For each of the potential candidate countries of the Western Balkans4 the Commission of European Communities negotiates SAAs which have three aims: first, to encourage regional cooperation; second to promote economic stabilisation and a swift transition to a market economy; and third to offer the prospect of EU accession. Thus, SAAs explicitly include provisions for future EU membership of the country involved. These Agreements are similar in principle to the Europe Agreements signed with the Central and Eastern European Countries (CEECs) in the 1990s.

In case of CEECs countries, the prospective EU accession served as the ultimate anchor for financial liberalisation. The EU candidate countries had to fully liberalise their financial system by the time of EU accession at the latest, as the free movement of capital is one of the leading principles of the EU. However, even if the SAAs are based mostly on the EU's acquis communautaire and predicated on its promulgation in the cooperation states legislation, the depth of the policy harmonisation expected by them is less that for EU member states.

Globally, the financial reporting of SMEs has progressed dramatically over the past 30 years. This current wave of financial globalisation was urged by liberalisation of capital controls in many of developing countries and transition economies, in anticipation of the benefits that cross-border flows would bring in terms of better global allocation of capital and improved international risk-sharing possibilities. With the surge in financial flows, however, came a spate of currency and financial crises5. These developments have provoked an intense debate among both academics and policy circles on the costs and benefits of financial reporting, which has intensified and become more polarised over time. Thus, this article proposes to analyse the potential benefits and potential costs of financial reporting, which could face the potential candidate countries from Western Balkans during integration of their financial systems into the European financial system, as well as into the world financial market6.

The paper is structured as follows. Paragraph 1 presents the current situation of financial systems in the EU potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia). Paragraph 2 discusses the potential benefits (§2.1) and the potential costs (§2.2) of financial reporting. The paper concludes with some recommendations concerning the integration process of financial systems for these countries.

2. FINANCIAL SECTOR RESTRUCTURING IN THE WESTERN BALKANS

Analytically, any financial system can be divided in three sub-sectors: the banking sector (regrouping the commercial or deposits banks), the non-banking financial institutions (like savings-institutions, insurance companies, private pension funds, mutual funds societies, investment funds,...) and capital (or financial) markets. Banks act as credit-suppliers from the deposits they collect and funds they borrow from the Central Bank; such specific financing facility is not available to the non-banking institutions. In the majority of transition economies, the role of non-banking institutions in mobilisation and allocation of financial resources was and remained quite negligible during the 1990s, and the same appears in Western Balkans countries, where the banking sector continues to dominate the financial system, managing for over 90% of total financial assets, while capital markets and non-banking financial institutions play only marginal roles (D. Müller-Jentsch, 2007).

However, the financial sector in the Western Balkans has improved significantly in recent years and a deep restructuring process has been (and proceeds to be) implemented. This owes to comprehensive reforms by governments and the support of international financial institutions like the IMF, the World Bank, and the EBRD. However, fifteen years ago, financial markets in former Yugoslavia and in Albania were poorly developed. The break-up of Yugoslavia led to the fragmentation of financial services companies, the establishment of new regulatory institutions and a freezing of foreign currency deposits. During the 1990s, pyramid saving schemes in Albania, hyperinflation in Serbia and Montenegro, the wars in Bosnia and Kosovo as well as banking crises in several countries of the region weakened the financial sector. Macroeconomic disturbances, a weak rule of law, a large stock of bad debt and low capitalisation rates further undermined the stability of financial markets.

The inefficiency in the financial sector was also influenced by its underdeveloped structure. It was characterised by domination of the banking sector, while the role of non-banking sector in mobilisation, concentration and allocation of financial resources was almost non-existent. In addition, the majority of banks were insolvent and unable to fulfil the requirements established by prudential norms while the banking balances were burdened by a high level of risky and non-performing loans (S. Goluboviæ and N. Goluboviæ, 2005).

As the consequence, the policy agenda during the late 1990s and early 2000s was dominated by efforts to clean up and stabilise the banking industry. Regulatory frameworks have been modernised and financial supervision has been strengthened. The share of bad loans has been reduced dramatically. Privatisation has helped to reduce state ownership in banking down to less than 20 percent in most countries and has attracted foreign banks into the market.

