

Money and Banking Issues in European Transition Economies

10th Bank of Albania's International Conference –
Monetary Policy in Albania: from the Past to the Present

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The views expressed in this Presentation are those of the author
and do not necessarily represent those of the IMF or IMF policy.

Structure of presentation

- Pros and Cons of CESEE banking model
- How the system came through the crisis of 2008-9
- How the system is coping now
- Challenges ahead



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Pros and Cons of the CESEE banking model

- ✓ The inherited financial system was compromised and unviable
- ✓ Virtually all countries had post transition banking crises



Post-transition Banking Crises



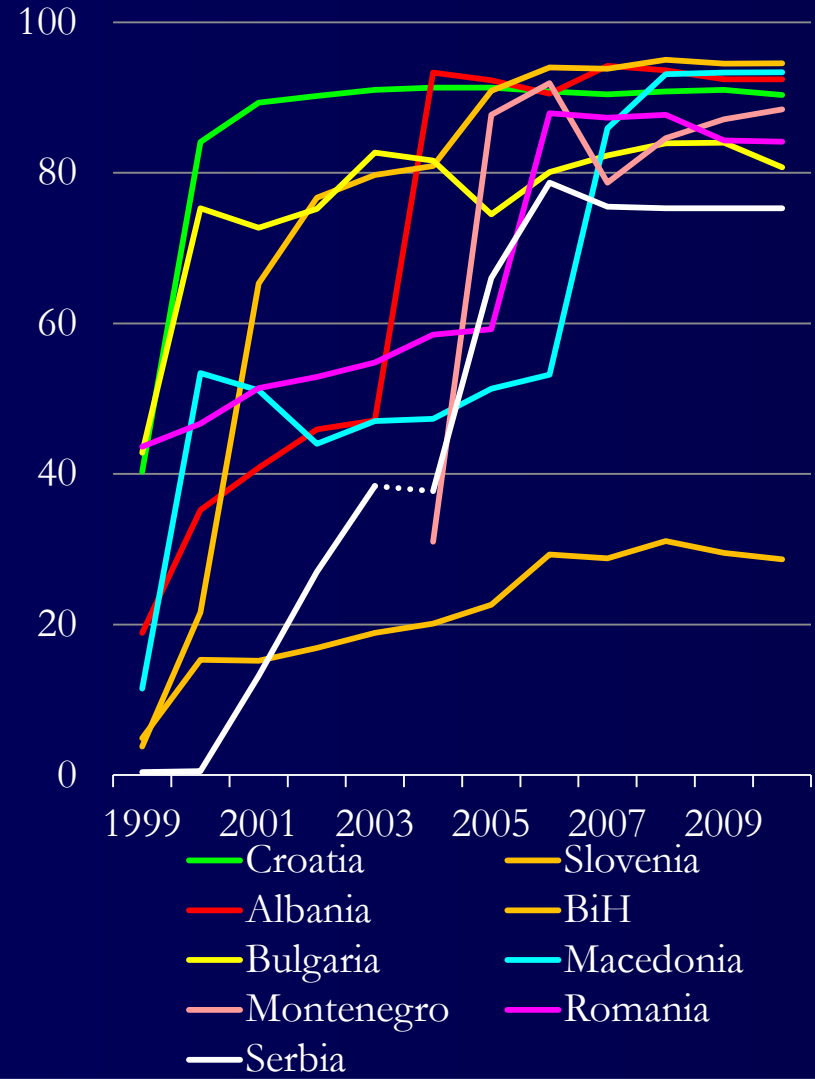
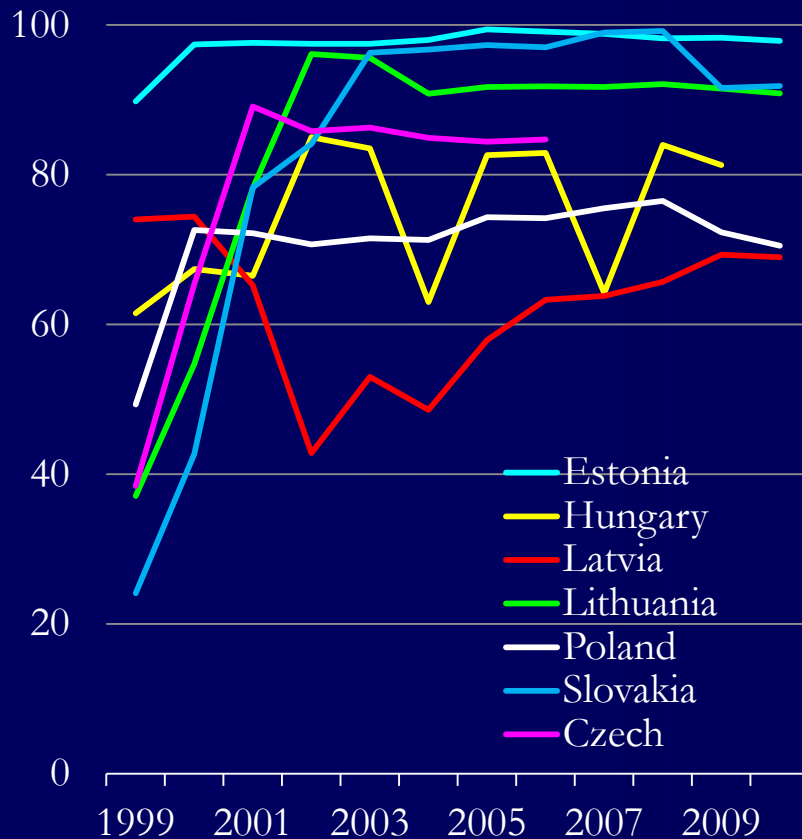
Pros and Cons of the CESEE banking model

