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## Into the void: Governing finance in Central and Eastern Europe

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## Into the Void

Governing Finance in Central and Eastern Europe

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May 2010

### Abstract

Twenty years after the fall of the iron curtain—which for decades had separated East from West—most countries of Central and Eastern Europe are now members of the European Union; some have even adopted the euro. Nonetheless, these countries have also remained exceptionally vulnerable to upset, including those that originate beyond their immediate sphere of influence as revealed by the global financial crisis. This paper explains this with the governance of finance, i.e., the allocation of *de jure* and *de facto* responsibilities for financial systems, which deprives host countries of capital flows of critical policy tools.

Keywords: financial regulation, global finance, home-host country regulation

JEL classification: G28, K20, P34

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## Acronyms

BIS	Bank for International Settlement
CEBS	Committee of European Banking Supervisors
CEE	Central and Eastern Europe
CESEE	Central, Eastern and South-Eastern Europe
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
IMF	International Monetary Fund
FMA	Austrian Financial Market Authority
FSAP	Financial Sector Assessment Programme
MoUs	memoranda of understanding
ONS	Österreichische Nationalbank (Austrian National Bank)

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## 1 Introduction

A functioning market-based economy depends on a well-working financial system—i.e., on organizations that intermediate between savings and investments and allocate resources, as well as on institutional arrangements that mitigate the risk of collapse associated with complex financial systems. The former socialist countries of Central and Eastern Europe (CEE) possessed certain elements of a financial system, such as savings banks and organizations used by the government to store and to channel money; however, intermediation and allocation functions were centrally controlled and not left to autonomous actors. This arrangement was consistent with the organizational features of a centrally planned economy, but it was unsuitable for de-centralized economies that relied increasingly on market mechanisms. For such economies to work, a new set of arrangements had to be found that allowed for greater dispersion of financial services combined with effective checks and balances to guard against the risk of systemic failure.

The story of the transformation of the financial sector in CEE from plan to market has been often told (Buch 1996; Rostowski 1995; Tihanyi and Hegarty 2007) and will not be recounted here. Nonetheless, recalling how finances were organized under socialist regimes serves to illustrate that the operation of financial systems is closely intertwined with the organization of the economies and the prevailing governance regime. The organization of finance takes one form under one, and quite a different form under another. Market economies are commonly distinguished by the organization of their financial systems, whether they are predominantly market or bank-based (Allen and Gale 2001; Mayer 1998). Both systems have their distinct institutional arrangements designed to address the specific vulnerabilities inherent in them. Market-based systems are vulnerable to the existence of stock-market bubbles, which may result in a crash. Bank-based systems have a high probability of suffering from bank failures and to the cyclical nature of credit booms and busts. Most economies have both stock markets and banks (Levine 2003), and thus are—albeit to varying degrees—vulnerable to either shock.

The history of financial markets is a history of crises (Kindelberger 2005; Minsky 1986); but it is equally a history of attempts to mend the institutional arrangements that shall prevent them. What is often overlooked is that crisis management itself is a critical part of the governance regime for financial markets, arguably the most important one. Once one recognizes that financial markets are inherently instable,<sup>1</sup> crisis management is viewed as an integral part of the governance of finance; it shapes the future behaviour of market participants—a fact that is widely acknowledged in concerns about moral hazard associated with government bailouts. More importantly, it reveals who is the ultimate guardian of the financial system: Whoever has the resources to rescue a financial system and as such is capable off-setting the terms for the rescue deal. This role is typically denoted as ‘lender of last resort’. In the context of the global crisis the role has morphed into ‘investor of last resort’ and even into the all-encompassing ‘whatever it takes’(Andrews 2009)—a commitment that is more appropriately labelled as ‘ultimate guardian’. Using the guardian metaphor also emphasizes that crisis

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<sup>1</sup> Clearly, this has not been a core assumption of standard finance theory. See, however, Minsky (1986); see also Sornette (2004).

management is not about the ‘bail out’ of individual banks or other intermediaries, but an attempt to prevent a collapse of the financial *system*.

This paper argues that the designation of the ultimate guardian is the result of policy choices about the governance of finance. They include decisions about liberalizing capital accounts or not; building or not building reserves for ‘rainy days’; pegging, floating, or managing the domestic currency; allowing foreign bank ownership/dominance, or restricting it; and accepting or rejecting the principle of home country regulator for foreign banks operating on one’s territory. These decisions are not necessarily made for the purpose of outsourcing the function of the ultimate guardian. In fact, most made by countries in CEE were pre-determined by the regional or global governance regimes they joined. The combined effect of these policies, however, has disabled governments in most CEE countries from protecting their economies against a looming crisis as evidenced by their ultimately unsuccessful attempts to control the credit boom in the years leading up to the crisis; once the crisis erupted causing the drying up of external finance, they were unable to effectively respond to it as their resources were no match against the scale of private funds that had earlier flooded their economies.

The countries in CEE may have been motivated to proactively relinquish governance over their financial systems in favour of a regional regime. Indeed, the EU has undertaken major efforts to Europeanize the governance of finance by standardizing financial regulation and improving coordination among national regulators (Corcoran and Hart 2002; Ferrarini 2002). It is obviously in the interest of this collective enterprise for countries to cede some of their sovereignty over finance. Those countries that have joined the European Monetary Union have relinquished their domestic currencies and control over monetary policies (Zilioli and Selmayr 2001). Moreover, the policy advice given to political leaders in the former socialist world regarding the benefits of financial liberalization was motivated by a desire to protect their economies from undue political interference and thereby promote prosperity (Barth, Caprio and Levine 2004; World Bank 1995, 1996).

