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The effect of the foreign bank entry on economic development.

A comparative case of Bulgaria and Serbia.

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CONTENTS

EXECUTIVE SUMMARY

Nowadays exists growing interest in the impact of foreign banking on the financial system and the economic development of emerging and transition countries, because foreign banks have played an important role in the development of these markets. Because of this reason, in my thesis, I am trying to describe the effect of the foreign bank entry on economic development and my case studies are countries Bulgaria and Serbia. It is very interesting to see this effect in the country which started earlier with transition process and now is the member of the EU- Bulgaria, and the country which had a big delay in starting the transition process and still is not the EU member- Serbia.

The banking reform in Bulgaria started at the beginning of 1990s, but because the bad governance, weak regulatory oversight, unsound credit policies, and lack of privatization efforts, the country had a severe banking crisis and a wave of banking failures in 1996- 1997. The adoption of a currency board at the same year stopped the further crisis and made a recovery of the whole banking economy. The country took a stable course to integration in the Euro- Atlantic structures, a process that successfully led to the EU accession in January 2007.

The first foreign banks came to the Bulgarian market in 1995. Most banks were privatized between 1998 and 2000. Today, the Bulgarian banking system have 31 banks, which 3 of them are private domestic and 27 are foreign banks (7 of them are just the branches of foreign banks in Bulgaria).

Serbia started its transition process in 2000, and it still have a long way to pass. With the transition, first foreign banks came to the market. Since the foreign presence is quite recent, comparing to the other developed countries, the major domestic banks still have strong local presence and high level distribution capacity.

There are seven banks which operate both on the Bulgarian and Serbian banking sector. These seven banks are amongst the biggest banks in their home country and some of them even do not have the office in the home country, still just abroad. The countries from where these banks are

coming are countries with the most developed banking system comparing to the Bulgarian and Serbian banking sector.

From the seven foreign banks which operate in the Bulgarian and Serbian banking sector, three are from Greece, two from Austria, and another two from France and Germany. The biggest investors in both countries are Austria, German and Greece. From the presented, we can see that, in the case of Bulgaria and Serbia, there are connections between flow of FDI and foreign bank entry in a sense that banks follow their customers abroad.

The opportunities in Bulgaria and Serbia are very good. Both countries are the members of the IMF, they are following the EU standards (like Basel II), privatization process is transparent, there is no currency risk, because the both currencies are pegged to Euro. Both countries have the most favorable taxes: 10% corporate income tax rate and high skilled, multilingual work force and Europe's most competitive salary levels.

Regression analysis which is done in this thesis shows that the foreign banks have the effect on the economic development in both countries. Foreign banks followed their consumers (big foreign investors) and that is one of the reason why they came to the Bulgarian and Serbian market. In order to be more competitive than domestic commercial banks, they decreased their landing rate which had for a consequence the increase of the loans given by foreign banks. But all this is proved for short- term, because the date for Bulgaria and Serbia is limited on 16 and 10 years, respectively.

The financial crisis which started in 2008 hit the Balkan countries one year after. Because of this delay, national banks of Bulgaria and Serbia had time to prepare their programme, so the banking systems of these countries had stood rather stable, because the huge losses of the Western banks did not directly affect the Bulgarian and Serbian banking system. What is expected is that after the crisis, Bulgaria continues its way to join the EURO zone, and Serbia to execute all the conditions for joining the EU.

INTRODUCTION

Today, banks are the backbone of the global economy, providing capital for innovation, infrastructure, job creation and overall prosperity. They also play basic role in society, in a sense they affecting not only spending by individual consumers, but also the growth of the entire industries. However, during the history, there were the periods of time when banks and banking sector attempted to be suppressed or tightly controlled. Recent example from the recent past is banking system during the communist era (pre- transition period).

Banking sector in pre- transition period was designed based on centrally planned economy (CPE) logic. The main role had had the state banking system which creates intermediation between savers and borrowers. The state banks had been creating systems for redirection of credits to state- owned enterprises for investments, but for the budget allocation, too. There was significant level of specialization between the banking sector: from the savings banks, to the foreign trade banks, agricultural banks and construction ones.

In the transition economies (TEs), the first step in banking sector reform involved the creation of a two- tier system with commercial activities carved out of the portfolio of the national monobank. At the beginning of transition, the new banking sectors in the former CPEs consisted of the newly created commercial banks and the specialty banks, along with a few foreign greenfield banks and often many relatively undercapitalized domestic private banks. Typically, three of four large banks dominated the emerging banking sector in a TE or there were a lot of small banks. This kind of situation was until the beginning of 1990s. Then the number of foreign banks started to increase on these markets. In addition, rapid progress in bank privatization and consolidation took place in the late 1990s and early 2000s, usually with the participation of the foreign banks. After few years, banking sector in many transition countries had developed sufficiently to provide a wide range of services with solid bank performance. Recently, banks have switched their focus from lending to enterprises in a somewhat underdeveloped institutional environment to new lending to households, which accounts for much of the recent growth of credit in many transition countries.

There is a growing interest in the impact of foreign banking on the financial system and the economic development of emerging and transition countries, because foreign banks have played an important role in the development of these markets. First of all, the capital brought by foreign investors decreased fiscal costs of banks' restructuring. Second, foreign banks brought expertise in risk management and higher culture of corporate governance. contributing banks more efficient. Third, foreign bank presence increased the competition, driving domestic banks to cut costs and increase efficiency. Finally, domestic banks have benefited from technological spillovers brought about by their foreign competition. During the 1990s, foreign involvement in the financial sector of emerging economies rose substantially. By the end of the last century, foreign owned banks in Central and Eastern Europe accounted for an average of 70% of bank assets (Mehic/ Babic-Hodovic/ Agic/ Kramo, 2007, p. 3).

The transition in Bulgaria had a goal to make a stable, well- regulated and competitive banking system. But this process has been long and twisting. The legal framework for commercial banks which was established at the beginning of the market reforms in the early 1990s, led to the rapid increase in the number of private banks, the consolidation of high number of state-owned banks and the entry of the foreign banks into the market. Nonetheless, the banking sector still had inefficient state-owned banks which were overdriven with nonperforming loans lending to loss-making state-owned enterprises and those banks were waiting the financial support from the government. Bad governance, regulatory failure, unsound credit policies and lack of privatization efforts were just some of the reasons for banking crises in 1996- 1997. The solution in a form of currency board indicated a fundamental change in the institutional framework of the banking sector introducing new methodical requirements for commercial banks, eliminating the soft-budget problem, and strengthening the regulatory and supervisory powers of the National Bank of Bulgaria. In the first half of the last decade, the changes that were made on the banking sector had for a goal to approach Bulgarian banking system to the European Union banking directives in a process of EU accession. As a result, in 2007, when Bulgaria joined the European Union, over 80% of banking assets were controlled by foreign banks and over 98% were privately owned.

The Serbian banking sector seems to be in the turmoil of restructuring, but there is still a long way to do. The establishment of outstanding issues with the past, the nationalization in 2002 of numerous banks and the failure of the others, graduate recapitalization, the entry of foreign investor reforms introduced and the privatization to be effected- all represent a hectic competitive environment unlikely to stabilize and settle in a short term. Of the various priorities, the question of bank ownership structures is crucial to stabilizing and strengthening the system, including via the contribution of equity. Alongside the "nationalized" banks and a dynamic group of recently incorporated foreign banks, there are several major private local competitors interested to retain their leadership positions, as well as a large number of small and minor domestic banks which are waiting their moment to be involved in the consolidation process. Since the foreign presence is quite recent (less than 10 years), comparing to the other developed countries, the major domestic banks still have strong local presence and high level distribution capacity.

The purpose of this thesis is to give an overview of the banking sectors in Bulgaria and Serbia, to compare foreign bank entry in these two countries and to examine the effect of the foreign banks' entry on economic development on the same banking markets. This paper is divided into two parts or five chapters.

Chapter I is divided into 2 parts. In the first part of first chapter, the readers will be introduced with the history of the Bulgarian banking sector. But, the main accent in this part is on the reforms which the Bulgarian government did during the crises period 1996- 1997 and also during preparation for joining the European Union. The second part shows the history of the Serbian banking sector, provided that the main accent in this sector is after 2000, because in this year Serbia has started its transition process which lasts to these days.

Chapter II is related to the foreign banks in Bulgaria and history of foreign banks' entry on this market. The second part of this chapter, consequently, is related to the foreign banks in Serbia and history of foreign banks' entry into the Serbian banking sector.

Chapter III gives information about foreign banks' entry in Bulgaria and Serbia- differences and similarities. Seven foreign banks operate both in Bulgaria and Serbia. In this Chapter will be presented theoretical background- which banks expand abroad, what draws foreign banks to expand abroad and what is the mode of foreign bank entry on the host country market. Then, for all these theoretical questions will be given the answers using Bulgaria, Serbia and these seven banks as a case study.

Chapter IV is dealing with the regression analysis. The aim of this Chapter is to analyse whether foreign banks have effect on the economic development of the host country- in my case, on the economic development of Bulgaria and Serbia.

Finally, conclusion, my personal comments and recommendations will be given in the Chapter V.

Chapter I

1.1. Banking sector in Bulgaria

The establishment of the Bulgarian National Bank (BNB) after the liberation from the Ottoman Empire is the beginning of banking in Bulgaria. The bank was established in 1879 by prince Alexander Dondukov- Korsakov, who in that time led the Temporar Russian Government in Bulgaria. The same year, the first Governor was appointed and the bank was officially opened. At the beginning of XX century until the economic crisis (1929), the independence of the bank was increased significantly and it became a real central bank of the banks with issuing and regulatory functions. After the end of the Second World War, ...“the banking system in Bulgaria already consisted of: BNB- 107 branch offices, Bulgarian agricultural and cooperative bank- 119 branch offices, Bank Bulgarian Credit- 32 branch offices, foreign banks- 33 branch offices, General union of popular banks- with 250 popular banks” (Stoyanov, 2008, p. 282).

As one would expect, during the communist regime (1944- 1989), Bulgaria had centrally-planned economy where has existed state monopoly over the banking system. There was one state bank- BNB- with a network of branches, acting more like a control agent than either a central bank or a commercial bank (Yonkova/ Alexandrova/ Bogdanov, 1999, p. 9). In a middle of 1980s, only two other banks existed in Bulgaria- State Saving Bank, where was the total amount of deposits of the Bulgarian population, and Foreign Trade Bank, which observed and did all international banking transactions.

The regime of Todor Zhivkov, who was at the leader position since the mid 1950s, ended in 1989, just one day after the fall of the Berlin Wall. In 1990, Bulgaria became a parliamentary democracy. The new government only nominally embraced a liberal agenda; not understanding free markets, it made only those changes it was forced to make (Koford/ Tschoegl, 2003, p. 18). Two years after the political changes, the new law for BNB was accepted with which the bank received the status of central bank with significant autonomy. With this law and with the role that Bank Consolidation Company had, the national economy of Bulgaria was restored. In a short period of time many of BNB’s branch offices and some other governmental banks have been transformed in new bank institutions, which have step-by-step introduced market mechanisms in their activity and take leading place in bank sector of the country. Still, how this government had handled with the reforms in the banking sector could be characterized as passivity or policy mismanagement, without comprehensiveness in the reform initiatives. Also, privatization, decapitalization, consolidation, were very sporadically implemented.

1.1.1. *Bulgarian banking crisis 1996- 1997*

The result of this policy was a collapse of the Bulgarian banking sector at the end of 1996. That year, 14 out of the 35 registered commercial banks failed. The financial market was hit with almost six- fold depreciation. The crisis didn't surprise the policymakers in office, because the lack of real attempt to reform the financial industry. Actually, rumors about the inability of the banks to serve their liabilities has already begun to spread by 1995. A precondition for the banking crisis was set in the beginning of the reforms, with the first non-communist government, when a process of establishing deeply fragmented banking system began with a large number of small state- owned banks specialized in providing funds to particular branches and region (Yonkova/ Alexandrova/ Bogdanov, 1999, p. 18). The second biggest problem which led to the banking crisis was the one with both non-performing loans extended to the SOEs in the pre-transition period, and non-performing credits given after 1990 by the most of the banks, especially the private ones. Almost half of all the loans given by state- owned banks to non-financial institutions are uncollectible. Furthermore, most of the SOEs got inside the circle- they took new loans from banks in order to pay old debts and cover the losses. The government had *soft- budget- policy* for these loss- making enterprises.