- ✓ The inherited financial system was compromised and unviable
- ✓ Virtually all countries had post transition banking crises
- ✓ Weak banks were replaced with foreign bank ownership



Penetration of the market started in the late 1990s

Asset share of foreign-owned banks
(percent)



...and created a trans-European network



Benefits of widespread foreign ownership of banks

- ✓ Import technology, service culture, and reputation
- ✓ Import supervision
- ✓ Access to liquidity
- ✓ Channel for inflows



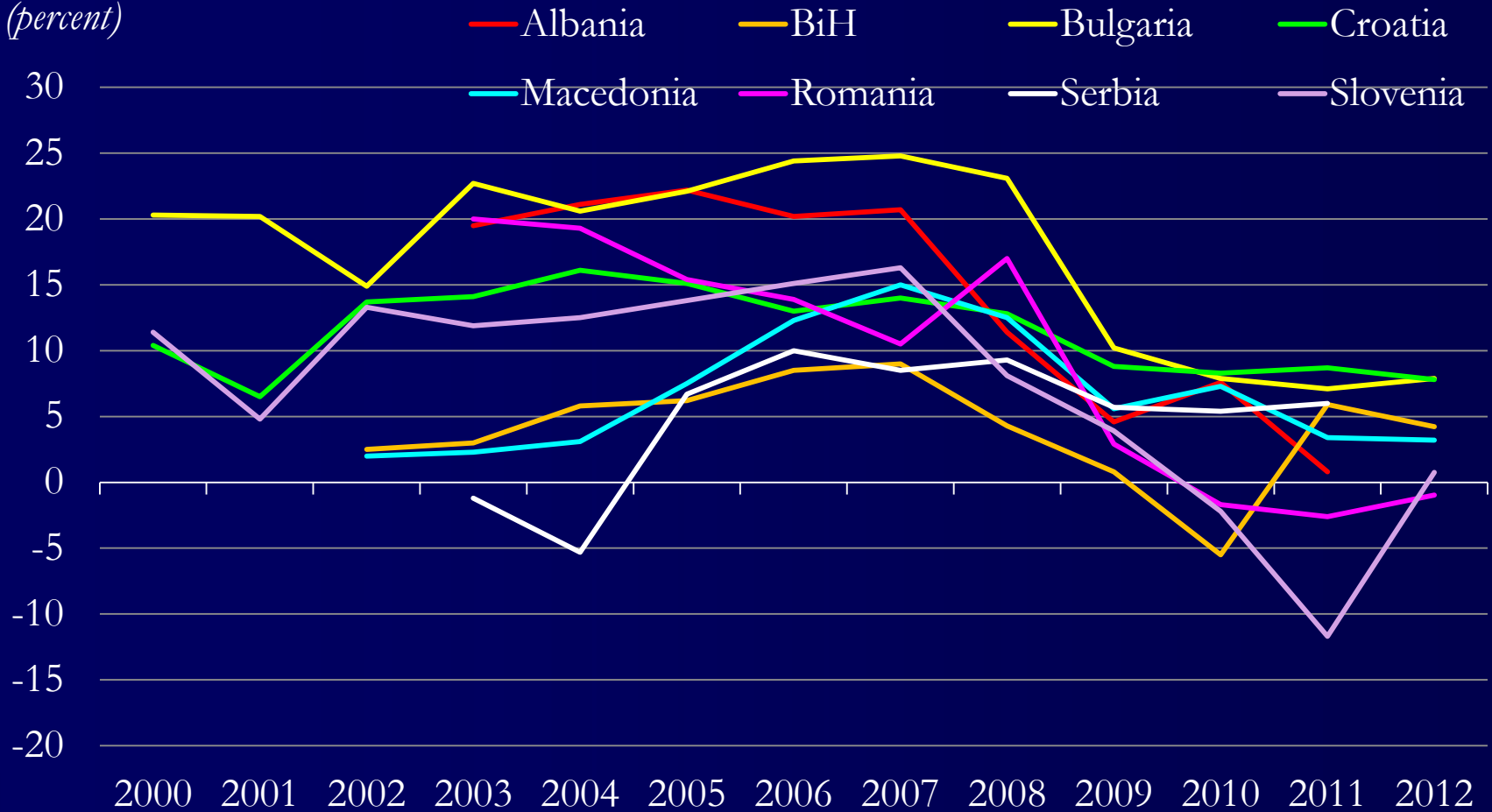
Some push factors

- ✓ Slow-growing home markets
- ✓ CESEE seen as severely under-banked
- ✓ Very profitable venture