Yet, there is a risk to this strategy—namely, that supranational governance regimes may be ineffective and/or serve ulterior interests, and the risk that in the event of a crisis a country is forced to depend on an ultimate guardian over whose strategies and policy directions it has little control. In the context of the global financial crisis many of these risks were realized in countries in CEE. This raises important questions about the costs and benefits of the manner in which not only countries in CEE as well as other emerging markets integrated into the global financial system.

## **2 The role of ultimate guardian in the governance finance**

The operation of finance rests on the credibility of a promise for future returns on investment. The Encyclopaedia Britannica defines ‘finance’ as ‘the process of raising funds or capital for any kind of expenditure’,<sup>2</sup> explaining that some need more money today than they have on hand while others have excess money that they can invest and

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<sup>2</sup> See [www.britannica.com](http://www.britannica.com) under ‘finance’.

thereby earn interests or dividends. The willingness of those with excess money to realize gains from parting with their money depends on the other party's ability to invest productively and to commit to pay returns. The regulatory regime for financial markets is primarily concerned with ensuring that the promises made are indeed credible; a range of legal and regulatory tools has been employed over time and across countries to accomplish this task. They include, among others, legal institutions such as civil and criminal courts for enforcing contractual and tort claims; entry regulations for entities and persons wishing to offer financial services; prudential requirements for financial intermediaries; agencies charged with monitoring and supervising such intermediaries; and government sponsored deposit insurances.

None of these tools, whether in isolation or in combination, have succeeded in eliminating financial crises. A possible explanation is that every new legal tool designed to contain risk invariably gives rise to strategies aimed at circumventing it. Even a perfect legal system could not guard against wide spread default resulting from broadly shared misjudgements about the future—not only because the future is difficult to predict, but also because collective denial about the sustainability of certain strategies is rampant, particularly in financial markets (Avgouleas 2009).

Perhaps even more importantly, the legal and regulatory tools listed above only partly address the supply of money—the very medium of financial transactions (Galbraith 1976/2001). A substantial change in the money supply can destabilize a financial system however well-designed laws and regulations might be. The sources of money supply are multiple; they are the government's printing press, the inflow of foreign capital, and the money multiplier effect embedded in the credit system. The relevant policy tools for governing the money supply include inflation targeting, the management of foreign capital inflows through exchange rate policies, capital controls and sterilization efforts, as well as interest rate policies and changes in reserve requirements to affect the costs of lending by the private sector. A comprehensive analysis of the governance of finance must, therefore, include both the credibility problem as well as the supply sides of finance. It is all the more important because the two are interdependent. Changes in the supply of money can undermine the credibility of financial commitments, and inflation has the potential to undermine parties' trust in the future value of money and increases incentives for borrowers to defect (Wolf 1993). As the subprime mortgage crisis suggests, an increase in the supply of credits reduces lenders' vigilance as they seek to expand their market share in an increasingly competitive environment. Once the credibility of financial promises is undermined—whether for reasons associated with credibility or money supply—and financial markets freeze up, this delicate system built on promises is prone to collapse.

Every financial system is vulnerable to credibility as well as to supply shocks. Available empirical evidence confirms that financial liberalization—which typically leads to greater supply of capital—is positively associated with subsequent financial crises (Reinhart and Rogoff 2008). In the past, the typical response has been to ensure that afflicted countries improve their institutions. This was based on the assumption that financial markets would operate efficiently as long as they could rely on effective institutions. In response to the East Asian financial crisis of 1997/98, for example, the IMF developed a comprehensive assessment program for the institutions governing financial markets around the world—the Financial Sector Assessment Programme

(FSAP).<sup>3</sup> It uses ‘best practice standards’ drawn from the ‘most advanced’ financial systems, such as the US and the UK, to guide other countries in reforming their legal and regulatory framework. In the current global financial crisis, the appropriate response to the apparent governance failure appears to be less obvious. After all, the crisis originated in the very countries that served as best practice models and that were home to the very market participants whose efficient operation had been assumed.

In reality, it is difficult to determine whether a financial crisis is related to bad institutions, i.e., the credibility problem of finance, or to excessive supply of capital in search for high returns. Recognizing the latter as a problem is made more difficult by the fact that capital inflows at first tend to have a positive effect on an economy, spurring investment and growth. Thus, policymakers in CEE and advisors at the IMF and elsewhere were very much aware of rapid credit expansion in the region in the years leading up to the crisis, but could not decide whether this was a good thing (a much desired catch-up with the west) or a bad thing (a credit boom that would eventually result in a bust). Ideological priors further complicated a correct diagnosis of what was happening. Advocates of market self-regulation tend to see the major problem of financial crisis not in behaviour of market participants, but in an unwarranted and undesirable ‘external’ intervention concocted by politicians: if only politicians were able to commit *ex ante* not to intervene in times of crisis, markets would effectively regulate themselves as market participants would fully internalize the costs of their actions. This argument assumes that the root cause of financial crises can always be found in the credibility problem, i.e., the inability of private agents to credibly commit only to those obligations they will be able to fulfil in the future. It largely misses the money supply problem. While banks control part of the money supply through the money multiplier effect associated with the credit system, each bank can do so only for its own lending activities and has no control over the system-wide implications of the rapid expansion, to which it contributes only as one among many. A bank that chose to cut back its own credit expansion would undercut its ability to compete with others. As the former CEO of Citigroup, Prince, famously quibbled, they have little choice but to get up and dance—until the music stops.