Looking whole picture of the development of the financial sector in Bulgaria, we can say that the real reforms started in 1997. That year, international financial institutions had to step in and put a firm conditions before the Bulgarian politicians to introduce a currency board and stabilize the national economy. Because of delay of reforms for more than 7 years, taken measures were drastic, but necessary. First consequences of the reform were sharp decline in economic activity, hyperinflation and financial crisis within radically malfunctioning state institutions. The IMF provided support in order to stop hyperinflation. The Bulgarian currency was fixed to the DMark, the volume of currency circulation was linked to the hard currency reserves, and the currency board undertook the monetary policy management (Vincelette, 2001, p. 5). But, one question is inescapably: why was the reform in the financial sector so long delayed, when the signs of the financial crisis were obvious before the crisis of the banking sector?

The first reason for the delay is that no extensive program for the development of the financial sector was introduced. This is because two reasons. Firstly, state was unwillingness to facilitate its own retreat. In the financial lawless situation, powerful groups found a way how to take advantage of the institutional chaos in the country; they found so called *holes in the laws*. But, on the other hand, for manipulating the interests of the state from inside was necessary to pacify the state and deal with the state structures by acting in a state- insolent way. Secondly, state did not consistently follow the market principles for the development of the banking industry. Because no continuity in the reforms, Bulgaria was facing with unstable institutional environment. Suitable banking sector regulations and supervision, fair competition and privatization were not the priorities for the government.

1.1.2. *The Beneficiaries*

One more question is evident here- who were the beneficiaries from the disruptions in this kind policy process that government were taking? The state landing to insiders made an exceptional number of credit millionaires[1]. The credit millionaires were individuals and companies related to the banks, big state- owned enterprises, or the organized, private, economic group with extended political connections (Vincelette, 2001, p. 26). Banks themselves are another group of credit millionaires. It is not a secret that private banks received credits up to the billions of Lev in order to provide some liquidity on their balance sheets. The BNB lent preferential loans for refinancing the troubled commercial banks. And, in the third group were SOEs which were absolutely unable to repay their debts to the commercial banks in the deadline. But crediting was not stopped to these enterprises- the government cut direct subsidies to the SOEs, but at the same time they

[1] "A credit millionaire is an individual or a firm that has made money by failing to service bank loans" (Capital, 1998/3).

found a indirect way how to keep them alive- state-owned banks gave them loans. In this way, the government sabotaged its credibility in order to save the economy.

1.1.3. *The situation after Currency Board Arrangement (CBA)*

As I have mentioned above, the situation in the financial sector of the Bulgaria economy changed radically in 1997 with the creation of the currency board arrangement (CBA) which major characteristic was tightly constraints the monetary policy of the BNB, the isolation of failing state enterprises and new efforts to privatize the banking system. The CBA fixes the Bulgarian Lev to the Euro, and the BNB does not operationally target interest rates. Encouraged by the IMF and the World Bank, the Bulgarian reformers put the effort in the new reform program, and soon positive results have shown.

By the end of 2003, around 98% of all total assets of the banking sector were in private ownership (Walko, 2004, p. 93). Privatization was mainly fast and based on the consensus for attracting strategic investors. Before taking over the banks, new investors had to make a commitment that they will improve the performance of the banks they bought through steps toward technological modernization and capital flow. This way of privatization had been criticized because the lack of transparency in choosing the buyers for the banks and increase of the unemployment in the banking industry. Regardless of the criticism, the country took a stable course to integration in the Euro- Atlantic structures, a process that successfully led to the EU accession in January 2007. The Bulgarian banking system has undergone a number of major changes in the last decade caused by the liberalization of financial markets and increasing integration with the European banking system and as well as the technological progress and later into the Economic and Monetary Union (EMU).

With a every day growing real sector and expanding credit demand, banks were expanded their credit portfolios. Corporate lending was on a very high level, featuring a trend to project financing and risk sharing among banks. Despite significant lending, the growth quality of assets still stayed good. Banks' liquidity also remained high, allowing more flexible asset management.

There were no signs of depositor nerves. Banks succeed in controlling the asset and financing structures, ensuring adequate liquidity.

1.1.3. *The International Financial Crisis and Bulgaria*

The financial crisis in 2008 largely rounded Bulgaria. But in 2009, the economic crisis came at the small Balkan country at full force. Although it late coming and despite the seriousness of the economic decline, Bulgarian banking system as a whole had stood rather stable. To be more precisely and to explain this better- initial effect, which caused huge losses of the Western banks did not directly affect the Bulgarian banking system. Indirectly, crisis had influence of headquarters of the banks. As I already said, because of the rapid privatization, the majority of the commercial banks were / are controlled by the foreign banks. Bulgaria were facing with the limited funding from the headquarter banks which obtain to control the largest three banks in Bulgaria. Overall situation on the worldwide market led to recession on the main Bulgarian external market which had for consequence a strong drop in sales and profitability considering the limited external and internal demand (as a result of increased unemployment and reduced incomes) which has lower dramatically in the second half of 2009. To conclude, the Bulgarian banking system stays stable. Moreover, despite the sharp decline of EUR 709 mln. in 2008 to EUR 399 mln. in 2009, the banking system in Bulgaria continues to report profit (Dimitrova, 2010, p. 18).

The Governor of the BNB Ivan Iskrov said that Bulgarian banking sector continues to be among the most stable ones in the EU. “It continues to show versatility and effectiveness on its way out of the crisis” (Iskrov, 2011, Interview at Radio Bulgaria).

1.2. Banking sector in Serbia

The first trace of the banking operations in Serbia can be found in XII century. Until the state fell under the command of Ottoman Empery, the national money was *dinar*. Dinar was replaced by Turkish silver money during the five century long Turkish occupation. Finally, in 1878, Serbia achieved international recognition and sovereignty, and that is how it became one of the states of the European system in that time. But the economy of Serbia was not in a good condition- trade was underdeveloped, manufacture had not been introduced yet and the money supply and demand were in imbalance. The next big progress was the establishment of the National Bank of Kingdom of Serbia in 1884. With a growing market, numerous heterogeneous banks as a system started to rise in a new state named Kingdom of Serbs, Croats and Slovenians.[2] The negative effect of the Great Depression did not bypass the banking system of Kingdom of Yugoslavia which had sharp decline of its performance. The banking sector was illiquid, and almost every second bank was asking for payment rescheduling, rehabilitation or out of court liquidation.

With the end of the Second World War, a lot of changes happened in the country, started first from the name of the state- Socialist Federative Republic of Yugoslavia. Together with the political changes, banking sector also passed under six stage reconstruction. In the first stage, all private banks were put under control or confiscated or nationalized. The number of the banks dramatically dropped- from 819 to 72. In the second stage, the National Bank of Yugoslavia became an issuing- deposit taking bank, which later in the fourth stage became the only bank in the country. Two new types of the banks were established in the third stage- State bank for agricultural cooperatives and communal banks. In the fifth stage, turn over happened in a sense of decentralizing and specializing- establishment of communal banks, city and cooperative savings institutions as well as banks with prefix Yugoslavia in their names[3] for the particular economy area. The sixth stage is characterized by the economy reform which took place at the market. A new Law of Banks was implemented by which ”...Enterprises and other legal entities (but not the physical persons) could be the founders of the banks by way of investing funds in the founders' funds of the banks” (Sredojevic/ Brkovic, 2010, p. 8). Founders' funds had a role of permanent investment capable of covering the losses that could be pulled out by the founders only after netting out their liabilities towards the bank. This situation at the banking market was until the end of 1980s, when the new law was implemented. The point of this law was banking and economy reform which brought progress into the market economy and market oriented banking.

[2] In 1929, the Kingdom of Serbs, Croats and Slovenians changed the name into Kingdom of Yugoslavia that was in place until 1941.
[3] Examples for these banks are: Yugoslav Bank for Foreign Trade, Yugoslav Investment Bank, Yugoslav Agricultural Bank, etc.

Many economists for this law said it was going ahead of some contemporary well established market regulations, like Basel I in that time.

1.2.1. *Banking sector during 1990s*

In 1991, UN Security Council introduced embargo to Yugoslavia which caused great damages to the local banking system in Serbia. The number of the departments of the foreign banks sharp decline at the very low level. In 1993, the hyperinflation shook Serbia so badly, that the prices were doubling each 16 hours, and the banknote of value of 500 billion was printed. Household savings in local currency were worthless, while foreign exchange savings were frozen. In early 1994, a Programme of Monetary Reconstruction and Economic Recovery was adopted. The goals of this programme were primarily linked with monetary and fiscal field. It was implemented without foreign assistance and without any capital inflow. In order to place the monetary economy on the healthy base, positive interest rates were introduced, while selective credits were retracted. The new dinar was introduced, with the fixed exchange rate of 1:1 in relation to the DMark. During the first year of implementation of this programme, Serbia achieved fascinating results in banking sector- the inflation was controlled and inflatory expectations were eliminated; prices were stable; interest rates became real positive.

The conflict with NATO over Kosovo, had many, at first hand, invisible implications for the Yugoslav banking sector. Many above described situations which were improved from 1995 until 1999, were badly affected. One year after bombing, the political situation changed in the country. Together with political changes, economic changes also happened. Since 2001 a completely new page of the banking system development and the financial system as a whole was opened.

1.2.2. *Banking sector after political reforms (after 2000)*

In 2001, Federal Government of Yugoslavia[4], Republican Government and National Bank of Serbia (NBS) adopted the Strategy for Reconstruction of the Banking System and the Programme of the National bank of Serbia which roles were to achieve fast recovery for weaknesses and problems the banking sector was facing with. In order to rebirth the confidence of citizens in banking system, the Government converted frozen savings into the public debt and issued bonds denominated in foreign exchange maturing in yearly installments to the year 2014. The growth of capital strength of the domestic banking industry and the access to the world capital market of the domestic economy in sense of the integration in the world trance is the consequence of the entrance of the foreign banks on the local financial market, first in the form of de novo banks. In the same year, the Bank Rehabilitation Agency was established which had to deal with the *ill* state owned banks. The Agency decided to liquidate the four largest banks of system, because it examined it was too late to save them by recapitalization from the budget. Two years after the establishment, the number of the banks at Serbian banking market declined from 86 in 2001 to 47 in 2003 (NBS Official Webpage). Main reason for this decline was that the remaining state owned banks were either merged to larger and healthier ones either remained under surveillance of the Agency.

In January 2002, when Euro became the official currency of EU thirteen countries, banks presented the offer to convert citizens' savings (and to remain on the accounts with banks) which were, until then, in their houses, dominated mostly in DMark. According to some published statistics, the new small foreign banks together with the largest private owned bank collected the major amount of new deposited foreign currency savings. The reason for this was still insecure in the domestic banks. Because of that, central bank representatives did the tough and independent prudential supervision of banks according to IMF recommendation and practice from developed economies.

[4] In 2003, the state changed the name into State Union of Serbia and Montenegro. In 2006, both countries, after the referendum in Montenegro, gained independence.

