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WILL WESTERN EUROPEAN BANKS PULL OUT OF CENTRAL AND EASTERN EUROPE?

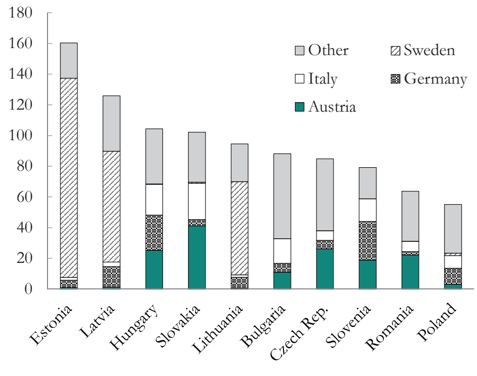
The current financial turmoil raises concerns about supportiveness of foreign banks from Western European countries for their Central and Eastern European subsidiaries. Foreign bank presence dominates banking business in almost all countries in the region, which would make their withdrawal very painful, if not catastrophic. For Austrian and Swedish banks, this region was a source of large profits in the last years, and, therefore, they are expected to stay in the region. While recognizing individual strengths and weaknesses of each country, such strong interconnectedness calls for a region wide approach for helping ailing banks.

Have foreign banks made the region more vulnerable?

During the last fifteen years, the banking markets in Central and Eastern Europe (CEE) have been liberalized, which has led to an unprecedented increase in the presence of foreign banks.[1] These banks have entered by first establishing greenfield institutions, but have afterwards acquired existing domestic banks during the privatization process. In 2008, the average foreign bank ownership in CEE amounted to 75 percent of the total banking assets, whereas in Estonia and Slovakia, this ratio reached 100 percent. Additionally, these banks have extended cross-border loans directly from parent banks to borrowers in host countries. As a result, the presence of foreign banks is overpowering and in a number of countries, the total foreign liabilities (local claims of foreign subsidiaries plus cross-border loans) vis-à-vis Western European banks surpass 100 percent of GDP (Estonia, Latvia, Hungary and Slovakia). Figure 1 illustrates tight links between Baltic States and Sweden, and also shows that Austrian, Italian and German banks have massively invested in the rest of the region.

The entry of foreign banks has been widely advised by international institutions and its consequences have been rather positively evaluated by economists. Foreign investors have recapitalized the acquired institutions and have transformed them into efficient and profitable banks with modern risk management practices.[2] Due to their superior access to international capital markets, they have contributed to the

Figure 1 – Foreign claims of western banks on new EU member states by bank origin December 2008, in % of GDP of host countries



Source: BIS Consolidated banking statistics (preliminary), April 2009.

1. Central and Eastern Europe includes the following counties: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey, Ukraine. We also talk about new EU member states or CEE10, which include Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.
2. O. Havrylchyk & E. Jurzyk (2008), "Inherited or earned? Performance of foreign banks in Central and Eastern Europe", *CEPII Working Paper* No. 16.

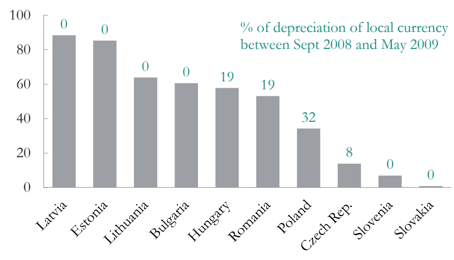
higher supply of credit, making it less sensitive to idiosyncratic shocks. Finally, there have been positive spillover effects on the remaining domestic banks[3].

Moreover, it has been a win-win situation as foreign banks have succeeded to earn higher profits in this region than in their home countries due to relatively underdeveloped local banking markets and large opportunities for market growth.[4] Many Austrian and Swedish banks, such as Raiffeisen Bank, Erste Bank, Osterreichishche Volksbanken, Bank Austria and Swedbank, earned more than thirty percent of their total pre-tax profits in this region despite the fact that their CEE exposure constituted a significantly smaller part of their total assets. Even such large and diversified banks as Société Générale and Commerzbank earned more than 10 percent of their profits in CEE.

