Implications of the Transformation of the State-Owned Banking System into System of Foreign-Owned Banks in New Member States for Macroeconomic and Financial Stability

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Abstract: All studied CEECs represent heterogeneous entities with different starting positions in their transition to market economies as well as chosen paths that have constrained or enabled the emergence of macro-economic and financial fragility, associated with the dominance of foreign-owned banks in the transition economies of CEE region. The implications of foreign ownership for macro-economic stability have to be presented and interpreted with caution. When drawing conclusions on the effects of different ownership structure, one has to bear in mind that in the case of CEECs, specific historical context needs to be acknowledged, as several problems and obstacles in achieving the macroeconomic stability with the state-ownership in the banking sector were related to the transition process from socialist production regime to the introduction of market economy institutions. In the 2000s, on the other hand, the activities of foreign-owned banks took place in the context of increasing global liquidity and asset prices’ boom that was taking place in the Western world. Hence, ownership as such has not mattered so much for the macro-economic stability in the CEECs, but rather internal developments, that is, transition to market economy with associated challenges in the 1990s that rendered these economies unstable, and external factors, such as international capital flows in the 2000s that incurred imbalances through the activities of the banking sector.

Key words: Central and Eastern Europe, banking, foreign direct investments, transition economies, financial fragility, Europeanization.
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1. INTRODUCTION

One of the characteristics of the Central and Eastern European countries (CEECs) has been low level of internally financed capital accumulation and investments that has implied reliance on foreign direct investments (FDI) as well as foreign trade since early 1990s. One of the reasons behind these tendencies has been de-regulation of financial systems and delegation of powers to international institutions, such as the European Union (EU). More importantly, such a growing internationalization of economic activities in the form of international competition and cross-border control has had a major impact on the form of capitalist production and ramifications for macro-economic stability in this region (see Lane and Myant 2007; Whitley 2000).

Hence, within the broader objective of analyzing the nature of macroeconomic relationships between the New Member States (NMS) and the ‘old member state’, and the ways in which the policies of the EU impact and constrain the policies of NMS, the current paper envisages to address the nature of financial integration of NMS with the rest of the Europe (and beyond, whenever relevant). The paper explores the nature and causes of transformation of the state-owned, and in Estonian case domestically privately-owned banks into the system of foreign-owned banks, while the main focus is on explaining what has been the role of foreign-owned banking sector in NMS in increasing macro-economic instability and financial fragility in these economies, compared to previous period of state-owned banking system. Analysis on the internationalization of the finance in NMS will be based on the country study of five member states in Central and Eastern European (CEE) region, that is, Slovenia, Hungary, Poland, Czech Republic, and Estonia, as representatives of the supposedly distinctive groups of CEE market economies – Baltic States, Visegrád group, and Slovenia (as the representative from former Yugoslavia in the EU). The paper will rely on previously undertaken studies, country reports, and other analyses on the topic. The study will be structured as follows: Introduction will be followed by sub-chapter on literature review on the subject matter that presents the theoretical framework for
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analyzing and understanding the cases of selected CEECs. This will give an overview of the existing literature and studies on the topic from both mainstream and heterodox perspective, and whenever possible, with direct reference to the CEECs. Yet, the case of the CEECs in selling the domestic banking sector the foreign owners is best understood from the Minsky-Kregel framework that has been selected as the most suitable for the topic and research objective, in particular, given its appropriateness for the transition/developing economies that has been a focus of Kregel’s analyses. Due to the limited scope of the study, it is not possible to consider the broad literature on the topic. Chapter 2 presents developments in and transformation of finance and banking in CEECs since early 1990s, drawing out general trends with divergent patterns, exemplified with statistical evidence on cross-border movement of capital and structure of banking ownership, while Sub-chapters elaborate on the causes – pull and push factors – of internationalization of the banking sector in CEECs. Chapter 3 addresses the implications of such transformation for both banking and real sector, that is, FDI in banking as a catalyst of changing the nature of host economies in CEECs in terms of introducing new business practices, business models and strategies; and investment activity and its direction in the real economy. Chapter 4 focuses on explaining how the foreign ownership of the banking system, but also other factors that have contributed to macro-economic fragility in CEECs. Final chapter 5 concludes by establishing a typology of market economies in the CEE region, based on the divergences in their economic performance, financial development, and the extent of foreign exposures. The purpose of the final chapter is to present the structural as well as policy variability in the CEECs as factors affecting viability and stability of these economies. All in all, the paper aims to present the historical overview of the developments in the banking sector and its relation to the real sector, supported by the statistical evidence, and present evidence on the potential sources of macro-economic instability, both before and after the foreign capital’ presence in these economies. In this regard, the chapters 2 to 5 present the empirical evidence, followed by the discussion. Such an approach is explained by the endeavor to deal with diverse areas and address the topic from rather historical-
institutional perspective that places developments in the banking sector into broader picture.

1.1 LITERATURE REVIEW

Two main academic traditions can be distinguished that address the topic under the study, that is, the implications of foreign ownership in banking for financial and macro-economic (in)stability: mainstream literature in the tradition of neo-classical economics and alternative, heterodox views on the topic. Mainstream literature has mainly focused on micro- or meso-level developments and effects of foreign ownership in the banking sector. Banks with foreign ownership in CEECs have been found to be more efficient and profitable due to a decrease in cost inefficiency, successful utilization of technology and expertise, and increased capital infusion (see Hasan and Marton 2003 on Hungarian case; Nikiel and Opiela 2002 and Havrylchyk 2006 on Polish case; also Claessens et al. 2001; Detragiache et al. 2008; Bonin et al. 2005; Yildirim and Philippatos 2002; Paez 2011). Other studies have looked at competition and spillover effects by foreign banks on domestic banking sector, concerning the effects on service and customer range, costs, interest rate margins, and profits (Lehner and Monika 2008;Claeys and Hainz 2006; De Haas and Naaborg 2006; Lensink and Hermes 2004; Degryse et al. 2012). A myriad of studies has come up with conclusions on the impact of foreign banks’ presence on the stability of the banking sector in host countries with their stabilizing role in the credit markets, better as well as cheaper allocation of funds, and prevailing long-term motives in their strategic behavior (see Demirgüç-Kunt et al. 1998; Dages et al. 2000; Levine 1996; Barth et al. 2001; de Haas and van Lelyveld 2006, 2010; Detragiache and Gupta 2004; Haselmann 2006; Stein 1997). Also, the literature has identified FDI, including in the banking sector, as a more stable source of foreign funding than portfolio debt and bank lending that are considered to be prone to sudden reversals (Claessens et al. 1995, Levchenko and Mauro 2007). Hence, the studies in the mainstream literature have found that selling banks to foreign strategic investors has generally paid off in CEECs by contributing to a structural catching-up process,
encouraging innovation and competition, and underpinning institutional soundness (see also Barisitz 2005; Wagner and Iakova 2001).

On the macro-level, foreign financial institutions have been seen as strengtheners of financial stability in transition economies by improving solvency and liquidity of local banking system, because foreign banks are better capitalized than their domestic peers. In addition, they are less open to government and political interference than domestic banks (Detragiache et al. 2008; Hellman and Murdock 1998). Moreover, foreign banks are perceived as mitigators of boom-bust cycles and stabilizers of credit growth in transition economies (see Mishkin 2001; Vogel and Winkler 2010). King and Levine (1993) have brought out that the main motivation for opening up to foreign banks is to foster economic growth by financial development. In that respect, Prasad et al. (2007) have presented contradicting cross-country and firm-level evidence, suggesting that countries that rely mostly on foreign financing grow more slowly than countries that rely on domestic savings, which constitutes a challenge to standard economic theory and proves why capital does not flow from rich to poor countries. Yet, they stress that Europe is unique because capital actually flows “downhill”, supported by Abiad et al. (2009) who show that financial integration has a positive effect on economic growth in Europe, but not anywhere else.

Literature in the heterodox economics tradition, on the other hand, has been more critical on the presence of foreign capital in host emerging and transition economies. Rodrik (2004 cited in Tridico 2011) has claimed that aside from inflation and debt, macro-economic instability is associated with deregulated financial system and uncontrolled FDI flows. Specifically, large capital flows have been associated with rapid credit expansion and riskier lending practices in catching-up economies. Moreover, massive inflows can have negative impact on local investment decisions, competitiveness, and ultimately on growth due to appreciative effect financial inflows have on local currency, implying the trade-off between greater consumption and a reduced investment, particularly in case of fixed exchange rate regime (see also Wagner and Iakova 2001; Rodrik and Subraimanian 2008).
In addition, Caramazza et al. (2004) and Calvo et al. (2008) have referred to the issue of systemic risks in terms of strong financial linkages that substantially raise the probability of contagion. On the micro- and meso-level, Stiglitz (1993, 2002) has brought out the dangers to domestic banks, local entrepreneurs, and the government that result from foreign bank entry, as international banks with better reputation incur extra costs for domestic banks, while credit for local entrepreneurs might get crowded out by preferential treatment of multinational firms, as government control over the economy diminishes. FDI is seen to entail substitution effects in terms of crowding out local businesses, including in the banking sector, whereby aggressive (and excessive) lending by subsidiaries of foreign banks leads to displacing of domestic banks and increases the risks of pro-cyclical lending policy of dominating foreign-owned banks (Ocampo et al. 2007, 36-38; King 2008, 1-5). Even worse, Detragiache et al. (2008) have shown that the presence of foreign banks may reduce credit growth and access to credit for the private sector, in particular in poorer countries, while Martinez Peria et al. (2002; see also De Haas and Lelyveld 2003a) have indicated to reduction of lending by foreign-owned banks due to adverse developments in home country of a parent bank. Similar concerns have been raised by Wade (2007) on damaging effect of foreign banks due to their reliance on home country in times of crisis and likely retraction of operations abroad in order to protect their home base. In that respect, Galindo et al. (2004) provide supportive evidence on how foreign bank presence can amplify external shocks. Other risks associated with the presence of foreign banks in host economies include an excessive short-term lending that can lead to severe liquidity shortages and provoke financial instability (Paez 2011). In principle, FDI that targets the domestic market, such as the financial sector, does not entail any exports to compensate for current account imbalances from repatriated profits, which tend to increase over time (see Myant and Drahokoupil 2011).

Theoretical propositions on macro-economic and financial instability, associated with the presence of foreign capital and banks in host transition economies, could be found in Minsky’s analysis, but also in works of scholars in post-Keynesian and classical
development economics traditions. Minsky (2008) discussed on the factors affecting the financial system’s stability that he ascribed to relative weight of three financing arrangements of economic entities – hedge, speculative, and Ponzi –, depending on the sources of funds to fulfill debt obligations, that is income cash flows, rolling over debt or balance sheet cash flows, and selling assets or portfolio cash flows, respectively. Essentially, the behavior of financial market triggers an unstable boom from appearing tranquility due to changing financial practices and the structure of financial commitments as endogenous forces. These forces render a situation dominated by stable hedge finance unstable, and disequilibrating forces become greater as the weight of speculative and Ponzi finance increases. A period of successful functioning of the economy leads to a decrease in the value of liquidity and to an acceptance of more aggressive financing practices. This is manifest in financial institutions’ experimentation with liabilities and increases in asset-to-equity ratio¹, that is, availability of excess funds over the demand for funds that raises capital-asset prices and induces speculative financing of investment. In principle, such a financing of investment in excess of internal funds is equivalent to an increase in the weight of speculative and Ponzi finance, implying the increasing fragility of the economic system. Fragility turns into instability and eventual crisis once margins of safety are eroded and asset prices start to decline and hence, lead to a spiral of declining investment, declining profits, and declining asset prices. As Minsky put it:

“To sum up, a marked increase in the fragility of an economy occurs as an externally financed investment boom takes place. The financing relations assure that an investment boom will lead to an environment with increased speculative financing of positions, which in turn will lead to conditions conducive to a crisis. That is, a financial structure in which a debt deflation can occur and events that trigger the start of a debt deflation are normal results of the financing relations that lead into and take place during an investment boom.” (Minsky 2008, 242).
In his view, constraint on bank leverage ratios and internal growth of stockholder’s equity through retained earnings may be necessary to constrain financial fragility. Minsky’s analysis on financial instability could be applied also for cross-border financing position of nation states in terms of external or internal financing of economic development (see Kregel 2004). In relation to the role of foreign capital, financial fragility in Minsky-Kregel framework would imply a high concentration of speculative or ponzi economic units, that is, highly leveraged business entities, decreasing margins of safety, and low liquidity of economy. The problems of heavy reliance on foreign capital are related to unsustainable debt creation and eventual reversal of capital flows, as growing capital inflows, accompanied by the rising share of interest payments, set in motion Ponzi financing position, where debt is sustained by continuous borrowing (ibid.). This is particularly the case with FDI, including in the banking sector, that has a propensity to increase foreign borrowing that worsens external balance and augments debt servicing in the forms of profit transfers and interest payments (Ocampo et al. 2007; Kregel 2007). All in all, strategy built around foreign capital is a Ponzi scheme that cannot succeed in the long-run, as ever-increasing foreign lending translates into an ever-rising external debt, whether interest rates are equal or below the rate of increase in inflows (Kregel 2004). This makes FDI one of the most expensive funding channels in the Minsky-Kregel framework.

Minsky’s analysis is also helpful for understanding the implications of cross-border regulatory and supervisory activities for financial (in)stability. Namely, the periods of financial stability submerge political risks, when the interests of both sets of countries tend to be closely aligned. However, financial instability heightens political risk of unilateral actions by either home or host country, as they face incentives to try to minimize the fiscal and social costs of crisis at the expense of each other (see Kudrna and Gabor 2013). In a historical record, foreign-owned banks have tended to leave host economies in times of crises and repatriate funds due to safer home markets, but also nationally oriented bailouts and decisions made by home regulatory authorities on banks’ capital or liquidity imply
the realization of political risks on the home country side (see Roubini and Setser 2004; Wade 2007).

Even before Minsky, Kalecki (1955, 1966) indicated to the problem of FDI being directed to economic activities that corporations expect to be profitable, not what the host economy most needs for its development, while the possibility to remit profits indefinitely renders FDI the most expensive of all forms of borrowing. In general, interest paid on imported capital burdens the balance of payments, implying a loss of resources and a risk of balance of payments difficulties, as in the long run the impact of continuous FDI on the balance of payment position of recipient country is negative. Outward-looking development strategy with reliance on external financing brings to the fore the aspect of absorptive capacity of a recipient country that depends on financial capabilities to service the debt with exports (see also Kregel 2004).

Issues related to the external financing of development were further elaborated by Nurkse (1952, 1953) who raised the problem of servicing debt and interest payments, given the tendency of foreign capital to finance private consumption due to aspiration to emulate Western living standards instead of productive investments that undermine positive returns and trade surpluses. All this would result in inflationary pressures and balance of payments disequilibrium, which has a reverse effect on financial stability. Eventually, outward flow of foreign investment would take place, once the fundamental conditions of creditor and debtor economies reverse in terms of saving propensity and investment needs. Furthermore, in his view, foreign investment and financing would lock host economies into undiversified economic and social structure due to narrow aim of a mere utilization of local resources.
2. DEVELOPMENTS IN AND TRANSFORMATION OF BANKING IN CEECs SINCE EARLY 1990s

Foreign investments are relatively high as a proportion of gross capital formation in the private sector in CEECs. All countries have higher proportions of investment coming from abroad than middle-income countries and have a much higher dependency on foreign capital than low-income countries (Lane 2007, 25-34). Capital flows into the CEE region have followed a certain sequence, starting with official funding, followed by FDI flows, and finally increasing share of international bond issues, direct local stock and money-market investments, but mostly cross-border loan financing in total private net flows (IBRD 1998; Mihaljek 2006). Liabilities from direct investment represented more than 50 per cent of total liabilities in Hungary and the Czech Republic in 2009, while they amounted to less than 30 per cent in Slovenia. On the other hand, the share of liabilities from ‘other investment’, which have accounted for most of the foreign debt, exceeded 50 per cent in the three Baltic countries and Slovenia in 2009, but it was below 30 per cent in the Czech Republic and Hungary. Lastly, liabilities from portfolio investment played a significant role only in Poland, the Czech Republic and Hungary due to more developed and liquid capital markets, where their share exceeded 15 of total liabilities. Consequently, all studied CEECs, except for Slovenia in 2002, were in a net external borrower position vis-à-vis the rest of the world throughout the whole period from 1999 until 2008 (Jevcák et al. 2010).