Given the indeterminacy of the ultimate causes of a financial crisis and given that the financial system is indispensable for the operation of a market economy, it is not surprising that most governments will try to protect their financial system from collapse. However, individual governments may lack the resources or the credibility to prevent it; the *actual* ultimate guardian, therefore, is not necessarily the domestic government, but whoever rescues a financial system. The ultimate guardian may be one or more domestic agent (i.e., the central banks and treasury in case of the US rescue operations in the global crisis), domestic agents in collaboration with their counterparts in other countries (i.e., the Mexican and US governments in the case of the 1994 bailout of the Mexican financial system), or multilateral agencies, such as the IMF, typically upon the request by domestic governments (i.e., interventions in most countries afflicted by the East Asian financial crisis in 1997/98 and a series of emerging markets in the ongoing global crisis). Thus, the identity of the ultimate guardian is often revealed only in a crisis, yet close inspection of a country’s governance arrangements can help determine the viability (or lack thereof) of domestic agents and thus establish whether ultimate guardianship has been effectively outsourced.

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<sup>3</sup> See [www.imf.org/external/NP/fsap/fsap.asp](http://www.imf.org/external/NP/fsap/fsap.asp) for details.

When finance in CEE countries dried up as a result of the global financial crisis, their governments turned out to be unable to protect their financial systems—and ultimately their economies—without outside help. The ‘sudden stop’ of foreign capital inflows (in fact the extensive reversal of capital inflows in 2008 and 2009) (Nagy 2009), left their economies in freefall and brought their currencies under attack. Luckily for them, help did come from various sides; at the time of this writing, the IMF had entered into emergency loans with Belarus, Bosnia-Herzegovina, Hungary, Latvia and Ukraine and had concluded standby agreements with Poland and Romania. The European Bank for Reconstruction and Development (EBRD) established a joint action program together with the World Bank and the European Investment Bank (EIB) in January 2009, committing €24.5 billion to support the banking sector in the region. The EBRD has already invested €1 billion of these funds in Romania and additional funds in Ukraine. In addition, the European Union has provided €50 billion for balance of payment support to countries in Central and Eastern Europe. Finally, the European Central Bank (ECB) has entered into and recently activated a swap arrangement with the Central Bank of Sweden (Sveriges Riksbank) to help it weather the storm of the financial crisis in the Baltics where many Swedish banks are deeply invested (Sweden has not adopted the Euro). The ECB also announced co-operations with Narodowy Bank Polski (Poland) as well as Magya Nemzei Bank (Hungary) to provide these countries—which had experienced extensive ‘euroization’ (Feige and Dean 2002) of their economies—with euro liquidity. These interventions benefited countries that received direct assistance, but also other countries as these actions signalled that the financial systems of these countries would not be allowed to implode. Still, the rescue operations were conducted in an ad hoc fashion and depended on the perception of third parties (the IMF, the EBRD, etc.) that assistance was warranted, as well as their own willingness and endowment with sufficient resources to step in. This uncertainty about the identity of the ultimate guardian and its commitment to an afflicted country creates a governance void.

### **3 Into the void**

Countries in CEE implemented extensive legal and regulatory reforms to improve their financial systems and received guidance and support from the EBRD (EBRD 1998; Fries, Neven and Seabright 2002), the World Bank (1996), and most importantly, the European Union to this end. One of the first major reform projects of the EBRD in the region was to improve the conditions for the development of credit markets by reforming the regime for collateralizing credit.<sup>4</sup> Additionally, the accession process the EU required countries in the region to adapt their laws and regulations to the European standards. Lastly, all countries were regular clients of the IMFs’ FSAP.<sup>5</sup> Thus, not only on paper but also in practice these countries have caught up with the institutional standards widely regarded as critical for maintaining financial stability; against this background, the rapid expansion of credit in most countries since the late 1990s was regarded as a positive response to the institutional reforms that had been implemented (Cottarelli et al. 2005). Whereas as of 1998 most countries in CEE still lagged behind countries at similar GDP levels in terms of the aggregate size of their credit markets,

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<sup>4</sup> A model law on secured transactions for the region was published as early as 1994. See EBRD, available at: [www.ebrd.com/pubs/legal/secured.htm](http://www.ebrd.com/pubs/legal/secured.htm).

<sup>5</sup> For recent FSAP reports on individual countries, see [www.imf.org/external/NP/fsap/fsap.asp](http://www.imf.org/external/NP/fsap/fsap.asp).



they now reached, if not exceeded, these comparative benchmark data.<sup>6</sup> The speed with which these changes occurred was remarkable. Within a period of only five years (from 2000 to 2005) the credit to GDP ratio doubled or even tripled in several countries (Enoch 2007). Between 2000 and 2004 alone, the average annual credit growth in Bulgaria and the three Baltic states was twenty per cent and in Hungary, Romania and Croatia the average annual credit growth was over 10 per cent. In Slovenia, the average was around 10 per cent. Only in Poland, the Czech Republic and Slovakia had credit growth been below 5 per cent and at times even negative (Arcalean et al. 2007). The credit growth persisted, and in some countries even accelerated in the following years. According to Backe, Egert and Walko (2007), ‘at the end of 2006, the annual growth rates of credit to the private sector ranged from 17 per cent to 64 per cent in the countries covered in this study’, namely Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.<sup>7</sup> These data almost certainly understate the real growth of credit, as they exclude direct cross-border lending by foreign banks to firms and households in these countries (see below). The persistent if not accelerating credit growth occurred notwithstanding the fact that many countries actively tried to reign in credit growth since the early 2000s. The means used varied from country to country, yet they shared a common fate: they proved largely ineffective.