Better access to foreign funding has allowed a faster loan growth, which made possible new investment by local firms and increased consumption by local households. Financial deepening is theoretically associated with faster economic growth, but when claims on private sector increase from 13 to 72 percent of GDP within 7 years, as is the case of Ukraine, we can rather talk about a lending bubble which is hardly sustainable. During such periods, lending standards diminish, increasing the default risks in the future. Banks become particularly vulnerable if loans grow faster than deposits, which was the case in Baltic States, Ukraine and Russia, where the share of local loans covered by local deposits is currently less than 60 percent. The rest of loans is covered largely by cross-border loans or bonds issued at international capital markets. Such strategy rendered these countries particularly vulnerable to the economic situation in the home countries of parent banks and to loyalty of these banks to continue lending to their subsidiaries in the time of the crisis.

Foreign banks also contributed to vulnerability of the region by extending large amount of credit in foreign currencies. High lending rates for loans in local currency motivated households and enterprises to borrow in foreign currency, which was a particularly attractive option as local currencies appreciated. In fact, the fast credit growth of the last years was only possible due to availability of foreign currency lending, because there was less demand for local currency loans. Except for new Euro area members (Slovakia and Slovenia) and Czech Republic where this practice was less widespread, all countries in the region are affected (Figure 2).[5] The problem is aggravated in Hungary and Poland, where most foreign currency loans were not even issued in Euros (which is partly rational in light of eventual accession of these countries to the euro area), but in Swiss francs and

Figure 2 – Share of foreign currency loans (December 2008, in %)



Source: Central Banks.

Japanese yen in order to benefit from even lower money market rates!

Large depreciation of CEE currencies, particularly Polish zloty, Hungarian forint, Romanian lei and Ukrainian hryvna have dramatically increased the repayment burden for households, that mostly receive income in local currency. This effect should have been partly offset by lower money market rates, such as CHF LIBOR and EURIBOR, to which many loans were linked. However, most banks were reluctant to pass on lower interest rates because their funding costs increased due to higher risk premiums. A large share of foreign currency loans also explains why countries with fixed exchange rates (Baltic States and Bulgaria) resisted devaluation of their currencies at the cost of depleting their foreign currency reserves.

Despite the above discussion, it would be incorrect to blame only foreign banks for contributing to fragility of the banking systems in CEE. Lax lending conditions and low interest rates in the whole world have led to higher foreign liabilities of domestic banks as well. Moreover, local supervision authorities should have intervened because lending in foreign currencies does not just increase credit risk, but interferes with monetary policy as well, since demand and supply of loans does not react to local interest rates.

It is difficult to obtain a counterfactual for the presence of foreign banks in most CEE countries and to know what would have happened if domestic banks had not been acquired by foreign investors. However, the experience of countries with comparable shares of foreign and domestic banks, like Ukraine, shows that foreign bank presence still had a stabilizing effect on the banking sectors. In fact, the only banks which suffered massive withdrawal of deposits after the beginning of the crisis were domestic banks in Ukraine and Latvia. In addition, foreign banks continued to benefit from higher ratings of their parent institutions and their financing conditions deteriorated less than those of domestic banks.

3. M. Giannetti & S. Ongena (2008), "Lending by Example: Direct and Indirect Effects of Foreign Banks in Emerging Markets", *CEPR Working Paper* 6958.
4. O. Havrylchyk & E. Jurzyk (2005), "Profitability of Foreign and Domestic Banks in Central and Eastern Europe: Does the Mode of Entry Matter?", CEPII *Working Paper* No. 21.
5. Before entering the eurozone, Slovakia and Slovenia also had 19 and 58 percent of their loans denominated in foreign currency, mostly in Euros.

