The impact of the crisis on financial integration in Central and Eastern Europe (by Ignazio Visco)

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Introduction[1]

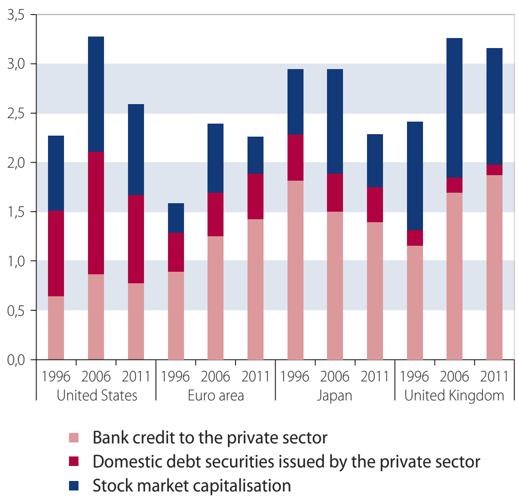
The global financial crisis has been severe and widespread, affecting different economies in different and long-lasting ways. The transition countries of Central and Eastern Europe[2] have been no exception: their quite rapid financial integration over the past twenty-years has brought enduring economic benefits but also left them relatively more exposed to the global financial turmoil, through their links with Western European banks, which hold dominant stakes in the region's markets.

Financial stability has become a fundamental objective of policy-making once again, and central banks are heavily involved in this endeavor, which calls for a thorough overhaul of financial regulation and supervision. Tomorrow's financial system will be different from the one that has developed over the last two decades.

Global financial integration during the past decade

In the decade before the financial crisis the financial system grew dramatically in size, and its role and pervasiveness in the economy increased in comparable measure. Since the advent of the crisis, this process has not been interrupted but only slowed down. In the euro area, the total financial resources collected by the private sector (bank credit, bonds issued domestically and stock market capitalization) rose from 160 per cent of GDP in 1996 to 240 per cent in 2007, before slipping to 230 per cent in 2011. A similar pattern is found for the United States, where over those same years the ratio rose from 230 to 330 per cent and then declined to 260 per cent in 2011 (Figure 1). Driven by the revolution in information and communications technology and by the process of financial integration, there was a considerable expansion in the supply of derivatives products, the securitization of banks' assets, and so-called structured financial instruments. The total outstanding notional amount of over-the-counter and exchange-traded derivatives rose from about 94 trillion U.S. dollars at the end of 1998 to around 670 trillion dollars at the end of 2007 and has hovered around

Fig. 1 Size of capital markets (ratios to GDP)

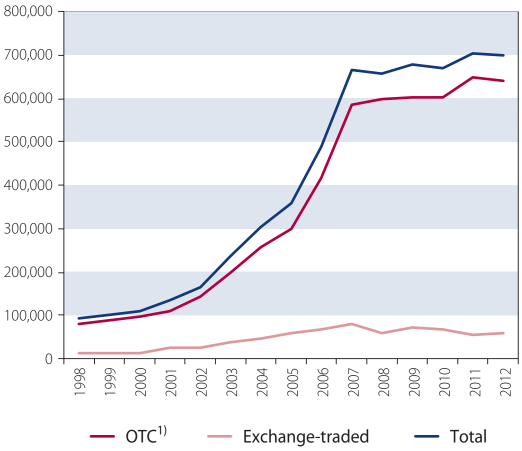


Sources: IMF International Financial Statistics, BIS, Datastream.

1 *I wish to thank Emidio Cocozza, Paolo Del Giovane and Valeria Rolli for useful discussions and assistance in preparing these remarks.*

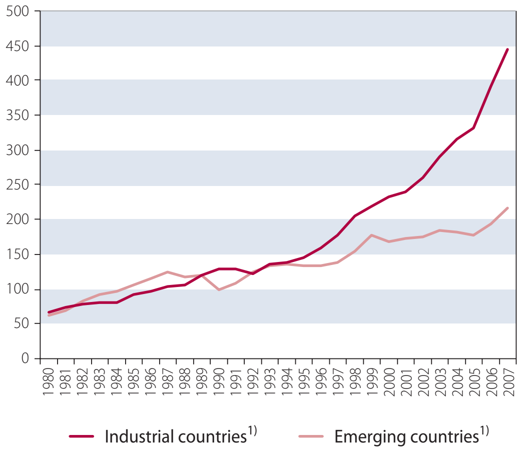
2 *I refer to the new Member States of the European Union in Central and Eastern Europe. I also consider Slovenia, Slovakia and Estonia, which joined the euro area in 2007, 2009 and 2011, respectively, insofar as the main focus is on international financial integration from the perspective of transition countries.*