When looking at the allocation of inward FDI, the manufacturing remained the single largest host sector in the 1990s that accounted for 40-60 per cent of the FDI stock in CEECs, although substantial foreign investments took place in financial services in all countries under study, except for Slovenia (EBRD 1998). Similarly, financial sector was one of the largest absorbers of FDI in CEECs in 2000s, in particular in Slovenia and Estonia, although in 2005, FDI stock in financial intermediation in Slovenia was only 17.3 per cent of the total, while 43.3 per cent of FDI stock was accounted for manufacturing sector with pharmaceuticals as the largest branch. In Estonia, on the other hand, investments in
financial intermediation have held a dominant position in 2000s, followed by activities connected with real estate, renting and other business activities (Hunya 2009; see Figure 1). Before the dominance of foreign capital in CEECs’ banking industry\(^2\), the banking model adopted was of universal banking with large role of the state in terms of greater reliance on government guaranteed loans and government rehabilitation bonds for recapitalization and replacement of non-performing loans of banks (Green and Petrick 1999). The structure of the banking in CEECs followed three stages: 1) a rapid increase in the number of banks, reflecting liberalization of the environment, 2) a stabilization or decrease in the number of banks, as many newly founded banks proved unviable due to more stringent prudential requirements, and 3) increasing dominance of foreign capital through greenfield investments and acquisition of privatized state-owned banks (Myant and Drahokoupil 2011; see Table 1).

By 2005, the asset shares of majority state-owned banks dropped to 1-digit percentage levels in Visegrad group, expect for Poland, where it stayed at 21.5 per cent, while in Czech Republic the share dropped to 2.5 per cent level (Barisitz 2008). As a result of such developments, the asset share of foreign-owned banks in CEE countries was among the highest of any banking sector in the world with Estonia recording over 95 per cent, the Czech Republic above 90 per cent, Poland at 74 per cent, and Hungary at 84 per cent, while Slovenia remaining an outlier with 23 per cent (Bonin et al. 2008). Moreover, already by 2002, all top five commercial banks in five countries displayed dominant shares of foreign capital with 65 to 100 per cent of capital, except for one private Hungarian bank, one Polish bank and two banks in Slovenia (Caviglia et al. 2002). This reflects the strategy of foreign investors who acquired banks in CEECs with a large market power that, on average, controlled a market share over twice as high as those that remained in domestic ownership (see Havrylchyk and Jurzyk 2011; Lanine and Vander Vennet 2007).

Yet, statistical evidence, presented above, indicates that CEECs cannot be taken as homogenous entities that have followed the same development path regarding the banking
sector privatization and its take-over by foreign investors. Even though there has been a general trend towards transnational banking by selling all large banks to foreign investors, the countries under study have diverged in their timing of opening the market to foreign competitors. For instance, Hungary was the first country to allow widespread foreign penetration in the banking sector, followed by the Baltic States. During the first three years of transition from 1992 to 1994, the majority of Hungarian state-owned credit institutions were privatized and the lion’s share of the banking sector was sold to foreign strategic investors by 1999 for 160 billion forints, that is, 1.4 per cent of 1999 GDP. The privatization of Postabank in 2003 marked the end of the era of privatizations in the Hungarian banking sector (Badics et al. 2014). In Estonia, the post-1997-98 crisis period was characterized by the entering of foreign investors who completed the privatization process by 2000, but also triggered concentration in the banking sector (Lepik and Tõrs 2002). Poland initially took a positive stance towards foreign ownership of banks, but then backtracked, before opening the banking sector again to foreign ownership. The Czech government was similarly resistant to foreign ownership of banks, manifest in the voucher privatization scheme that left the state the majority ownership of the largest banks, but several bank failures changed the situation in 1998-2001, when foreign strategic investors took over the largest part of the Czech banking sector (see Berglof and Bolton 2001; Bonin et al. 2008; Myant 2007). All in all, drastic changes were taking place in the banking sectors of CEECs at the turn of the millennium that were evidenced by the fact that in the largest economy of the region, Poland, loans granted by foreign-owned banks accounted for 70.5 per cent of all loans in 2002 – an increase from around 5 per cent in 1995. In Estonia, the smallest economy in the region, foreign capital controlled 86.7 per cent of banks’ total capital base and 97 per cent of sector’s assets in 2002, while in 1996, the same figures were 33.4 per cent and 2.6 per cent, respectively (Janc 2004).

Slovenian case, however, deviates from the above described dynamics in the banking sectors of other CEECs, as Slovenia has stood out for roughly stable number of banks and a low share in foreign ownership. In Slovenia, the banking system was relatively closed and
only at the turn of the millennium was opened to foreign banks. Out of 21 banks in Slovenia in 2002, 16 banks were owned by domestic shareholders and 5 were controlled by foreign shareholders with about 15.4 per cent of equity of Slovenia’s banking sector, compared to 51 per cent controlled by state institutions (Cufer et al. 2002; Janc 2004). Even by 2012, Slovenian financial sector remained unreformed with state banks in an increasingly entrenched position (EBRD 2012). The next section will shed a light on the factors that affected the transformation of the banking industry in studied CEE countries in one or another direction.

2.1 PULL AND PUSH FACTORS FOR INTERNATIONALIZATION OF THE BANKING SECTOR IN CEECs

When analyzing the causes of foreign capital flows into the banking sector, Dunning’s (1993, 2002) approach provides a combination of explanatory conditions in terms of the ownership, location, and internalizing advantages that explain the flows of FDI. In general, theoretical discussions have focused on location factors, such as market size, proximity to major markets, and legislative, political and economic environment. In that respect, Kinoshita and Campos (2003) have found that the most important drivers for FDI are agglomeration effects and institutions in terms of the quality of bureaucracy and the rule of law (see also Bruno and Campos 2010). The findings by Campos and Kinoshita (2010), on the other hand, emphasize the role of structural reforms and financial liberalization aside from stable macroeconomic environment and high level of economic development. Foreign investors could be also analyzed in terms of their preferences in searching for resources, markets, efficiency, or strategic assets, such as brand names or existing network systems (EBRD 1994; Marinov and Marinova 2000).

2.1.1 INSTITUTIONAL AND SOCIO-ECONOMIC FACTORS

Several factors have impacted cross-border capital flows in CEECs, such as the geographical and cultural proximity to countries that were the source of FDI and economic as well as financial conditions, including high rate of economic growth, liberalized capital
account transactions, and institutional competitive advantages (European Commission 2010; Jevcák et al. 2010; Claessens et al. 2008; Aydin 2008). The wish to gain access to local markets was the dominant factor inducing foreign investors to enter the CEE economies (EBRD 1998). Estonia, the Czech Republic, Hungary, and Slovenia that attracted majority of total investment flows to the region were relatively advanced concerning the perceived country risk. The Czech Republic and Slovenia (to some extent also Hungary) had an advantage of a better initial condition in terms of GDP per capita, infrastructure, advanced industrial base and technology, and experience with market reforms in the functioning private economy model during the communist era. Estonia, on the other hand, had advantage in advanced tertiary sector, including banking industry that attracted FDI (Whitley 2000). The general reasons behind the internationalization of finance were the ‘follow the client’ logic in extending overseas banking operations to meet the demand of multinational corporations (MNCs), globalization of capital markets, and overall trend towards greater deregulation of national financial markets from late 1980s (Dicken 2011, 368-386). For instance, foreign investors entered the Hungarian banking market in order to meet the demand for banking services from foreign firms operating there and to fill the void in the underdeveloped retail banking market (IMF 1997). Yet, the main motive was the search for higher returns in an environment of attractive growth prospects and low global interest rates, but generally higher interest margins in CEECs than in Western Europe that led the international banks to expand their operations in CEECs (see Herrmann and Mihaljek 2010; EBRD 2006).

Althammer and Haselmann (2011) found that foreign banks tended to enter the transition economies in periods of market instability, i.e. in the aftermath of major clean-up or financial crises episodes that were usual in the 1990s in CEECs (see also Barisitz 2005; Vogel and Winkler 2010). In the early 1990s, private banking was underdeveloped due to low level of experience in lending, small capitalization, and ownership by public and private enterprises that saw the banks as in-house sources of funds, implying severe loan losses (Rhyne et al. 1994). Moreover, the continuing soft budget constraint in CEECs, meaning
connected lending to inefficient state-owned enterprises (see below), did not provide enterprises with an incentive to restructure within this vicious circle, the breaking of which was seen in the privatization of banks and their customers to a strategic investor. Furthermore, foreign banks were seen as solution to an inexperienced group of bankers appointed by government officials and ill-trained for managing banks in a market-economy (see Buch 1993; Thorne 1993; Petrick 2002). Hence, given the costly public recapitalization and restructuring schemes in reforming the banking sectors in the CEECs, the influx of foreign capital was widely regarded as critical for rapid transformation. Authorities in CEECs argued that foreign banks represented an important measure to render their banking sectors more resilient against external shocks (see Tihanyi and Hegarty 2007; Epstein 2013; Pistor 2009; Grittersova 2014; Mishkin 2001). By encouraging foreign banks to enter the CEE market, the main argument was to import their expertise and technology as well as a culture for banking in market economies, encourage competition, increase bank’s prestige, provide easier access to foreign markets, reduce political pressures, and restructure problematic banks by increasing the capitalization of these banks (see De Castello Branco et al. 1996; Bedrankski and Osinski 2002; Ogrodnik 2003; Bonin et al. 2008). At the same time, several warnings were issued in the 1990s in relation to privatization to foreign owners, such as diminution of the efficiency of monetary policy, threats to economic policies stemming from external disturbances on host economies, prioritization of the interests of foreign owners, hesitance to grant credit to enterprises in host economies and its negative influence on the economic growth, and prospective transfer of gained profits abroad – aspects of relevance for macro-economic stability (Ogrodnik 2003; see also below).

Finally, public finances and indebtedness played their role in affecting the transformation of the banking sectors in CEECs. In Hungary, privatization resulted in extensive foreign ownership of the largest banks and enterprises due to lack of local capital and pressures from of the IMF and World Bank to raise money to service the large foreign debt, which had been inherited from the previous regime. In Slovenia, on the other hand, low external debt
burden resulted in substantial internal control of Slovene enterprises. In broader terms, it was the inherited economic system that decentralized control over the economic transformation process to firms’ internal coalitions of managers and other employees and hence the transfer of ownership and control to private shareholders was relatively slow (see Whitley 2000; Samary 2012; Marinov and Marinova 2000; Tihanyi and Hegarty 2007; Filatotchev et al. 2003). Similarly to the Japanese tradition of a main bank being at the heart of any Japanese ‘keiretsu’, Slovenia had practiced the concept of ‘internal banks’ to support growth and financing projects from internal sources (see Sevic 2000; Kraft 1997; Bonin et al. 2005; Borac and Lavrac 2002; Samary 2012).

2.1.2 IDEOLOGIES, PRIVATIZATION POLICIES, AND REGULATIONS - INDIGENOUS AND EXTERNAL FACTORS

In general, reforms in transition economies followed the Washington Consensus (WC) policies. The transformation paradigm was inspired by the simple assumption, whereby transition equals liberalization, coupled with privatization. The WC policies with the emphasis on shock therapy approach included the implementation of monetarist policies, anti-inflation policies, minimal deficit policies, the privatization of state assets, the complete liberalization of prices, and deregulation, i.e., the withdrawal of the state from the economy for the purpose of macro-economic stabilization (Tridico 2011; Lane 2007). Yet, the initial conditions were different in all CEECs and therefore the transformation process has not been similar, as the WC presumed. While Estonia followed radical and fast approach in its transition process, other countries under study, except for Slovenia, began with a gradual easing of restrictions on capital movements in 1995, as non-FDI-related transactions were restricted in 1990s with tight controls on outflows and constraints on short-term transactions (see EBRD 1998; Buchen 2007; IBRD 1996). In the early 1990s, all Baltic States adopted a mix of Washington Consensus policies that included fixed pegs, fiscal discipline, rapid privatization, and governments’ focus on deregulation, attracting FDI, and the abolishment of most capital account transactions (Kattel and Raudla 2013; Lepik...
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and Törs 2002). Slovenia differed from other CEE countries by a more gradual and cautious approach to FDI in the form of acquisitions, and retained many non-financial and financial companies in domestic ownership (Mencinger 2014).

CEECs also differed in terms of privatization strategies⁴ for banks, but also in political positions on foreign entry into the banking sector, which all affected the internationalization process of the financial systems of these countries. Estonia’s policy was to sell controlling shares in state-owned banks to strategic foreign investors due to the danger of empowering ethnic Russian managers and workers through management and employee buy-outs (MEBO) approach, whereas Hungary attempted to attract strategic foreign investors by first recapitalizing the state-owned banks (Bonin and Wachtel 2003; Bohle and Greskovits 2012). In contrast, the initial ideological position of the Czech Republic, but also Polish governments was to keep the banking industry ‘national’⁷, as foreign capital was seen as not serving national interests (Balcerowicz and Bratkowski 2001). Hence, the Czech Republic relied on voucher privatization in the first wave, but in 1998—2001, followed the example of Hungary by taking a new direction, whereby the state sought strategic investors for the four largest banks. Poland, on the other hand, ended up with an eclectic approach by combining the search for strategic foreign investors, distribution to insiders, including debt-equity swaps, MEBOs and public offering. Given the availability of domestic capital, Slovenian governments preferred to privatize to Slovenian owners rather than to foreign strategic investors⁸. Hence, Slovenia adopted insider-dominated MEBOs as primary and voucher as secondary technique of privatization, which extended the period of domestic ownership structures and delayed the takeovers by strategic foreign investors, accompanied by a variety of protectionist measures (see Wagner and Iakova 2001; Myant and Drahokoupil 2011; Samary 2012; Green and Petrick 1999; Bonin and Wachtel 1998; Barisitz 2005; Bonin et al. 2008 on banking privatization). In principal, Slovenian rehabilitation and privatization policies, that is, writing off current losses against capital, replacing bad bank assets with government guaranteed bonds, recapitalization, and transfer of ownership to the Rehabilitation Agency in dealing with insolvent banks led to the
nationalization of most banks (Mencinger 2014; Bonin et al. 2008). Banks were granted
subsidies and loans to restructure for gradual transformation into genuine market actors.
Furthermore, state control over the commercial banking sector also mattered for the
feasibility of a gradual and macro-economically stable transformation strategy (Bohle and
Greskovits 2012).

Policies towards foreign bank participation through subsidiaries, branches, and acquisition
of shares in state-owned commercial banks differed considerably across the transition
countries. During the first decade of transition from 1989 to early 2000s, CEECs liberalized
their financial sectors at different speed by removing such barriers as restrictions on
capital account, interest rate controls, de-specializing financial institutions, etc. Most of the
liberalization measures were implemented in early 1990s, although most of the restrictions
on foreign banks and capital account transactions were removed in Visegrad countries in
late 1990s and early 2000s that were affected by a change in the privatization and
restructuring process (Havrylchuk 2006; McGrath 2005). In some countries (Hungary),
policies such as tax holidays encouraged greenfield foreign operations, while in others
(Poland and Czech Republic), licensing was restrictive and foreign banks were limited to
taking minority stakes in banks or to the participation in the rescuing ailing domestic
banks. Hungary and Slovenia restricted the establishment and operation of branches of
foreign credit institutions and provision of any cross-border financial services up until 2004.
These countries took an infant industry approach with states retaining shares in banks until
late 1990s (and beyond in Slovenian case). In these more protectionist countries, resistance
to foreign-owned banks was based on the fear of potential capital flight and failure to
provide credit for local economic development (see Bonin et al. 2008; Havrylchyk 2006;
Degryse et al. 2012; EBRD 1998; Alfred et al. 2012; Borak and Lavrac 2002; Horvath and
Zsamboki 2000). Until 1994, commercial banks in Estonia were in the hands of state
enterprises or joint stock companies, as foreign ownership of banks was not allowed
(Korhonen 1996). By gradual tightening of regulations, Estonia managed to adopt fully-
fledged banking legislation only in 1995, after which first branches of foreign banks were
established. In Estonia, Poland and elsewhere, it was the rising equity requirements and other stricter prudential norms due to previous banking crises that led domestic banks to look for strategic investors and resulted in acquisitions in late 1990s (see Khoury and Wihlborg 2006; Havrylchyk 2006; De Castello Branco et al. 1996; Tison 2002; Ross 2013).

