Into the Void

Governing Finance in Central & Eastern Europe

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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 (hereafter referred to as CEE) are now members of the European Union; some have even adopted the Euro. Their readiness to open their borders to foreign capital and their faith in the viability of market self-governance as well as supra-national governance of finance is both remarkable and almost unprecedented: Virtually no other regions in the world have tolerated foreign dominance of their domestic banking sectors. The eagerness of the countries in CEE to politically and financially join the West and to become part of a regional and global regime as a way of escaping their closeted socialist past has both benefitted and harmed them. There is little doubt that joining the EU and opening to the rest of the world has helped transform these economies at a pace that otherwise would have been unthinkable; yet, as the global financial crisis reveals, these countries have also remained exceptionally vulnerable to upset, including those that originate beyond their immediate sphere of influence. This paper seeks to explain why that is. It looks for answers in the governance of finance, i.e. the allocation of de jure and de facto responsibilities for financial systems. The paper argues that countries in CEE have largely relinquished policy tools that would allow them to protect their economies and societies against a financial melt down or to respond effectively in a crisis following such a meltdown. The actual policy choices they made were aimed at integrating them into the European and the global financial system. A frequently overlooked side effect of the cumulative effect of these policies has been that they find themselves once more on the periphery—dependent on the goodwill of multilateral organizations over which they have little sway.

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I. 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 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 (Rostowski 1995; Buch 1996; 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 (Mayer 1998; Allen and Gale 2001). 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,[2] crisis management is viewed as an integral part of the governance of finance; it shapes the future behavior 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 ofsetting 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

[2] Clearly, this has not been a core assumption of standard finance theory. See, however, Minsky (1986); see also (Sornette 2004).

all-encompassing "whatever it takes"[3]—a commitment that is more appropriately labeled as "ultimate guardian". Using the guardian metaphor also emphasizes that crisis management is not about the 'bail out' of individual banks or other intermediaries, but an attempt to prevent a collapse of the financial *system*. Theoretically it is conceivable that a private organization (i.e. another powerful financial intermediary) could assume the role of ultimate guardian, however, the more typical candidates are domestic governments, foreign governments [including more recently Sovereign Wealth Funds, see (Pistor 2009)], or supranational organizations, such as the IMF or some coalition among them. The reason that these organizations are likely to assume the role of ultimate guardian is that they are more likely to have access to the resources needed for a large-scale rescue. They also tend to have broader social objective functions than most private actors, enabling them to mobilize resources for the 'common good'.

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 regional or global governance regimes

[3] Emund L. Andrews, "Fed will do everything possible" to meet crisis, Bernanke says", The New York Times, 19 February 2009, available at www.nytimes.com.

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 not match against the scale of private funds that had earlier flooded their economies.

An argument could be made that these countries are ultimately better served by outsourcing the governance of finance—including the role of the ultimate guardian. There certainly are ample examples of countries outside Europe that proved unable to protect themselves against major financial crises. Mexico's Tequila crisis of 1994, the East Asian Financial crisis of 1997/98, and the crisis in Argentina in 2001 serve as powerful examples. Although these countries were not part of an evolving regional governance structure, the strategies they pursued in their quest to join the global financial—namely financial liberalization and financial deregulation—resemble those of the countries in CEE. The countries in CEE may have been motivated to proactively relinquish governance over their financial systems in favor or 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, even though they take part in the collective governance of the European Central Bank (ECB) (Zilioli and Selmayr 2001). In addition, the policy advice given to political leaders in the former socialist world regarding the benefits of financial liberalization were motivated by a desire to protect their economies from undue political interference and thereby promote prosperity (Worldbank 1995, 1996; Barth, Caprio, and Levine 2004).

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 ultimate guardians 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 but other emerging markets as well were advised to pursue the process of integrating their economies into the global financial system.

This paper argues that the financial transformation in CEE countries has created a governance void for individual countries and for the region as a whole, leaving them unable to control the risks associated with exposure to greater capital flows. When their financial systems found themselves on the brink of collapse this left them dependent on the IMF, the EBRD, and other multilaterals as ultimate guardians. The causes for this void lie in policy decisions aimed at integrating the CEE economies as quickly and as completely possible into the European and global systems at a time when the governance regime for these supra-national systems remained incomplete and tilted in favor of interests that—as has become evident in the crisis—were not fully aligned with the CEE countries' welfare objectives.

This paper is organized as follows. Part II develops the concept of the ultimate guardian and explains its role as an integral part to the governance and operation of financial markets. It also identifies the ultimate guardian(s) of finance for CEE countries based on the crisis experience. Part III uses the credit boom that swept CEE economies in the years preceding the crisis to show that extensive foreign ownership combined with governance regimes that effectively outsourced governance of finance left domestic policy makers with few—if any—effective tools to protect their economies against the risks associated with a credit boom or respond effectively once the crisis had materialized. Part IV considers governance options available to countries in the region. Part V concludes by highlighting implications of this analysis for the governance interdependent financial systems.