In principle, countries have a broad menu of choices to respond to excessive credit expansion. Hilbers, Ötoker-Robe and Pazarbasioglu (2007) have compiled a menu of such choices, which includes macroeconomic policy measures to manage supply side of money, including fiscal, monetary and exchange rate responses. It also lists prudential, supervisory and administrative measures, which address the core credibility issues.<sup>8</sup> While some countries appear to have had temporary success at least in slowing the rate of credit growth by employing some of these tools—especially Poland, and to some extent Bulgaria—the subsequent renewed expansion of credits suggest that ultimately these tools were not effective; this can, at least in part, be explained with the accession of countries in CEE to the European Union. In 2004, the three Baltic states, Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia joined the EU; in 2007 Bulgaria and Romania followed suit. All countries experienced a major post-accession boom, which has been attributed to increases in capital flows.

With the accession to the EU, the countries of CEE relinquished important tools for governing their financial systems they previously had at their disposal. The restrictions

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<sup>6</sup> This has been the case in Bosnia-Herzegovina and Croatia. See Figure 2.6 in Arcalean et al. (2007: 22).

<sup>7</sup> In the United States, a country with a much larger and deeper financial system, credit extended by commercial banks grew by about 11 per cent in 2006. See FRB (2006: 22).

<sup>8</sup> In addition, the menu includes two other items, namely ‘market development measures’ and the ‘promotion of better understanding of risks’. The former includes legal institutions for contract enforcement and improved accounting standards, i.e., institutions that fall broadly within the category of credibility measures. Other ‘market development measures’ like hedging instruments as well as ‘market based’ risk diversification instruments potentially have implications for the credibility as well as the money supply sides of financial governance. See the country reports in Enoch and Ötoker-Robe (2005).

on policy choices imposed by EU law are plenty.<sup>9</sup> With respect to the governance of money supply, most restrictions can be traced to the new member states' commitment to strive towards introducing the Euro. Specifically, Articles 3 and 4 of the respective Accession Treaty entered into by each new member state provides that it participates in the monetary union from the date of accession. Yet, the adoption of the Euro has been delayed, as membership has been derogated in accordance with Article 122 of the Maastricht Treaty until the relevant convergence criteria have been met. These include fiscal restraint and the reduction of government debt, price and interest rate stability, and exchange rate stability. The European Central Bank monitors convergence and issues annual convergence reports.<sup>10</sup>

Some policies associated with the convergence criteria work towards taming a credit boom. Fiscal restraint is the most obvious one. The implications of interest rate, price and exchange rate stability requirements are more ambivalent. Hilbers, Ötoker-Robe and Pazarbasioglu (2007) list greater exchange rate flexibility as an important tool for controlling rapid credit expansion. Indeed, Poland seems to have been quite successful in employing such strategies at times, but the ECB took note of this in its convergence report (ECB 2008).<sup>11</sup> Other countries had their hands bound by pegging their exchange rates or using currency board arrangements that required a tight exchange rate management. Among the various macroeconomic tools for taming the credit boom, this left them only with fiscal policies (Hilbers, Ötoker-Robe and Pazarbasioglu 2007: 101).

In addition, the EU is in the process of harmonizing the financial governance regime across member states as part of the integration of European financial markets. Notably, the free movement of capital was the last of the 'four freedoms' tackled by the EU. After creating the conditions for the free flow of goods, persons, and (most) services, serious attempts to harmonize financial market regulation were made only with the adoption of the Financial Services Action Plan in 1999; the regime that evolved in the subsequent years became part of the *Acquis Communautaire*, which the new member states had to comply with prior to being accepted as new member states. No serious attempts were made to modify the impact of this regime on the new member states despite the fact that their financial systems were still in the early stages of transformation and nowhere nearly as developed as the mature financial systems of old member states at the time they conceded that it was time to liberalize.

The EU governance regime for credit institutions has strong parallels in the global financial governance regime developed by the Bank for International Settlement (BIS). However, the Basel Concordat as well as the two Basel Accords (I & II) is 'soft law' and as such not legally binding. In contrast, a EU directive requires member states to transpose the directive into national law. The key governance principles for finance in the EU are home country regulation, bilateral coordination among home and host country regulators under the leadership of the home country regulator, and multilateral

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<sup>9</sup> Appendix 1 lists the policy menu compiled by Hilbers, Ötoker-Robe and Pazarbasioglu (2007) and identifies legal constraints under EU law.

<sup>10</sup> The ECB convergence reports are available at [www.ecb.int/pub/convergence/html/index.en.html](http://www.ecb.int/pub/convergence/html/index.en.html).

<sup>11</sup> The ECB (2008) noted that 'in March 2008 the real effective exchange rate for the Polish zloty stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year historical averages.' However it did caution not to over-interpret the results in light of Poland's convergence process.

coordination within a three level system within the EU.<sup>12</sup> Attempts to vest the ECB with centralized regulatory powers over finance or to create an alternative EU wide regulator have met with stiff resistance by member states, as well as from their respective financial industries. Therefore, a coordinative governance regime—the so-called ‘Lamfalussy Process’—which had originally been developed for the governance of securities markets (Lamfalussy 2001), was extended to credit institutions (Vander Stichele 2008).