Despite these positive developments cited above, financial markets in the Western Balkans remain small, fragmented, and at an early stage of their development. The general characteristics of this market are: activity on the equity market is considerably lower than activity of the banking sector; majority of the countries are characterised by low liquidity on the capital market, with exchange concentrated on small number of shares of listed companies; and, an increased sensitivity of the financial markets to the movements of speculative capital (S. Goluboviæ and N. Goluboviæ, 2005).

Western Balkan banking sector has recently attracted considerable attention from foreign investors through a removal of national restrictions, the liberalisation of market access, and the sale of stateowned banks. The transition process from plan to market economy has proved to be an opportunity for many foreign banks to expand their activities to countries of the region. In the early years of transition, many EU banks set up small representative offices in the Western Balkans in order to serve their home clients who were entering the region. As cross-border linkages became more familiar with local conditions, they gradually expanded their presence in the region. Now some of them have established branch networks throughout the region and act as "universal banks" that offer a broad range of financial services.

It is notable that the majority foreign-owned banks still retain the highest share of the total assets of the banking system in the region. In 2007, banks with majority of foreign capital, controlled approximately 75% of banking market of Albania, Bosnia and Herzegovina, Montenegro and Serbia. In 2005- 2007, the market share of foreign banks stood at around 90% in Albania. Banks with majority of foreign capital controlled 86.1% of Bosnia and Herzegovina banking market in 2005, 90.3% in 2006 and 91% in 2007. In Serbia, it increased from 37% in 2005 to 75.5% in 2007, due to privatisation and organic growth of the subsidiaries of EU banks. Share of foreign capital, in Montenegrin banking sector, was around 78.8% by the end of 2006.

Owners include international banking groups coming primarily from EU countries (such as Austria, Italy, Greece, France, etc.). Austrian and Italian banks in particular operate across the Western Balkans. For instance, the Austrian investors are dominant in Bosnia and Herzegovina (59% of banking assets in 2007) and in Albania (55% of banking sector in 2005). Greek banks have also entered the region; by mid 2005, they had invested around EUR 750 million in the Western Balkans, half of which in Serbia alone. Since the start of financial system reform, these groups introduced numerous positive changes in the region, improving the performances of the domestic banking sector and providing stable foreign sources of financing domestic credit expansion.

Thus, the process of financial reporting of SMEs of the Western Balkans has primarily been driven by foreign direct investments (FDI) of EU banks into domestic banking sector. These strategic investors have been a way to strengthen the banking system in the region and to improve the low level of financial intermediation. They brought with them technical know-how, such as modern risk-management and marketing techniques. They tend to raise governance standards, introduce new financial products. They come with the resources to re-capitalise domestic banks and modernise branch networks. Moreover, FDI from the EU also helps the Western Balkan countries to "import" modern prudential regulation from EU. However, there are also some concerns about the growing influence of foreign banks in these regional banking markets. These, mainly, relate to the possibility that foreign banks turn out to be instable sources of bank credit, especially during financial crises or during economic downturns (either in Western Balkan countries or in their home markets).

3. FINANCIAL REPORTING, ITS POTENTIAL BENEFITS AND COSTS

Financial globalisation and financial reporting of SMEs are, in principle, two different concepts. Financial globalisation is an aggregate concept that refers to rising global linkages through cross-border financial flows. Financial reporting of SMEs refers to an individual country's linkages to international capital markets. Nevertheless, these two concepts are closely related. For instance, increasing financial globalisation is necessarily associated with rising financial reporting of SMEs on average7.

Some academic economists consider increasing financial liberalisation and unrestrained capital flows as a serious hazard to global financial stability (e.g., D. Rodrik, 1998; J. Bhagwati, 1998; J. Stiglitz, 2002) and dispute its utility for reasons of provoking the generation and propagation of serious financial crises. Thus, these economists call for maintenance of capital controls and the imposition of frictions, such as "Tobin taxes", on international asset trade.