1.2.3. *The International Financial Crisis and Serbia*

Since 2004, private sector loans in Serbia recorded dynamic growth, where the main source of these credit activities were growing deposit potential, recapitalization of the banks and loans from abroad. But, in 2008, Serbia recorded the decline in the growth of the banking sector because the restrictive monetary policy, and in the last quarter, additional reason for decline was economic crisis which hit Serbia. Since then, credit activity had a minimum real growth and and retail loans achieved a nominal decrease. This situation is caused by the reduction of demand for loans due to negative macroeconomic trends as well as by the reduction in credit supply due to the bad situation in terms of sources of liquidity and minimized tendency towards by the banks (Simovic/ Vaskovic/ Poznanovic, 2009, p. 2). But, not only that, the effects of the crisis have more serious consequences for Serbia. Serious consequences of the global financial crisis are manifested through the decrease in the value of the domestic currency, increase in premium risk, the decline of domestic economic activity and, finally, the growth of inflator's expectations (Muric, 2009, p. 402). In order to reduce the negative effect of financial crisis, the National Bank of Serbia took some measures. In a first set of adopted measures, the National Bank of Serbia has affected the incentives of banks to obtain funds from abroad, which on that way, made borrowing much cheaper and stimulating. As the second measure, the National Bank of Serbia adopted the set of new conditions under which business banks may require credit (from the National Bank) for liquidity to overcome temporary difficulties with liquidity. By this decision, the National Bank is granting the loans to the banks under the conditions that they previously used the other favorable sources of liquidity available on the market. As a next big measure, banks changed the current regulation related to investments of financial institution. In this field, the National Bank of Serbia modified the criterion about business of the insurance companies- increase the limit for investment of technical reserves in bank deposits and change the conditions to be met by action in that invest technical reserves. Furthermore, banks and other residence can make payments for purchases of financial products abroad.

Chapter II

2.1. Foreign banks in Bulgaria

When the communist regime came, the role of any foreign bank stopped. During this era, domestic private banks did not exist and the regime excluded foreign banks. However, in the second half of 1960s, some changes were introduced. In 1964, Bulgaria established the Bulgarian Foreign Trade Bank (BFTB) out of the foreign operations of the BNB, as the regimes in Poland, the USSR, Czechoslovakia, and East Germany created similar institutions (Koford/ Tschoegl, 2003, p. 16). BFTB established its representative offices in three towns- London, Frankfurt and Vienna. At the end of 1990s, BFTB established the joint venture together with the Bayerische Vereinsbank, with the head office in Munich. And with the Soviet Union's Vnesheconombank established Bulgarian- Russian Joint Finance Company.

2.1.1. *Foreign banks at the beginning of transition period*

With the break up of the communist regime, the Bulgarian banking sector passed several banking system reforms. The new laws were established- all of them were connected with the banking sector and expended role of the BNB. In this period of time, there was a growing competition among the commercial banks themselves due to entry of new banks. Table 1.2.1. shows the number of commercial banks for 1991 until 1994.

Table 1.2.1. Number of commercial banks

	1991	1992	1993	1994
Large Banks	3	4	7	10
State	3	4	6	9
Private	0	0	1	1
Small and Medium Banks	75	76	33	28
State	69	65	18	6
Private	6	11	15	22
Savings Banks (SSB)	1	1	1	1
Foreign Banks	0	0	0	0
Total	79	81	41	41

Source: Miller/ Petranov, 1996, p. 16.

The reason why the number of the banks is declining is entirely due to consolidation of state-owned banks, not exit. In the meanwhile, the number of the private banks is constantly growing. As it is shown in the Table 1.2.1., at the Bulgarian banking market were 22 private banks at the end of 1994. Also, the number of the large banks is also increasing.

But, as we can see, the presents of the foreign banks is still small. By the Law, the green light was given to the subsidiaries of foreign banks but not for the branches. It also stipulated that acquisition of more than 5 per cent of the total voting shares in a bank required BNB permission (Koford/ Tschoegl, 2003, p. 18). However, by 1994 the two foreign banks has opened their branches. It was the Greek “Xios” and the Dutch “ING Bank”. In 1995, two additional foreign banks came to the Bulgarian market, the BNB Dresdner and the Ioanian Bank.

Given their comparative advantages in reputation, viability and experience, these foreign banks were clearly in a position to put strong competitive pressure on local Bulgarian banks. An important policy issue at that was how much to restrict the entry of foreign banks into the Bulgarian market. Foreign banks could bring skills and experience. On the other hand, Bulgarian banks needed time to become fully competitive, and uncontrolled entry of foreign banks might have created an environment where Bulgarian banks could not serve. The protectionist policies in the period 1991- 1995 were a compromise. Foreign banks were allowed to entry, but only if they specialized in a limited range of services.

2.1.2. *Foreign banks during the Bulgarian banking crisis*

The problem with the Bulgarian banking system during this period was the wrong government policy. State- owned banks had many loans to state- owned enterprises that dated back to the pre-reform period. In order to reduce the burden of these loans, the government replaced these loans with government debt. The programme broke down because the government continued to pressure the banks to extend the new loans to weak enterprises which were unable to repay. The banks started to be more weaker, and the BNB provided more loans to the banks in order to keep them from failing. This led to the crisis in the banking system in 1996. As a part of series of measures, in 1997, the government adopted the currency board, which removed the government’s control over monetary policy and stabilized the currency. The government also pushed forward privatization of the banking system. Lastly, the government favored the entry of foreign banks because these could draw on their parents for liquidity as the currency board system limited the BNB's ability to set as a lender of last resort.

Table 2.2.1. Bulgarian banking system 1991- 2001

Ownership		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
State	Number	72	69	25	15	12	7	6	5	7	3	3
	Savings	1	1	1	1	1	1	1	1			
	Share (%)	98.5	96.8	93.6	84.4	76.9	82.5			51.1	17.6	18.1
Bulgarian private	Number	6	11	15	23	22	13	13	11	7	9	10
	Share (%)	1.5	3.2	6.4	15.6	22.4	15.2			6.9	9.9	10.3
Foreign	Subsidiaries				0	3	5	9	10	13	15	16
	Branches				2	4	4	5	7	7	8	7
	Share (%)				0.1	0.6	2.3		25	42	73	72
All banks	Number	79	81	41	41	42	30	34	34	34	35	35
	Assets (BL Bn)	463	582	810	1072	1,089	3,301	8,076	7,589	8,223	9,774	11,908
H^2 (a)		0.38	0.33	0.30	0.15	0.11	0.19	0.12	0.11	0.12	0.11	0.09

Notes: (a) H^2 is the Hirschman-Herfindahl index. H^2 is the sum of the squares of each bank's share of the total assets in the banking system. H^2 ranges between 1, which represents a situation of monopoly, and 0, which would represent complete dispersion.

Source: Koford/ Tschoegl, 2003, p. 45

Most banks were privatized between 1998 and 2000. With the privatization of the Bulbank, the largest bank in Bulgaria, only three banks were still under state control at the end 2000. As we could see from the Table 2.2.1., these three banks had less than 20 % of total banking system's assets. Foreign banks could entry the local market in three ways: purchase banks, open branches or establish Bulgarian subsidiaries. All Bulgarian state- owned banks that have were privatized were bought by foreign institutions. At the end of 2000, more than 70 % of the banking system assets were either in foreign owned banks or branches of foreign banks.

2.1.3. *Foreign banks after 2000*

Table 3.2.1.. Bulgarian banking system 2002- 2010

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Market share by type of ownership:									
-state	16.6%	18.35%	17.88%	17.8%	18.07%	17.68%	16.09%	15.96%	19.27%
-foreign	83.4%	81.65%	82.12%	82.2%	81.93%	82.32%	83.91%	84.04%	80.63%
Number of banks:									
-state owned	3	2	2	2	1	1	1	1	1
-private domestic	10	10	10	9	7	5	3	3	3
-foreign	21	23	23	22	23	23	26	26	26
TOTAL	34	35	35	33	32	29	30	30	30

Source: author's calculation using data from the BNB Official Website

In order to join the EU, the highest priority was given to the restructuring of the banking system. The banking privatization process was completed with the sale of Commercial Bank Beochim to Bank Austria Creditanstalt at the end of 2002 and the purchase of the former State Saving Bank by Hungarian OTP Group in 2003 (Mirchev, 2009, p. 6). As it is presented in the Table 3.2.1., the only state- owned bank until nowadays is the Bulgarian Development Bank, which 99.99% of its shares are in the hand of the Ministry of Finance. Also, the Table 3.2.1. shows that the number of banks in Bulgaria during period 2002- 2010 was between 35 and 29. The last information published by the BNB is that on 31 August 2011, the Bulgarian banking system has 31 banks, which 3 of them are private domestic and 27 are foreign banks (7 of them are just the branches of foreign banks in Bulgaria). The last foreign bank which came on the Bulgarian market is the ISBANK- Bulgaria Branch.

The number of private domestic banks has decreased during the same period, while the number of the foreign banks has been increased. In the Bulgarian banking system, foreign banks found to be more efficient than domestic private banks, but the gap narrowed significantly in the latter years of the sample period. State- owned banks were the least efficient, but achieved efficiency gainst after being privatized. In 2007, Bulgaria joined the EU. In the same year, the BNB introduced the Basel Capital Accord requirements. All this, plus enhanced corporate governance practices and transparency attracted the high level of foreign investment in the Bulgarian banking system.

2.2. *Foreign banks in Serbia*

The financial sector in former SFRY was more liberalized and more independent then was the case in a typical centrally planned socialist economy. The sector was rather developed but, of course, did not posses the breath of the depth of capitalist market economies. In the nineties the sector was almost completely destroyed. Also, at the beginning of 1990s, the United Nation Council put the embargo to Yugoslavia, so country was totally isolated. At the beginning of 2000, the political changes happened, and together with them, the economic changes too. After these changes, foreign banks started to come again on the Serbian market.

2.2.1. *Foreign banks after the openning of the Serbian borders*

The banking sector reform started at the beginning of 2001. The NBY characterized the banking sector as 1) sector with a very low profitability, 2) sector with severe undercapitalization and low level of provisioning, 3) high illiquidity sector, 4) sector of high level of bad assets and low level of interest rate. But the biggest problem was the largest banks, whose assets accounted more than half of total banking assets, were de facto insolvent.

The situation during 2001 was next- at the banking market were 86 banks (67 in Serbia, 17 in Vojvodina and 2 at Kosovo). From this number, 23 banks had their operating licenses revoked, 4 banks were given a deadline for recapitalization, 5 banks were placed in rehabilitation programs, in 1 bank administration was introduced, 5 banks were placed in problem bank category, 17 banks began undergoing a program of measures for the adjustment of business indicators and 18 banks merged with other banks, including those whose merger is in progress. During the same year, the NBY issued operating licenses to 5 foreign and 1 domestic banks. The ownership structure of the banking system for the years 2001, 2002 and 2003 is presented in the Table 1.2.2.

Table 1.2.2. Ownership structure of the banking system

Type of ownership	2001				2002				2003			
	Total assets		Total capital		Total assets		Total capital		Total assets		Total capital	
	mil. YUD	% of sector total	mil. YUD	% of sector total	mil. YUD	% of sector total	mil. YUD	% of sector total	mil. YUD	% of sector total	mil. YUD	% of sector total
Domestic	253,065	86.8	38,924	84.3	231,128	73.0	51,247	80.6	226,351	61.6	63,612	73.7
State owned	11,230	3.9	2,682	5.8	138,287	43.7	20,566	32.3	125,477	34.1	32,330	37.5
Socially owned	179,677	61.6	12,049	26.1	18,049	5.7	5,412	8.5	na [a]	na	na	na
Private	62,158	21.3	24,193	52.4	74,792	23.6	25,269	39.7	100,874	27.4	31,282	36.2
Foreign [b]	38,395	13.2	7,262	15.7	85,450	27.0	12,340	19.4	141,135	38.4	22,691	26.3
Total	291,460	100.0	46,186	100.0	316,578 [c]	100.0	63,587	100.0	367,486 [d]	100.0	86,303	100.0

[a] For 2003, state-owned banks include also socially owned banks
[b] Banks under majority control of foreign banks or other foreign entities
[c] Excluding the data for Jugobanka a.d. Kosolovska Mitrovica
[d] Excluding the data for two banks whose operating licence were revoked in 2003, and the data for Borska banka a.d. Bor for which the decision on initiating bankruptcy proceedings was issued in early 2004

Source: Coletti/ Tirri, 2005, p. 206

At the beginning of 2002, the number of Serbian banks declined to 50. The reform of the NBY gave first results: interest of foreign banks in opening their representative offices and banks, as well as in recapitalization of domestic banks, increased. At the end of 2002, 6 banks were under majority control of foreign banks and 6 in majority ownership of other foreign entities. The reforms in 2003 were continued. One of the most important direction of the reform was no new banking license were issued, as the NBY aims at restricting greenfield investment in banking until the privatization process relating the state- owned banks have been fully completed. At the end of 2003, the Serbian banking sector included 47 banks supervised by the NBY, of witch 16 banks were mostly owned by foreign shareholders, 15 banks were owned by the Republic of Serbia and 16 banks had predominantly private capital. Even though the number of the foreign banks increased, the Republic of Serbia still was highly involved in the banking sector. Approximately, one third of the total assets was in a hand of state- owned banks.