The basic idea of this process named, after the chair of the ‘Committee of Wise Men’ that authored the report, is that EU directives (level 1) set forth the general framework for financial market governance. The implementation and enforcement of the directives by domestic legislatures and regulators shall be guided by complementary guidelines developed by two committees. At level 2, the European Banking Committee, and any body run by the European Commission, shall facilitate the implementation of directives by addressing political issues as well as design problems. At level 3, the Committee of European Banking Supervisors (CEBS) brings together regulators from the member states involved in the regulation of banks. CEBS is charged with providing technical advice and ensuring the consistent implementation of the directive by dispersed national regulators. In addition to collecting information, conducting peer review and involving the financial industry through consultation processes, CEBS also functions as mediator in disputes between home and host country regulator.

The complexity of the process and the sheer size of the new committees (51 regulators from 27 countries are currently represented in CEBS) as well as the lack of actual enforcement powers leave key decisionmaking in the hands of domestic regulators: the regulator in the jurisdiction where a credit institution has been authorized (licensed). A bank wishing to establish a branch in another EU member state can do so by simply notifying the regulatory authorities of that country. The same applies if the same bank wishes to offer financial services in another member state without channelling them either through a branch or a subsidiary, thus facilitating direct cross-border lending. This European passport system was designed to promote financial market integration by reducing regulatory costs for transnational financial intermediaries within the common market. In contrast, for a separately incorporated entity, i.e., a subsidiary—special authorization is still required.

The distinction between branches and subsidiaries can be interpreted to suggest that domestic regulators maintain full regulatory authority over credit institutions incorporated and licensed within their territory, irrespective of their ownership structure. In other words, the fact that 65 to 98 per cent of bank assets in CEE countries are foreign-owned should not matter much, as by far the majority of these banks are fully (domestically) incorporated subsidiaries rather than branch offices. This contrasts with the rest of the EU, where foreign branches rather than foreign-owned subsidiaries have been much more common. However, in practice the distinction between branches and subsidiaries has become blurred. Two factors account for this: First, banks with EU

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<sup>12</sup> Most of these principles are reflected in Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), 30 June 2006, OJ L 177/1 and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), 30 June 2006, OJ L 177/201.

wide or global operations treat subsidiaries increasingly as branch offices; they have morphed into vertically integrated financial groups with centralized strategies implemented throughout the group in a manner that is oblivious of national borders and formal differences between branch offices and subsidiaries. The latter remain relevant mostly for accounting and tax purposes. The corollary to the changing industry practice has been the consolidation of regulation for financial groups operating in more than one country.<sup>13</sup> Relevant EU directives allocate regulatory oversight over subsidiaries of EU parent credit institutions and financial holdings to the home regulator of the parent. This ‘consolidated supervision’ entails the ‘coordination of the gathering and dissemination of relevant or essential information’ as well as the ‘planning and coordination of supervisory activities’ for the going concern as well as in emergency situations.<sup>14</sup> Home country regulators of the subsidiaries shall consult and coordinate with host country regulators. This division of labour has been re-enforced by the so-called home-host guidelines adopted by CEBS (one of the banking committees established as part of the Lamfalussy framework). Upon consultation with the finance industry, these guidelines emphasize that in order to reduce regulatory costs, the home country regulators of the subsidiary should seek information not from the subsidiary or its parent, but from the parent’s home country regulator. The finance industry has made no secret that it would favour comprehensive delegation of supervisory powers to the parent’s home country regulator.<sup>15</sup> Technically, this has been feasible since the adoption of the credit institutions directive in 2000, but so far not a single domestic regulator has done so. In light of the dominance of foreign bank ownership of the domestic banking sector in CEE—which implies that virtually all banks in these countries are subject to consolidated supervision by the home country regulator of the parent—the difference between consolidated and delegated supervision is, however, less pronounced than suggested by the law on the books.

The dominance of foreign banks in CEE countries is a result of privatization in the 1990s and the opening of the financial service sector to foreign investors in anticipation of EU membership. The asset share of foreign-owned banks in CEE countries ranges from a low of 36 per cent in Slovenia to a high of 98 per cent in Estonia (ECB 2005). Only in Estonia and Latvia (47 per cent) is the asset share below 50 per cent. In comparison, in Latin America the asset share of foreign-owned banks is, on average, 45 per cent. Only New Zealand and Botswana have financial systems that are dominated by foreign owners to an extent that matches the countries of CEE. This suggests that the financial systems of CEE countries have been integrated into multinational financial groups with headquarters located outside their jurisdiction (De Haas and Van Lelyveld 2008). The home country regulators of the parent banks viewed these developments favourably, as they positively affected the growth of ‘their’ institutions, and regulators in CEE countries still had at least nominal regulatory control over subsidiaries and could seek information about them via the parent’s home country regulator. Indeed, regulators in most CEE countries have signed memoranda of understanding (MoUs) with regulators in the home countries of parent banks that own or control banks within their jurisdiction, however, they could do little to enforce their ultimate policy objective,

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<sup>13</sup> See Arts. 129 of Directive 2006/48 op cit at 14.

<sup>14</sup> See Art. 129 Credit Institution Directives 48/2006 EC.

