

## FOREIGN BANK PRESENCE AND ITS EFFECT ON FIRM ENTRY AND EXIT IN TRANSITION ECONOMIES

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### NON-TECHNICAL SUMMARY

While most economists agree that foreign bank entry benefited developing and transition countries by larger supply of credit, it is less clear whether all borrowers benefit from better credit access. Some studies reveal that foreign banks are less likely to grant credit to small enterprises and instead increase lending to large firms. The consequences could be particularly dire for start-ups, which are the most opaque clients and face credit constraints even in the presence of well developed financial markets. In this paper, we analyze the impact of foreign bank presence in Central and Eastern European countries on the rate of firm entry and exit, size of entrants and their survival probability in the initial years. This region is particularly well suited for our study, because bank credit is the main source of finance for enterprises, and shallow capital markets cannot provide a substitute for bank loans. At the same time, the banking sector in these transition economies experiences the highest level of foreign bank presence in the world.

We provide consistent evidence that foreign bank penetration has led to lower rate of firm entry and a higher rate of firm exit in informationally opaque industries compared to transparent ones. Moreover, we find that the mode of foreign bank entry is crucial, because the negative impact is driven by virtual disappearance of domestic banks due to their acquisition by foreign investors. Interestingly, the entry of greenfield foreign banks has spurred firm creation in more opaque industries, which is consistent with market segmentation theories.

Unlike previous studies that use interchangeably notions of opacity and size, we define opacity in terms of technological process at the industry level. Firm opacity is not always correlated with firm size.

In fact, many small firms can be rather transparent because they have fixed assets that can be used as collateral, whereas creditworthiness of many large firms can be more difficult to evaluate due to their technological sophistication. We show that the economic significance of foreign bank entry is larger for opaque industries than for industries with large share of small firms. Finally, we show that the negative effect of foreign bank acquisitions is not experienced by sole entrepreneurs, which means that the average size of new entrants diminishes, in line with the hypothesis of credit constraints.

Our results provide important policy implications because they show that foreign bank entry can be harmful for the creation of new firms in industries with higher informational asymmetries. By definition, opaque industries possess high levels of knowledge and skill intensity, such as new information

technologies and, therefore, are crucial for future growth. This negative aspect should be considered along positive consequences of foreign bank entry, such as the increased and more stable supply of lending to larger firms. If foreign banks have a massive presence in the country and no domestic banks are left, different ways to support entrepreneurship should be explored, such as venture-capital funds or state funds, to assist start-ups in more opaque industries.

*JEL Classification:* E51, G21, M13

*Key Words:* Entrepreneurship, Foreign bank entry, Asymmetric information, Credit constraints