In 2004, the presence of foreign strategic investors still was relatively scarce, probably on account of the late opening of the market. The private banks were owned by local companies, and individual investors. The involvement of the European banking groups most active in the CSEE area, however, started to grow faster. That is how, at the end of 2005, the number of foreign banks was 17 and they had 66% of the total market share. In the Table 2.2.2. is presented the Serbian banking sector during the period 2005- second quarter 2011.

Table 2.2.2. Serbian banking sector during the period 2005- II quarter 2011

	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**II 2011**
Total domestic banks:	23	15	14	14	15	12	12
-state-owned	11	8	8	8	10	8	8
-privately-owned	12	7	6	6	4	4	4
Foreign banks	17	22	21	20	20	21	21
TOTAL SECTOR	**40**	**37**	**35**	**34**	**34**	**33**	**33**
Market share by type of ownership							
-state-owned	23.9%	14.8%	15.7%	16%	16.6%	18%	18%
-privately-owned	10.1%	6.5%	8.8%	8.7%	8.7%	9%	9%
-foreign	66%	78.7%	75.5%	75.3%	74.7%	74%	74%

Source: author's calculation using data from the NBS Official Website

During this period, the number of the banks which operate on the Serbian market was between 40 and 33. The number of the foreign banks have increased, while the number of the state- owned and private- owned banks have decreased. The market share of the foreign banks in this period has been between 70 and 80%. Still, the state- owned banks have the 1/5 of the total market share, which means that the state is still, in a huge part, involved in a banking sector. Therefore, the next round of privatization in Serbia is already in preparation. As the result of the new wave of the privatization, we cannot expect so many new international groups to enter the Serbian market, since almost all of them are already presented. The most possible scenario is a concentration of the existing ones, which means that one or the other international banking groups can use the opportunity to expand its existing network by taking over the banks which are in process of privatization and the total number of the banks will drop below 30. Also, the banks which are waiting the privatization are mostly state- owned banks, so if this scenario is realized, foreign banks will increase their market share, while the market share of the state- owned banks will decrease.

Chapter III

Foreign banks' entry in Bulgaria and Serbia- differences and similarities

The first five banks in Bulgaria are 1) UniCredit Bulbank, 2) DSK Bank, 3) United Bulgarian Bank, 4) Raiffeisenbank (Bulgaria) and 5) Eurobank EFG Bulgaria. The main shareholder of the UniCredit Bulbank is Unicredit Bank Austria with 92.13% of the total shares. OTP Bank Budapest is the only shareholder of the DSK Bank. United Bulgarian Bank is 99.91% in the hands of the National Bank of Greece, while the 100% of shares of the Raiffeisenbank has Raiffeisen International, Vienna. Eurobank EFG has 3 shareholders- EFG New Europe Holding Amsterdam with 54.27%, EFG Eurobank Greece with 34.56% and CEN Balkan Holdings Cyprus with 11.16% of the total shares.

In Serbia, the top five banks are 1) Bank Intesa, 2) Komercijalna Bank, 3) Raiffeisen Bank, 4) Unicredit Bank and 5) Eurobank EFG. All banks are foreign banks, except Komercijalna Bank which is private domestic bank. 93% of the Bank Intesa has Intesa Saopaolo, Italy and the rest 7% has International Financial Corporation, World Bank. Raiffeisen bank is 90% owned by Reiffaisen International Vienna and 10% by the International Finance Corporation, Washington. Unicredit Bank is 100% in a property of Unicredit Bank Austria, while the Eurobank EFG has the three shareholders just like in Bulgaria.

Next to these three banks that operate both on the Bulgarian and Serbian market, we have four more banks. Alpha Bank AE, Athens is the only shareholder of the Alpha Bank- Bulgarian branch and also of Alpha Bank, Serbia. The second is Piraeus Bank, with a 99.98% of the shares of the both banks in Serbia and Bulgaria. The third bank is ProCredit Bank, where in Serbia and in Bulgaria the main shareholder is ProCredit Holding with 80% of the total shares and the last one is Societe- General Bank, where the only shareholder is Societe Generale, Paris. NLB Bank, where the main shareholder is Nova Ljubljanska Banka, Slovenija, was also on the both markets, but this year, it closed its branch in Bulgaria.

In a total, seven banks are operating both in Serbia and Bulgaria. These seven banks will be my objects of the analysis.

3.1. Which banks expand abroad?

The first step that I will take in order to understand why exactly these banks expand on the Bulgarian and Serbian banking market is to describe the characteristics of the banks that are mostly likely to expand abroad. A widely accepted result of the empirical literature is that banks with foreign asset participations are typically larger and better run, that they are located in countries more open to international trade and with a more developed banking system (Pozzolo, 2008, p. 5). Some authors, for example, found a ...”positive correlation between the size of the bank and the probability that it has foreign participation, a fact that might be related to the presence of fixed costs in bank internationalization, to a stronger incentive for asset diversification, and to the fact that larger banks have larger clients who are more likely to benefit from having their home country bank follow them abroad” (Focarelli/ Pozzolo, 2008, p. 15). Same authors also found that banks with higher profitability and a larger share of non- interest over total income are more likely to hold foreign participations.

Also, the characteristics of the country of origin affect the probability that banks expand abroad. Focarelli and Pozzolo found that from countries with the more developed banking sector are more likely to be present in foreign markets. They also found that country with higher total GDP are more likely to be present in foreign markets. Summarizing, the available evidence seems to suggest that foreign banks are likely to be among the most efficient in their country of origin and to come from the most developed banking markets. However, this might not be sufficient to make them more efficient than their local competitors when they operate abroad.

From these seven banks which are presented on the Serbian and Bulgarian banking market, three of them are coming from Greece, two from Austria and the other two from France and Germany. The ProCredit Group is consists of 21 growing banks operating in transition economies and developing countries in Easter Europe, Latin America and Africa. When Bulgaria and Serbia opened their borders for foreign investments, it was logical to expect that the ProCredit Holding will come to these markets. The Raiffeisen Bank International is the leading corporate and investment banks and it see Central and Eastern Europe as its home market. EFG Group is the international banking group, whose operating holding company is European Financial Group EFG (Luxembourg). The Group is organized into two subgroups- EFG International which is a global private banking and asset management group headquartered in Zurich, and Eurobank EFG, which is one of the largest banking groups in Greece. Alpha Bank Group is one of the leading banking and financial services groups in Greece which is active just in the Balkan countries plus United Kingdom and Ukraine. Piraeus Bank Group is one of the most dynamic and active financial organization in Greece today and it has an international presence focused in Southeastern Europe and Eastern Mediterranean, and also in the financial centers of London and New York. UniCredit Group is divided into several divisions, where the most important is the CEE Division which operates in 19 countries of Central and Eastern Europe. Societe General is the leading group in France and also has its banking network in 85 other countries.

To conclude, as the empirical research says, the size of the bank is important in the decision will some bank will expand abroad or not. All these seven banks are amongst the biggest banks in their home country and some of them even do not have the office in the home country, still just abroad. The countries from where these banks are coming are countries with the most developed banking system comparing to the Bulgarian and Serbian banking sector. Some of these banks have the foreign asset participation which is also one of the characteristics of the banks which are most likely to expand abroad.

3.2. What draws foreign banks to Bulgaria and Serbia?

Empirical research on the factors that encourage entry by foreign banks shows that economic integration between a foreign bank's home country and the host country it enters, the market opportunities in the host country, and entry restrictions and other regulations (including tax treatment) all affect the pattern and timing of foreign entry (Clarke/ Cull/ Peria/ Sanchez, 2003, p. 33).

3.2.1. *Economic Integration between the Home and Host Countries*

Many studies have found a positive and significant correlation between foreign direct investment in the banking sector and integration between home and host countries. Studies that link foreign bank entry with other FDI are often seen as supporting the claim that banks follow their customers abroad. But, even if FDI in the nonfinancial sector is correlated with foreign bank entry, it is not clear that it has causal effect. With technological advances and better communications, banks are increasingly able to provide many types of financial services across borders to firms' foreign affiliates without needing to establish affiliates in foreign markets. Furthermore, firm can increasingly obtain trade- and project- finance related services from local banks that have improved their capacities. Rather it seems banks have been expanding abroad to seek new, local market opportunities.

In a period after 2000, the second country from SEE countries which attracted the most FDI is Bulgaria due to the fact that in that period Bulgaria was candidate for the entry into the EU. Starting with 500 millions of dollars of the FDI in 1997, then 1000 millions of dollars in 2000, around 3000 millions of dollars in 2004, the amount of the FDI is still on the high level even thought the economic crisis which started in 2008. The biggest investor in Bulgaria is Germany. This country invest in the sector of IT, transport, trade and energy. Austria is the biggest investor in the sector of telecommunication, Greece is for trade and petrol, while France made its investment in trade, construction material and finance. If we get a total of FDI by countries, on the first place is Austria, Greece is on the third place, Germany on the fifth and France on the sixteenth (Invest Bulgaria Agency).

In Serbia, after 2000, the bulk of FDI came from the EU countries. Austria, Greece and Germany are on the top of the list. Austria and Greece were the major investors in Serbia over the past seven years. FDI inflow from Austria accounted over $2 billion and from Greece more than $ 1.3 billion. A large part of Austrian investments flows into service sector: construction, trade, accommodation, transport and communications, credit and insurance, real estate, renting and business services (Sieber, 2006, p. 619). Following further the UNCTAD statistics, the biggest past of Greek investments flows into energetic, banking and retail sector. For the German investors, the sectors which were interesting to them were wholesale and industry.

The biggest investors in both countries are Austria, German and Greece. From the seven foreign banks which operate in the Bulgarian and Serbian banking sector, three are from Greece, two from Austria, and another two from France and Germany. From the presented paragraphs, we can see that, in the case of Bulgaria and Serbia, there are connections between flow of FDI and foreign banks' entry in a sense that banks follow their customers abroad. In a case of Serbia that is even more imposingly, all four countries are among top 5 investors.

3.2.2. *Opportunities in the Host Country*

Several studies offer support for the notion that foreign banks are attracted by profit opportunities in host country. The market of the host country may offer new opportunities to make money, depending on the characteristics of the market (like size, stability of the country, features of the local banking sector, etc). For example, Claessens model foreign bank presence in 80 countries, including some transition countries, from 1988 to 1995 and find that foreign banks are attracted to markets with low taxes and high per capita income (Lensink/De Haan, 2002, p. 215). Some other recent studies found out that other variables also have influence on the foreign bank entry: the rate of return on equity, non- performing loans and banking crisis, greater foreign presence where local banks have higher average costs, lower net interest margins. These variables can be interpreted that foreign investors envision using their expertise and human capital to restructure inefficient banks. Some studies also find greater foreign presence where banks are smaller on average, perhaps because it is easier to acquire in these markets and because there is a greater opportunity to increase market share after the restructuring (Clarke/Cull/Peria/Sanchez, 2003, p. 36).