Others8 argue that free movements of international capital can encourage a relatively more efficient allocation of economic resources, offer good risk diversification opportunities and help to promote financial development9. According to these authors, the abolishment of capital controls should allow a more efficient global capital allocation, which would transfer capital from capital-rich countries (industrial countries) to capital-poor countries (developing countries or transition economies). The capital inflows, resulting from financial liberalisation, should facilitate the transfer of foreign technology and management experience, encourage the competition and promote higher levels financial development, spurring economic growth. Moreover, increased openness to capital flows has, by and large, proven essential for countries aiming to upgrade from lower- to middle-income status, while significantly enhancing stability among industrialized countries (e.g., S. Fischer, 1998; L. Summers, 2000).

Some argue that the increasing presence of foreign firms in financial sectors can bring the important benefits to the markets they enter: added investment, cutting edge technologies and managerial practices (especially risk management), and because they tend to be more diversified than local institutions, more financial stability.

From this point of view, the financial reporting of SMEs potentially benefits both capital-importer and capitalexporter countries. Thus, the process of financial reporting of SMEs can be considered as a sign of country's attachment to a good economic policy. Consequently, it seems quite natural, from this point of view, to expand the process of international financial reporting of SMEs to other less economically developed countries. However, even if the deregulation of international capital movements is certainly desirable, some authors argue that such reforms should be implemented slowly.

4. POTENTIAL BENEFITS OF FINANCIAL GLOBALISATION IN THEORY

In theory, there are a number of direct and indirect channels through which financial globalisation could enhance growth.

Among the direct channels we can distinguish the augmentation of domestic savings (cross-border capital flows, in principle, allow to increase investment in capital-poor countries while they provide a higher return on capital from capital-rich countries); the reduction in the cost of capital through better global allocation of risk (it was predicted that stock market liberalisation can improve the allocation of risk (P. Henry, 2000)); the transfer of technological and managerial know-how (financially integrated economies seem to attract a large share of FDI inflows, which have the potential to generate technology spillovers and to serve as a conduit for passing on better management practices); the stimulation of domestic financial sector development (international portfolio flows can increase the liquidity of domestic stock markets and increased foreign ownership of domestic banks can also generate a variety of other benefits (R. Levine, 1996).

There are also a number of indirect channels through which financial globalisation could enhance economic growth. It could help promote specialisation by allowing for sharing of income risk, which could in turn increase productivity and growth as well. Financial flows could foster development of the domestic financial sector and, by imposing discipline on macroeconomic policies, lead to more stable policies.

Since the financial sector in the Western Balkans is bank-dominated, it seems important, for us, to pay more attention to the benefits that can bring foreign participation in the local bank sector. Theoretically, foreign bank participation can generate a variety of benefits (R. Levine, 1997, 2005). First, foreign bank participation can facilitate access to international financial markets. Second, it can help improve the regulatory and supervisory frameworks of the domestic banking sector. Third, it can improve the quality of loans, as the influence of the government on the financial sector should decline in more open economies. Fourth, in practice, foreign banks may introduce a variety of new financial instruments and techniques and also foster technological improvements in domestic markets. Fifth, the entry of foreign banks tends to increase competition, which, in turn, can improve the quality of domestic financial services as well as allocative efficiency. Sixth, the presence of foreign banks can also provide a safety valve when depositors become worried about the solvency of domestic banks. Finally, foreign banks entry enhances legislative framework, financial monitoring, reduces corruption and stimulates the development of transparent intermediary operations (R. De Haas and I. Van Lelyveld, 2003).

Even if theoretical models have identified a number of channels through which international financial reporting of SMEs can help to promote economic growth, and on the surface, there seems to be a positive association between embracing financial globalisation and the level of economic development11, it is quite difficult to empirically identify a strong and robust causal relationship between financial reporting of SMEs and growth, especially for developing countries (B. Eichengreen, 2000; E. Prasad and al., 2003). Besides, many of empirical papers have often found mixed results, suggesting that the benefits are not straightforward.