Fig. 2 Notional value of over-the-counter and exchange-traded derivatives (outstanding amounts in billions of US dollars; end of year data)



Source: BIS Quarterly Review, March 2013.
1) OTC derivatives include credit default swaps, 2) Data as of June for 2012.

Fig. 3 Gross stocks of foreign financial assets and liabilities (sum of financial assets and liabilities in per cent of GDP)



Source: Our calculations based on Lane and Milesi-Ferretti database.
1) For each group, weighted average calculated using GDP weights.

that level since (Figure 2). An important aspect of this process has been international financial integration. In the last decade industrial countries' gross external financial assets and liabilities more than doubled in proportion to GDP, reaching 440 per cent at the end of 2007 (Figure 3).

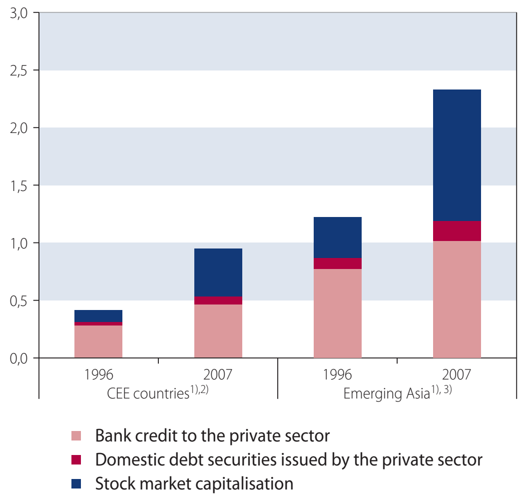
Financial market development in the emerging economies has also been dramatic. Total financial resources collected by the private sector (outstanding stocks of bank credit, domestic debt securities and equity market capitalization) increased from about 120 to 230 per cent of GDP between 1996 and 2007 for the emerging Asian economies as a group, and from about 40 to almost 100 per cent for the countries of Central and Eastern Europe (Figure 4).[3] International financial integration – with foreign direct and portfolio investment and the involvement of foreign banks in domestic financial systems – was boosted by the overcoming of a series of obstacles: macroeconomic instability, vulnerable external positions and inefficient institutional and regulatory setups. Since the mid-2000s, this process has been greatly furthered by exceptionally favorable global financial conditions, with abundant liquidity, low risk aversion, and falling long-term interest rates.

FINANCIAL INTEGRATION IN CENTRAL AND EASTERN EUROPE

The transition countries of Central and Eastern Europe were the recipients of a massive influx of capital from abroad, mostly from Western Europe. Between 2003 and 2008 capital inflows reached very high levels – averaging more than 12 per cent of GDP – compared with an average for the emerging market countries overall of about 6 per cent (Figure 5). The transition countries were perceived as attractive investment opportunities: the lure of potential high returns, underpinned by relatively low wages and capital-output ratios, was reinforced by the prospect of faster income convergence entailed by economic and institutional developments in the context of EU membership and expectations of rapid interest rate convergence in connection with the eventual adoption of the euro.

Financial integration in Central and Eastern Europe has been nearly unique. International banks played a fundamental role indeed in spurring financial integration. In the years running up to the global financial crisis, Western European banks expanded rapidly in the region, gaining substan-

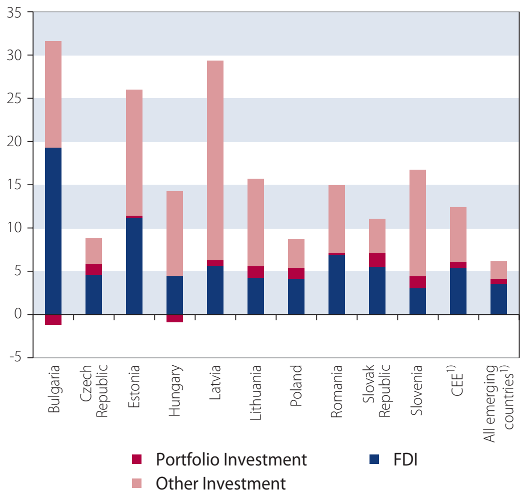
Fig. 4 Size of capital markets in selected emerging regions (ratios to GDP)