Bulgaria has stable political environment and low country risk. The country is a member of NATO and the EU, which gives additional security to the foreign investors. There is no currency risk, because the currency is pegged to Euro. As the EU member, Bulgaria has the most favorable taxes: 10% corporate income tax rate. There are regions in Bulgaria subject to 0% corporate tax due to high unemployment. Also, this country has high skilled, multilingual work force and Europe's most competitive salary levels.

Just like Bulgaria, Serbia has 10% corporate income tax rate. Serbia is seen as a leader of the region in terms of business reforms. With a unique combination of high- quality and low- cost skill- set, Serbian workforce is widely regarded as a strong business performance driver. Internally, with 9.5 million people, the Serbian market is the second largest in South Eastern Europe. The average net monthly salary rose from €91 in 2001 to €402 in 2010 (SIEPA). From the seven foreign banks which are both on the Bulgarian and Serbian banking sector, 4 of them are amongst top 5 on the Serbian market. In Serbia, and also in Bulgaria, these of these banks are amongst the largest in a country. They are more efficient and have better business and profit opportunities in Bulgaria and Serbia.

3.2.3. *Regulations in the Host Country*

A third consideration for foreign bank entry is host country regulation, which generally limits competition and protects inefficient domestic banks. Transition economies are in process from a communist plan economy to a democratic market economy. The degree to which this has taken place, i.e. the level of economic reforms and political freedom, may be an important consideration for foreign banks to enter one of these countries. For instance, countries that successfully established safe, transparent and enforceable rules for financial markets are probably attractive for foreign banks. In addition, the removal of entry barriers, membership to WTO and enterprises operating according to "Western standards" with respect to financial structure, make the market more attractive for foreign banks.

As it was mentioned before, the reform of the financial sector of Bulgaria changed radically in 1997 with the creation of the currency board, the isolation of failing state enterprises and new efforts to privatized the banking system. It was shown in Chapter II- until 1997 just 4 foreign banks were on the Bulgarian market. At the beginning of the reform, the number of foreign banks was doubled. As the reforms have progressed, the number has increased. If we look seven banks which are object of this analysis, just 2 of them came on the Bulgarian banking system before the 1996, the other 5 came after.

When it was formed in February 2001, the Serbian government was overwhelmed with the disastrous state of the economy. Then, the political and institutional changes have begun, but the most important is that was also the beginning of the economic reforms. Significant progress in institutional reform- especially in the transformation of the entire judicial system and establishment of an independent judiciary- was a necessary prerequisite for financial intermediation to develop. That year, apart from Societe General Bank, operating licenses were issued to another five foreign banks, between them were Alpha and ProCredit Bank. The year before, in 2000, Serbia has met the necessary preconditions for joining the IMF and to became a full member. Although with a long delay, in 2007, the NBS in accordance with recommendations of the Basel Committee on Banking Supervision (BCBS), has commenced the process of introducing Basel II standards. Namely, the BCBS encourages implementation of Basel II standards by supervisors from countries worldwide, but within a time frame that the supervisors themselves consider as optimal, or consistent with their supervisory priorities. Implementation of Basel II standards in Serbia is a transparent process and all information are available on the NBS Official Website. As we can conclude, the foreign banks started to come to Serbia when the reforms- political and economical, started. It was a point when Serbia went into the transition. Before that, they did not feel safe in a country. From the 7 banks that I am analyzing, 6 came to Serbia after 2000, when the country started with the reforms. Just one bank (Societe General) came to Serbia in 1990, but it was the year before the war and disorder in the country.

- *Privatization*

Here we should mention the process of privatization as one way of the new regulation. In Bulgaria, the privatization of the banking system happened after establishment of the CBA. Prior to 1996 bank privatization was suppose to be undertaken under the direction of the BCC (Bank Consolidation Company), but it was perceived to be a political issue rather than a means of enhancing competitiveness in the economy. For this reason, the BCC did not pursue any concrete measures to accelerate the process. Because of this, the establishment of the CBA was the turning point. The entry of foreign banks was seen as a way to increase training, bringing in more expertise and improving the overall functioning of the commercial banking system. The first privatization in Bulgaria was finalized in 1997. Until 2000, more 5 state- owned banks were privatized. In order to become a member of the EU, Bulgaria continued with the privatization of the banking sector and the consequence of that is just one state- owned bank on the market nowadays.

Financial system of the Republic of Serbia consisted of a number of financial institutions from which banks are predominant (90% of the total balance of the financial sector) while non-banking financial institutions such as insurance companies, private pension funds and investment funds had reached 10% of the total financial system until the mid 2000s. Number of institutions in financial sector, from the beginning of the process of reforms, have changed, due to process of restructuring and privatization in the banking sector. From 2003 to 2008, reforms of the banking system had several directions. One of these directions is the continuation of the policy which had limited greenfield investments in banking until the completion of the process of the privatization of banks with the majority state capital, which means that in that period new licenses were not issued. During this period, there were 12 mergers in which foreign banks and foreign legal entities took over majority stake. However, in that period (end of 2006) harmonization of other depository financial institutions were made in accordance in accordance to provisions of the new Law on banking.

Table 3.2.1. Active and passive interest rates in Serbia

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**Jun 2011**
Active interest rate	77.90	32.52	19.16	14.81	14.59	14.41	15.88	11.13	18.11	11.78	12.43	14.24
Passive interest rate	6.31	4.08	2.62	2.72	3.60	3.71	5.06	4.08	7.32	5.06	5.55	6.51
Interest rate spread	71.59	28.44	16.54	12.07	10.99	10.70	10.82	7.05	10.79	6.72	6.88	7.73

Source: author’s calculation using data from the NBS Official Website

In the Table 3.2.1. we can see that privatization and restructuring of the banking sector had substantial positive impact on the stability and efficiency of the financial system, and contributed largely to decrease of active banking interest rates and interest rates spreads followed by increase of passive banking interest rates on domestic and foreign currency dominated deposits, as well as multiple increase of savings. Similar to other countries, the global crisis in 2008 shook Serbia. Whit the beginning of the crisis, we can see that the active interest rate increased for 6.98, while the passive interest rate also increased for 3.24. But, due to the very restrictive policy of the NBS, the active and passive interest rates do not have big oscillation, they are now on the level around 12 and 6, respectively.

3.3. The mode of foreign bank entry on the Bulgarian and Serbian banking market.

There are two modes of entry- the acquisition or merger with a domestic bank and de novo entry, and four organizational forms- branch, subsidiary, representative office and agency of the parent bank.

-Mergers and Acquisitions

Foreign bank participation in developing economies has increasingly occurred through cross-border mergers and acquisitions and will continue to do so. Most of the literature have the conclusion that the foreign banks are generally less efficient than domestic banks in developed countries. But efficiency differences between foreign banks from developed economies and domestic banks in developing economies suggest that much of the future cross- border consolidation in financial services is likely to occur in developing economies, because domestic banks in these countries are relatively inefficient.

When the foreign banks entry in the host banking market through mergers and acquisitions, the outcome for the developing economies is likely to be a net gain, because they will benefit from the efficiency improvements brought by foreign banks. Moreover, there are gains to be made from economies of scale that will result from such mergers and acquisitions. In particular, some authors note that technological change may have recently increase the potential for scale economies. Scale economies may be greater for new service delivery method such as phone centers, internet banking and automated teller machines (Clarke/Cull/Peria/Sanchez, 2003, p. 48.).

-De novo Entry

Developing economies might experience de novo entry by banks, because, as argued before, foreign banks enter these markets to pursue local profit opportunities. So, what can be impact of de novo entry? Studies suggest that greater de novo entry could benefit small borrowers. Studies of de novo entry in the US suggest that de novo entrants are unlikely to meet a large share of a host country's credit need in the near term, because they may find it difficult to attract deposits and identify profitable lending opportunities (Clarke/Cull/Peria/Sanchez, 2003, p. 49). It is unclear whether the findings for de novo bank entry in the US will carry over to developing countries. De novo foreign banks in these countries may defer from de novo banks in the US. In many instances foreign banks that set up de novo operations in developing economies have existed in their country of origin for some time and could ever be large. One think that is for sure is that the further study of de novo entry in developing economies is needed.

Table 3.3.1 The mode of foreign bank entry on the Bulgarian and Serbian banking market

	BULGARIA	**SERBIA**
1. ProCredit Bank	2001, de novo entry	2001, de novo entry
2. Alpha Bank	1999, acquisition of Ionian Bank, 2000 merger with the same	2004, acquisition of Jubanka
3. Raiffeisen Bank	1994, greenfield investment	2001, greenfield investment
4. Societe General Bank	1999, takeover of Expressbank	1990, joint- venture
5. EFG Bank	2007, merger with Postbank	2003, greenfield-type of expansion by acquiring the local Postbanka
6. Piraeus Bank	1995, acquisition of Eurobank AD	2005, acquisition of Atlas Bank
7. UniCredit Bank	2000, privatization of Bulbank	2001, greenfield operation

Source: author's table using data from the sites of the banks

As we can notice for the Table 3.3.1. the banks keep the same way of entry to the both markets. Foreign banks penetrated into the Serbian market either by establishing the new banks or by taking over the existing domestic bank resulting in ownership structure of Serbian banking sector to be predominantly foreign owned. The Serbian government decided to give the priority to the privatization method of direct sales to foreign investors, with the objectives of recapitalizing banks, providing a basis for a transfer of technology and know- how. The admitions of the new banks, i.e. greenfield investments, as an indirect form of privatization has been strictly limited until the privatization process will finish. Because of that, most of these seven banks came to the Serbian market through merger and acquisition form. With Bulgaria is the same story. The country had a high number of state- owned banks and after 1997, when the reform process started, the Bulgarian government decided to make a privatization of the six biggest state- owned banks. Also, one of the reason why foreign banks decided to make this kind of entry on those two markets is that Serbia and Bulgaria, at the beginning of the transition process did not have developed banking system and the Law which regulated banking system was in unenviable position. For foreign banks was easier through merger and acquisition to enter the market and to own existing banking network and keeping customers. This strategy was better than to make greenfield investment and try to get confidence of the citizens who in that period, did not have trust in banks and banking system.

3.3.1. *Branches or Subsidiaries?*

Foreign banks can adopt a range of organizational forms when entering a host country. The most limited but almost easily established organizational form is the representative office. These offices neither take deposits nor make loans. Instead, they act as agents for the foreign bank and make forward payments to the home office. Representative offices are generally established to test the possibility of further involvement in a host country. Agencies represent a more expensive form of entry. They can make commercial and industrial loans, but cannot make consumer loans or accept deposits (Clarke/Cull/Peria/Sanchez, 2003, p. 50).

Subsidiaries are permitted to engage in a broader range of financial services, and in many countries they have powers identical to those of domestic banks and thus are regulated in the same way. As wholly owned subsidiary companies of parent banks, they must lend based on their own capitalization. By putting foreign banks on an equal footing with domestic ones, subsidiaries are thought to enable banks to draw on their comparative advantages. In some empirical studies, conclusion was that countries that permit universal banking have a larger percentage of subsidiaries, presumably because branches cannot take advantage of all profit opportunities. Even there are some differences between branches and subsidiaries, the literature doesn’t answer on the question: which regulation form should regulators promote? Regulators will probably want to encourage the form that supports the greatest range of financial services while not raising concerns about financial stability.

When Bulgaria started to be open for the foreign bank entry, the number of branches was higher than the number of subsidiaries. That is intelligibly if we know that the Bulgarian market just started with the reforms and that opening the branch is more easier and more cheaper. As the reforms were progressing, that is how the number of subsidiaries started to be higher than the number of branches. From these seven foreign banks which operate both in Bulgaria and Serbia, just Alpha bank has the form of branch; other six banks are subsidiaries. In Serbia, the situation is different. Even the Serbian banking sector has a big progress, still there are some regulations which should be implemented. Because of that, most of these seven banks have branches in Serbia, rather than subsidiaries.