Aside from crises episodes, external actors, such as the EU, IMF etc. had significant impact on the regulatory developments in CEECs. Moreover, success in establishing safe, transparent and enforceable rules for financial markets was seen as a pre-requisite for entry of foreign banks (EBRD 1998; Barisitz 2008). In this respect, attractiveness of CEECs for foreign investors was associated with the prospect of the EU membership and adoption of the *acquis communautaire* (Barisitz 2008; Tison 2002; Bonin et al. 2008). Furthermore, given the aspiration to join the EU, policy choices and decisions made by CEECs about the governance of finance that included decisions about liberalizing capital accounts and allowing foreign bank ownership or dominance were pre-determined by the EU governance regimes they joined. Thus, the EU has provided outside anchors in terms of pressures for adopting the EU regulations for building the financial infrastructure (see Berglof and Bolton 2001; Lane and Myant 2007; Pistor 2009; Corcoran and Hart 2002, 221; Haselmann 2006). Moreover, under the Europe Agreements, CEE countries needed to have in place a fully EU-compatible system of banking and financial services regulation by the date of accession and moreover, non-discriminatory access by foreign banks to the banking systems of CEECs was required by the EU Association Agreements (EBRD 1998). The EU accession process was a driving force of bank privatization, as a more competitive banking system was a pre-requisite of entry to the EU (Bohle and Greskovits 2012). Bonin and Wachtel (2003) have argued that the EU accession was a dominant political concern that led to the acceptance of foreign bank ownership in the Czech Republic and Poland that were lagging behind Hungary and Estonia. However, the EU membership did not rest on the conditionality to sell banks to foreigners (Epstein 2014a).
In conclusion, three major explanations have been presented for the liberalization banking sectors in CEECs: structural and institutional changes, financial crises, and pressures by international financial institutions, such as the EU that resulted in the dominance of foreign banks in CEECs after the privatization rounds in the 1990s.

3. PRE- AND POST-FDI PERIOD IN THE BANKING AND ITS IMPLICATIONS FOR THE REAL ECONOMY IN CEECs

As noted by Lane and Myant (2007), one of the common features of CEECs was the initial absence of capitalists and of matching forms of financial intermediation. The new commercial banks, mostly state-owned that were formed from the break-up of the monobank, inherited balance sheets, which included household deposits and a portfolio of enterprise loans of unknown quality. Banks, whose clients were yet to be privatized, had low quality assets in their balance sheets, as lending policies were not based on any financial or economic logic, but were politically motivated, while losses were usually rolled over, often with additional loans provided by the central bank (Berglof and Bolton 2001; Barisitz 2002). This was due to the interlocking ownership structure, whereby preferential access to credit was given to state-owned enterprises, which were either shareholders of banks or closely related to them. Consequently, most banks provided banking services to medium and large enterprises in the first part of the 1990s, while retail banking to households and small enterprises was limited with little need to raise small deposits (De Castello Branco et al. 1996). For instance, the share of individuals in the total loan portfolio of Estonian banks reached only 8 per cent at the end of 1993 (Lainela and Sutela 1994). Moreover, banking services for retail clients in the early 1990 were regarded as unprofitable and also risky due to rapidly changing market conditions, lack of experience, deficient accounting standards for establishing the credibility of financial statements, few credit reference systems, and inadequate legal foundation for secured lending. For instance, housing credit was constrained in the 1990s by missing or unclear land and property titles, difficulty of enforcing foreclosure of residential properties, lack of credit...
registries as well as non-completed housing privatization. Consequently, commercial banks - large state-owned banks, smaller private domestic banks, but also banks with foreign participation - tended to focus on corporate banking (see Rhyne et al. 1994; Mihaljek 2006; De Castello Branco et al. 1996).

Furthermore, banks also preferred to invest in high-yielding and low-risk state bonds, except for Estonia and other Baltic States, where the share of bank claims on the government diminished gradually (Whitley 2000). State-dominated universal banking model that emerged during transition implied the banking sector’s significant net defensive position and creditor passivity that was revealed in the maintenance of government and central bank operations. On banks’ balance sheets, exposures and liabilities to government as well as state-owned enterprises in CEECs accounted to about 60 per cent of total assets and total loans, and about 70 per cent of total deposits in mid-1990s before foreign acquisition of banks (Borak 2000). In Poland, for example, where the private sector was relatively large with the share of 45 per cent of GDP in 1992, banks held 35.5 per cent of assets in loans to enterprises, but most of those were issued to state-owned enterprises. Net lending to the entrepreneurial sector in Hungary was 63 percent of total assets in 19992, but, again, most of that was to state-owned enterprises (Rhyne et al. 1994). Hence, the financing of government budget deficits and state-owned enterprises as traditional customers continued through the sheer momentum of past practices and incentives, or even pressures because of institutional connections and concerns about further declines in employment, while non-performing loans tied up funds and caused banks to increase lending spreads. Furthermore, inflationary pressures put nominal interest rates beyond the reach of borrowers, unsure about whether sales will keep pace with inflation (Rhyne et al. 1994; Naaborg 2007). As a result, state-owned banks were unable, but also unwilling to engage in new lending for industrial investment or to support new firms. All things considered, the privileged access to bank financing that large state enterprises continued to enjoy was one of the financial barriers to the restructuring of the economy and the emergence of new private firms (IBRD 1996). In this context, smaller banks expanded their
customer loans more rapidly than the dominant banks in CEECs in the 1990s, as they sought to develop new banking opportunities among small and medium-sized enterprises (EBRD 1998). Still, the banking sectors in CEECs were considered as underdeveloped in the 1990s, measured by the ratio of private sector credit to GDP (Levine 1996; EBRD 1998; Figure 2).

Crediting of the economies in the CEECs presents a mixed picture, as only Estonia, Poland, and Slovenia saw relatively steady expansion of credit, while Hungary had four severe banking crises during the first half of the 1990s resulting in a sharp drop in credit from 45 per cent of GDP in 1990 to 24.7 in 1994 (Berglof and Bolton 2001; Szikszai et al. 2012). Also, the general inexperience with financial operations and uncertainty over the future economic situation turned banks’ attention towards short-term goals (Buch 1993). For instance, in Estonia, but also in Hungary, newly created banks engaged in foreign exchange dealings and later in financing trade (Korhonen 1996; Barisitz 2002; Hasan and Martor 2003). Another characteristic of CEE banking in the 1990s was the dominance of domestic currency denominated assets and liabilities. For instance, in 1995, 44 per cent of all assets in Estonia were Estonian kroon denominated and 44 per cent of banks’ liabilities were comprised of demand deposits, while foreign currency liabilities representing only 15 per cent of all liabilities (Korhonen 1996).

3.1 BUSINESS MODEL OF FOREIGN-OWNED BANKS AND IMPACT ON BANKING SECTOR

The basic regulatory infrastructure has been modelled on the bases of European banking directives, implying universal type banks (Steinherr 1997). Yet, both local and foreign owned banks in CEECs are mostly commercial banks with reliance on traditional businesses and mostly lending10 (Lehmann et al. 2011; Deuber and Shiplevoy 2013). Their strategy has been based on the assumption of a structural catch-up in the labor-intensive loan business, while being less active on the capital markets that implies less important trading income than for the average major European universal bank. Trading accounts for 2 to 8 per cent of
total income, while net interest income makes up some 60 per cent of total revenue at leading foreign banks in CEECs\textsuperscript{11}.

During the booming years, Western banks in CEECs relied upon business model that financed domestic lending via international capital inflows, although varieties exist even in this dimension. For instance, compared to Czech Republic and Estonia, Poland has presented an opposite picture with international wholesale funding considered to be most important, while parent and customer funding being less relevant (see EBRD 2011a; Mucci \textit{et al.} 2013). The reliance of CEECs on subsidiaries of foreign banks and the latter’s funding was also prompted by the absence of a sufficient deposit base and more importantly, underdeveloped local currency capital markets (see Kavan \textit{et al.} 2013). Reliance on foreign funds instead of individual deposits was due to low interest rates that discouraged depositing of savings in banks and alternative channels of investing savings, e.g. the implementation of mandatory pensions fund systems (Janc 2004). Consequently, by 2009, around 1,700 billion USD of CEE borrowing was held by West European banks, with priority given to buying public debt and crediting private consumers, i.e. households (Samary 2012).

In the post-2008 crisis period, however, banks have changed their approach in doing business in the CEE region. Due to regulatory changes\textsuperscript{12}, banks have been moving towards a business model that foresees new lending by subsidiaries being financed by domestic funds with the aim to deleverage at the group level\textsuperscript{13} (Atanas and Sanne 2013; Mucci \textit{et al.} 2013; EBRD 2011b). This finding has been supported by Klingen (2013) who indicated to withdrawal of funds from the CEE region, which has lowered credit growth and domestic demand. Two important factors drive ‘capital flight’: pressures at the group level and strategic objective to increase local sources for funding subsidiaries (see below).

In CEECs, the majority of foreign-owned banks are fully incorporated subsidiaries, which contrasts with the rest of the EU, where foreign branches have been much more common, while branches in CEECs, subject to home country regulation, account for only a minor part\textsuperscript{14} (Lehmann \textit{et al.} 2011; Pistor 2009; Figure 3).

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\textsuperscript{11} Total income, net interest income.

\textsuperscript{12} Changes in regulatory frameworks and capital adequacy requirements.

\textsuperscript{13} Deleverage at the group level refers to the process of reducing the leverage or debt-to-equity ratio.

\textsuperscript{14} Majority vs. minority.
With regard to the corporate strategy at the group level, large transnational banks have tended to centralize funding and liquidity management across the group in order to exploit operational advantages and to avoid liquidity being trapped in underperforming subsidiaries (BIS 2010). The internal organization of multinational banking groups has influenced the lending behavior of the subsidiaries in CEECs, as parent banks have often set credit growth targets for each subsidiary by providing substantial internal funding (EBRD 2006). Similarly, cross-border banks tend to concentrate strategic decision-making, risk management and auditing, but also standardized information technology systems and other back-office operations at the headquarters (Kudrna and Gabor 2013; Tiahnyi and Hegarty 2007; Thimann 2002). As Pistor (2009) has put, this has implied a “vertically integrated financial groups with centralized strategies implemented throughout the group in a manner that is oblivious of national borders”. Yet, there have been differences between greenfield banks and acquired ones. De Haas and Naaborg (2005) have found that many local banks in CEECs that have been taken over by foreign banks remained relatively independent with local management kept in place, risk management practices gradually adjusted with those of parent banks, and subsidiaries financing themselves relatively independently. Most greenfields, on the other hand, have been found to be more integrated into the parent bank organization, managed by home country managers and relied on the parent bank’s risk management practices. Similarly, when comparing countries, parent banks have exerted stronger influence on their subsidiaries in Czech banks, particularly in relation to credit risk assessments and credit risk portfolio management, than other CEECs. On the other hand, with regard to funding and credit growth targets, foreign bank subsidiaries in the Czech Republic have been most independent (EBRD 2011c).

As to the banking sector outcomes, Fries and Taci (2002) concluded that a greater presence of foreign banks in the financial sector has had a positive (spillover) effect on lending activity, as foreign-owned banks have collected more deposits and made more loans than domestic private or state-owned banks (see also Bonin et al. 2005). In addition, Atanas and Sanne (2013) and Bonin et al. (2008) found that the presence of foreign banks has had a
positive influence on the banking environment by introducing technologies, expertise, modern business and risk management practices, and capital injections. Foreign-owned banks improved access to credit and introduced banking products that were largely absent in CEE economies until early 2000, like mortgages. In that regard, the contribution of foreign investors has been decisive factor in improving the quality of banking intermediation in CEECs under study. For instance, in 1998, two major Swedish banking groups, SEB and Swedbank changed the market structure fundamentally by acquiring the majority shareholdings of the biggest Estonian banks. After full acquisition of daughter banks in Estonia in mid-2000s, a number of activities, including treasury operations, were centralized due to increasing management of banking groups from the overseas headquarters (Ross 2013). In Czech Republic, the number of bank employees dropped from 60,000 to 39,000 between 1995 and 2003, which was connected to efficiency adjustments, downsizing in the head offices, and the concentration of strategic activities in parent institutions abroad (Barisitz 2005). Green and Petrick (1999), on the other hand, have found that the activities of foreign banks did not have much impact in the traditional areas of bank lending in the 1990s with little evidence of raising efficiency in the banking sector.

With regard to competition, foreign-owned banks intensified competition, but also stimulated the consolidation process, implying fewer competitors to challenge the leading Western banks in CEECs, as domestic banks are too small in terms of balance sheets (Barisitz 2005). With regard to market concentration, Estonia stands out from the rest of CEECs (see Table 3).

It is also noteworthy that in Estonia and Czech Republic, top 5 banks in terms of their assets’ share have been comprised of only foreign-owned banks since early 2000s, while Poland and Hungary have managed to maintain domestic control over the largest bank on the market. Only in Slovenia, top 3 banks have not been acquired by foreign investors. Furthermore, foreign banks in CEECs tend to compete with their domestic counterparts for market shares in the same market segments (Haselmann 2006). This is revealed in the
share of top 5 foreign-owned banks in two credit portfolios of the total banking sector: loans to households and corporate loans, where Estonia and the Czech Republic stand out again (see Figure 4).

The power of foreign-owned banks is particularly remarkable, given that the assets of leading Western banks in the CEE region make up a mere 4 to 20 per cent of their total assets. On the other hand, the operational scales of both domestic and foreign banks and their potential contagion effects cannot be overestimated, because compared to the balance sheets of Western Banks, banking sectors in CEE region are relatively small. For instance, the size as the total CEE banking assets is roughly equal to balance sheets of top-three European banks such as Deutsche Bank, HSBC and BNP Paribas (Deuber and Shpilevoy 2013). Moreover, as foreign banks in CEECs were little exposed to toxic assets and wholesale funding played an insignificant role in their (re)financing, their traditional business models were not much impacted by the turmoil in Western financial institutions in 2008 (Kavan et al. 2013).

3.2 IMPACT OF FOREIGN OWNED BANKS ON REAL SECTOR DYNAMICS

In the first half of the 2000s, bank credit to private sector as a ratio to GDP grew at an annual average rate exceeding 1.5 percentage point of GDP in CEECs under study, with peaks of almost 4.5 percentage points in Estonia (Cottarelli et al. 2005). Even though the credit to GDP ratio doubled or even tripled in several countries within a period of only 5 years from 2000 to 2005, some countries, including Poland and the Czech Republic, had credit growth been below 5 percent or even negative due to macroeconomic policy measures to manage supply side of money, including fiscal, monetary and exchange rate responses (Pistor 2009; see Figure 2 above). In general, foreign banks have been found to expand loaning activity more rapidly compared to state-owned banks in CEECs (EBRD 1998), reflected in the finding by Clarke et al. (2003, 2006) that all enterprises have faced lower financing obstacles in terms of interest rates and access to long-term loans in countries with higher levels of foreign bank presence. De Haas and Lelyveld (2003b)
concluded in their study on foreign bank ownership in Central European economies that there was a positive relationship between foreign banks and private sector credit growth. For instance, during the five-year period after the acquisition of domestic banks by non-residents, the credit exposure of banks to Estonian real sector enterprises and households increased from 25 per cent of GDP to 40 per cent of GDP (Lepik and Tõrs 2002). On the other hand, some studies have referred to no correlation between the share of foreign-owned banks in total banking sector assets and the share of private sector credit in GDP over time. Some of the countries with the highest share of foreign-owned banks, such as the Czech Republic, have seen some of the slowest rates of credit expansion (Mihaljek 2006). This is revealed in data for 2000-2004, when the average annual credit growth in the three Baltic countries was 20 per cent that was fed by foreign banks, compared to less than 5 per cent in Poland and the Czech Republic (Bohle and Greskovits 2012). How foreign loans were used varied also considerably in CEECs, as some countries – Estonia, Hungary, and Slovenia – emphasized credits to households with majority of its long-term credit for housing, while others emphasized credits to businesses (Myant and Drahokoupil 2013). Yet, some general trends could be observed, as shown below.