Sources: Our calculations based on data from BIS, IMF, national statistics and Datastream.
1) For each group, weighted average calculated using PPP shares of world GDP; 2) Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia; 3) China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

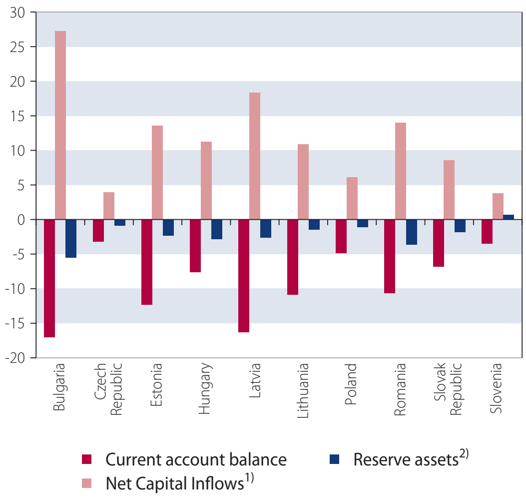
3 See V. Rolli, "New policy challenges from financial integration and deepening in the emerging areas of Asia and Central and Eastern Europe", Bank of Italy Occasional Paper Series No. 33, October 2008.

Fig. 5 CEECs: International capital inflows (2003-2008 average; as a percentage of GDP)



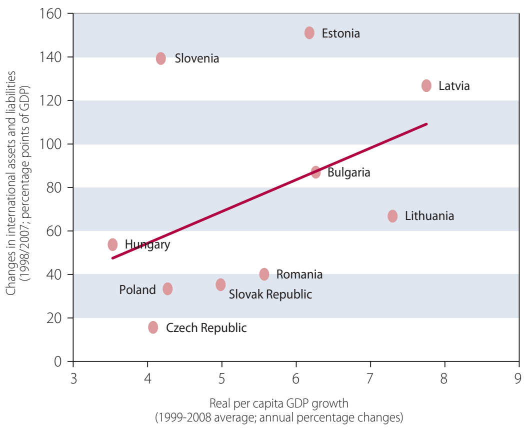
Source: Our calculations on data from IMF WEO database and national statistics.
1) For groups, weighted average calculated using GDP weights.

Fig. 7 CEECs: net international capital inflows (2003-2008 average; as a percentage of GDP)



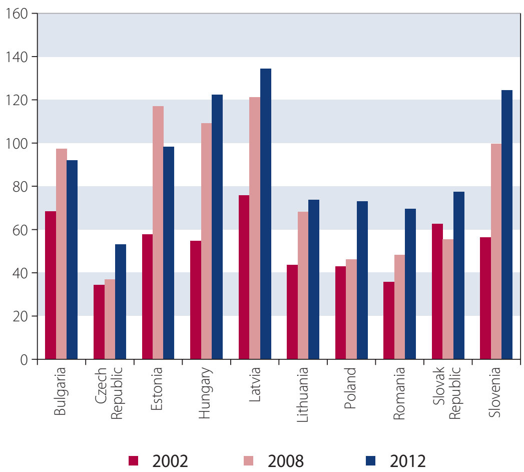
Source: Our calculations based on data from IMF WEO database.
1) Inflows – Outflows (excluding reserve assets); 2) A minus sign indicates reserve accumulation.

Fig. 6 CEECs: changes in international assets and liabilities versus real per capita GDP growth



Source: Our calculations based on Eurostat and Lane and Milesi--Ferretti database.