Chapter IV

Regression analysis

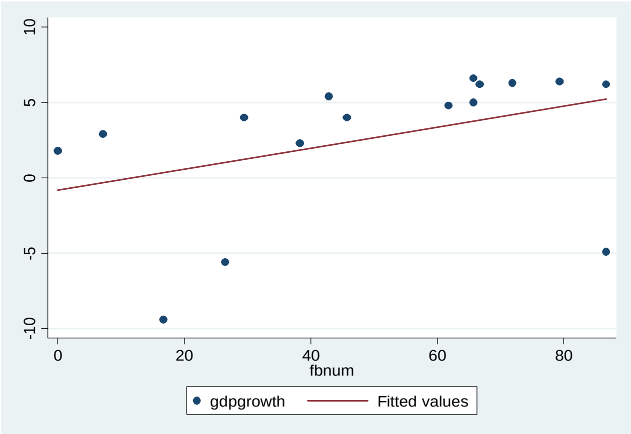
The aim of this Chapter is to analyse whether foreign banks have effect on the economic development of the host country- in our case, on the economic development of Bulgaria and Serbia. Both Bulgaria and Serbia were communist countries which relatively soon have opened their borders for foreign banks. As it is mentioned above in the text, the foreign banks started to come to Bulgaria in the mid of 1990s, and to Serbia in 2000, after the political changes in a country which took place in 1999. Because my data is limited with the low number of years which represent the foreign banks' presence on the market, I will investigate the short- term effect of foreign bank entry on economic development.

I will use two variables to measure measure the presence of foreign bank in host country. The first will be the number of foreign bank as a share of the total number of banks (FBNUM). The second variable will be FBSHARE and it presents the share of foreign banks' assets in total banking assets in a given country and year. The other independent variables will be the CPI- Consumer Price Index, BIR- Basic Interest Rate at the end of the year, LR- Landing Rate and FDI- Foreign Direct Investment. As the dependent variable I use real GDP growth for a given country and year. All data is available in Appendix.

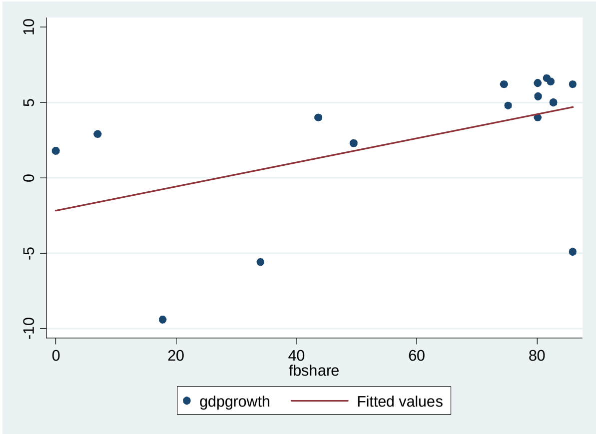
4.1. Scatter plots for Bulgaria

Firstly, I will use Scatter plot in order to see does there appear to be any relationship and what is the direction of relationship between my dependent variable and different independent variables.

4.1. Bulgaria- FBNUM and GDPgrowth

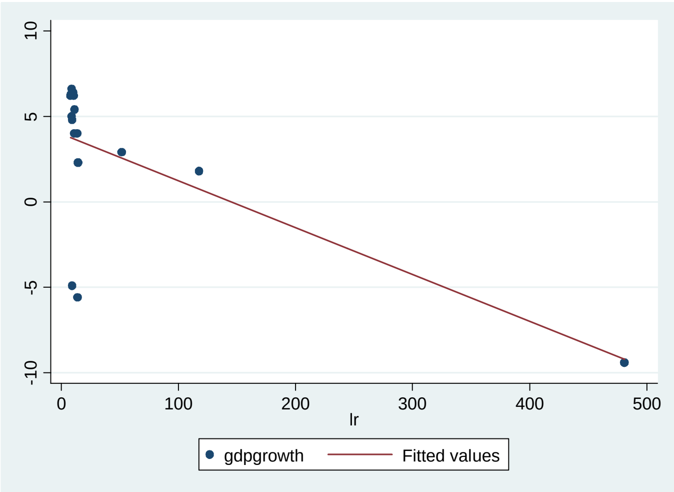


4.2. Bulgaria- FBSHARE and GDPgrowth



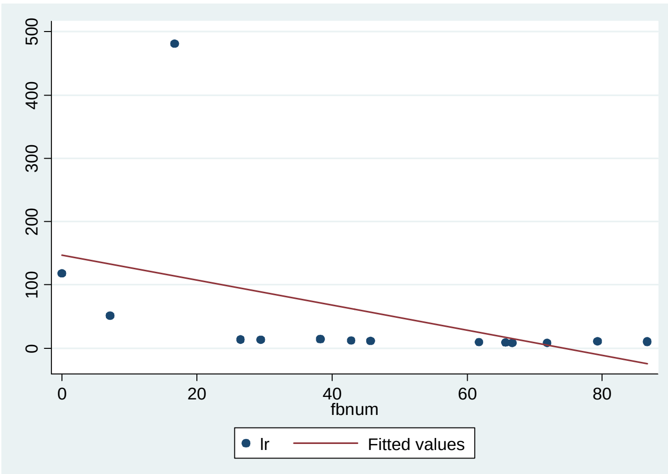
Graph 4.1. and 4.2. show to us that there is a positive linear relationship between number of foreign banks/ share of foreign banks' assets in total banking assets and real GDP growth in Bulgaria. That means when the number of foreign banks increased/ the share of the foreign banks' assets in total banking assets increased, we also had the increase of the real GDP growth.

4.3 Bulgaria- LR and GDP growth



As I expected, there is a negative linear relationship between landing rate and real GDP growth- landing rate was going to decrease as the market started to be more developed. But, when the foreign bank went to the Bulgarian market, the commercial banks had high landing rate. In order to be more competitive, foreign banks decreased their landing rate. So, there should be also negative correlation between number of foreign banks and landing rate. I will try to prove this theory in the next Scatter plot (Graph 4.4.)

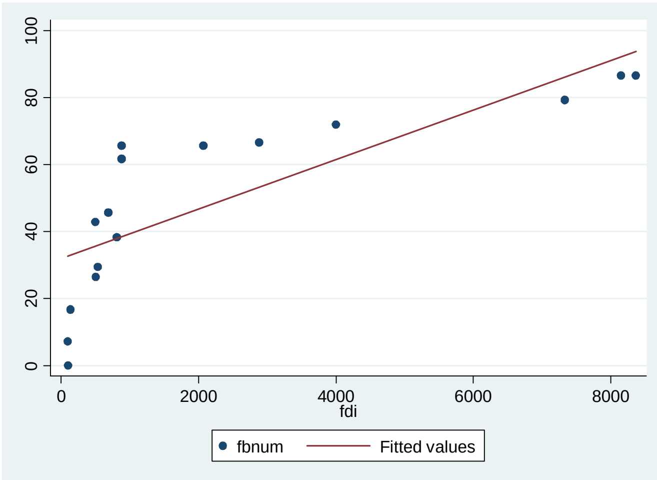
4.4. Bulgaria- LR and FBNUM



In the Graph 4.4. I used landing rate as my dependent variable and number of foreign banks on the Bulgarian market as my independent variable. I proved the theory from the previous paragraph- there is a negative linear correlation between landing rate and number of foreign banks. In the case of Bulgaria it means that as the foreign banks started to come to the Bulgarian market, in order to be more competitive, they decreased the landing rate which led to the expand of the credits given to the individuals and business entities. Given credits improved economical situation which had for the consequence increase of economic development of the country (increase of real GDP growth).

In the Chapter III, I explained that one of the reason why foreign banks expand abroad is that they are following their customers. When foreign investors feel safe and secure in some country, they will make investments and the foreign banks will follow them. So, there should be positive correlation between number of foreign banks and foreign direct investments. The next Scatter plot (Graph 4.5.) will show us that. I took FBNUM as dependent variable and FDI as independent variable.

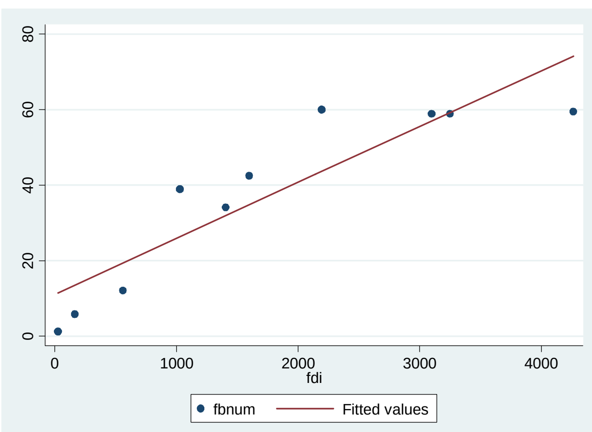
4.5. Bulgaria- FDI and FBNUM



4.2. Scatter plots for Serbia

In order to see the connection between FDI and numbers of the foreign banks, I will do Scatter plot where my dependent variable will be FBNUM and independent variable will be FDI.

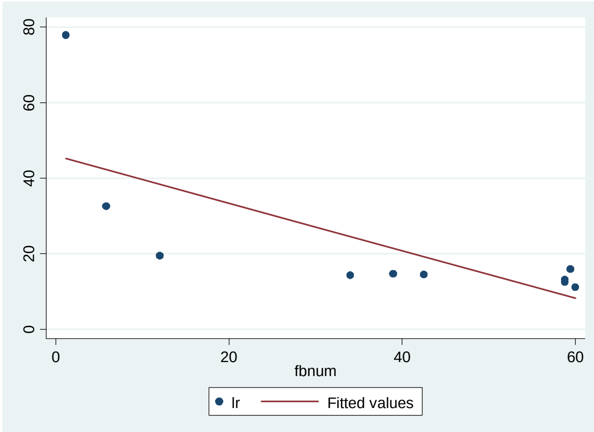
4.6. Serbia- FDI and FBNUM



As we can see from the Graph 4.6. there is a positive linear relationship between number of foreign banks and foreign direct investments. During the years, as the foreign direct investments have increased, the number of the foreign banks has also followed this trend.

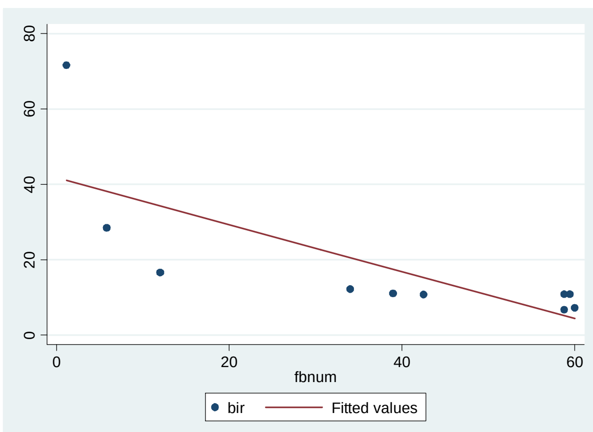
This fact lead us to the next fact- as the number of foreign banks increased, the landing rate decreased. It will be showed in the next Graph.

4.7. Serbia- LR and FBNUM



At the Graph 4.7., the dependent variable is landing rate and independent variable in number of foreign banks on the Serbian market. We can see that there is a negative linear relationship, which means as the number of foreign banks increased, the landing rate decreased during the observing period- 2000 until 2009.

4.8. Serbia- BIR and FBNUM



At the Graph 4.8. I used base interest rate as my dependent variable and number of foreign banks as independent variable and we can see that there is a negative linear relationship between these two variables. That means when number of foreign banks increased, the base interest rate decreased during observing period in Serbia.

4.3. Correlation analysis- matrix

The next that I will do is correlation analysis. Correlation is also dealing with relationships among variables. The correlation coefficient is a measure of linear association between two variables. Values of the correlation coefficient are always between -1 and +1. A correlation coefficient of +1 indicates that two variables are perfectly related in a positive linear sense, a correlation coefficient of -1 indicates that two variables are perfectly related in a negative linear sense, and a correlation coefficient of 0 indicates that there is no linear relationship between the two variables.