One of the reasons for the lack of consensus can be ascribed to the difficulty in properly measuring the extent of financial reporting of SMEs (M. Chinn and H. Ito, 2007). Although many measures exist to describe the extent and intensity of capital account controls, it is generally agreed that such measures fail to capture fully the complexity of real-world capital controls for a number of reasons12. In fact, we can distinguish three main measures of the extent of financial reporting: de jure measures (that capture the legal restrictions on cross-border capital flows based on data from IMF's AREAER13); de facto measures which includes the price-based measures (CIP, UIP and RIP14) and the quantitybased measures (based on actual flows); another de facto measure of financial reporting of SMEs is savinginvestment correlation (M. Feldstein and C. Horioka, 1980). Apparently, the distinction between de jure and de facto integration appears to matter a great deal in understanding the macroeconomic implications of financial globalisation. The basic problem with de jure measures is that implementation and enforcement differ so greatly across countries that international comparisons are doubtful. Consequently, even if most empirical papers analysing the effects of financial reporting of SMEs rely on de jure measures, de facto integration measures may be more appropriate for analysing the direct and indirect benefits of financial reporting.

An alternative line of inquiry into the effects of financial globalisation is based on the notion that not all capital flows are equal. Flows like Foreign Direct Investment (FDI) and, perhaps, international portfolio flows are not only presumed to be more stable and less prone to reversals (S-J. Wei, 2006), but are also believed to bring with them many of the indirect benefits of financial globalisation such as transfers of managerial and technological expertise. Thus, the composition of capital inflows can have an important influence on the benefits of financial reporting of SMEs for developing countries as well as for transition countries.

Finally, it seems that is not just the capital inflows themselves, but what comes along with the capital inflows that drive the benefits of financial reporting of SMEs for developing and transition countries (M. Kose and al., 2006). There is considerable evidence that financial reporting of SMEs serves as an important catalyser for a number of indirect benefits, which M. Kose and al. (2006) name potential "collateral benefits" since they may not generally be the primary motivations for countries to undertake financial reporting. They could include development of the domestic financial sector, improvements in institutions (defined broadly to include governance, the rule of law, etc.), better macroeconomic policies, etc. These collateral benefits then result in higher growth, usually through gains in allocative efficiency.

The empirical implications of this perspective are powerful. Actually, these collateral benefits affect growth and stability dynamics through indirect channels rather than just directly through financing of domestic investment, implying that the associated macroeconomic gains may not be fully evident in the short run. Moreover, in cross-country regression, it may be difficult to uncover the effects of financial reporting of SMEs if one includes measures of institutional quality, financial sector development, quality of macroeconomic policies etc (M. Kose and al., 2006).

While it is difficult to find a strong and robust effect of financial reporting of SMEs on economic growth, there is some evidence in the literature of various kinds of "threshold effects". For example, there is some evidence that the effect of foreign direct investment on growth depends on the level of human capital in a developing country. The list of "threshold effects" includes: financial sector development, overall institutional quality, corporate governance, macroeconomic policies framework, and trade However, studies that use measures of de facto integration or finer measures of de jure integration tend to find more positive results. Moreover, studies using micro data are better able to detect the growth and productivity gains coming from financial reporting. In fact, these threshold effects play important roles in shaping the macroeconomic outcomes of financial globalisation. In other words, countries meeting these threshold conditions are better able to reap the growth and stability benefits of financial globalisation. This generates a deep tension as many of the threshold conditions are also on the list of collateral benefits (M. Kose and al., 2006).

5. POTENTIAL COSTS OF FINANCIAL REPORTING

In spite of its beneficial effects, financial reporting of SMEs can also be dangerous, as it has been witnessed in many past and recent financial, currency and banking crises. It can make countries more vulnerable to exogenous shocks. In particular, if serious macroeconomics imbalances exist in a recipient country, and if the financial sector is weak, be it in terms of risk management, prudential regulation and supervision, large capital flows can easily lead to serious financial, banking or currency consequences.