Fig. 8 CEECs: Gross External Debt (year-end stocks; as a percentage of GDP)

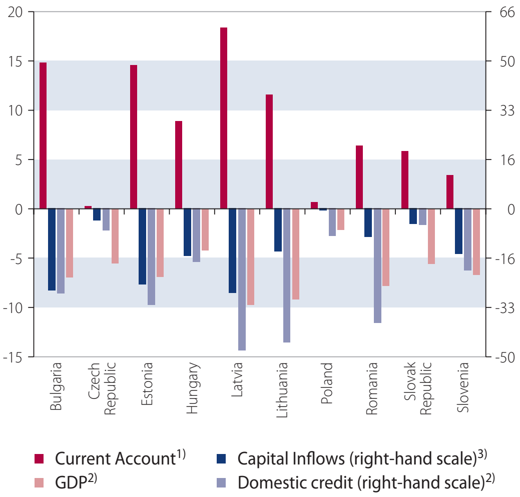


Source: Our calculations based on IMF WEO and Wold Bank database.

tial market shares through branches and subsidiaries; by 2008 they held as much as 80 per cent of total banking assets in these countries. The entry of foreign intermediaries with long-term strategic goals and the ensuing radical transformation of the ownership structure of banks in the CEE countries was a crucial element of discipline and stability in breaking the vicious circle of systemic crises and macroeconomic volatility that had marked the early years of transition. It is generally accepted that international financial integration has played a positive role in the long-term process of economic convergence in the CEE transition countries: long-term per capita GDP growth in the region before the crisis was positively correlated with conventional measures of financial integration, such as the ratio of gross foreign assets and liabilities to GDP (Figure 6). The evidence of this linkage in other emerging areas tends to be less clear-cut. The key extra contributing factor for the countries of Central and Eastern Europe may well be the interaction with institutional convergence implicit in the EU accession process. Thanks to this unique, favourable combination, presumably financial integration as such acted as a catalyst for the development of the domestic financial sector and the adoption of structural reforms to strengthen the institutional framework.

However, a balanced account of the process of financial integration in this region must not overlook such drawbacks as excessive, cheap lending, currency mismatches and demand overheating in the years running up to the crisis. Between

Fig. 9 CEECs: changes in selected variables before and after the last global crisis (2009-2012 versus 2003-2008 periods; as a percentage of GDP)



Source: Our calculations based on IMF WEO and International Financial statistics database.
1) Changes in average balances; 2) Changes in average annual growth rates; 3) Changes in average annual flows.

2003 and 2008, many economies recorded rapid import growth, real-estate bubbles and wage increases far outpacing productivity gains – sometimes rooted in overly optimistic expectations of fast income convergence. Inflationary pressures spilled over into the tradeable sector and cut into export performance. Balance-of-payments deficits on current account widened (Figure 7). Several countries accumulated large external debts (Figure 8), largely private and denominated in foreign currency, making them vulnerable to a reversal of the capital flow or depreciation of the currency. When the global crisis began to impact on these countries, there was a sharp decline in capital inflows and a consequent slowdown in bank credit (Figure 9).

Although there was concern over the possible meltdown of domestic financial systems driven by a rush of foreign banks to exit, a fully-fledged financial crisis along the lines of that in East Asia in 1997–98 did not materialize. Overall, during the first phase of the crisis, the reversal of capital flows was actually less severe than in other emerging areas. In some cases (Hungary, Latvia and Romania) substantial financial support from the EU and the main international financial institutions was crucial to avoiding the worst; coordination between home and host country authorities, international financial institutions and multinational banks, in the context of the Vienna Initiative, also helped prevent the sort of collective action problems that could have triggered the feared massive withdrawal of foreign banks.[4] There is evidence that the foreign banks that participated in the Vienna Initiative were relatively stable lenders.[5]

Moreover, the distinctive model of financial integration in Central and Eastern Europe – where foreign banks operate mainly through local subsidiaries and branches in the retail market – evidently offered a high degree of risk-sharing and stability during the crisis, as parent banks tended to be less sensitive to information asymmetry and counterparty credit risk and more committed to long-term market prospects, given the important sunk costs of their in-country structures. This compares favourably with the dominant pattern in the other EU countries, where external borrowing by domestic banks is mainly in cross-border wholesale markets.[6]

The differing intensity of the boom-bust cycle in the various CEE countries suggests that apart from the influence of specific structural features (such as differences in starting income levels, international trade and financial links), domestic policy had a role, although capital inflows of the magnitudes observed in the region in the run-up to the crisis would certainly have strained any toolkit available to national policy makers.