4.3.1. *Correlation analysis for Bulgaria*

Chart 1. FBNUM and real GDP growth

```
. correlate fbnum gdpgrowth
(obs=16)

             |    fbnum gdpgro~h
-------------+------------------
       fbnum |   1.0000
   gdpgrowth |   0.3940   1.0000
```

Chart 2. FBSHARE and real GDP growth

```
. correlate fbshare gdpgrowth
(obs=16)

             |  fbshare gdpgro~h
-------------+------------------
     fbshare |   1.0000
   gdpgrowth |   0.4947   1.0000
```

On the Chart 1. we can see the correlation between the number of foreign banks on the Bulgarian market and the real GDP growth. The correlation coefficient is 0.3940. It is positive, which means that as the number of foreign banks increased, the real GDP growth also increased and vice- versa. On the Chart 2., we have correlation between real GDP growth and the share of foreign banks' assets in total banking assets. The correlation coefficient between these two variables is 0.4947. It is also positive, but it is higher than the previous one, which means there is a stronger degree of linear relationship between these two variables.

Chart 3. CPI and real GDP growth

```
. correlate cpi gdpgrowth
(obs=16)

             |      cpi gdpgro~h
-------------+------------------
         cpi |   1.0000
   gdpgrowth |  -0.2906   1.0000
```

On the Chart 3. we can see the correlation between consumer price index and real GDP growth. The correlation coefficient is negative, -0.2906. This negative coefficient indicates that as consumer price index decreased, the real GDP growth increased and vice- versa.

Chart 4. FDI and FBNUM

```
. correlate fdi fbnum
(obs=16)

             |      fdi    fbnum
-------------+------------------
         fdi |   1.0000
       fbnum |   0.7932   1.0000
```

The Chart 4. shows very strong correlation between foreign direct investments and number of foreign banks. The correlation coefficient is approximately 0.8 which is close to 1 (perfect linear relationship). As the amount of foreign direct investment increased, the number of foreign banks also increased and vice- verse.

4.3.2. *Correlation analysis for Serbia*

Chart 5. FBNUM and FDI

. correlate fdi fbnum
(obs=10)

	fdi	fbnum
fdi	1.0000	
fbnum	0.8996	1.0000

On the Chart 5. we can see the correlation between the number of foreign banks and foreign direct investments. The correlation coefficient is very high, even higher than the same one for Bulgaria, and it is 0.8996. Also, the coefficient is positive, so as the amount of foreign direct investments increased, the number of foreign banks also increased.

Chart 6. CPI and real GDP growth

. correlate gdpgrowth cpi
(obs=10)

	gdpgro~h	cpi
gdpgrowth	1.0000	
cpi	0.6376	1.0000

The CPI measures inflation as experienced by consumers in their day-to-day living expenses, then from the Chart 6. we can see that as the real GDP growth increased, the CPI also increased in Serbia during the observing period.

4.4. Regression analysis for Bulgaria

Chart 7. Regression analysis- real GDP growth and FBSHARE

. regress gdpgrowth fbshare

Source	SS	df	MS
Model	88.2919464	1	88.2919464
Residual	272.418044	14	19.4584317
Total	360.709991	15	24.0473327

Number of obs =	16
F(1, 14) =	4.54
Prob > F =	0.0514
R-squared =	0.2448
Adj R-squared =	0.1908
Root MSE =	4.4112

gdpgrowth	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
fbshare	.0801799	.0376408	2.13	0.051	-.0005516	.1609115
_cons	-2.1873	2.513948	-0.87	0.399	-7.579182	3.204582

In this analysis, I used real GDP growth as my dependent variable and the share of the foreign banks' assets in total banking assets as my independent variable. The coefficient is 0.080 which means when the share of the foreign banks' assets increase for 1%, in average real GDP growth will also increase for 0.080 %. Also, p- value of FBSHARE is 0.051 which means that FBSHARE is vary significant at 8% and 10% level of significance.

4.4. Analysis of the results

Scatter plots for Bulgaria for the observing period between number of foreign banks/ share of foreign banks' assets in total banking assets and the real GDP growth show the same results as the correlation analysis and as the regression analysis. First, we can see very clear from these analyses that there was a positive relationship between number of foreign banks/ share of foreign banks' assets in total banking assets and the real GDP growth. Between these observing variables existed the same tendency- when one variable increased, the another is also increased. Correlation analysis confirmed the results derived from the scatter plots and gave us the correlation coefficients which were approximately 0.4/ 0.5 which shows very strong degree of linear relationship between these two variables. Also, the regression analysis gave us the coefficient that is very significant (at 8% and 10% level of significance), indicated when the share of foreign banks' assets increased for 1% in average the real GDP growth also increased for 0.080%.

For Serbia, these analyses did not give the reliable results, which means there is not yet the impact of number of foreign banks to the real GDP growth. The argument for this conclusion lies in limited data, i.e. in short observing period. What should be done is the correlation analysis and regression analysis using the same variables afterwards few years, so we can be able to see real trend and to get reliable results.

Correlation analysis for Bulgaria shows us very interesting results for the relationship between consumer price index and real GDP growth. Historically, in the absence of what is termed "persistent inflation", the early inflation growth theories were built on cyclical observations. Persistent inflation is regarded as the post World War II phenomenon. Before then, bouts of inflation were followed by bouts of deflation. Having showed no upward of downward trend, inflation was said to be behave like a *lazy dog*. It stays at the particular level unless and until there is a disturbance. Thereafter, it moves to another level, at which it settles. Theory, therefore sought to account for a positive correlation between inflation and GDP growth (Gokal/ Hanif, 2004, p. 4). But, results for Bulgaria between consumer price index and real GDP growth show negative trend for the observing period- when consumer price index decreased, the real GDP growth also decreased and vice- versa. For Serbia, this coefficient is positive and very strong, almost 0.7, exactly how it should be following the theory.

The theory that foreign banks follow their customers abroad is approved through scatter plots and correlation analysis for the both countries. Correlation coefficients between these two variables for Bulgaria and Serbia are on very high level, 0.8 and 0.9 respectively, which show almost perfect linear relationship between the number of foreign banks and foreign direct investment in the host countries.

When foreign banks came to the Bulgarian market, there put the landing rate at the lower level than commercial domestic banks had. In that way foreign banks were more competitive. That is the reason why we have the negative correlation between landing rate and the number of foreign banks in Bulgaria during observing period. In order not to lose the customers, the commercial banks also decreased their landing rate. All this had for consequence the expand of the credits given to the individuals and the business entities that improved economical situation in the country. That is why we have the negative correlation between the landing rate and real GDP growth in Bulgaria- as the landing rate was increasing, the Bulgarian market was starting to be more developed.

Chapter V

Conclusion

The economic development of Bulgaria during the period after the collapse of the communist regime was marked by a series of upheavals. It was uneven trajectory of new hopes, crisis and reforms. The instability and the major disruptions in the social and the political fields affected greatly the economy of the country. The first years after 1989 saw tremendous changes in all spheres of life. Bulgaria took a course towards transition to market economy and abandoned the paradigms that directed its economic and social life. The weak government could not handle the intensive dynamics of the new transition reality which affected seriously the whole country. Many industries discontinued their production, unemployment rose, the currency depreciated. The liberalization of the prices although gradually produced a dramatic effect on the population and considerably shrunk the consumption. Inflation soared high and there were little incentives for private entrepreneurs of foreign investors. As a result by 1997 the economy of the country shrunk half of what it was in 1989.

The negative economic trend reached its peak in 1996- 1997. During these years the worst page of Bulgarian economic history were written. Financial collapse, mass bank and other enterprise bankruptcies, hyperinflation and food shortage worsened the economic situation dramatically. After this, a period of consolidation and reforms followed. The decisions of the government after 1997 led to stabilization and economic revival. A currency board was introduced to ensure the trust in the national currency, privatization was launched at a high speed and structural reforms were implemented. The country took a stable course to integration in the Euro- Atlantic structures, a process that successfully led to the EU accession in January 2007.

High inflation in the beginning of the 1990s was triggered by the liberalization of the prices. In 1997 the financial crisis resulted in record high inflation. Although it reached more than 1000%, it was successfully dealt with and by 1999 was totally under control. With the introduction of the currency board, which marked a cornerstone in the last two decades' economic development of Bulgaria, a lot of the competences of the Central Bank were taken away and the monetary policy started working according to much stricter rules. Eventually this led to a decrease in inflation, stabilizing the interest rated and keeping the exchange rate of the Bulgarian lev predictable in the long- run. These, among other factors, increased the credibility of the economy and improved the business conditions. Since joining the EU, the goal of the Bulgarian government and the Central Bank has been to keep the inflation, the exchange rate and the long- term interest rates within the margins of the Exchange Rate Mechanism in order to eventually join the Euro zone.

A lot of attention is paid to the privatization process, its administration, downfalls and achievement. The liberalization of the banking sector in Bulgaria was particularly indicative of the transition of the country. The uncontrolled proliferation of credit institutions was followed by financial collapse and bankruptcies. The banks that survived were sold to foreign investors. The protectionist policies in the period 1991- 1995 were a compromise. Foreign banks were allowed to entry, but only if they specialized in a limited range of services. Because of that, the new wave of foreign banks happened after 1997. In the same period, most of the banks were privatized. After 2000, the market share hold by the foreign banks has never fallen under 80%.

The political and economic changes in Serbia have started after 2000. With the new democratic government, a new strategy for a whole economy and also for a banking sector was adopted. The banking sector was undergo considerable restructuring, including rapid acceleration of the privatization process and assumption of the leading role in the privatization process by foreign banks. An extensive screening of the Serbian banking sector began in the context of the new legal framework. This included the classification of the commercial banks into four groups according to their liquidity and solvency. At the beginning of 2002 this was followed by the closure of the four largest Serbian banks on account of fiscal restrictions. Based on the banking sector total assets, these four banks had market share more than 50 %. Within the framework of portfolio restructuring, the state furthermore acquired majority or significant minority interests in sixteen banks through debt- equity swaps pursuant to the new laws of 2001 and 2002, i.e. the state assumed the obligations of ailing Serbian banks towards Paris and London Club creditors, and in return received equity in the banks involved. These restructuring measures were followed by the initiation of the privatization process. Initial privatization successes and the growing presence of foreign- owned banks in the market have in the last 10 years strengthened confidence in the banking sector, while changing the market’s structure and specific features.

As in other transition countries in Central and South- East Europe, the opening of the market to private banks, lax licensing regulations and low capital requirements led to a sharp rise in the number of banks in Serbia at the beginning of 1990, peaking at 112 in 1995. Ten years and the first round of banking reform later, the number of banks has dropped by two- thirds, but still it remained high. Bulgaria, which is comparable with Serbia in terms of area and population, also was considered to be overbanked at the beginning of the transition process. As the banking reforms were going deeper to the banking system, the number of foreign banks started to increase. But government decided to give priority the the privatization method of direct sales to foreign strategic investors, with the objectives of recapitalizing banks, providing a basis for the transfer of technology and know- how. On the other side, foreign banks seem to prefer to strengthen their positions via mergers with and acquisitions of other private, foreign participants, without waiting for bank restructuring to be completed. Nowadays, there is 34 banks on the Serbian market, 21 of them are foreign banks which have 74% of the market share. Still, the state- owned banks have the 1/5 of the total market share, which means that the state is still, in a huge part, involved in a banking sector. Solution for decrease the state role in banking sector is to continue further with the privatization. In 2008, the crisis also hit the Serbian economy and I expect, after the recovery, privatization process to be continued.

Seven banks operate both on the Bulgarian and Serbian banking market. All seven banks are amongst the biggest banks in their home country and some of them even do not have the office in the home country, still just abroad. The countries from where these banks are coming are countries with the developed banking system. Some of these banks have the foreign asset participation. All these characteristics that these seven banks have are the characteristics of the bank which is more likely to expand abroad.