The EBRD transition report (2006, 47) concluded that despite some regional variation, bank loans have played a limited role in enterprise financing. When compared to Western economies with average 180 per cent level, the average level of domestic credit to the private sector in post-socialist countries has been around 38 per cent of GDP, implying that most investment for companies originates from internal sources (Lane 2007; see Figure 5). Employee owners have been considered as functional equivalent to a banking system in CEECs (see Crouch et al. 2005: 375). In addition, foreign banks have been found not taking into account host country’s macroeconomic conditions in their credit policies, but being biased towards “cherry picking” behavior and in financing multinational enterprises or firms from their home country, implying the ‘follow your client’ strategy, while the change in their strategy to serve local customers occurred at a later point of time (see Petrick 2002; De Haas and Naaborg 2005; Havrylchyk 2006; Aydin 2008; Myant and Drahokoupil
In addition to foreign MNEs, foreign-owned commercial banks lent primarily to governments and non-bank financial institutions in CEECs in the late 1990s (Berglof and Bolton 2001; Barisitz 2002). Against these developments, the most problematic aspect of banks’ credit policy has been SME lending, as SMEs lacked for a long time a credit track record or collateral. Various empirical studies have indicated that foreign owned and large banks tend to lend less to opaque SMEs (Berger and Udell 2002; Berger et al. 2001; Giannetti and Ongena 2009, 2012; Bohle and Greskovits 2012). Small firms have had a much lower proportion of their working capital and fixed investments financed by bank loans and lower shares of credit from suppliers. Lending to local enterprises has also required expertise on client relationships and the ability to evaluate unique situations, both of which have generally lacked in foreign banks (see Bonin et al. 2008). Hence, there have been concerns about the negative effect of large-scale foreign bank entry on the availability of bank loans to local SMEs (EBRD 2006). Overall, banks have preferred to do business with medium and large enterprises besides retail market transactions, while high failure rates and poor information on SMEs have increased collateral requirements and hence, foreclosed possibilities for bank lending (Bonin and Wachtel 2003; Wagner and Iakova 2001). As a result, smaller banks have had a higher share of SME loans in their portfolio than larger banks: on average 57 per cent of their portfolio comprised of loans to SMEs, whereas the largest banks allocated only 28 per cent in 2006.16 It is also noteworthy that in Poland, Hungary and Slovenia, after mid-1990s most firms continued to borrow from domestic banks and did not develop close connections to foreign ones (Whitley 2000; Alfred et al. 2012). This was affected by foreign banks’ policies to serve only few local Hungarian clients in the early 1990s (Rhyne et al. 1994). Similar developments occurred in Czech Republic in 1997-98, when banks came under foreign ownership and links to Czech-owned enterprises were gradually broken. For instance, the volume of bank credit as a percentage of GDP fell from 63.9 per cent in 1997 to 39.0 per cent in 2002 (Myant 2007). Yet, the differences in SMEs credit policies between domestic and foreign banks have disappeared over time, even if foreign banks lent less to SMEs during the earlier transition years than
domestic private banks. As competition in corporate segment as well as consumer loan and mortgage markets intensified, foreign-owned banks turned to servicing SME segment that after all comprises the most important customer category for almost all types of banks in transition economies [see De Haas et al. 2010; EBRD 2006; Mihaljek 2006; Bohle and Greskovits 2012; Balcerowicz and Kratkowski 2001; also Table 4]. Another contributor to the levelling of SME loans among different banks has been the EU funding, as after 2004, there has been a tendency for banks to provide co-financing loans to those risky customers that represent a quickly growing sector with the support from the structural funds of the EU\textsuperscript{17} [see Šimek 2010, 34-35].

Although capital transfers from parent banks to their subsidiaries in CEECs were used to finance investments, expectations for rapid income growth in the beginning of the last decade gradually directed foreign financing to less productive uses in the region, as revealed in Figure 5. In 2000s, foreign-owned banks gradually switched their focus from lending to enterprises to collateralized lending to households, which accounted for much of the pre-2008 growth of credit in CEE economies [see Bonin et al. 2008; Atanas and Sanne 2013; Balcerowicz and Kratkowski 2001]. If in the late 1990s, two-thirds of loans on average were extended to enterprises, 20 per cent to the government, and only 15 per cent to households, then by 2004 the composition of lending had shifted towards the households [Mihaljek 2006]. In principle, as shown by Haselmann and Wachtel (2006) and Zsamboki (2002), banks in CEECs, in particular foreign-owned ones, shifted their asset portfolios out of government securities towards mortgages and consumer credit, while trying to maintain the existing level of lending to enterprises, especially to large firms and foreign affiliates. This could be explained by the strengthening of the financial position of large firms and their diversification of financing sources by issuing bonds, equities and borrowing directly from banks abroad that forced foreign-owned banks to extend services to the previously underserved household sector [see Mihaljek 2006; Csubák and Fejes 2014; Myant and Drahokoupil 2011]. As a result, lending to enterprises grew at a much slower pace than household credit [see Figure 6; also Figure 4].
By 2005, the share of loans to households accounted for between 45 and 60 per cent of total credit to the private sector in the CEE region compared with 10 to 15 per cent in 1996 (EBRD 2006). Mortgage lending as a percent of GDP in 2005 ranged from around 12 per cent in Hungary to moderate levels of about 8 per cent in the Czech Republic and around 5 per cent in Poland. Yet, credit to households grew around 27 per cent annually in the Czech Republic and Poland during the 2003-2008 period and was 2-3 times faster than the rate of credit growth allocated to corporate sector. Slovenia, on the other hand, has been an anomaly in that its ratio of loans to GDP was near the top of all new member countries in 2005, but mortgage lending lagged well behind, compared to other countries. In fact, construction boom in Slovenia was caused by investments in public infrastructure (see Bohle 2014; Bonin et al. 2008; Alfred et al. 2012). The expansion of household lending in transition countries has been related to the dominance of foreign-owned banks since with the established legal environment, lending to households can be undertaken in the relatively low-risk business easily through the application of banking technology from abroad (EBRD 2006). Consequently, there has been a positive link between house price developments and capital inflows, in particular in Estonia and other Baltic States (Jevcák et al. 2010).

Moreover, demand for consumer and housing credit was supported by decreasing interest rates and low households’ level of indebtedness, that is the ratio of household financial liabilities to disposable income, that stood at 7 per cent in 2002, compared to 50 per cent in EU member states at that time (Zsamboki 2002; Mihaljek 2006; see Figure 7).

Hence, aside from financing CEE corporations and SMEs, the main market segment of foreign-owned banks has been private consumers (Epstein 2014b). Further, in comparison to domestic banks, foreign banks have been lending more to households - on average 19 per cent of the loan portfolio against 30 per cent, respectively, as domestic private and state-owned banks have not been able to keep up with introducing mortgage loans (see De Haas et al. 2010).
3.2.1 FINANCING OF PRODUCTIVE INVESTMENTS AND MORTGAGE FINANCING

There are several reasons for meager financial intermediation, reflected in the relatively low level of domestic credit supply for financing productive investments in CEECs by Western standards (see Steinherr 1997). First of all, enterprises in CEECs have relied mostly on internal funds\(^9\) for financing both fixed investment and working capital, while external long-term finance coming from FDI that has accounted for a significant portion of corporate finance (see IMF 2000; EBRD 1995, 1998; Schoors 2002; Czako and Vajda 1993; Bonin and Wachtel 2003; Wagner and Iakova 2001; De Castello Branco \textit{et al.} 1996; Alfred \textit{et al.} 2012; Sziksza\i \textit{et al.} 2012). Aside from FDI inflows, another peculiarity of CEECs has been reliance on cross-border loans from parent companies, foreign capital markets, and non-resident banks that have been a substitute for domestic bank credit in CEECs since the mid-1990s and explain the relatively slow growth in domestic credit to corporate sector\(^20\) (see Feldmann and Wagner 2002; Ihnat and Prochazka 2002; Lepik and Törs 2002; Watson 2003; Barisitz 2008; Myant and Drahokopil 2011; Hanley \textit{et al.} 2002). Moreover, many corporations in CEECs have been listed on stock exchanges outside the home country – approximately 40 to 50 companies from Hungary, Poland\(^21\), the Czech Republic each (see Caviglia \textit{et al.} 2002; Alfred \textit{et al.} 2012). Firms have also used short-term liabilities to non-banking institutions and inter-enterprise credit due to hardening of external budget constraints (Scholtens 2000; Calvo and Coricelli 1992; Petrick 2002; Alfred \textit{et al.} 2012; Sziksza\i \textit{et al.} 2012), although banks have provided some working capital for the corporate sector, but had a limited role in financing investments\(^22\) (Berglof and Bolton 2001; IBRD 1996; see Table 5).

Moreover, given the macroeconomic volatility, delays in the implementation of creditor rights, insufficient credit history of enterprises, and inadequate accounting standards, banks were cautious in issuing long-term loans, which explains their engagement in low-risk investments, such as government securities and central bank bills\(^23\) (Barisitz 2005; De Castello Branco \textit{et al.} 1996; Takla 1994; Rao and Hirsch 2003). On the demand side,
enterprises were discouraged from applying for loans due to foreign banks’ collateral conditions, high real interest rates, and cumbersome lending procedures, implying a negative impact of foreign ownership of the banking sector on loan application behavior, which also provides support for “cherry-pick” behavior by foreign banks in host countries (see Brown et al. 2012; EBRD 1998; Bedranski and Osinski 2002; Molnár 2010). This situation improved at the turn of the millennium, when credit registers and government financial support as well as guarantees were introduced that facilitated the growth of SME lending (Barisitz 2005).

Similarly, public policies in CEECs were also behind the emergence of mortgage (and consumer) loans and their rapid growth in 2000s. By 2000, mortgage financing for commercial and residential building was virtually non-existent in CEECs, except for Estonia with a mortgage loan to GDP ratio around 5 per cent. This was caused by the delays in the privatization of the housing stock until late 1990s and often ambiguous ownership rights that impeded the development of the mortgage lending. Also, in contrast to advanced economies, low loan to value ratios, short maturities, poor legal environment for mortgages, controlled rents, lack of institutional investors, and high inflation all constrained housing finance (Bonin and Wachtel 2003; IBRD 1996). Essentially, the situation in the housing market changed with the accomplishment of privatization of real estate that coincided with falling real interest rates, increasing housing prices, and the integration of local banks into the multinational banking groups through acquisitions, the combination of which introduced consumer and mortgage lending in CEECs (see Bohle 2014; Molnár 2010). Furthermore, strong growth and improved macroeconomic and structural conditions, accompanied by generous state interest subsidies for households and other budgetary enticements, introduced in early 2000s, supported ballooning mortgage lending in 2000s, particularly in Hungary and Estonia (Barisitz 2005; Myant et al. 2013).

In order to lure credit institutions to provide loan capital to entrepreneurs that are short of credit records or sufficient collateralizable wealth, the governments in transition countries
established various credit supporting institutions, whose major activities have been the provision of loan guarantees, direct loans, and interest rate subsidies (see Janda 2005). For that purpose, all Visegrad countries under study and Slovenia have established national development banks\textsuperscript{24} that provide long-term infrastructure financing, productive sector financial support, or other financing mechanisms for development. Yet, the magnitudes of their financing activities are not comparable to the products and services offered by commercial banks in CEECs, except for Slovenia (see Figure 8).

In conclusion, four main features in relation to foreign-owned banks in CEECs could be brought out: 1) higher credit growth in foreign than in domestic banks, 2) increasing reliance of foreign-owned banks on cross-border interbank funding during the 2000s with declining share of domestic sources\textsuperscript{25}, 3) declining interest rate margins and increasing credit supply due to entering of foreign banks, and 4) focus of foreign banks on lending activity due to high economic growth and relatively high interest rates, compared to the euro-area rates (see Aydin 2008). Although banks in CEECs lent to domestic entities and were relatively cautious by avoiding involvement in speculative profit-making activities, banks were not a major force in the successful development of domestically owned businesses. FDI triggered the development of new economic activities and sectors, while the spillover effect was a stimulus to further inward investments by MNCs that led to the transformation of whole economies in CEECs (see Myant and Drahokoupil 2011). The main contribution of foreign-owned banks was the aggressive introduction of retail lending in 2000s, i.e. loans to households for consumption and real estate purchases that kept up the demand and rapid GDP growth.

4. VULNERABILITIES AND INSTABILITY IN CEECS AND THE ROLE OF FDI IN THE BANKING SECTOR

Rather than banking and finance per se, neo-liberal policies have been blamed for fragilities in CEECs’ societies that have favored income ‘incentives’, legitimized inequalities, placed greater reliance on individualism, and reduced levels of public support (see Lane
2007; Knell and Srholec 2007). Furthermore, as mentioned above, mainstream literature has perceived the financial globalization that intertwined transition economies with capital markets of advanced countries as mutually advantageous process. Several studies (see EBRD 1998, 2006; Mishkin 2006; Berglof and Bolton 2002; Barisitz 2005; Thimann 2002; Grittersova 2014; Bohle 2014) have indicated to the access to capital and foreign parent banks’ de facto ‘lenders of last resort’ facility that has implied the ‘outsourcing’ of the liquidity provision and bail-out to foreign counterparties. The high degree of financial and monetary integration with advanced Western economies in terms of lending between parent banks and subsidiaries through internal capital markets has been found to entail less problems of asymmetrical information and relatively sound banking systems in the region. Furthermore, parent banks of CEECs’ subsidiaries have been eager to protect their reputation and equity investments since they perceive host economies as an extension of their home countries (Herrmann and Mihaljek 2010; Vogel and Winkler 2010; De Haas and Levyland 2010; Lahnsteiner 2010; De Haas and Naaborg 2005, 2006). Moreover, Berglof et al. (2009) as well as EBRD (2009) have argued that the integration of CEECs’ banks into the European networks was a crisis-mitigating factor. Therefore, detecting the sources of financial fragility and instability in CEECs is not such a straightforward issue to be resolved. First, in order to understand the position and role of the banking sector in affecting directly and indirectly macro-economic (in)stability, some of the peculiar features of the banking business in CEE region are presented.

As noted above in several sections, banking sectors all over the CEE region suffered from deficiencies at the beginning of 1990s that were inherited from the former central planning system, i.e. undercapitalization, a burden of bad loans, inexperienced banking staff, lacking risk management, regulatory and supervisory deficiencies, etc. (see Bártá and Singer 2006; Khoury and Wihlborg 2006; De Castello Branco et al. 1996). Consequently, banking sectors went through several episodes of crises that involved a collapse in financial assets and intermediation, being facilitated by general economic downturn: in Estonia in 1992, in Latvia and Lithuania in 1995, in Hungary in 1991-93, and in the Czech Republic in 1996, which did
not produce any significant real-side disruptions, as non-financial firms depended on financial intermediaries only to a limited extent [EBRD 1998].

In the light of the 1990s’ banking crises, questions were raised over the appropriateness of universal banking model in CEECs, when it was introduced in early 1990s in line with the EU banking principles. Given that the ownership of the commercial banks was mainly in the hands of state enterprises and joint-stock companies, multiple factors were brought out against the universal banking model, such as continuing connected and insider lending to insolvent enterprises, inexperience of bank staff in managing private enterprises, difficulties in valuing equity, and ‘captivity’ of banks to their enterprises27 (see Bahra et al. 2000; Lee 1996; Buch 1993; De Castello Branco et al. 1996; Hansson 1995; Polanski and Graff 1994). Moreover, lending to government and state enterprises by state-owned banks implied high levels of non-performing loans and because of the implicit guarantee of the state in terms of future bail-outs in case of failures, the problem of moral hazard was aggravated (Keuschnigg 1997; Scholtens 2000; Green and Petrick 2002). In the light of such inter-connectedness and lack of independence of bank governance from state control, the resolution of bad loans implied several rounds of recapitalization by governments28, which increased the states’ stakes further until foreign investors were allowed to take majority stakes and change the banks’ behavior [Bonin et al. 2008; Barisitz 2008].