<sup>15</sup> See comments by the Federation of European Banks (FEBS) on the home-host-country guidelines issued by CEBS. See [www.cebs.eu](http://www.cebs.eu).

namely to guard the stability of their domestic markets when the group switched strategies in response to regulatory constraints they tried to impose. In particular, they could not prevent parent companies from lending directly to side-step constraints imposed on their subsidiaries by CEE regulators. In a recent study, researchers at the Austrian Central Bank revealed that direct lending by the Austrian parent company grew rapidly between 2002 and 2007 amounting to over €36 billion annually in 2007. In countries that joined the EU in 2004 direct lending by Austrian parent banks grew by an annual rate of 20 per cent on average and in Bulgaria and Romania (both of whom joined in 2007) by 50 per cent. As it turns out, most of the borrowers in CEE countries were leasing companies affiliated with the same banking group that owned one or more bank subsidiaries in the same country; the critical difference is that, as leasing companies rather than banks, they escaped the regulations CEE countries sought to impose on their domestic banks to counter the effects of an accelerating credit boom.<sup>16</sup> In other words, the group had found an easy mechanism to arbitrage around regulatory constraints. For countries in the region, direct lending came at the additional risk of foreign currency exposure: 85.4 per cent of these direct loans were denominated in foreign currency (ONB 2009). While Euro-denominated loans dominated direct lending, the Swiss franc became increasingly common in Croatia, Hungary, and Slovenia.

The combination of financial liberalization within the EU, the dominance of financial groups from other EU member states, and the emphasis on reducing regulatory costs for these groups by consolidating regulatory oversight in the hands of the home country regulator implies that CEE countries have effectively abdicated the governance of their domestic financial markets. Undoubtedly, the integration of CEE banks into multinational banking groups has also benefitted these countries. Reforming the financial sector in the post-socialist CEE countries has previously proven itself difficult, and the influx of foreign capital and expertise was widely regarded as critical for their speedy transformation. Moreover, foreign bank ownership shielded banks against downturns in their domestic economy. Empirical analysis of the lending practice of multinational financial groups suggests that they tend to cross-subsidize subsidiaries in countries facing a temporary downturn (De Haas and Van Lelyveld 2008), helping many banks in the region weather the first impact of the global crisis, yet, the study also suggests that the same intra-group dynamics that operate in a counter-cyclical fashion when the locus of downturn is the economy in which the subsidiary is located turns pro-cyclical when the downturn affects the parent's home economy. Thus, the price for insurance against purely local economic troubles is exposure to problems that originate with the parent company or its home market. The global crisis has revealed that this price can be substantial; in 2008 alone US\$57 billion left the region as banking groups withdrew their capital to protect their home base (Nagy: supra note 5).

#### **4 Wither financial governance in CEE?**

The policy choices made by countries in the CEE region have effectively outsourced governance of their financial systems, and most critically, the role of ultimate guardian.

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<sup>16</sup> See ONB (2009): '... the share of recipient *intra-group* FIs increased from 65 per cent to more than 70 per cent of total direct credit to FIs. These growth rates are inter alia due to the growing importance of leasing firms affiliated with Austrian firms'.

This conclusion begs the question: to whom? There is no simple answer to this question, which is why in crises these countries find themselves devoid of reliable governance. In the end, the most vulnerable countries had to rely on the IMF while others benefited from the announcement of the EBRD and the ECB to stand ready for additional aid if need be (see above).

With respect to crisis prevention in the form of credibility enhancement or management of parts of the money supply, regulatory oversight was transferred to the home countries of the dominant banking groups. As a result, the most important regulators of banks located in CEE countries are those of Austria, Italy,<sup>17</sup> Sweden, and Belgium as banks from these countries dominate the scene in CEE countries. The new scope of regulatory jurisdiction of Austria and Sweden recalls their spheres of influence in past eras of empire building; yet, the commitment to guard the interests of these countries and protect them against financial crises has been limited. This raises the question whether the concept of coordinated governance over financial markets is workable: clearly, the European financial governance framework is still a work in progress, nonetheless, it is worth asking how this framework will affect different countries in good as well as in bad times. Ultimately this requires an investigation into the interests and purposes the governance regime shall serve. The relevant EU directives skirt the issue by assuming that if all credit institutions complied with the standards established therein, and all domestic regulators made sure that they did, financial markets should operate and savings should be protected.<sup>18</sup> In such a conceptualization, there is little room for conflicting objectives of prudential regulation and oversight from the perspective of the home and host country regulators whether in times of relative stability or in times of crisis. Yet, such conflicts are easily conceivable. As Herring (2007) suggests, from the host country perspective, the ‘nightmare scenarios’ involve a foreign entity with a large share of local (i.e., host country) markets ‘to be systematically important, while at the same time, being so small relative to the parent group that it is not regarded as significant to the condition of the parent company’; in this case, the home country regulator may not see a case for intervention as it is naturally concerned with the stability of the financial group for its own market, not with the stability of the financial system of countries in which that group operates a subsidiary. For CEE countries the basic features of this ‘nightmare scenario’ are endemic: not only are their domestic banking systems dominated by foreign financial groups, but the banking system is highly concentrated. As of 2005, the top five banks in key CEE countries had a market concentration ratio<sup>19</sup> ranging from 48 per cent in Poland to 99 per cent in Estonia (Uhde and Heimeshoff 2009). As noted above, foreign-owned banks’ asset share in the same countries is between 36 per cent (Slovenia) to 97 per cent (Estonia) (Enoch 2007). Put differently, a few foreign banking groups own most of the banking sectors in any given CEE countries. Even for Poland, the largest country among the new member states, the importance of foreign owned banks to the domestic economy is far greater than the importance of its subsidiaries to the portfolio of the foreign bank that serves as its parent

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<sup>17</sup> As a result of Unicredit acquiring the Austrian Bank Creditanstalt.