Monetary and exchange rate regimes probably played a critical role in determining each country's ability to counteract the effects of capital inflows: the internal and external imbalances of the fixed- and floating-exchange-rate countries differed in size.[7] The countries with fixed-exchange-rate regimes had sharper credit booms, higher inflation rates and larger current account deficits than the floating-rate countries, on average. Yet the contribution of the exchange rate regime remains an open issue; the question is whether the more extreme boom-bust cycle was driven mainly by the fixed exchange regime as such or rather by the inconsistency of the overall policy mix in countries where this setting was in place; in particular, a stricter fiscal stance and a better macroprudential policy framework might have at least partly compensated for the absence of exchange rate flexibility.

As for monetary policy, the experience of the CEE countries appears to confirm that it is a less effective lever for restraining credit booms in small, financially open economies. This is the case even for floating-rate regimes, as a number of factors – currency substitution in the form of balance-sheet effects associated with initial high euroization, or the shift to foreign-currency-denominated lending – could undermine or even reverse the intended effect of monetary tightening.

This underscores the importance of maintaining a prudent fiscal stance during credit booms. Actually, in the years preceding the crisis headline fiscal positions in most CEE countries were broadly balanced, but in many cases this was the result of exceptional revenues associated with cyclical demand and asset price booms. Adjusted for these factors, the underlying fiscal positions looked much less healthy. With hindsight it is easy to recognize the need for a conservative approach in evaluating tax revenues during booms, and the useful role of automatic stabilizers (particularly income taxes and welfare spending) in increasing fiscal policy flexibility and attenuating economic fluctuations.

4 The "Vienna Initiative" brought together systemically important cross-border banks, home and host country authorities, and international financial institutions to produce a coordinated response to the crisis. The banks pledged to their continuing commitment to the region, and in the case of five countries with IMF-supported programmes (Bosnia Herzegovina, Hungary, Latvia, Serbia, and Romania) the parent banks pledged to maintain their exposure.
5 See R. De Haas et al., "Foreign banks and the Vienna Initiative: turning sinners into saints", EBRD, Working Paper, No. 143, March 2012.
6 See B. Cœuré, "International financial integration and fragmentation: Drivers and policy responses", Conference organised by the Banco de España and the Reinventing Bretton Woods Committee, Madrid, 12 March 2013.
7 In the period before the crisis, Bulgaria, Estonia, Latvia and Lithuania adopted hard pegs to the euro; Slovenia followed an intermediate crawling-band regime; the Czech Republic, Hungary, Poland, Romania, and the Slovak Republic were floaters.

8 For an analysis, see my lecture: "The Financial Sector After The Crisis", Imperial Business Insights - Imperial College, London, 5 March 2013.

In addition to the standard macro policy tools, CEE countries also took a wide range of prudential actions before the crisis. Prudential instruments can prevent or contain systemic financial risk in upswings (by affecting the incentives associated with asset price booms, foreign exchange lending, excessive risk-taking and the erosion of lending standards) and can also build buffers to cushion the impact of downturns. In general the evidence is that these measures produced the intended effects in the short run but sometimes failed to have a lasting impact on credit dynamics. In some instances, in fact, circumvention of the prudential intervention through direct cross-border financing and/or lending from unregulated, non-bank financial intermediaries proved to be a major issue; this was the case with direct limits on credit growth. A more effective role in containing systemic financial risks was played by measures specifically devised to build liquidity and loss-absorbing capital buffers, such as reserve and capital requirements. And when they were appropriately formulated, prudential regulations helped to curb the growth of foreign exchange loans and to keep default rates lower during the crisis.

Lessons learnt from the global crisis: in search of better regulation

Global financial deepening and international integration have resulted in greater risk sharing and made finance accessible to more countries, households and firms, thus proving instrumental in broadening economic development. But an interlinked and more closely connected financial system heightens the risks of contagion. Most importantly, the crisis has shown that market participants were not capable of mastering the inherent complexity of the system that they themselves had developed. And it has highlighted the shortcomings of the idea that self-regulation and market discipline are sufficient to ensure stable financial systems. In this regard, accepting the concept of benign neglect was a critical mistake on the part of regulators. Rather, financial regulation and supervision have to keep pace with developments in the financial industry. Moreover, national authorities need to be aware of the risk that their powers may become narrow compared to the sphere of influence of the global financial players. The coordination of financial supervision across countries and across sectors is a key condition for the stability of the global financial system.[8]