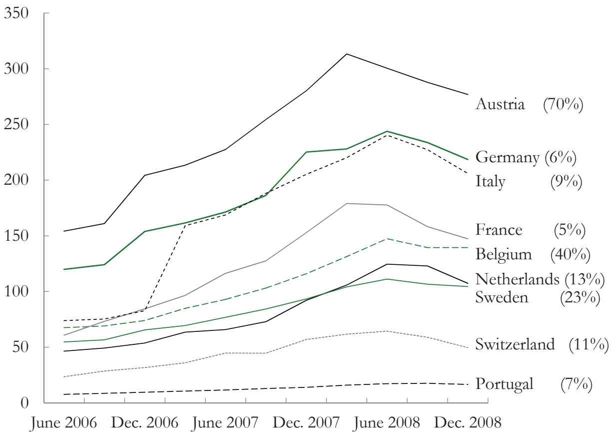
Reduction in CEE exposure: sharp but sill moderate

The crisis has incited a vibrant debate about whether foreign banks will withdraw from CEE, which they could do for two reasons. First of all, they experience financial problems in their home countries and have fewer resources to devote to their subsidiaries and branches abroad; we have already witnessed an example of Bank of America and Royal Bank of Scotland that had sold their stakes in Chinese banks. Second, CEE countries have been badly hit by the crisis due to their export oriented economies and large reliance on foreign capital.

Not all Western European countries have the same level of exposure to CEE economies. With USD 277 billion of foreign assets, Austria has the largest absolute exposure, as well as relative one to its GDP (70%) (Figure 3). Smaller but still considerable exposures are faced by Belgium and Sweden. While Germany and France hold large absolute amounts of foreign assets in CEE, their exposures amount to around 6 percent of their GDP. Between June and December 2008, foreign assets of western banks in CEE have declined by 11%. Countries that are the most exposed to the region have experienced the smallest declines in their total foreign assets (Austria -8%, Belgium -5%, Sweden -6%), whereas countries with relatively small exposures, such as France, have seen the largest falls (-17%).

Table 1 presents the evolution of foreign claims of western banks on CEE, Asian and Latin American countries between June and December 2008. Central and Eastern Europe has experienced a decline of USD 210 billion in foreign liabilities,

Figure 3 – Foreign claims of banks in nine Western European countries on CEE economies (in billion of USD)



Note: The share of foreign claims in source country GDP is put near country name (in parenthesis).
Source: BIS Consolidated banking statistics (preliminary), April 2009.

12% of its total amount in June 2008, which is relatively less than in other developing countries (17%). The main reason for this is the total dominance of foreign banks in CEE economies, whereas domestic banks continue to play main roles in Asia and Latin America (90% and 60% of their total banking assets). This difference has two main consequences. First of all, local foreign claims are less volatile because they are primarily financed though local deposits, protected by generous deposit insurance and therefore not likely to be withdrawn.[6] In fact, the largest part of decline in local claims could be explained by the depreciation of local currencies. For example, if we consider new EU member states with fixed exchange rates we observe that local claims declined by only 1.6 percent.[7] Second, large part of cross-border loans in CEE is extended by foreign parent banks to their subsidiaries, which are less volatile than borrowings of domestic banks in Latin America and Asia from international banks. This explains why the decline of cross-border claims of western banks in CEE is less pronounced than in other regions (13% vs. 24% in Asia and 16% in Latin america).

Table 1 – Foreign claims of western banks on CEE, Asia and Latin America (in December and change between June and December 2008)

		CEE	CEE10	Asia	Latin America
Foreign claims in December 2008	bn USD	1 580	1 020	1 225	865
Change between June and December 2008	bn USD	-210	-116	-256	-181
	%	-12	-10	-17	-17
Local claims	%	-10	-9	-10	-19
Cross border claims	%	-13	-11	-24	-16
Share of cross-border claims	*%*	*42*	*34*	*47*	*31*

Source: BIS Consolidated banking statistics (preliminary), April 2009.