Bulgaria and Serbia were communist countries which after 1989 started their reforms. Even though Bulgaria had ups and down on its transition process, it is a very attractive country for the FDI, because the opportunities that foreign investors have on this market. The biggest amount of the FDI flows in Bulgaria, and also in Serbia are coming from the EU countries. This is expected, because Bulgaria is the EU member and Serbia is now waiting the status of the EU candidate.

Also, both countries have the most favorable corporate income tax rate from 10% (the loves rate in the EU). Even it was at the beginning of the transition process, foreign investors are not afraid anymore to come to these markets, because they follow the “Western” standards. Apart from the EU, Bulgaria is also the member of the WTO and NATO. Since 2001, Serbia got back its membership in the IMF. The biggest investors on the both markets are Greece, German, Austria and France. Seven banks, which were the object of my analysis, are coming exactly from these countries. So, this confirm the theory that the banks are following their customers abroad. These markets are also attractive for the foreign investors because they have high skilled, multilingual work force and Europe’s most competitive salary levels.

One more thing was common for Bulgaria and Serbia. After the banking crisis, citizens did not have the confidence in the banks and the whole banking system. For these seven foreign banks it was more easier and smarter to come to the Serbian and Bulgarian market through mergers and acquisition, than via de novo entry. In the Table 3.3.1. which is presented in the Chapter III, it is showed very clear that the banks use the same way of entry on the both markets. And most of them came to the market via mergers, acquisitions and privatization. Just ProCredit bank and Raiffeisen bank made de novo entry on the Bulgarian and Serbian markets.

If we now compare the number of branches with the number of subsidiaries, we can see that these two markets are different in this respect. In Serbia, these seven banks have more branches than subsidiaries, while in Bulgaria the situation is opposite. The only reason that I can see for this kind of situation is that these banks (and foreign investors in general) still do not see the Serbian market as totally safe. Even though Serbia signed the Stabilisation and Association Agreement, it still has some unsolved political and economical issues, and recent crisis slowed down the reform process, which probably had for a consequence not full confidence from foreign investors.

Scatter plot, correlation analysis and regression analysis done for Bulgaria showed us that there is a positive correlation between number of foreign banks and real GDP growth. That connection is even more obvious between the share of foreign banks’ assets in total banking assets and real GDP growth in Bulgaria for a period 1994- 2009. If we start with the theory that when some country opens its borders, the foreign investor will come in order to make a good profit in that country. Empirical results say that one of the main reason why foreign banks expand abroad is to follow their consumers. So, following their consumers, foreign banks will come to the new market. In order to stay competitive, foreign banks will offer the loans using the landing rate which will be less than landing rate which use commercial banks in the host country. That will have for consequence the expand of the short- term and long- term credits. Investing these credits in the economy of the country will bring economic growth and growth of the GDP. Implementing this theory on the case of Serbia and Bulgaria, we can see that there is a positive correlation between FDI and number of foreign banks on the both markets. Also, scatter plot shows us negative correlation between number of foreign banks and landing rate (also it is case for the both markets). As the conclusion, at the end we have the negative correlation between landing rate and GDP growth- GDP increased when landing rate decreased. So, foreign banks' entry has the effect on the economic development, especially in the financial and banking system and there are strong indicators that foreign banks have a positive impact in these areas.

-Recommendations

Observing the bank credits interest rates in Bulgaria and Serbia, I can conclude that the interest rates in Serbia are still extremely high comparing with the interest rates at the Bulgarian market. The reason for that could be that the foreign banks still do not feel safe in Serbia- because the unsolved political situation on Kosovo or because the political changes in the Serbian government or because the crisis which took part also in Serbia and now foreign banks want to pay off as soon as it possible the entrance on the Serbian market through extremely high difference between interest payable and interest receivable. In order not to be confused, as it is presented in the Chapter III, the interest rate in Serbia was decreasing every year, but comparing to the other countries in the neighborhood (especially with the Bulgaria) it is still on the high level. For them, Serbia is now more attractive region in which they could make high profits comparing to Bulgaria, but the risk is also higher. For the future, we can expect the end of the crisis and new wave of the loans by lower interest rates. Also, as I said, Serbia started to implement the Basel II, so the branches on the foreign banks in Serbia will lead the client classification according to credit risk exposure in such a way that first- class clients will pay a lower cost of credit.

Furthermore, Serbia should solve its political problems. Unstable political situation is not good picture for the foreign investors. Even Serbia signed the Stabilization and Association Agreement, with the unsolved political problems it would be impossible to get the status of the candidate country. Because the investors do not feel safe, most of the time they use the strategy *hit and run*. Like this, the Serbian banking sector and the Serbian economy in total lose a lot of money and health investments.

Now, when the Serbian economy shows some modest signs of recovery after the recession in 2009, it should start further with the privatization process of the banking sector, so the banking sector could become the healthiest part of the Serbian economy. I cannot expect that some new foreign banks will come to the Serbian market (because the biggest banks are already there), still foreign banks which are already on the market will do mergers or acquisitions with the state-owned banks.

Bulgaria finished with its privatization- from all the commercial banks on the market, just one bank is state- owned bank. Bulgaria is a member of the EU. The next step is to become a member of the EMU- to adopt the euro. A country set itself a target date of 1 January 2015, but I think that the International Financial Crisis will postpone this date. Accepting the euro will have positive impact for foreign investors, it will be easier for them to operate on the Bulgarian market. Also, in 2009 the Bulgarian economic growth was slow down because of the effect of the global financial crisis. As Serbia, in Bulgaria at the end of the last year the first sign of recovery was appeared. That is a positive indicator for restart of the Bulgarian economic growth.

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Appendix

Table 1. FBNUM in % in Bulgaria

Year	FBNUM	Year	FBNUM
1994	0	**2002**	61.76
1995	7.14	**2003**	65.71
1996	16.67	**2004**	65.71
1997	26.47	**2005**	66.67
1998	29.41	**2006**	71.88
1999	38.24	**2007**	79.31
2000	42.86	**2008**	86.67
2001	45.71	**2009**	86.67

Note: The data about FBNUM (both for Bulgaria and Serbia) was obtained from national central banks.

Table 2. FBNUM in % in Serbia

Year	FBNUM	Year	FBNUM
2000	1.16	**2005**	42.50
2001	5.81	**2006**	59.45
2002	12.00	**2007**	60.00
2003	34.04	**2008**	58.82
2004	38.97	**2009**	58.82

Table 3. FBSHARE in % in Bulgaria

Year	FBSHARE	Year	FBSHARE
1994	0	**2002**	75.2
1995	6.9	**2003**	82.7
1996	17.8	**2004**	81.6
1997	34.0	**2005**	74.5
1998	43.6	**2006**	80.1
1999	49.5	**2007**	82.3
2000	80.2	**2008**	85.9
2001	80.1	**2009**	85.9

Note: The data about FBSHARE (both for Bulgaria and Serbia) was obtained from EBRD Transition report for the years 2000, 2002 and 2008. Data for year 2008 and 2009, for the both countries, was obtained from the national central banks.

Table 4. FBSHARE in % in Serbia

Year	FBSHARE	Year	FBSHARE
2000	9.1	**2005**	66.0
2001	13.2	**2006**	78.7
2002	27.0	**2007**	75.5
2003	38.4	**2008**	72.6
2004	37.7	**2009**	69.3

Table 5. GDP growth in Bulgaria *(Percentage change)*

Year	GDP growth	Year	GDP growth
1994	1.8	**2002**	4.8
1995	2.9	**2003**	5.0
1996	-9.4	**2004**	6.6
1997	-5.6	**2005**	6.2
1998	4.0	**2006**	6.3
1999	2.3	**2007**	6.4
2000	5.4	**2008**	6.2
2001	4.0	**2009**	-4.9

Note: For the Table 5 and Table 6, data was obtained from EBRD Transitional report for the years 2000, 2002, 2005 and 2010.

Table 6. GDP growth in Serbia *(Percentage change)*

Year	GDP growth	Year	GDP growth
2000	5.0	**2005**	6.3
2001	5.5	**2006**	5.5
2002	4.5	**2007**	6.9
2003	2.4	**2008**	5.5
2004	9.3	**2009**	-3.1

Table 7. Consumer price index (CPI) in Bulgaria *(Percentage change)*

Year	CPI	Year	CPI
1994	43.0	**2002**	21.3
1995	46.0	**2003**	22.0
1996	52.0	**2004**	24.7
1997	14.4	**2005**	21.3
1998	15.8	**2006**	21.3
1999	17.2	**2007**	18.6
2000	20.0	**2008**	15.7
2001	20.6	**2009**	9.3

Note: For the Table 7 and Table 8, data was obtained from EBRD Transitional report for the years 2000, 2002, 2005 and 2010.

Table 8. Consumer price index (CPI) in Serbia *(Percentage change)*

Year	**CPI**	**Year**	**CPI**
2000	8.8	**2005**	9.2
2001	9.2	**2006**	9.9
2002	11.0	**2007**	11.0
2003	11.2	**2008**	8.6
2004	11.2	**2009**	6.6

Table 9. Base interest rate (BIR) in Bulgaria *(in per cent per annum, end- year)*

Year	**BIR**	**Year**	**BIR**
1994	72.0	**2002**	3.3
1995	34.0	**2003**	2.8
1996	180.0	**2004**	2.4
1997	6.7	**2005**	2.1
1998	5.1	**2006**	3.3
1999	4.5	**2007**	3.9
2000	4.6	**2008**	5.1
2001	4.7	**2009**	2.4

Note: For the Table 7 and Table 8, data was obtained from EBRD Transitional report for the years 2000, 2002, 2008 and 2010 and from the Annual Report from the central national banks. BIR- Effective interest rate at the end- month, based on the average annual yield attained at three-month government securities primary auctions.

Table 10. Base interest rate (BIR) in Serbia *(in per cent per annum, end- year)*

Year	**BIR**	**Year**	**BIR**
2000	71.6	**2005**	10.7
2001	28.4	**2006**	10.8
2002	16.5	**2007**	7.1
2003	12.1	**2008**	10.8
2004	11.0	**2009**	6.7

Table 11. Landing rate (LR) in Bulgaria *(in per cent per annum, end- year)*

Year	**LR**	**Year**	**LR**
1994	117.8	**2002**	9.4
1995	51.4	**2003**	8.8
1996	480.8	**2004**	8.8
1997	13.9	**2005**	7.9
1998	13.3	**2006**	8.1
1999	14.1	**2007**	10.3
2000	11.5	**2008**	10.6
2001	11.1	**2009**	9.2

Note: For the Table 10 and Table 11, data was obtained from EBRD Transitional report for the years 2000, 2002, 2008 and 2010.

Table 12. Landing rate (LR) in Serbia *(in per cent per annum, end- year)*

Year	**LR**	**Year**	**LR**
2000	77.9	**2005**	14.4
2001	32.5	**2006**	15.9
2002	19.4	**2007**	11.1
2003	14.2	**2008**	13.1
2004	14.6	**2009**	12.4

Table 13. Foreign direct investment, net (FDI) in Bulgaria *(in millions of US dollars)*

Year	**FDI**	**Year**	**FDI**
1994	105.0	**2002**	876.3
1995	98.0	**2003**	2070.3
1996	138.0	**2004**	2879.2
1997	507.0	**2005**	4002.5
1998	537.0	**2006**	7332.5
1999	806.0	**2007**	8153.7
2000	500.0	**2008**	8364.4
2001	688.2	**2009**	8533.1

Note: For the Table 7 and Table 8, data was obtained from EBRD Transitional report for the years 2000, 2002, 2008 and 2010.

Table 14. Foreign direct investments, net (FDI) in Serbia *(in millions of Euros)*

Year	**FDI**	**Year**	**FDI**
2000	25.0	**2005**	1600.0
2001	165.0	**2006**	4264.0
2002	562.0	**2007**	2195.0
2003	1405.0	**2008**	3100.0
2004	1028.0	**2009**	3249.7