A major effort is required at the national but especially at the international level to strengthen the regulatory and supervisory framework. At the international level, under the political impulse of the G-20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision have introduced substantial regulatory changes to prevent new financial crises and enhance the resilience of economic systems. Much has been already achieved. The quantity of capital that banks need to hold has been significantly increased and the quality enhanced, in order to ensure that they operate on a safe and sound basis. International standards for bank liquidity and funding have also been instituted to promote the resilience of banks to liquidity shocks. Initiatives have been taken to strengthen the regulation of the OTC derivatives market, aimed at reinforcing market infrastructures, in order to minimize contagion and spill-over effects among today's more closely interconnected players. But further progress in important areas is needed, in that bank capital and liquidity regulation must be accompanied by improvements in internal risk control arrangements and actions aimed at correcting the incentives for excessive risk-taking.

What is more, it is indispensable to level the playing field, since when a country relaxes the rules in order to attract financial intermediaries it generates negative externalities for other countries. The transition to a uniform system of rules and financial oversight must be hastened. In the euro area, and in the European Union at large, the plan for a banking union is ambitious, to be sure, but this is the direction in which to move. Among other things, it would limit regulatory arbitrage, help remove national bias in supervision, and reduce the phenomenon of "regulatory capture" by powerful cross-border banks, while at the same time reducing compliance costs for cross-border banks and enhancing the functioning of the single market for financial services. The planned European banking union would also benefit the economies of Central and Eastern Europe. It would work against the fragmentation of the European financial markets along national lines and – by enhancing the financial resilience of the euro area – it would reduce the risks of negative spill-over effects to the CEE banking systems.

In conclusion

The recovery of the CEE economies remains fragile. With few exceptions, output, held back by debt overhang and direct and indirect exposure to the eurozone debt crisis, has not yet regained pre-crisis levels. Import demand from the euro area remains at depressed levels. And although financial conditions have improved since the end of 2011 they remain volatile. Bank credit dynamics remain weak, reflecting subdued domestic demand and a large volume of non-performing loans. The banking systems of most of these countries remain well capitalized, however, and are consequently in a position to withstand the lingering deterioration of their asset quality.

The financial legacy of the crisis will not be short-lived. The evolution of the international banking sector in the coming years will continue to shape financial conditions also in the CEE countries. The regulatory and supervisory responses adopted at global level will imply more stringent capital and liquidity requirements. In response to these more demanding rules, as well as to spontaneous market forces, international banks are adapting their business strategies, unwinding unsustainable pre-crisis practices and shifting to longer-term sources of funding. In this context the main European banks with large stakes in the CEE markets are gradually going over to more decentralized business models, in which subsidiaries will have to rely more heavily on local sources of funds and set their lending conditions accordingly. Orderly and even desirable for the resilience of the global financial system as this process may be, it could also put significant pressures on emerging countries that are highly dependent on external financing owing to underdeveloped domestic financial systems and structurally low national saving rates. Indeed, this calls for decisive reforms to bolster the development and deepening of local money and capital markets, including the issuance of bonds denominated in local currency. The process will be lengthy and complex, requiring a suitable legal framework, adequate infrastructures, a large institutional investor base, stable macroeconomic conditions and predictable policy-making, as has been demonstrated by the extensive analysis conducted and the guidelines then issued by the Bank of International Settlements (BIS), the World Bank and the G20.[9] Several of these conditions have already been achieved in the process of integration in the EU.

Against the backdrop of this changing financial environment, one risk is that, arguing the need to preserve domestic financial stability, national regulators could adopt ring-fencing measures, hampering the smooth functioning of the EU single market. As the long-term benefits of free capital mobility and international financial integration remain substantial, averting this risk requires that the EU institutions, notably the European Commission and the European Banking Authority, play a greater role in monitoring these measures and enhancing coordination among national regulators, in order to avoid the fragmentation of the European financial markets.

9 See: BIS Committee on the Global Financial System: "Financial stability and local currency bond markets", CGFS Papers, No. 28, June 2007. See also the "G20 Action Plan to Support the Development of Local Currency Bond Markets", November 3-4, 2011.