In CEE, most western banks' affiliates have legal status of a subsidiary, meaning that parent banks are not obliged to bail them out. Still, there are good reasons to believe that western banks would do their best to keep their subsidiaries for a number of reasons. Entry costs to banking markets are very high and it would be difficult to return to the abandoned markets. We have seen that CEE subsidiaries have turned out to be quite profitable in the past and western banks are unlikely to want to bite a hand that feeds. This is particularly true for smaller banks that have large exposures relative to their size, such as Austrian and Swedish banks. These banks have a comparative advantage over banks from other countries to lend to CEE and Baltic states due to their close cultural and economic links as well as similar legal environment. These considerations, for example, explain why in the wake of the Argentinean crisis, Spanish banks had more incentives to stay than banks from other regions. Therefore, we can

6. Since the beginning of the crisis, most of new EU member states have raised their deposit insurance to 50 thousand euros, while Lithuania introduced the coverage of 100 thousand euros, and Slovakia, Slovenia and Hungary – unlimited coverage.
7. Here we consider countries with fixed exchange rates (Bulgaria, Estonia, Latvia, Lithuania) and new members of Euro area (Slovakia and Slovenia).

conclude that foreign banks would not leave this region in order to reallocate to a different one, but only if they decide to withdraw from emerging markets altogether.

Despite good reasons to stay, the level of lending by foreign banks is going to continue to decline. In the wake of the Asian crisis, foreign exposure to that region has dropped by 3% in the first half a year and by 20% in one year. We see that the initial reaction to the current crisis is faster, but even if we assume an Asian scenario, we can expect to see additional USD 148 billion to be withdrawn from the region within one year.[8] However, the impact on the local economies should be relatively even more catastrophic because foreign funding plays a much bigger role in CEE economies than it did in Asia. If decline of 20% of foreign liabilities represented 5.6% of Asian GDP, it would correspond to 15% in new EU member states. It should also be reminded that one of the consequences of the Asian crisis was to promote the entry of foreign banks via acquisition of local affiliates, which was seen as a guarantee against future problems with rollover of cross-border loans. The present crisis will show whether such thinking is going to pay off and whether foreign banks are really more loyal to those countries in which they have larger local presence.

Policy measures

Given vulnerability of banks in CEE to withdrawal of foreign funding and fragility of their loan portfolios, there is a need to discuss potential rescue packages. The lack of internal resources calls for international support packages for possible recapitalization of banks and macroeconomic stabilization. The EU Commission facility for non-Euro area EU members has been doubled and currently amounts to EUR 50 billion. However, Austria, Hungary and EBRD have been very vocal in advocating a package in the range of USD 150-230 billion, which is comparable to USD 210 billion which have been so far withdrawn from the region. Despite the numerous demands for the regional rescue funds, this idea was rejected by EU leaders at the summit on 1 of March, which instead emphasized a "case-by-case" approach in order to differentiate between weaker (Hungary, Latvia and Ukraine) and stronger CEE countries (Czech Republic, Poland, Slovakia and Slovenia). The absence of an active EU support has placed IMF in the center of rescue operations in the region. USD 75 billion of its financing has been already extended to Hungary, Ukraine, Latvia, Serbia, Romania, Moldova, Belarus, and Poland. The EU Commission facility for non-Euro area EU members has augmented the above amount to Hungary, Latvia and Romania by EUR 14.6 billion, but only after the disbursement decision of IMF.

Another issue that is hotly debated is the adoption of Euro by some of the new EU member states. This would alleviate the problem of debt in foreign currencies and a number of economists agree that faster entry into Euro area would be particularly beneficial for small open economies, like Baltic ones, whereas flexible exchange is better suited for larger economies like Hungary and Poland. The officials of IMF have also proposed that the adoption of Euro should be viewed as a potential strategy for CEE countries in case of their economic collapse. The ECB has strongly rejected any such possibility by stating that countries should meet all entry rules before entering the Euro area in order not to undermine the credibility of the Euro. While the stance of ECB is well grounded, it is regrettable that there are few discussions about a new roadmap for the entry of these countries to Euro area.

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8. We arrive at this number by assuming that foreign assets should decline by 20 percent from their amount in June 2008 and then by subtracting the realized fall of USD 210 billion which took place between June and December 2008.

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