<sup>18</sup> Recital 5 of Directive 2006/48/EC lists as one of the objectives ‘to protect savings and to create equal conditions of competition between these institutions.’

<sup>19</sup> Calculated as the fraction of assets of the total banking system’s assets held by the five largest domestic and foreign banks per country. See Uhde and Heimeshoff (2009: 1299-311). The ECB (2005) confirms a high concentration ratio in these countries.

company (Bednarski and Starnowski 2007). In a small country like Croatia, Austrian banks controlled 60 per cent of the banking sector as of 2007 (Gardor 2008), which translates into 14.7 per cent of total Austrian banking assets;<sup>20</sup> this is not trivial, and indeed Croatia features prominently in the annual report of the Austrian Financial Market Authority (FMA) after the Czech Republic and Romania as one of the three ‘main countries’ among all countries in Eastern Europe and the former Soviet Union in which Austrian banks hold assets. Notably, the ranking employed by the Austrian FMA is by asset value, and not by the systemic effect that Austrian banks’ activities might have on the host country’s financial system. It clearly reflects the perspective that the home country regulator brings to its role as consolidated regulator. Indeed, the presentation of Austrian bank exposure in CEE both in the annual report of the FMA and the Financial Stability Report of Austria’s Central Bank (Österreichische Nationalbank, ONB) is illuminating. For the FMA, CEE features primarily as a place of expansion and a profit centre:

The region of Central, Eastern and South-Eastern Europe (CESEE) became even more important to Austria’s banks in 2008. The aggregate balance sheet total, following some restructuring, grew by close to 30 per cent during the third quarter of 2008 compared with the same period of 2007 to approximately €272 billion, whilst the result for the period rose by a disproportionately high amount, up by around 47 per cent to close to €3.45 billion (FMA 2008).

The ONB reported that the ‘exposure’ of Austrian banks in the region has had negative repercussions for the Austrian banking sector during the crisis, but downplayed the likely effect on the Austrian financial system as ‘the Austrian financial intermediaries are regionally diversified, a factor that reduces the risk of country specific or sub-regional clustering’ (ONB 2009: 46).<sup>21</sup> Whether the countries on the receiving end of Austrian banks’ expansion strategies are similarly diversified is apparently of little concern.

In sum, the focus of home country regulators is on *their* domestic banks and *their* domestic financial system, yet, in the event of a crisis—whatever its cause—someone must assume the role of ultimate guardian for the sake of people living in the countries on the receiving end of capital flows, both for their own sake and to avoid spillover effects for the European or the global system.<sup>22</sup> In the capital exporting countries of Europe and elsewhere, home country governments have stepped in aggressively for the benefit of their own national systems. They have left multilaterals to deal with those

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<sup>20</sup> According to FMA (2008), total assets of Austria’s financial markets amount to €1069.3 billion, 44.7 per cent of which is held by banks (Table 3). Thus, total assets of the Austrian banking sector in 2008 amounted to €478 billion (FMA 2008: Table 6 Table 6 and accompanying text). €32.26 billion in Croatian bank assets held by Austrian banks.

<sup>21</sup> Translation by author.

<sup>22</sup> This threat has been clearly voiced by the Erik Berglöf, the EBRD’s chief economist, who wrote on the EBRD blog in May 2009 that not only do foreign banks affect CEE countries, but CEE countries can invoke policies that might adversely affect the banks located in other EU member states: ‘...Eastern European governments can also damage the international bank groups by preventing them from transferring profits or adjusting their exposures. The public pressures to interfere are great’. Available at [www.ebrdblog.com](http://www.ebrdblog.com) (7 May 2009).

countries that served as capital importers during good times. Thus, the ONB reassured readers in its financial stability report in June 2009 that ‘in light of recent rescue measure by the IMF and the EU Commission, extreme scenarios have become much less likely’ (ONB 2009).

This is good news for everyone, including the people of the CEE countries, however, it also goes to show that countries that have been subjected to unconstrained cross-border capital flows—and as a result, have lost the ability to rescue themselves—must depend on the IMF and other multilateral organizations to perform the role of ultimate guardian once the risks inherent in such a strategy materialize. The implication of the IMF’s governance structure with its peculiar voting system is that most countries on the recipient side of IMF rescue packages have little influence on the design of these policies. The ten CEE countries that recently joined the EU, for example, jointly hold 2.75 per cent of voting rights.<sup>23</sup> At the EBRD they control 5 per cent.<sup>24</sup> The countries that had experienced the East Asian financial crisis learned that lesson ten years ago. They did not like the policies imposed by IMF conditionalities, which let them to experiment with their own insurance devices. Some closed their borders to free capital flows, as Malaysia did, however temporarily (Jomo 2006). CEE countries are prevented from exercising this option by EU treaty obligations, which prohibit restrictions on cross-border capital flows within the EU not only vis-à-vis other member states but also vis-à-vis third countries.<sup>25</sup> Alternatively, countries can make provisions for ‘rainy days’ by ensuring that they will have sufficient resources to conduct their own rescue should the occasion arise again. Indeed China,<sup>26</sup> Taiwan, Hong Kong, South Korea and Singapore have doubled their stockpiles of foreign exchange reserves in the years following the East Asian financial crisis, with over US\$800 billion collectively controlling 38 per cent of global reserves by the end of 2002 (Aizenman and Marion 2003). This option, however, presupposes a strong export base for earning foreign currency. It would also run counter to the aspirations and obligations of the new members states to join the euro.