In addition, lax entry requirements resulted in many new private banks in the first part of the 1990s, some of which were of dubious quality, or even fraudulent, and virtually all of which were severely undercapitalized (Bonin et al. 2008; Hansson 1995). Although liberalization measures gave these newly established banks more freedom to take excessive risks and increase financial fragility, it was insider loans, abuses, and ill-advised lending by these entities that resulted in non-performing loans and eventual crises, particularly in Estonia29 [see Steinherr 1997; Keuschnigg 1997; Barisitz 2002; De Castello Branco et al. 1996]. Also, the strain on the pool of human resources was evident in some underdeveloped areas such as credit evaluation, management information systems, audit
and internal controls, loan work-outs, and compliance with banking regulations (Rhyne et al. 1994). In that respect, the banking expertise and discipline imposed by foreign owners led to rapid improvements in the banking environment (Bonin et al. 2008). A study by the OECD (1999 cited in Khoury and Wihlborg 2006) on FDI in the Estonian banking sector concluded that:

‘In general ... foreign entry has been considered positive, as it has raised corporate governance standards and quality control, as foreign banks were controlled by their home country regulations, while local banks typically exhibit more reckless lending practices.’

Thus, it can be said that many of the problems in the CEE banking in the 1990s were attributable to the transition process to a market economy, i.e. dealing with the burden of previous regime’s heritage and its resolution, and introducing new market institutions, not to the ownership structure of banks per se.

4.1 FRAGILITIES CAUSED BY FOREIGN-OWNED BANKS?

Although the appropriateness of universal banking model for addressing transition challenges in the 1990s was widely criticized (see above), several concerns were also raised, once foreign capital took the control of universal banks. One of them being systemic risks, as large, foreign owned, universal credit institutions have become the backbone of financial systems in CEECs. These banks not only control all institutional assets in the financial system, they also own major stakes in the capital markets, insurance and fund sectors (see Badics et al. 2014). More importantly, foreign-owned banks have entailed significant implications for macro-economic instability and financial fragility in the region. Notwithstanding the subsidiaries’ impact on raising prudential standards and efficiency by not getting involved in subprime markets or buying most risky assets (see Myant and Drahokoupil 2011), they have affected macroeconomic developments in terms of contributing to excessive credit provision (see chapters 3.2 and 3.2.1 above), increasing foreign liabilities, foreign currency denominated lending, and widening internal as well as
external imbalances that rendered these economies vulnerable to various shocks (EBRD 2010; Kudrna and Gabor 2013; Mihaljek 2006; Kavan et al. 2013). One of the problems related to foreign banks operation in CEECs has been the credit boom that was disproportionately biased towards consumer credit and mortgage lending. Large capital inflows that were directed into these economies through foreign bank subsidiaries fuelled the growth in the 2000s (Bohle 2014). Once the credit bubble burst, that is, financial inflows halted and internal demand as well as exports declined, output fell about 6 per cent on average in Visegrad countries and 14-17 per cent in the Baltic States (EBRD 2012; Myant et al. 2013).

As noted above, during the period of 1994-2010, foreign banks provided significantly more loans than domestic banks in CEECs, reflected in relatively low liquidity and high leverage ratios of the banking sectors (see Allen et al. 2013; Figure 9).

Banking sectors in all CEECs, except for Czech Republic, had accumulated large net external liabilities by mid-2000s ranging from 13 to 21 per cent of GDP in Hungary and Slovenia to 35 per cent of GDP in Estonia, dominated by FDI, currency, and deposits and loans before the collapse of Lehman Brothers (Lahnsteiner 2010). In 2008 the stock of net foreign liabilities exceeded 70 per cent of GDP in Hungary and Estonia, while it remained below 40 per cent of GDP in Slovenia (Jevcák et al. 2010). Reliance on foreign capital, however, has meant that foreign bank ownership exacerbated the “normal” business cycles in CEECs aside from exposing these countries to foreign financial turmoil. Also, given a high share of foreign liabilities on the balance sheets of foreign-owned banks, the possibility of deleveraging and divestment has always remained on the agenda. Multinational banks can easily relocate funds to different markets through their internal capital markets, in particular, when hints of economic instability emerge or simply on the basis of expected risks and returns calculations that expedite capital flight. CEECs have faced a risk of foreign banks abandoning the host country in case of mounting credit losses or shifting bad loans from other countries to a subsidiary in CEECs, leaving host country
depositors and taxpayers to wear the burden of bank resolution (see Althammer and Haselmann 2011; Morgan and Strahan 2004; Haselmann 2006; de Haas and van Lelyveld 2006; Khoury and Wihlborg 2006). In that respect, foreign banks reduced lending earlier and faster than domestically owned banks in CEECs (see Claessens and Van Horen 2012; De Haas and Lelyveld 2011; EBRD 2012). Capital outflows from the CEECs in 2008 materialized through portfolio investment and financial derivatives, followed by flows of other investments in 2009. Although net foreign loans by financial institutions remained a source of foreign capital inflows to CEECs in 2008, they turned into a channel for foreign capital outflows throughout 2009 due to falling demand for bank lending (Jevcák et al. 2010). Capital outflows in 2008-09 affected both Estonian banking sector that had high level of net foreign liabilities and Slovenian banking industry with comparatively low levels of foreign ownership (Lahnsteiner 2010). Hence, considering the channels of contagion within financial integration, increases in risk premiums and reduced access to credit were the main manifestations of the 2008 crisis in CEECs (Király et al. 2008). Yet, unlike the previous experiences of Turkey, Brazil, and Asia in the 1990s and 2000s, there were two main factors that inhibited a full run on foreign banks in CEECs in the aftermath of 2008 events: 1) Vienna Initiative averting the disaster, and 2) expansion of foreign banks through subsidiaries rather than branches or direct cross-border lending, implying supervision by host authorities and limits on immediate cuts and runs on foreign banks (Epstein 2014b). Nevertheless, funding constraints, regulatory and market pressures to improve capitalization levels, but also subdued demand for credit have prompted banks to withdraw funds from the region, especially from Hungary (Mucci et al. 2013). In contrast to other transition countries, Hungary was the only country (with Latvia and Romania) that faced quite significant problems in the financial sector in the aftermath of 2008 events, as declining cross-border capital inflows put a strain on domestic banks that had relied extensively on external financing and with difficulties in accessing funding, they depended on government rescue packages. Increasing foreign indebtedness brought up the rollover risk in the banking sector, as banks were engaged in short term contracts in the swap
market in which they swapped the euros for Swiss francs and extended typically long term mortgage loans in Swiss franc. This maturity mismatch of assets and liabilities created the need for the regular rollover of these swap contracts, which eventually prompted the bailout by international financial institutions to prevent a run on Hungarian assets and the collapse of the Hungarian financial system. Furthermore, as a large part of loans were denominated in foreign exchange, devaluation aggravated the situation for borrowers and increased the risk of a growing share of non-performing loans (see OECD 2012, 64–65; Epstein 2013; Becker and Jäger 2010; Molnár 2010; Szikszai et al. 2012).

Therefore, another risk for CEECs stems from lending to unhedged borrowers in foreign currencies, exposing several economies to foreign exchange risks in terms of the threat of wide-spread private sector defaults sparked by devaluation, as was in the case of Hungary. Such lending practices have been true for both domestic and foreign-owned banks, owing to the failures to match the credit growth with deposits (see Lehmann et al. 2011; Bonin et al. 2008; Barisitz 2008; Myant and Drahokoupil 2011). Yet, there are differences between the countries. The Czech Republic has differed from other CEECs in terms of credits being covered by a domestic deposit base and prevalence of fixed-rate mortgage loans, denominated in local currency. While the share of foreign exchange denominated loans in the Czech Republic has ranged between 10–20 per cent, over 80 and 70 per cent of all loans have been issued in foreign currency in Estonia and Hungary37, respectively (EBRD 2009, 2012; ECB 2006). Three groups of countries can be distinguished: Estonia and Latvia with a very high foreign currency loan share; Hungary and Lithuania with a medium share; and finally, countries with relatively small shares: Poland, the Czech Republic and Slovenia (before the euro adoption in January 2007, the share was 64 per cent and had risen substantially in the period immediately before euro adoption) (Szikszai et al. 2012). The trap of private borrowing in foreign currency was avoided in the Czech Republic due to the lower interest rates than those of the euro area. This was made possible by the relatively high growth rates with decreasing taxes and public finances kept in order (see Bohle and Greskovits 2012).
Lastly, the activities of foreign-owned banks in CEECs have had several implications for macro-economic (in)stability in terms of internal and external (im)balances, one them being already mentioned an exceptional, but unsustainable economic growth with expanding sheltered sector (see Atanas and Sanne 2013; Klingen 2013; Ross 2013). As domestic savings have been insufficient to cover investment and consumption demand, the combination of demand pressures and access to cheap credit, intermediated through the banking sector, resulted in asset price inflation and widening current account deficits (Barisitz 2005). As a result of strong capital inflows, external and internal imbalances were further aggravated by appreciating real exchange rates from 2001 (EBRD 2006). Consequently, CEECs have faced the problem of mounting international debt, but also the inability to control consumption levels beyond the countries’ earnings and failures to build export potential to finance growth in domestic consumption (Myant and Drahokoupil 2011).

Aside from the impact of the banks on external imbalance, it was also aggravated by the operation of MNCs that transferred part of their production to CEE region, where taxes and wages were low, imported semi-finished products, and exported final products to the Western markets, hence contributing to both exports and imports in trade balance, but also to current account imbalance with the outflow of profits (Samary 2012; Figure 11). In that respect, macro-economic vulnerabilities in the Visegrad group have been related to high export dependency and issues around public finance, while in Estonia and other Baltic countries to low export competitiveness and high dependency on foreign credit (Bohle and Greskovits 2012).

In more broader terms, CEECs’ imbalance problem has been a result of a general neoliberal agenda on the European dimension that turned the periphery countries into markets for the core economies of the EU without prospects of catching-up due to insignificant fiscal transfers targeting productive investments, and hence, causing differentials in productivity. In light of the Growth and Stability Pact as well as EU competition regulation, there has not been much room to maneuver in the national
industrial policy sphere. Hence, with lacking productive investments, industrial policy, and devaluation options, competitiveness has been built around the wage moderation and increased deregulation in labor markets (Onaran 2012). In principle, with wages being treated as costs to be squeezed, the change in the share of value added at the expense of wages has been accompanied by a rise in household debt to maintain consumption levels (Samary 2012; also Alfred et al. 2012).

In conclusion, macroeconomic vulnerability of CEECs has been associated with a structural savings shortfall, evident in current account deficits, excessive loan-to-deposit ratios, and an ongoing funding need from parent banks (Lehmann et al. 2011). Financial fragility in CEECs was further increased by lowered risk-perception, while markets gave wrong signals that resulted in leveraged structures and extensive use of credit for inappropriate debt-financed investments in terms of distribution and amount. For instance, in Estonia, excessive demand and easy credit resulted in external financing being concentrated in a limited number of economic activities (real estate and construction) that triggered speculation-led inflation (Lucas 2009; Kattel 2009, 11-13). Such expansionary effects resulted in the ongoing real appreciation of domestic currencies that worsened current account balances. In general, it is the combination of several factors that has driven deepening financial fragility in Estonia and to lesser extent in other CEECs (see Onaran 2012; Bohle and Greskovits 2012; EBRD 2006; Kattel and Raudla 2013; Myant and Drahokoupil 2011; Mencinger 2014):

- highly leveraged economic units;
- appreciating currencies in real terms that deteriorated the competitiveness of exports;
- worsening net international investment position and current account deficits, in particular, continuous deficit on the income account (repatriation of profits earned on FDI);
- high ratios of foreign debt to GDP;
• inflating assets and increasing wages without productivity gains;
• inappropriate distribution of foreign capital – financing of non-tradable goods;
• lost risk-perception that led to endogenous fragility;
• currency and maturity mismatches.

These features of CEECs reveal the typical situation of financial fragility that Minsky’s analysis addressed. The build-up of financialized economic growth and development model that heavily relies on absorption of external funding for meeting domestic demand can be sustained only by further capital inflows with the outcome of ever-increasing external debt servicing. Also, given the FDI-dominated manufacturing sector with matured low- or medium-technologies that face the saturation of markets, low profit margins, and decreasing demand, the Minsky moment and eventual crisis can be realized by the drop in FDI stock due to shrinking profits and plummeting stock prices that would induce capital flight. Furthermore, massive sale-offs of inflated assets would have a contagion effect that leads to decreasing value of assets and shareholders’ equity, implying the typical Minsky’s Ponzi position, where liabilities of indebted entities cannot be met.

The question is, whether such negative macro-economic developments could have been avoided, if domestic capital and state control in the banking sector had prevailed in CEECs. Surprisingly, Epstein (2013, 2014b) has not found any significantly positive relationship between domestic control and limited macroeconomic vulnerability. Although foreign banks contributed to unsustainable credit boom in the run-up to the crisis through cross-border and foreign currency lending, a number of domestically state- and privately owned banks in CEE region did this too. There is anecdotal evidence on several cases of state-owned banks failing to support macroeconomic stability in CEE region during the pre- and post-2008 crisis periods. For instance, while Polish state-owned bank PKO Bank Polski was conservative in the pre-crisis phase and played a countercyclical role in the post-Lehman crisis, state-owned banks in Slovenia, Hungary (largest Hungarian-run multinational banking group OTP Bank), and Latvia (second largest domestically, but privately controlled
bank Parex Bank) took on excessive risks by engaging in large-scale cross-border borrowing in the run-up to the crisis, but also failed to boost lending during the crisis, except for Hungarian case. These three cases from Latvia, Hungary and Slovenia reveal that domestic bank ownership does not guarantee sustainable support for local economy. Therefore, given a dichotomy between the views on the impact of different ownership structures on macro-economic stability, but also ambivalence in this issue, Allen et al. (2013) have claimed for advantages of a mixture of foreign-owned and government-owned banks in CEECs by showing their complementary crediting policies during domestic banking crises or global financial crisis. Their study revealed that “foreign banks provided credit during domestic banking crises in host countries, while government-owned banks contracted. In contrast, foreign-owned banks reduced their credit base during the global financial crisis, while government-owned banks expanded” (Allen et al. 2013). In that regard, lending by state-owned banks has been found to be politically motivated and hence, governments have been in a position to use state-owned banks to compensate for market failures and limit credit contraction during a crisis period (see Jackowicz et al. 2013). Foreign-owned banks, on the other hand, play a dual role during two different episodes of crises: contributors to stability during domestically induced turmoil, but in case of global or home market crisis, importers of instability from abroad (Goldberg 2009, De Haas and Lelyveld 2011; Bonin et al. 2008). Because of that, there is a potential for conflict, if a home country regulator perceives a foreign subsidiary as a small part of a multinational bank, but for a host country financial sector it is an important player (see below). Hence, rather than a mere presence of foreign capital in the banking sector, challenge for CEECs lies in uncoordinated supranational regulation and supervision that has undermined financial stability in CEECs within the current financial regulatory architecture in the EU. The wish of CEECs to exercise national control over capital and liquidity standards through regulation and supervision goes against the European Banking Union’s approach that would require all Eurozone states to cede national control (see Spendzharova 2014).

4.2 BANKING REGULATIONS AND POLICY MEASURES
Banking regulation in CEE region has taken the EU’s regulatory framework as a model, although progress in legislation transposition on paper has been more advanced than its implementation due to the scarcity of human capital as well as infrastructure and evidenced in weak enforcement of contracts, difficult access to collateral, inefficient bankruptcy procedures etc. (see EBRD 1998; Bonin et al. 2008; Keuschnigg 1997; Barisitz 2005; Rhyne et al. 1994; Bonin and Wachtel 2003; Scholtens 2000; Borak 2000; Wagner and Iakova 2001; Steinherr 1997; Barisitz 2005). On the other hand, the existing EU-based regulatory regime has undermined host countries’ regulatory and supervisory powers. This has been due to the emphasis of the EU law on the lead role of home country regulators in case of consolidated banking supervision that has revealed two problems for CEECs: the misallocation of regulatory responsibility and the lack of accountability for failure to regulate in markets beyond the home regulator’s jurisdiction (Pistor 2010; Begg 2009). Given these supervisory challenges against the entrance of foreign banks that has exposed the CEECs to developments in the banks’ home markets, some of the CEECs, such as Hungary and Slovenia, forbade the establishment of foreign bank branches until early 2000s (Wagner and Iakova 2001; Epstein 2014b).