II. 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 Encyclopedia Britannica defines 'finance' as "the process of raising funds or capital for any kind of expenditure",[4] explaining that some need more money today than they have on hand while others have excess money that they can invest and 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

[4] See www.britannica.com under "finance".

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. In fact, empirical evidence suggests that the frequency, if not severity, of financial crises has increased in recent times notwithstanding major improvements in the legal governance of financial commitments (Bordo et al. 2001). A possible explanation is that every new legal tool designed to contain risk invariably gives rise to strategies aimed at circumventing it. Given the stakes involved, regulatory arbitrage is part of the game, thus, the legal governance of finance will always remain incomplete and thus susceptible to failure (Pistor and Xu 2003). Even a perfect legal system could not guard against wide spread default resulting from broadly shared misjudgments about the future——not only because the future is difficult to predict, but also because collective denial about the sustainability of certain strategies are 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 —

whether an increases or a decrease—can destabilize a financial system however well designed laws and regulations might be. The sources of money supply are multiple; these include 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, bringing down with it the entire economy as has happened during periods of hyperinflation (Germany in the aftermath of World War I; or Zimbabwe in the 2000s) or in financial crashes following a asset booms and busts associated with major credit expansion (as in the Great Depression in the US, or in Argentina in 2001).

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 worlds – the Financial Sector Assessment Program (FSAP).[5] 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 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, policy makers 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

[5] See http://www.imf.org/external/NP/fsap/fsap.asp for details.

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 behavior 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 fulfill 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 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 indispensible 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 bail out 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.

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[6]), 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,

[6] Prisoska Nagy, "BIS Data on Cross-Border Flows – A Closer Look", EBRD blog, 11 May 2009, available at www. ebrdblog.com

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. The EBRD has also taken measures to stabilize individual banks; an example is a $75 million loan granted to Raiffeisenbank Aval–the Ukrainian subsidiary of Raiffeisen International Austria. 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 signaled 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.

III. Into the Void

The ability to perform the role of ultimate guardian for a financial system is ultimately revealed in the context of a crisis. Yet, it is shaped by policy choices that precede it. This section will review some of these choices and highlight how they have affected the ability of countries in CEE to perform their role as ultimate guardians to their own financial systems.

As has been pointed out in the previous section, an effective governance regime for finance has to address both the credibility and money supply aspects of finance due to the fact that credibility problems are capable of affecting the supply side, and conversely, that the supply side can affect credibility. 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 (Worldbank 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.[7] 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.[8] 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

[7] A model law on secured transactions for the region was published as early as 1994. See http://www.ebrd.com/pubs/legal/secured.htm.
[8] For recent FASP reports on individual countries, see http://www.imf.org/external/NP/fsap/fsap.asp.

background, the rapid expansion of credit most countries since the late 1990s was regarded as a positive response to the institutional reforms that had been implemented (Cottarelli, Dell'Ariccia, and Vladkova-HOllar 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, they now reached, if not exceeded, these comparative benchmark data.[9] What was remarkable was the speed with which these changes occurred. Within a period of only 5 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 percent and in Hungary, Romania and Croatia the average annual credit growth was over 10 percent. In Slovenia, the average was around 10 percent. Only in Poland, the Czech Republic and Slovakia had credit growth been below 5 percent 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 et al. (2007), "at the end of 2006, the annual growth rates of credit to the private sector ranged from 17% to 64% in the countries covered in this study", namely Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.[10] 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

[9] This has been the case in Bosnia-Hezegowina and Croatia. See Figure 2.6 in (Arcalean et al. 2007) at p. 22.
[10] In the United States, a country with a much larger and deeper financial system, credit extended by commercial banks grew by about 11 percent in 2006. See Board of the Federal Reserves, Monetary Report to Congress, 19 June 2006, at p. 22.

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 et al. (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.[11] While some countries appear to have had temporary success in at least 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, which incurred in two waves. 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.

[11] 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. These items are not included in the review of policy tools available to CEE countries, because hedging and derivative instruments did not play a major role in the credit boom in CEE. Neither shall the policy response of "promotion of better understanding risks" be analyzed in detail as country reports indicate that 'moral suasion' to tame the credit boom proved – perhaps not surprisingly – ineffective. See the country reports in Enoch and Ötker-Robe (2005).