The EU has meanwhile developed a number of proposals to reform the governance of finance following the recommendations of the De Larosière report (2008). The central theme of these reforms is to strengthen European supervisory and monitoring bodies, including CEBS, which is to be renamed into European Banking Authority (EBA) and to ensure that host countries are better represented in the regulation of multinational groups by including them in the colleges of supervisors, which, however, will be led by the home country regulator. The proposals fall short of full centralization, yet do little to strengthen the position of host countries to protect themselves against future excessive capital flows. Within the current EU legal framework, that would be difficult in light of

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<sup>23</sup> Own calculation based on information on voting rights available at [www.imf.org/external/np/sec/memdir/members.htm](http://www.imf.org/external/np/sec/memdir/members.htm)

<sup>24</sup> Whereas at the IMF voting rights are determined by the size of the economy at the date of entry (with some adjustments made over time), the Basic Document of the EBRD provides that voting rights are determined by the number of subscribed shares in the capital stock of the bank (Art. 29). Calculations are based on subscription levels published on the EBRD website.

<sup>25</sup> See Art. 56 (1) EU Treaty.

<sup>26</sup> China did not suffer from the East Asian financial crisis as it still had capital controls in place. However, it responded to the lessons learnt from observing its neighbours.



the strong commitment of free movement of capital and the substantial degree of harmonization, which effectively limits the member states' policy space (Pistor 2010).

This raises the question, whether countries in CEE have other options. Two come to mind. One is to push for a central regulator for the entire European Union that replaces national regulators for all financial groups with cross-border operations. This option has been repeatedly proposed within the EU, but has been vetoed by powerful countries, most notably the UK. Alternatively, individual countries could assert greater regulatory power by asserting effect-based regulatory power over their financial system—irrespective of where an entity with a material effect on that system is domiciled or whether relevant actions are taken. Effect-based regulation is commonly applied in antitrust law, including the EU, both within the EU and with respect to its external relations. Because anti-competitive behaviour is widely perceived to restrain the free flow of goods, decentralized enforcement by individual countries that assert extra-territorial reach of domestic law is widely perceived to be compatible with the EU Treaty as well as international trade obligations. In contrast, similar constraints on the free flow of capital would constitute a violation of the EU Treaty. It may be justified on a case-by-case basis on public policy grounds, but within the existing framework has to be treated as exception rather than the rule.

## **5 Concluding comments: implications for the global governance of finance**

The financial crises that swept emerging financial markets in the 1990s and the early 2000s left the impression that the world could, and should, be divided into two camps: countries with good institutions capable of participating in an increasingly globalized financial system on one hand, and countries with bad institutions that participated at their own peril, if at all, on the other. The global crisis that has engulfed members of both camps and the aftermath of the crisis suggest a different divide: countries that are capable of bailing themselves out, and those that are not. This difference implies that the two groups of countries have different demands on the governance regime for global finance. For countries with bailout capacity and sufficient political clout to act independently irrespective of existing regional or international commitments, a global regime serves two critical purposes: it enables the financial intermediaries it houses to expand in good times, and facilitates cross-border workouts for them in bad times. In comparison, countries that have either *de jure* or *de facto* abdicated their role as ultimate guardian for their financial system have greater needs for risk management in good times to reduce the probability of a crisis. They also are more dependent on external help to bail out their financial system in the event of a crisis.

The governance regime for global financial markets as it existed prior to the crisis played a critical role as enabler for global expansion strategies of financial groups, most of which are located in countries with ultimate guardianship capabilities. It has been less effective in providing cross-border workouts—something that not surprisingly has become a major focus of future reforms. The IMF has repeatedly performed the role of ultimate guardian to countries that lacked this capacity. In that sense, there already exists a workout regime for afflicted financial systems. Whether it served the interest of those countries is much disputed by the countries around the world that have been subjected to IMF policies. But it is probably beyond dispute that the IMF has used its influence in countries it has helped rescue at least in part to re-enforce the first strategy,

namely to foster the global expansion of financial groups by streamlining institutional and regulatory conditions around the world; moreover, the regime fell short of adequate risk management with respect to countries that were unable to protect themselves against financial crises. Instead, financial liberalization was endorsed without much concern for the lack of an appropriate global governance regime that could cope with major financial crises.

Reform proposals currently under discussion do not depart from this trend. Most address regulatory standards, that is, the credibility problem of financial governance, as well as post-crisis workouts for financial intermediaries. In addition, the G20 has committed to strengthen the IMF, and G20 countries have collectively agreed to commit US\$850 billion to ensure that capital will keep flowing to emerging markets and developing countries—that is, to ensure that the IMF has the capacity to bail them out if needed. Moreover, the IMF is signalling a renewed willingness to improve its own governance structure to reclaim the legitimacy it has lost. However, neither the G20 nor the IMF have put much efforts into designing a regime that would address the vulnerability of countries and financial systems that have lost control over the supply side of money. That would require questioning a key assumption on which the current regime rests, namely that unconstrained capital flows are an unmitigated good.

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