In addition, the EU-level regulatory developments have not been taking into account peculiar aspects of CEE economies or been in line with domestic stability considerations for setting banking regulations (see Ross 2013). For instance, the implementation of EU banking directives has meant pro-cyclical loosening of requirements as stricter domestic rules had to be cut back in CEECs. Hence, the application of common EU regulations has been at odds with country-specific actions in addressing macro-prudential concerns. Notwithstanding their nominal regulatory control over subsidiaries of foreign banks, regulators in CEECs have managed to do little to enforce their policy objectives for the stability of domestic financial system. As recipient countries of foreign capital, CEECs have largely renounced policy tools to hedge their economies against financial turbulences. Liberalization of capital account transactions and reliance on home country regulators of foreign banks were adopted in order to integrate to European financial systems, implying...
dependence on the goodwill of multilateral organizations. Thus, it has turned out that, while countries in CEE have implemented primarily extensive legal and regulatory reforms in line with the EU principles, another facet of the effective governance regime for finance – money supply - has not been addressed within the established regulatory architecture of international banking (see Pistor 2009).

To some extent, national governments also aggravated macro-economic imbalances by introducing a number of tax provisions in early 2000s, such as tax deductibility of mortgage interest payments, provision of housing loan guarantees and subsidies, and abolition of corporate tax on reinvested profits, among others, that resulted in a lending boom of unprecedented proportions (Bohle and Greskovits 2012). Instead of curtailing the increasing internal and external imbalances, policies supported the mortgage boom without any significant measures to correct the risks of households, that is, increasing exposure to exchange and interest rate risk due to mortgages issued in foreign currencies with adjustable interest rates (Bohle 2014; Szikszai et al. 2012). In Hungary, government provided grants and subsidized housing loans by fixing interest rates and exempting households with housing loans from income tax from 1998-2004. In Estonia, the tax system has been geared towards home ownership, as income tax act has offered the possibility to deduct interest payments from taxable income and exempted gains from selling residential property from taxation. Moreover, abolishment of corporate income tax on reinvested profits re-directed investments into real estate. Finally, government’s credit scheme in the early 2000s guaranteed parts of the down payments of housing loans that enabled banks to reduce the minimum down payments. In both countries, foreign currency mortgage loans took off, but in Hungary they were a consequence of political decisions related to financing public welfare, while in Estonia, logical choice in line with unfettered market economy approach (see Bohle 2014). Unlike Estonia and Hungary, the Czech Republic and also Poland have been able to manage aggregate demand through counter-cyclical fiscal measures, accompanied by low domestic interest rates that constrained the pre-crisis boom and made foreign exchange borrowing unattractive. Slovenia mitigated foreign
currency borrowing risks with the corporatist system that enabled to adhere to fiscal restraint, predictable monetary policy, and accession to Eurozone (Myant and Drahokoupil 2013; Bohle 2014). In addition, unlike Slovenia and Estonia, other CEECs – Poland, Czech Republic, and Hungary – have used flexible exchange rate regime and liquidity management measures as a policy tool to mitigate imbalances (Klingen 2013; Alfred et al. 2012). In principle, CEECs under study have differed in terms of the extent of outsourced functions of financial regulation and supervision as well as monetary regimes and fiscal policies, implying varying effects of foreign banks’ operations in CEECs.

In the light of policy measures that have been undertaken in the CEECs as a response to either overheating economy or recessionary trends, Kudrna and Gabor (2013) have raised the issue of political risks in the CEE region, related to exchange rate regimes, macro-economic policies and sovereign solvency issues. These political risks emanate from both home and host countries, responsible for coordinated supervision of cross-border banking activities, and hence make relevant policies of home and host countries interdependent, since they can transmit the effects of policy changes both ways. More importantly, as the effects of policy decisions usually get transmitted through unregulated internal capital markets, which have been relied upon for allocation of funds by transnational banks, these markets pose a potential risk for CEECs in terms of undermining counter-cyclical macroeconomic policy measures. In other words, the responsibility of both home and host country (supervisory) authorities has complicated the exercise of effective oversight over subsidiaries in CEECs, and particularly the application of macro-prudential instruments to mitigate credit booms, as host-country authorities’ control over subsidiary lending has been limited due to the lack of possibility to interfere with cross-border flows and information about or influence over parent bank funding (see EBRD 2012). That said, banks were not much affected by policy efforts to curb the lending boom in the pre-2008 period. Besides, host country authorities tended to rely on home regulators in ensuring financial stability in CEE region (Rosenberg and Tirpak 2008; Thimann 2002). At the same time, home regulators’ reluctance to interfere with rapid growth in banks’ foreign markets diminished
the effectiveness of any measures undertaken by host countries to curb lending. On top of that, parent banks circumvented regulations and monetary policy measures by providing direct cross-border credit to companies based in host countries or through leasing companies and asset management companies within the banking groups, implying that the core function of banks has been performed by non-bank institutions that escape the regulatory oversight (see Pistor 2010; Kavan et al. 2013; Barisitz 2008; Wu et al. 2011; Mihaljek 2006; Spendzharova 2014). In mid-2000s, several CEECs introduced macro prudential measures such as higher reserve, liquidity, and capital requirements and, in the case of Bulgaria, specific credit ceilings that were all circumvented by foreign banks (Atanas and Sanne 2013).

Lastly, in light of increased cross-border banking, host supervisors have been put in a challenging position in assuring financial stability and monitoring systemic risks in the system as a whole, as the focus of supervisory principle lies on the solvency of individual financial entities, but not on macro-prudential issues (Begg 2009; see also Kregel 2014 for a general discussion of this issue). The systemic importance of foreign financial institutions in the CEECs has also challenged central banks as lenders of last resort and in particular, providers of adequate liquidity support in case the liabilities are denominated in foreign currency that could destabilize the whole system (Wagner and Iankova 2001). On the other hand, the dominance of foreign banks has provided government more fiscal space in times of crises, as bailing out banks has been essentially ‘outsourced’ to the foreign central banks (see Kattel and Raudla 2013). Hence, cross-border coordination of banking supervision and also resolution has been stressed in an environment of high capital mobility in order to enable host-country supervisors to effectively implement macro prudential measures, given that insufficient international coordination between supervisors contributed to the 2004-08 credit boom (EBRD 2012; Ross 2013). On the practical level, several international initiatives have been undertaken in response to 2008 crisis and its consequences for CEECs, such as Vienna Initiative I and II, with the aim of committing
foreign banks to maintain sufficient levels of external financing necessary to stabilize Central and Eastern European economies (Kudrna and Gabor 2013).

5. CEECS IN THE VARIETIES OF CAPITALISM PERSPECTIVE AND CONCLUSIONS

Institutional and cultural characteristics yielded a particular result in each CEE economy that has implied diverging transition processes towards capitalist economic system. One of the reasons for diversity has been historical variation in the institutional arrangements, creating path dependencies in the transformation processes (see Tridico 2011; Lane and Myant 2007; Knell and Srholec 2007). In addition, punctuated by major crises, the period of 1989-1998 witnessed critical juncture points at which key decisions on the shape of post-socialist capitalism were taken (Bohle and Greskovits 2012). Therefore, the typologies of market economies in CEECs, reflected in the contrasts in economic structures, financial development, and the extent of external exposures have had different implications for the viability and stability of these economies. Similarly, differences in experiencing the 2008 crisis were affected by heterogeneous economic and political structures that, in turn, led to diverging policy choices (see Myant and Drahokoupil 2013).

While Hall and Soskice (2001) developed a dual typology of capitalist systems, that is liberal market and coordinated market economies from the point of view of ways how activities of firms are coordinated, Amable (2003) extended the analysis by adding financial intermediation, among others, into his five types of capitalism. However, these typologies in the varieties of capitalism (VoC) approach, as elaborated by Hall and Soskice (2001), Coates (2000), or Amable (2003) have been criticized for not being able to capture the dynamics of economic systems in CEECs that have been subject to transformation processes. In contrast to advanced economies with long capitalist tradition, the legacy of socialism provided a quite different footprint for the following evolution of capitalist production (see Myant and Drahokoupil 2011, 299-302; Lane 2007, 13-15). Nonetheless, pursuant to the VoC approach, Buchen (2007) and Feldmann (2006, 2007) have presented Estonia and Slovenia as antipodes regarding their institutional settings in the capitalist transformation along the
liberal and coordinated market economy trajectories, respectively. Nölke and Vliegenthart (2009) and King (2007) have added a third classification to Visegrad countries as the liberal dependent market economies, where business entities have been coordinated in hierarchical intra-firm relationships within transnational corporations and operate as export platforms of semi-standardized industrial goods. Similar conclusions were reached by Knell and Srholec (2007) who tried to group CEECs according to multiple parameters, such as social cohesion, labor market regulation, and business regulation on the axis of liberal-coordinated economic system: strategic market coordination prevailing in Slovenia, liberal market coordination in Estonia, and the rest of studied countries in between.

More detailed analysis on typologies of CEECs has been provided by Myant and Drahokoupil (2011) who proposed five varieties of capitalism that emerged in transition countries, linking the forms of international integration to other key features of these economies, including the nature of property rights, the role of the state, and relations between the state and main economic actors. Countries under study have been classified into 1) FDI-based market economies, that is Visegrad countries, and Slovenia to some extent, where reliance on free markets has been balanced with the development of stable state and export structures built around manufacturing goods produced by foreign-owned MNCs with a considerable potential for upgrading and development within international production networks, and 2) Peripheral market economies, that is the Baltic States with weak manufactured-goods export structure and reliance on financialized development with low levels of welfare provision. Dependence on financialized growth implied international integration by foreign borrowing and financial inflows to support private-sector activity, including consumption, and to cover current account deficits. Fixed exchange rates guaranteeing macroeconomic stability and real exchange rate appreciation, capital account liberalization, light-to-no-touch regulation of lending, and low-to-zero taxation on capital gains were particularly favorable to financialized development in the Baltic States, countries that lacked sound export structures and domestic deposit bases (ibid.).
Similar classification of studied CEECs has been presented by Bohle and Greskovits (2012) who elaborated on the emergence of three forms of capitalism in CEE region: a neoliberal type in the Baltic States, an embedded neoliberal type in the Visegrad countries, and a neocorporatist type in Slovenia. The Baltic neoliberal regime embodies a combination of market radicalism with inadequate industrial policies to capture promising market niches and meager social safety nets, reflected in the limited influence of social groups in policymaking and trade unions. Slovenia, on the other hand, has taken the least radical approach to marketization with the preservation of inherited industries, support to domestic entrepreneurs, generous social compensation measures, and many features of a democratic corporatist polity, where negotiated relationships among business, labor and the state are directed toward compromises. The Visegrad states’ embedded neoliberalism lies in between these two extremes with a search for compromises between market transformation and social cohesion in a more inclusive and foreign capital favoring, but rather inefficient governance system. In that respect, the Slovenian state appears to have been the most capable followed by the Visegrad and Baltic States. Everything considered, the forms of post-socialist capitalism can be differentiated by neoliberalist, welfare capitalist and democratic corporatist approaches (ibid.).

Thus, the differences, how regimes were affected by the 2008 crisis, can be traced to regime-specific economic structures and patterns of international integration, that is, whether through manufacturing FDI and exports or through the financial sector. In Visegrad countries, the developmental prospects have depended on investment decisions made by foreign investors who have bought more successful enterprises. Hence, providing the infrastructure and support for inward investment has been the most important state role in development for manufacturing industry and in an attempt to attract as well as embed higher-quality FDI through targeted subsidies. Given these circumstances, a combination of structural and institutional factors launched virtuous cycles of capital accumulation in the Visegrad region, revealed in the industry upgrading, the clustering of complex-manufacturing export industries, and generous subsidy packages offered by the
Visegrad states to transnational complex industry investors (EBRD 2009; Bohle and Greskovits 2012). The Baltic course of radical liberalization, however, entailed the vicious circle, manifest in the accelerated deindustrialization and collapse of complex industries, accompanied by a weak export potential in traditional light and resource-based industries and services at the core of the production profile. For that reason, only credit could expand the purchasing power of most of the population and which explains the overindebtedness of households in CEECs’ neoliberal regimes, indicating to a kind of “privatized (house price) Keynesianism” that has entailed a shift from counter-cyclical state policies for securing income and employment in times of recession to the growth of private credit to low-and middle-income groups for compensation of low salaries and job insecurity. It was under the pressure of rising unemployment, poverty, and social unrest as well as financial constraints that the Baltic States opted for the privatization of welfare provision and retrenchment. In these economies, one can observe a vicious circle of consumer credit, mortgage lending, and a construction and housing boom reinforcing each other with dire consequences for export competitiveness due to galloping inflation and appreciating real exchange rate within a system of fixed exchange rates. Thus, owing to a rapid development of simpler manufacturing activities in a low-cost and flexible environment with easy access to international credit, unsustainable financialized growth took off in the Baltic States (see Bohle 2014; Myant and Drahokoupil 2011; Bohle and Greskovits 2012). Such a financialized accumulation mode, based on borrowing in foreign currency and import of capital, has been revealed in structural blockages in the productive structure and disproportionate price increases of financial assets as underlying causes of financial fragility and eventual imbalances. On the other hand, countries that have adhered to the dependent industrialization regime by relying on the export of manufactured goods, weathered the dynamics of 2008 crisis more easily by declining foreign demand for a relatively short period. Such a dichotomy unveils also different policy responses to the crisis by being either pro-cyclical or counter-cyclical, respectively (see Becker and Jäger 2010). In broad terms, Estonia with other Baltic States could be classified as following a debt-led
consumption boom and development path, while the rest of the studied countries encompass characteristics of both debt-led consumption and domestic demand-led development typologies (see Hein 2012), although Slovenia and lately Estonia as well as Hungary have indicated the signs of a weakly export-led type of growth.

In contrast to other CEE economies under study, Estonian post-2008 experience encompassed ‘internal devaluation’ approach that implied sharp cuts in public spending and reductions in wage levels rather than currency devaluation. The rest of the CEECs, aside from Slovenia that was in the Euro-zone, typically combined currency devaluation with a lower degree of austerity measures (Myant and Drahokoupil 2013). In spite of the responses in CEECs falling broadly into a social-democratic and a neo-liberal spectrum, all countries have moved towards fiscal austerity by cutting expenditures with a switch towards indirect rather than direct taxes. CEECs stand out from Western European countries in terms of higher level of social acceptability for such drastic measures to deal with the crisis and the weaker acceptance of the need for a government role in overcoming the effects of the crisis, whereby fears over the level of public debt set limits to any social-democratic strategy that could have raised concerns over long-term economic weaknesses, revealed by the crisis (see Myant et al. 2013; also Kattel and Raudla 2013; Alfred et al. 2012).

In conclusion, all studied CEECs represent heterogeneous entities with different starting positions in their transition to market economies as well as chosen paths that have constrained or enabled the emergence of macro-economic and financial fragility, associated with the dominance of foreign-owned banks in the transition economies of CEE region. That said the implications of foreign ownership for macro-economic stability have to be presented and interpreted with caution. First of all, when drawing conclusions on the effects of different ownership structures on the fragility and instability, one has to bear in mind that in the case of CEECs, specific historical context needs to be acknowledged, as several problems and obstacles in achieving the macroeconomic stability with the state-
ownership in the banking sector were related to the transition process from socialist production regime to the introduction of market economy institutions. Similarly, historical context needs to be considered when analyzing the impact of foreign ownership in the banking sector in the 2000s, as at that time, the activities of foreign-owned banks took place in the context of increasing global liquidity and asset prices’ boom that was taking place in the Western world. Hence, ownership as such has not mattered so much for the macro-economic stability in the CEECs, but rather internal developments, that is, transition to market economy with associated challenges in the 1990s that rendered these economies unstable, partly due to managerial problems in state-owned banks, and external factors, such as international capital flows in the 2000s that incurred imbalances through the activities of the banking sector.