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 on policy choices imposed by EU law are plenty.[12] 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.[13]

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 et al. (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).[14] Other countries had their hands bound by pegging their exchange rates or using currency board arrangements that

[12] Appendix 1 lists the policy menu compiled by Hilbers et al. (2005) and identifies legal constraints under EU law

[13] The ECB convergence reports are available at http://www.ecb.int/pub/convergence/html/index.en.html

[14] The ECB 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-interprete the results in light of Poland's convergence process. See (ECB 2008)

required a tight exchange rate management. Among the various macroeconomic tools for taming the credit boom, this left them only with fiscal policies (Hilbers et al. 2005 at 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) are 'soft law' and as such not legally binding. In contrast, an 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 coordination within a three level system within the EU.[15] 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, conducing peer review and involving the financial industry through consultation

[15] 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 f irms and credit institutions (recast), 30 June 2006, OJ L 177/201.

processes, CEBS also functions as mediator in disputes between home and host country regulator (Vander Stichele 2008).

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 leaves key decision-making 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 channeling 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 percent 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 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.[16] 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.[17] 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.[18] Home country regulators of the subsidiaries shall consult and coordinate with host country regulators. This division of labor 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 favor comprehensive

[16] ECB report
[17] See Arts. 129 of Directive 2006/48 op cit at [].
[18] See Art. 129 Credit Institution Directives 48/2006 EC.

delegation of supervisory powers to the parent's home country regulator.[19] 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 percent in Slovenia to a high of 98 percent in Estonia (ECB 2005). Only in Estonia and Latvia (47 percent) is the asset share below 50 percent. In comparison, in Latin America the asset share of foreign-owned banks is, on average, 45 percent. Only New Zealand and Botswana have financial systems that are dominated by foreign owners to an extent that matches the countries of CEE. The financial systems of CEE countries thus 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 favorably, as they positively affected the growth of 'their' institutions. 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

[19] See comments by the Federation of European Banks (FEBS) on the home-host-country guidelines issued by CEBS. [ADD LINK]

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, 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 form 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 percent on average and in Bulgaria and Romania (both of whom joined in 2007) by 50 percent. As it turns out, most of the borrowers in CEE countries were leasing companies affiliated with the same banking group that owned one ore more bank subsidiaries in the same country; the critical difference is that as leasing companies rather than banks they escaped regulations CEE countries sought to impose on their domestic banks to country the effects of an accelerating credit boom[20]: 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 percent 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.

[20] See (ONB 2009): "… the share of recipient *intra-group* FIs increased from 65% to more than 70% of total direct credit to FIs. These growth rates are inter alia due to the growing importance of leasing firms affiliated with Austrian firms."

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 on all accounts, 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). In fact, this counter-cyclical cross-subsidization has helped 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.[21]

[21] Prisoska Nagy, supra note [].

IV. 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. 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,[22] Sweden, and Belgium. 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 countries with different banking structures 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

[22] As a result of Unicredit acquiring the Austrian Bank Creditanstalt.

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.[23] In such a conceptualization there is no 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[24] ranging from 48 percent in Poland to 99 percent in Estonia (Uhde and Heimeshoff 2009). As noted above, foreign-owned banks' asset share in the same countries is between 36 percent (Slovenia) to 97 percent (Estonia) (Enoch 2007). Put differently, a few foreign banking groups own most of the banking sectors in any given CEE countries. Even for the largest country among

[23] 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."

[24] 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). The ECB confirms a high concentration ratio in these countries. See (ECB 2005)

the new member states—Poland—the importance of foreign owned banks to the domestic economy is far greater than the importance of it's subsidiaries to the portfolio of the foreign bank that serves as its parent company (Bednarski and Starnowski 2007). In a small country like Croatia, Austrian banks controlled 60 percent of the banking sector as of 2007 (Gardor 2008), which translates into 14.7 percent of total Austrian banking assets[25]; 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 on the host country of strategies designed and implemented by Austrian parent companies. 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 center:

> "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% 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 % to close to €3.45 billion" (FMA 2008).

[25] According to FMA(2008), total assets of Austria's financial markets amount to € 1069.3 billion, 44.7 percent 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 and accompanying text. €32.26 billion in Croatian bank assets held by Austrian banks.

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".[26] Whether the countries on the receiving end of Austrian banks' expansion strategies are similarly diversified is of no 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 spill over effects for the European or the global system.[27] 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 countries that served as capital importers during good times. Thus, the ONB reassured readers of 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

[26] See (ONB 2009) at 46 (translation by author).
[27] 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 (7 May 2009).