In fact, the experience of the past three decades has led economists and policy makers to recognize that, in addition to the potential benefits discussed above, open financial markets may also generate significant costs. Such potential costs include a high degree of concentration of capital flows and a lack of access to financing for small countries (either permanently or when they need it most); an inadequate domestic allocation of these flows (which may hamper their growth effects and exacerbate pre-existing domestic distortions); a loss of macroeconomic stability; a pro-cyclical nature of shortterm capital flows and the risk of abrupt reversals; a high degree of volatility of capital flows (which relates in part to herding and contagion effects); and risks associated with foreign bank penetration (PR. Agénor, 2001).

Again, since financial sector of Western Balkan countries is bank-dominated, we would like to point out the potential "danger" of presence of foreign bank on the domestic financial sector. Although foreign bank penetration can yield several types of benefits (as discussed earlier), it also has some potential disadvantages as well.

First, foreign banks may ration credit to small firms to a larger extent than domestic banks, and concentrate instead on larger and stronger ones. If foreign banks concentrate their lending operations only to the most creditworthy corporate borrowers, their presence will be less likely to contribute to an overall increase in efficiency in the financial sector. More importantly, by leading to a higher degree of credit rationing to small firms, they may have an adverse effect on output, employment, and income distribution (P-R. Agénor, 2001).

Second, entry of foreign banks, which tend to have lower operational costs, can create pressures on local banks to merge in order to remain competitive. Furthermore, the process of concentration (which could also occur as foreign banks acquire domestic banks) could create "too big to fail" banks. A toobig- to-fail problem may, in turn, increase moral hazard problems: knowing the existence of an (implicit) safety net, domestic banks may be less careful in allocating credit and screening potential borrowers (P-R. Agénor, 2001). Concentration could also create monopoly power that would reduce the overall efficiency of the banking system and the availability of credit. In particular, a high degree of banking system concentration may adversely affect output and growth by yielding both higher interest rate spreads (with higher loan rates and lower deposit rates relative to competitive credit and deposit markets) and a lower amount of loans than in a less concentrated more competitive system.

Third, entry of foreign banks may not lead to enhanced stability of the domestic banking system, because their presence per se does not make systemic banking crises less likely to occur – as it may happen if the economy undergoes a deep and prolonged recession, leading to a massive increase in default rates and an across-the-board increase in no performing loans, and because they may have a tendency to "cut and run" during a crisis (P-R. Agénor, 2001).

6. CONCLUSION

The common characteristic of the Western Balkan countries is that, in the early transition, these countries avoided any radical reform of their financial sector. Instead, they undertook partial changes like transformation of the monobank system into two-tired banking system. The transition countries experience points out that the financial sector restructuring is necessary if macroeconomic crises are to be avoided. Therefore, the financial sector development is an important segment of economic transformation.

On the other hand, the financial sector reform is one of the first steps of the process of financial reporting, both on a regional basis and on an European perspective. The main goal of the financial sector reform in the Western Balkan countries is the change of the financial sector role. It means that the financial sector must have an active role in mobilisation, concentration and allocation of financial resources. Until now, the most important changes in financial system in these countries were realised only in banking sector, while the changes were almost insignificant in the other segments of the financial sector.

In the banking sector, the very strong entry and presence of foreign banks in Western Balkans seem to bring great advantages in terms of efficiency and banking performance. Among these foreign banks, the Austrian ones hold the first place that settles more firmly Vienna’s position as regional financial hub in the Central Europe. However, it would be necessary to determine the optimal level of foreign banks participation in order to leave enough space for the domestic banks which would risk to become entirely dependent from these foreign banks. In fact, the local banks play a very important role in these countries by financing the numerous small and medium size enterprises which are not financial attractive for banks from abroad.

Moreover, in order to "successfully" integrate the EU financial market, the potential candidate countries should envisage to develop the two other financial sectors of their financial system in following a gradual and orderly sequencing of external and internal financial liberalisation. The current worldwide crisis shows that a too large financial liberalisation can easily lead to serious financial and banking risks. Therefore, local authorities should adopt a cautious attitude towards financial liberalisation and take in consideration the current macroeconomic situation which, in fact, is specific to each country.

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