In particular, foreign ownership in the banking sector has increased vulnerability to internal and external imbalances in Estonia and the rest of the Baltic States that have implemented neo-liberal unfettered market economy approach in their transition process. In such a liberalized and deregulated macro-economic environment, excesses in housing demand and certain economic activities have been fuelled by aggressive lending activity of foreign-owned credit institutions that resulted in overheating economy in terms of housing market and consumption boom. Visegrad countries, on the other hand, have managed to alleviate the negative effects of foreign ownership in the banking sector through macro-prudential policies and strong industrial base as an export platform that have enabled governments to manage external and internal imbalances. Slovenia, in turn, avoided any negative implications on its macro-economic stability by retaining domestic and to some extent, state control over the banking sector, although incurring risks through exposures to external liabilities. All in all, it can be said that the ownership in the banking per se has not refrained from or prompted macro-economic instability. Compared to analogous development paths, such as the one in East Asia in the 1990s, foreign ownership in the banking sector in the CEECs did not lead to the total collapse of these economies after the 2008 events, despite the increasing fragility caused by the banks. This was due to prevailing
traditional lending activity of banks, financial support from both international and home country monetary authorities, and embeddedness of subsidiaries in host economies. Rather, vulnerability of the CEECs has stemmed from the international specialization of these economies and their volatile export production, but also financial architecture, based on the common EU standards, and overall liberalization as well as deregulation tendencies, that is, deteriorating degree of monetary and fiscal sovereignty, that have rendered these economies vulnerable to potential capital flight due to increased dependence on foreign capital as a source of domestic demand financing.
Minsky (2008) claimed that the leverage ratio of banks, that is increased asset-to-equity ratio, and speculative or Ponzi financing in the economy are two sides of a coin, as leverage by banks decreases the margins of safety and thus increases the potential for instability of the economy.

In the first half of the 1990s, foreign commercial banks showed little interest in acquiring state banks due to difficulties in evaluating loan portfolios and integrating them with their own systems (IBRD 1996).

Against these developments, four biggest eurozone countries – Germany, France, Italy, and Spain – have had below 15 per cent foreign bank ownership level (Epstein 2014a).

Visegrad and Slovenia connected to Germany, Italy and Austria, whereas Estonia linked to Finland and Sweden (EBRD 1994).

Aside from a liberal FDI policy in Estonia, the expansion of foreign ownership was encouraged by decreased stock prices of targeted banks due to the crisis of 1997-98 (Khoury and Wihlborg 2006).

Approaches to and speed of privatization of banks were, in turn, affected by varying measures undertaken to deal with the bad-debt problem of state-owned banks (Rhyne et al. 1994). One of the approaches to restructure the banking sector and deal with the bad debt issues was Hungarian ‘sticking plaster’ approach by providing the minimum amount of financial support to the banking sector before privatizing to foreigners. ‘Once and for all’ solutions to the problem of capitalization of the banks were implemented in Poland with requirements for banks to create bad debt workout units, while ‘hard supervision’ whereby banks were restructured via mergers, withdrawal of licenses, or putting them under moratorium, or allowed to go bankrupt with significant losses for depositors, was practiced in Estonia. Slovenian strategy in the rehabilitation of banks only sought to rescue failing banks without any intention to restructure or transform the banking industry, while the
Czech approach transferred bad debts to specialized “hospital” banks (see Rostowski 1995; Hansson 1995; IBRD 1996).

7 In Poland, for instance, a plan to delay privatization and to create a strong Polish-owned banking sector was strongly opposed external actors, such as the IMF and EBRD (Myant and Drahokoupil 2011).

8 In Slovenia, FDI in finance was also delayed due to the perception of Balkans as a fairly risky region for investment (Sevic 2000).

9 Although CEECs officially introduced universal banking system, the banking laws in early 1990s were restrictive in that respect and provisioned that banks could only perform all kinds of commercial banking activities. Hence, the role of the banking sector in the restructuring and privatization of the enterprise sector was much weaker, even if the state in Visegrad group countries was heavily involved in the rehabilitation of banks without linking it with their privatization (Borak 2000). The Hungarian banking system was the most restrictive one, as banks were not permitted to engage in investment banking activities and legislation contained safeguards against bank involvement in corporate decision-making. In Poland, banks played more significant role in restructuring enterprises, as bad debt issue that had to be worked out between enterprises, banks and other parties (Buch 1993; Thorne 1993; Scholtens 2000). In Czech Republic, given the governments’ pressures to grant loans to troubled Czech enterprises against enterprises’ shares as collateral, banks were rendered into passive owners of businesses. Hence, either directly or through investment funds banks owned much of the private sector, implying continuing ‘state capitalism’ and thus inefficiency and slow restructuring of Czech enterprises (Myant 2007; Tihanyi and Hegarty 2007; Wagner and Iakova 2001). In Slovenia, in light of shares held by insiders and state-controlled funds, banks’ role in corporate governance took place through bank-owned privatization investment funds (see Gregoric 2003; Buchen 2007).

10 To some extent, only Poland witnessed a growth of derivatives’ market and currency
exchange transactions. Foreign-owned banks tried to develop also instruments of the domestic money market, such as commercial papers and certificate of deposits, but without any significant success (Balcerowicz and Kratkowski 2001).

11 For instance, in Estonia, banks have followed conservative approach in managing their securities portfolio after the stock market crash in 1997 and the take-over of banks by foreign financial institutions that was reflected in low share of securities held for trading or short-term investments of 3 per cent in the securities portfolio in 2001. At the same time, approximately 30 per cent of banks’ assets were invested in liquid instruments in the central bank and abroad as a consequence of the high rate of reserve requirement that has been in the range of 10-15 per cent of liabilities, while around 60 per cent of bank assets were directed into domestic real sector (Lepik and Törs 2002). Similarly, in Poland, foreign banks’ asset portfolios have comprised mostly loans and off-balance sheet items, whereas domestic banks holding primarily government bonds (Havrylchyk 2006).

12 Banks operating in CEECs see stricter micro- and macro-prudential requirements adopted within the Basel III framework as a threat to their banking model, that is increased integration of funding relationships within cross-national bank groups – so-called internal capital markets (Lehmann et al. 2010).

13 Interestingly, Czech Republic has had the highest share of subsidiaries that have sent liquidity to their foreign headquarters and is also the only country in the region that has more banks providing financial support to than receiving from their parents (EBRD 2011c).

14 Although in Hungary, branches have been the most dynamic group of institutions: their assets grew by an annual average rate of 108 per cent between 2005 and 2011. However, most of this dynamism is due to the fact that the biggest institutions that previously operated as banks (Citibank, BNP Paribas, ING) switched to operate as branches in order to save costs and focus on their core business. Their total assets combined were more than 5
per cent of all assets in the financial system and almost reached 9 per cent of Hungarian GDP in 2011 (Szikszai et al. 2012).

15 In Czech Republic, for instance, foreign banks entered mainly to serve their own clients and did not aim to gain power on the market (Šmídkova 1996, 18).

16 In the Polish banking sector, the share of large private firms and small enterprises has amounted on average to 48 per cent and 11 per cent of banks’ portfolios, respectively, whereas loans to large firms have constituted around 67 per cent of foreign-owned (greenfield) banks’ portfolios. Domestic private banks, on the other hand, have devoted 1.5 times more of their portfolio to opaque borrowers than other banks (Degryse et al. 2012). This result in Poland has been in line with similar findings in other CEE transition economies (see Clarke et al. 2005, 2006; Berger et al. 2001; Giannetti and Ongena 2009, 2012).

17 The Baltic States have been among the leaders in absorbing the EU funds and directing these to new domestic start-ups and social policy measures that reintegrate people into workforce, which indicates to the purpose of bank loans for co-financing the EU-funded projects. Utilization of banks as intermediary bodies is perceived to accelerate EU funds absorption, in particular in channeling funds to SMEs, but their role in absorbing EU funds has included the project assessment, fund disbursement, monitoring, and on-site inspections (see Bohle and Greskovits 2012; The European Bank Coordination Initiative 2011).

18 Even more impressive was increase the ratio of household loans to GDP that quadrupled from 8 per cent to 33 per cent between 2000 and 2008 in Hungary (Badics et al. 2014).

19 Debt-asset ratio for non-financial firms was 44 per cent in the Czech Republic in 1994, 32 per cent in Hungary and 41 per cent in Poland in 1992, while being around 65 per cent in advanced economies (Keuschnigg 1997).
In addition, the EU funds and government co-spending on EU-financed investments have provided the Baltic States one of the leeways to contribute to, and in some occasions substitute the role of private funds in financing productive investments in Estonia and other Baltic States (see Kattel and Raudla 2013).

In the Polish case, local Warsaw Stock Exchange Group has organized and operated trading on the NewConnect platform, designed for start-ups and developing companies, that is, trade in equities and other equity-related securities of small and medium-sized enterprises (Alfred et al. 2012).

Borrowing from banks to finance working capital accounted for around 10 per cent of total financing in CEECs, while bank loans for financing fixed investment stood around 14 per cent in 2006 (EBRD 2006). For external financing, SMEs have used also the services of leasing companies (Alfred et al. 2012).

This was evident also in post-2008 crisis period, when banks were rather reluctant to make loans to the private sector and bought profitable, riskless treasury securities, as in the Polish case (Alfred et al. 2012).

For instance, the Hungarian Development Bank (MFB) as a development bank in the classical sense of the word has been instituted as a strategic state-owned bank in Hungary to promote economic development, increase technological level and employment by providing government guarantees as well as capital- and loan-financing to SMEs and infrastructure projects, but also to large enterprises by funding large-scale development projects that generate the strongest spinoff-effects in the economy. These long-term loans that have been provided under favorable conditions and selected on the basis of economic policy considerations, have been either borrowed from international money markets with exchange-rate guarantees offered by the state or financed by issuing securities. The bank has also been responsible for the efficient use of EU funding by assisting businesses to improve their absorption capacity (MFB 2014; Janc 2004; Szikszai et al. 2012). In early
1990s, state-led crisis management for strategically important state-owned enterprises in Hungary resulted in some of the subsidized firms ending up in the portfolio of the Hungarian Development Bank through direct cash transfers, the write-off of payment arrears, and the restructuring funds. Thus, by collecting the assets of ailing manufacturing companies, the bank acted as a professional reorganizer of these entities (Szanyi 2003). In later stages, MFB has played the role of providing funds through the state-subsidized small-enterprise credit schemes, possessing a credit portfolio at the value of HUF 356.3 billion (1.3 per cent of GDP) in 2012. Moreover, the funding made available through lending schemes with state-backed interest subsidies represented more than 90 per cent of existing SME loan volume in 2012 (Csubák and Fejes 2014). The Hungarian state has also intervened in the local venture capital industry with direct corporate investments through the financial body ‘Venture Finance Hungary’ Ltd at the MFB, whose aim is to develop and run financial programmes that expand the financing options of the Hungarian SMEs by utilizing the resources committed by the EU and Hungary (The European Bank Coordination Initiative 2011). For discussion on other national development banks, see NEFI (2014); Balcerowicz and Kratkowski (2001) and Klonowski (2010) on Polish development bank; Bohata and Mladek (1999) and Šimek (2010) on Czech development bank; SID (2014) on Slovenian development bank.

25 In the 1990s, lending by both local and foreign-owned private banks was restricted by the domestic market conditions, i.e. limited deposits that constituted an important source of funding for them at that time, as only in later stages banks began to use parent bank resources (Aydin 2008).

26 According to Hungarian central bank, MNB (2009, 2010), foreign parent banks increased the financing of their Hungarian subsidiaries by nearly EUR 3 billion in the last quarter of 2008, hence, mitigating the risks arising from foreign funding. Similar developments were seen in Poland with foreign owned banks retaining 2008 profits in capital and receiving subordinated loans from parent banks (Lahnsteiner 2010). In Estonia, banks were able to
rly on additional funds from parent banks where necessary after 2008 crisis. Furthermore, the central bank entered into an arrangement with the Swedish peer to enhance its capabilities to provide liquidity to complement liquidity and capital buffers of Swedish banks’ subsidiaries operating in Estonia (Eesti Pank 2009).

27 For instance, in the Czech Republic, the effect of voucher privatization and the early recapitalization of four large state-owned banks with the transfer of bad debts to centralized ‘hospital’ bank was continued soft lending practices and non-performing loans, as banks took position in voucher-privatized enterprises, implying persistence of both direct and indirect state-ownership in banks’ and firms’ cross-ownership structures. Banks could not undertake a restructuring of enterprises as this would have led to the bankruptcy of their customers and hence, the collapse of the banks themselves. Thus, state-owned banks extended the soft budget constraint and did not seem to foster any hardening, which implied operational inefficiency and managerial underperformance (see Bárta and Singer 2006; Bonin and Wachtel 2003; Green and Petrick 1999). Similarly in Poland, the program on resolution of bad debt that entailed debt-equity swaps and put responsibility on banks, rather strengthened the ties between banks and their clients through continuous credit provision and, thus enabled ailing state-owned enterprises to postpone restructuring (Bonin and Wachtel 2003). Vulnerabilities in Hungary stemmed from the industrial banks that were carved out from the previous planned economy regime and were created along sectoral lines with very little portfolio diversification both by company and by industrial sector, implying high exposures to any downturn (Petrick 2002).

28 In Hungary, the financial crisis of 1991-93 with state-led bailouts was estimated to have cost over 10 per cent of GDP (IMF 1998).

29 In Estonia and other Baltic States it was mainly private banks that were involved in destabilizing the Estonian commercial banking sector in early 1990s as a result of lax licensing requirements, lacking banking know-how, weak supervision, and insider lending
practices (Barisitz 2002; Keuschnigg 1997; EBRD 1998).

Barisitz (2005) has indicated to positive impact of foreign banks in the Czech Republic as they contributed to overcoming the lingering financial crisis that had plagued the country since the mid-1990s. In Hungary, the new foreign owners applied new management practices to acquired banks and pressured local authorities to enhance banking supervision and regulation that increased financial stability in the banking sector (Grittersova 2014; McDermott 2007). Similarly, in Estonia, the acquisition of local banks by Scandinavian investors was accompanied by increased capital and liquidity base of banks as well as strengthened banking regulation, competition, transparency, and risk management (Grittersova 2014).

The extreme case of unsustainable credit growth in the CEE region has been Latvia, who had among the highest ratios of domestic credit to GDP before crisis at 78 per cent with the credit demand strongest in consumption and housing and relatively weak for productivity enhancement (EBRD 2008, 144; EBRD 2009, 184; Becker and Jäger 2010).

This has not applied to Czech Republic and Poland, whose financial systems have been relatively sound due to insignificant exposure to sophisticated financial instruments and low leverage - the loan-to-deposit ratio in the banking systems was around 80 and 120 per cent, respectivey, as the lowest in the CEE region in 2009, compared to 160 per cent in Hungary and 155 per cent in Estonia (EBRD 2009; Szikszai et al. 2012).

Still, the reversal of capital flows in CEECs was not initiated by any major domestic policy change but was rather mainly the result of a sharp turn in investors’ risk sentiment and the deterioration of macroeconomic conditions in the euro area (Jevcák et al. 2010).

Full-blown banking crisis in Estonia was mitigated by the subsidiaries’ access to Swedish government support measures to the banking sector in home country, sizeable capital buffers through retained earnings, and sound capital adequacy ratio that stood at over two
times the 10 per cent minimum [EBRD 2009; Lahnsteiner 2010]. In Hungary, on the other hand, outflows were triggered by levies on financial institutions and unpredictable regulations concerning household-debt restructuring (see below on political risks; also Szikszai et al. 2012).