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 10 CEE countries that recently joined the EU, for example, jointly hold 2.75 percent of voting rights.[28] At the EBRD they control 5 percent.[29]

The countries that had experienced the East Asian financial crisis learned that lesson 10 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 treaty obligations, which prohibit restrictions on cross-border capital flows within the EU. 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[30], 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 controlled 38 percent of global reserves by the end of 2002 (Aizenman and Marion 2003). This option, however, presupposes a strong export

[28] Own calculation based on information on voting rights available at http://www.imf.org/external/np/sec/memdir/members.htm

[29] 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 web site.

[30] 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 neighbors.

base for earning foreign currency and therefore is not available to all countries, neither is it necessarily desirable as global imbalances on the current scale create their own interdependencies, if not dependencies. As China and the Gulf states have come to realize the value of the reserves they accumulated hinges on the value of the US dollar.

To countries in CEE membership in the European Union offers far better representation than membership in the IMF, although CEE countries could hardly muster a veto much less determine the outcome of new regulatory proposals. Not surprisingly, the latest reform proposals for the EU appear to re-enforce the bias in favor of home country regulation. The key policy reform recommended by the De Larosière report (2008) is the system of "colleges of supervisors" for multinational financial groups comprising of regulators from different countries in which the group operates. Critically, the College is chaired by the home country regulator of that group; as of now it remains unclear how this regimes shall operate in practice.

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 could be the ECB or a similar entity. While countries from CEE almost certainly will be disadvantaged vis-à-vis foreign banking groups that are likely to ensure that their interests will be heard at such an organization, such an arrangement might still be superior to relying on the home country regulator of a financial group that is more concerned about the health of the group than the stability of a another country's financial system. Another option is to reassert domestic regulatory powers and to supplement the EU regime with national regulatory oversight; the US can serve as an example for such a strategy. First, until recently states exerted regulatory oversight over subsidiaries of nationally authorized banks that operated on their territory. In fact, some argue that the dismantling of this co-regulatory regime by federal agencies, which was backed by the courts, contributed to the regulatory failure in the subprime mortgage area (Kim 2009). Second, after the events of 11 September 2001, which rose the specter of further attacks on systemically important organizations in the United States, the Federal Reserve issued a guideline declaring that every large complex banking organization whose operations had a substantial effect on the US market (defined as a share of at least 5 percent of a relevant market) would be subject to US regulatory oversight irrespective of its country of origin (Lichtenstein 2005).

The announcement of this effect-based regulation is inconsistent with the principle of home country regulator as set forth in the Basel agreements, but this did not deter the United States. Countries in CEE would find themselves in a greater bind when considering effect-based jurisdiction because unlike the Basel principles, EU law has established the principle home country regulator as a legally binding principle; however, the EU Treaty does give countries some discretion for safeguarding its own financial system in the public policy exemption stipulated in the EU Treaty.[31] To be sure, the European Court of Justice has narrowed the scope of the public policy exception over time, especially in the area of free movement of legal persons and free movement of

[31] Art. 58 (1)(b) provides that member states have the right "to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures *which are justified on grounds of public policy or public security*." (emphasis added)

capital, where many countries maintained restrictions.[32] Still, the experience of the global financial crisis might give governments more leeway in making a public policy case. A critical issue will be to define an appropriate trigger for asserting domestic regulatory jurisdiction.

The suggestion to strengthen national regulatory control over financial intermediaries superficially appears as a major setback to globalization and financial integration aspirations. Indeed, the Institute of International Finance (IFF)—a lobby group of major global bankers—has already raised the flag of protectionism in response to regulatory reforms initiated in many countries in the aftermath of the global financial crisis, yet, as long as a regional or global system does not adequately address the risk of countries that are on the receiving side of capital flows—nor provides for ultimate guardian functions other than in an ad hoc fashion by organizations whose own resources depend on the capital exporting countries—national responses will remain the default option; those EU member states that bailed out their own financial systems in the midst of the crisis—including those that had adopted the common currency, have seen this clearly and have acted accordingly. EU institutions have responded by scrutinizing their measures under EU competition law, restrictions on state aid, and the like, yet, EU institutions were unable to prevent countries from adopting national rescue packages in the first place or to offer their own rescue instead.[33] As a matter of principle, there is no reason why other EU member states should

[32] Examples include the freedom to incorporate a company in a jurisdiction of choice (see Centros, Überseering, etc.) as well as a series of decisions on golden shares and other restrictions of foreign direct investment in sensitive industry sectors.
[33] This was true even for countries that had adopted the euro. While the ECB adopted a range of measures to boost liquidity, unlike the Fed it does no have the power to lend directly to financial intermediaries, i.e. to engage in specific rescue operations.

not be allowed to do the same preemptively, if failure to act will expose them to the risk of a governance void.

IV. 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 suggests 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 bail out capacity and sufficient political cloud to act independently irrespective of existing regional or international commitments, a global regime serves two critical purposes: it enables 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 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 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 signaling 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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