Although the Slovenian state-owned financial sector weathered the global crisis, its vulnerability stems from reliance on foreign financing. After entering the EU, banks in Slovenia were eager to “gamble” by borrowing cheap money in the EU or acquiring it from mother banks abroad, evidenced in the inflow of capital to the extent of 12 percent of GDP in 2007, with half of it used for buying securities abroad. At the same time, the proportion of loans funded by deposits fell from 99 per cent to 62 per cent from 2005 to 2008 at the expense of growing short-term foreign borrowing. As a result, net foreign debt increased from 0 € in 2005 to 10 billion € at the end of 2008 when the crisis hit (Mencinger 2014; Epstein 2013). After the crisis of 2008, foreign banks in Slovenia squeezed credits by reducing liabilities to their mother banks, while large domestic banks faced the problem of repayment of loans abroad and tougher rules on capital adequacy by Bank of Slovenia, implying a contraction in their balance sheets and the tightening of credit standards. As a result, the balance of financial account in has been characterized by continuing repayments to the rest of the world with the banks’ net repayments of liabilities on the wholesale financial markets amounting to 10 per cent of GDP in 2012 (Mencinger 2014).

What has been observed in CEECs, is ‘second home market’ business model of subsidiaries of foreign banks that turned out to entail a relatively stable funding due to long time horizons, high absorption of volatility and mass-marketing strategy in host economies. Furthermore, there were reputational concerns at stake and investments losses from withdrawal from CEE region, as western banks had extended significant amount of funds to their subsidiaries, reflected in over 100 per cent loan to deposit ratios in these countries, expect for Czech Republic. In general, it was subsidiaries’ autonomy in their decision to stay
in CEE that did not limit banks’ operations in the region in favor of home market (Epstein 2014b).

37 After the introduction in 2003, loans denominated in foreign exchange crowded out both common and subsidized forint loans due to interest rate differentials, the phasing out of housing loan interest subsidy scheme, the relative stability of the exchange rate of forint, the overwhelming presence of well-funded foreign-owned credit institutions, loose fiscal policy, and the expected adoption of the euro. While in 2000 foreign currency loans only represented 4 per cent of the total retail loan portfolio, by 2007 the shares of outstanding foreign currency loans had surpassed that of forint denominated ones, which made the Hungarian bank sector rather vulnerable (see Badics et al. 2014; Molnár 2010; Szikszai et al. 2012).

38 Also in Slovenian case manufacturing companies have relied on exports and were hit by the drop in foreign demand, when the financial and economic crisis deepened in 2009. As a result, GDP fell by 7.8 per cent, exports by over 15 per cent, gross fixed investments by more than 30 per cent (Mencinger 2014).

39 Among studied countries, only the Czech Republic and Poland managed to avoid excesses with no drastic tensions in the financial markets due to focus of banks on core credit-deposit activities. In the Polish case, relatively good performance has been achieved due to meager financialisation and local character of the financial market, protected large internal market, high investments by public sector and other macro-economic measures for stabilizing internal demand, and floating exchange rate regime that absorbed external shocks (see Alfred et al. 2012; Klingen 2013).

40 Corporate leverage in 2008 was among the lowest in the Czech Republic, Poland, and the Slovak Republic and among the highest in Estonia, Latvia, Lithuania, and Slovenia (Szikszai et al. 2012).
The average net international investment position of these countries deteriorated gradually from -30 per cent of GDP in 1999 to -42 per cent in 2003 and dropping to -63 per cent of GDP in 2008 (Jevcák et al. 2010).

In broad terms, three main types of regulatory responses to financial crisis of 2008 could be detected in CEECs that were at their disposal: 1) stricter standards on lending practices, such as limits on loan-to-value or payments-to-income ratios, 2) restraints on lending in foreign currencies, for example through additional capital requirements to dissuade banks from lending in foreign currency, and 3) stricter disclosure requirements imposed on banks vis-à-vis potential borrowers with regard to risks (Lehmann et al. 2010). These regulations were envisaged to address the behaviour of banks in late 2000s, as in the pursuance of maintaining their income and acquiring new clients, banks took increasingly greater credit risk that was manifest in the increase in loan to value (LTV), the ratio of installments to income and the duration of loans, in the relaxation of conditions in the loan approval process, in the preferential installments at the beginning of the life of the loans and in the appearance and the spread of foreign currency loans. As a result of risk-based competition, banks were willing to offer increasingly riskier products to increasingly riskier clients (Szikszai et al. 2012).

Beside the requirement to hold significant liquid reserves at the Bank of Estonia, regulators mostly used moral suasion and small deductions in the favorable tax treatment of borrowing in trying to mitigate rapid credit growth (see Ross 2013).

Before the introduction of Euro in Slovenia, the managed floating exchange rate system was maintained by both the state and the market, as commercial banks operated in the foreign exchange market under an agreement with the central bank, while at the same time being obliged to maintain the exchange rate at the desired level in the period when central bank intervened in the foreign exchange market. Hence, banks co-operated with the central bank in the formation of the exchange rate (Cufer et al. 2002).
In contrast to other CEECs, the Hungarian government approached the banking sector with unilateral policy response. In 2010, it introduced a series of changes in tax and regulatory rules that shifted costs of the crisis onto foreign investors, e.g. a moratorium over house repossessions related to non-performing foreign currency mortgages and a levy based on the size of banks’ balance sheet (see Kudrna 2010; Gabor 2010; Bohle 2014). Further regulatory measures were taken to reduce households’ burden of foreign currency debt, whereby distressed borrowers were enabled to switch their foreign currency mortgages to a fixed exchange rate that was around 25 per cent less than the market rate in 2011. In late 2011 the government envisaged partial debt cancellation for overdue loans, new conditions for Swiss franc mortgages where the government assumed some of the currency risk, permission for banks to deduct losses from the 2012 bank tax, and the phasing out of the bank tax by 2014 (Kudrna and Gabor 2013; Kavan et al. 2013). Another country that took drastic measures was Latvia that strengthened the position of debtors relative to creditors and required Latvian banks to absorb a higher proportion of losses stemming from the collapsed real estate bubble. Debtors are only liable to pay back the market value of their collateral rather than the actual amount of the loan, while banks have been required to cover the administrative costs of the personal bankruptcy procedures (Danske Bank 2010; Kudrna and Gabor 2013).

Only Czech Republic has limited the extent to which foreign banks can repatriate capital and liquidity out of their subsidiaries, while Poland has subjected foreign banks to Polish regulations by protecting the maintenance of minority shareholdings (Epstein 2014b).

Parallels could be drawn with two socio-economic models – continental European and Anglo-Saxon – that were envisaged as potential options among former communist countries. Within a continental group of countries, Poland resembles to a consolidated market economy with highly regulated product markets, government involvement in the economy, a relatively high level of coordination of economic agents through non-market signals, and trade and investment protectionism, while Slovenia’s ‘stakeholder’ approach,
on the other hand, reveals a corporatist’s type of economic model that for a long period retained social welfare provisions, some trade protection within a liberal foreign trade and payments regime, and managed float system with temporary capital controls for dealing with external shocks. Also, the adopted insider-privatization allowed for old networks to persist and the continuity of economic and political elites. The Czech Republic, on the other hand, involves characteristics of different paradigms of capitalism. Only Estonia resembles to the Anglo-American model with more individualistic features (see Lane and Myant 2007; Buchen 2007; Mykhnenko 2007; Feldmann 2007; Alfred et al. 2012).

48 Initially debt-free economies, such as the Baltic States, caught up with or even surpassed the original large-scale debtors, such as Poland and Hungary, by accumulating huge and mainly private debts during the 1999-2007 period, whereas Slovenia’s pragmatism and gradualism managed to keep external debt, current account deficit, inflation, budget deficit, and state debt under control during that period (Bohle and Greskovits 2012; Mencinger 2014).

49 Although decreasing export demand translated into limited investments, as profits waned that, in turn, affected negatively bank lending to businesses (Alfred et al. 2012).
This project has received funding from the European Union’s Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

Figure 1. Inward FDI stock by economic activities as shares (%) in total stocks, 2007

- Real estate, renting and business services
- Financial intermediation
- Transport, storage, and communication
- Wholesale and retail
- Manufacturing
- FDI stock in financial intermediation as % of GDP [line]

Source: Hunya 2009; author’s calculation, based on central banks’ statistics

Figure 2. Domestic credit to private sector [bars; left axis] and government and state-owned enterprises [lines; right axis] by banks as % of GDP

Source: World Bank 2014
Figure 3. Bank ownership shares in total assets, 2007

Source: ECB 2014

Figure 4. Lending by top 5* foreign-owned banks (% of total loans), 2012

* in terms of controlled assets

Source: BankScope; annual reports of commercial banks, Estonian FSA website, Statistics of national central banks, authors’ calculations
Figure 5. Private sector debt as a % of GDP (bars; left axis) and debt-to-equity ratio of non-financial corporations (lines; right axis)

Source: OECD Statistics 2014

Figure 6. Business loans (bars) and loans to households (lines) by the banking sector as a percentage of GDP

Source: Statistics of national central banks; OECD Statistics, authors’ calculations
This project has received funding from the European Union’s Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800.

Figure 7. Domestic mortgage lending [bars; left axis] and debt to gross disposable income ratio of households and NPISH* [lines; right axis]

Source: EBRD 2005, 2009; OECD Statistics; Statistics of national central banks; authors’ calculations

Figure 8. Assets [bars] and loans to customers [lines] by national development banks, as a percentage of GDP

Source: Annual reports of national development banks; OECD Statistics; authors’ calculations
This project has received funding from the European Union’s Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

Figure 9. Bank loans to currency and deposit liabilities ratio (bars; left axis) and liabilities of banks to non-residents as a percentage of GDP (lines; right axis)

Source: OECD Statistics; Statistics of national central banks; authors’ calculations

Figure 10. Gross external debt of the economy (bars; left axis) and current account balance (lines; right axis) as a percentage of GDP

Source: OECD Statistics; Statistics of national central banks; authors’ calculations
This project has received funding from the European Union’s Seventh Framework Programme for research, technological development and demonstration under grant agreement no 268800

Figure 11. Net primary income on current account balance (bars) and goods and services trade balance (lines) as a percentage of GDP

Source: OECD Statistics; World Bank dataset; authors’ calculations
This project has received funding from the European Union’s Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

Table 1. Number of all banks, foreign banks, and assets of banks (% of total assets)

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<th>Estonia</th>
<th>Slovenia</th>
<th>Poland</th>
<th>Hungary</th>
<th>Czech Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of all banks</td>
<td>18.4%</td>
<td>17.4%</td>
<td>15.1%</td>
<td>39.4%</td>
<td>28.6%</td>
</tr>
<tr>
<td>(foreign owned)</td>
<td>19.6%</td>
<td>18.6%</td>
<td>16.1%</td>
<td>37.1%</td>
<td>27.2%</td>
</tr>
<tr>
<td>Majority state-owned</td>
<td>9.2%</td>
<td>0%</td>
<td>0%</td>
<td>41.7%</td>
<td>42.2%</td>
</tr>
<tr>
<td>banks’ assets (% of</td>
<td>14.4%</td>
<td>0%</td>
<td>14.4%</td>
<td>71.7%</td>
<td>24.4%</td>
</tr>
<tr>
<td>total assets)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Majority foreign-owned banks’ assets (% of total assets)</td>
<td>2%</td>
<td>97%</td>
<td>99%</td>
<td>5%</td>
<td>12%</td>
</tr>
</tbody>
</table>

Source: Bonin and Wachtel 2003; Naaborg 2007

Table 2. Economic indicators of western banks operating in CEE/CIS and their western peers (%)

<table>
<thead>
<tr>
<th></th>
<th>Top Western banks present in CEE/CIS*</th>
<th>European universal / investment banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2012</td>
</tr>
<tr>
<td>Trading revenue (% of total revenues)</td>
<td>2.7</td>
<td>6.2</td>
</tr>
<tr>
<td>Net interest revenue (% of total revenues)</td>
<td>54.3</td>
<td>63.2</td>
</tr>
<tr>
<td>Capital leverage</td>
<td>14.7</td>
<td>10.8</td>
</tr>
<tr>
<td>Loan-to-deposit ratio</td>
<td>1.17</td>
<td>1.06</td>
</tr>
<tr>
<td>Tier-1 capital ratio</td>
<td>8</td>
<td>11.8</td>
</tr>
</tbody>
</table>

* these include Erste, Intesa, OTP, RBI, SocGen, and Unicredit

Source: Deuber and Shiplevoy 2013

Table 3. Herfindahl index for credit institutions and share of total assets of the five largest credit institutions

<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
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<th>Hungary</th>
<th>Czech Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>HHI index (0 - 10,000)</td>
<td>3,410</td>
<td>2,493</td>
<td>1,282</td>
<td>1,115</td>
<td>640</td>
</tr>
<tr>
<td>Top 5 (%)</td>
<td>95.7</td>
<td>89.6</td>
<td>59.5</td>
<td>58.4</td>
<td>46.6</td>
</tr>
</tbody>
</table>

Source: ECB 2010; ECB 2014
Table 4. Loan volume disbursed to SMEs by the banking sector, 2010

<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
<th>Slovenia</th>
<th>Poland</th>
<th>Hungary</th>
<th>Czech Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of SME loans in total business loans (%)</td>
<td>67.05</td>
<td>51.75</td>
<td>57.77</td>
<td>54.54</td>
<td>50.73</td>
</tr>
<tr>
<td>SME loans to GDP ratio (%)</td>
<td>30.98</td>
<td>30.77</td>
<td>8.95</td>
<td>18.04</td>
<td>10.44</td>
</tr>
</tbody>
</table>

Source: OECD 2013; CGAP 2010; Websites of national central banks, authors’ calculations

Table 5. Enterprises’ financing of investments, 2009

<table>
<thead>
<tr>
<th></th>
<th>Estonia</th>
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<th>Poland</th>
<th>Hungary</th>
<th>Czech Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of firms not needing a loan</td>
<td>47.7</td>
<td>38.7</td>
<td>48.9</td>
<td>59.2</td>
<td>47.7</td>
</tr>
<tr>
<td>Percentage of firms using banks to finance investments</td>
<td>41.5</td>
<td>52.2</td>
<td>40.7</td>
<td>48.7</td>
<td>33.4</td>
</tr>
<tr>
<td>Proportion of investments financed by bank loans (%)</td>
<td>22.8</td>
<td>37</td>
<td>23</td>
<td>32.3</td>
<td>16.2</td>
</tr>
<tr>
<td>Proportion of investments financed internally (%)</td>
<td>64.4</td>
<td>55.9</td>
<td>58.3</td>
<td>58.2</td>
<td>69.5</td>
</tr>
</tbody>
</table>

Source: Enterprise Surveys 2014
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Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number: 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation?; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?
THE PARTNERS IN THE CONSORTIUM ARE:

<table>
<thead>
<tr>
<th>Participant Number</th>
<th>Participant organisation name</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (Coordinator)</td>
<td>University of Leeds</td>
<td>UK</td>
</tr>
<tr>
<td>2</td>
<td>University of Siena</td>
<td>Italy</td>
</tr>
<tr>
<td>3</td>
<td>School of Oriental and African Studies</td>
<td>UK</td>
</tr>
<tr>
<td>4</td>
<td>Fondation Nationale des Sciences Politiques</td>
<td>France</td>
</tr>
<tr>
<td>5</td>
<td>Pour la Solidarite, Brussels</td>
<td>Belgium</td>
</tr>
<tr>
<td>6</td>
<td>Poznan University of Economics</td>
<td>Poland</td>
</tr>
<tr>
<td>7</td>
<td>Tallin University of Technology</td>
<td>Estonia</td>
</tr>
<tr>
<td>8</td>
<td>Berlin School of Economics and Law</td>
<td>Germany</td>
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<td>9</td>
<td>Centre for Social Studies, University of Coimbra</td>
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<td>10</td>
<td>University of Pannonia, Veszprem</td>
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<td>11</td>
<td>National and Kapodistrian University of Athens</td>
<td>Greece</td>
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<tr>
<td>12</td>
<td>Middle East Technical University, Ankara</td>
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<td>Lund University</td>
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<td>University of Witwatersrand</td>
<td>South Africa</td>
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<tr>
<td>15</td>
<td>University of the Basque Country, Bilbao</td>
<td>Spain</td>
</tr>
</tbody>
</table>

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