Banking in the region was very profitable

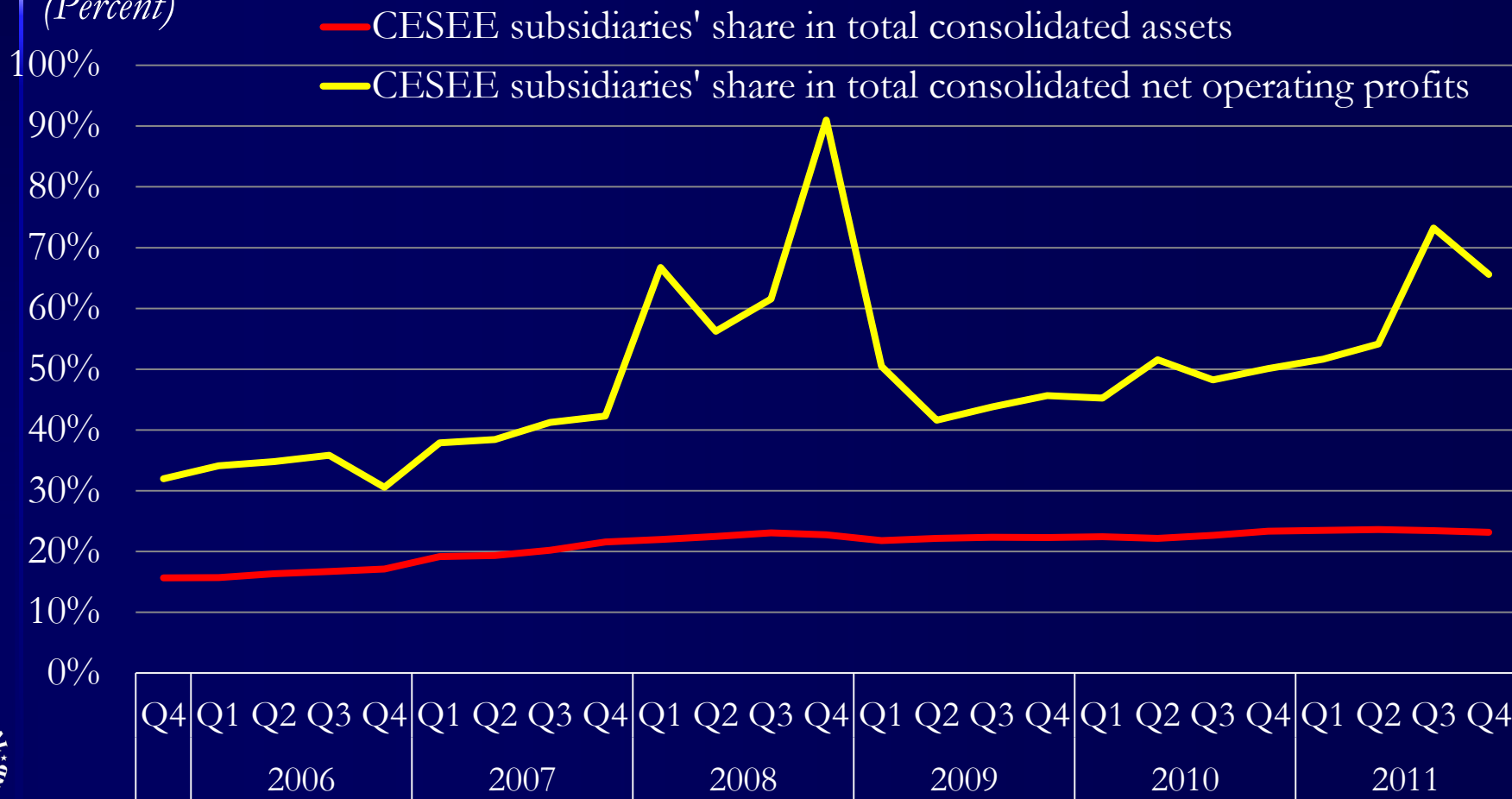
Return on Equity
(percent)



... even after the 2008/9 crisis

Austrian banks' CESEE subsidiaries' shares in total consolidated banking sector assets and in total operating profits

(Percent)



Disadvantages of foreign bank ownership

- ✓ Inflows created vulnerabilities
 - Consumption and asset booms
 - Foreign exchange lending
 - Balance of payments deficits
 - But how much due to world conditions rather than inherent in ownership structure?
 - Convergence story overrode rational banking
- ✓ Domestic authorities unable (when not unwilling) to find ways to tackle the problem
- ✓ Dependent on strength of parent



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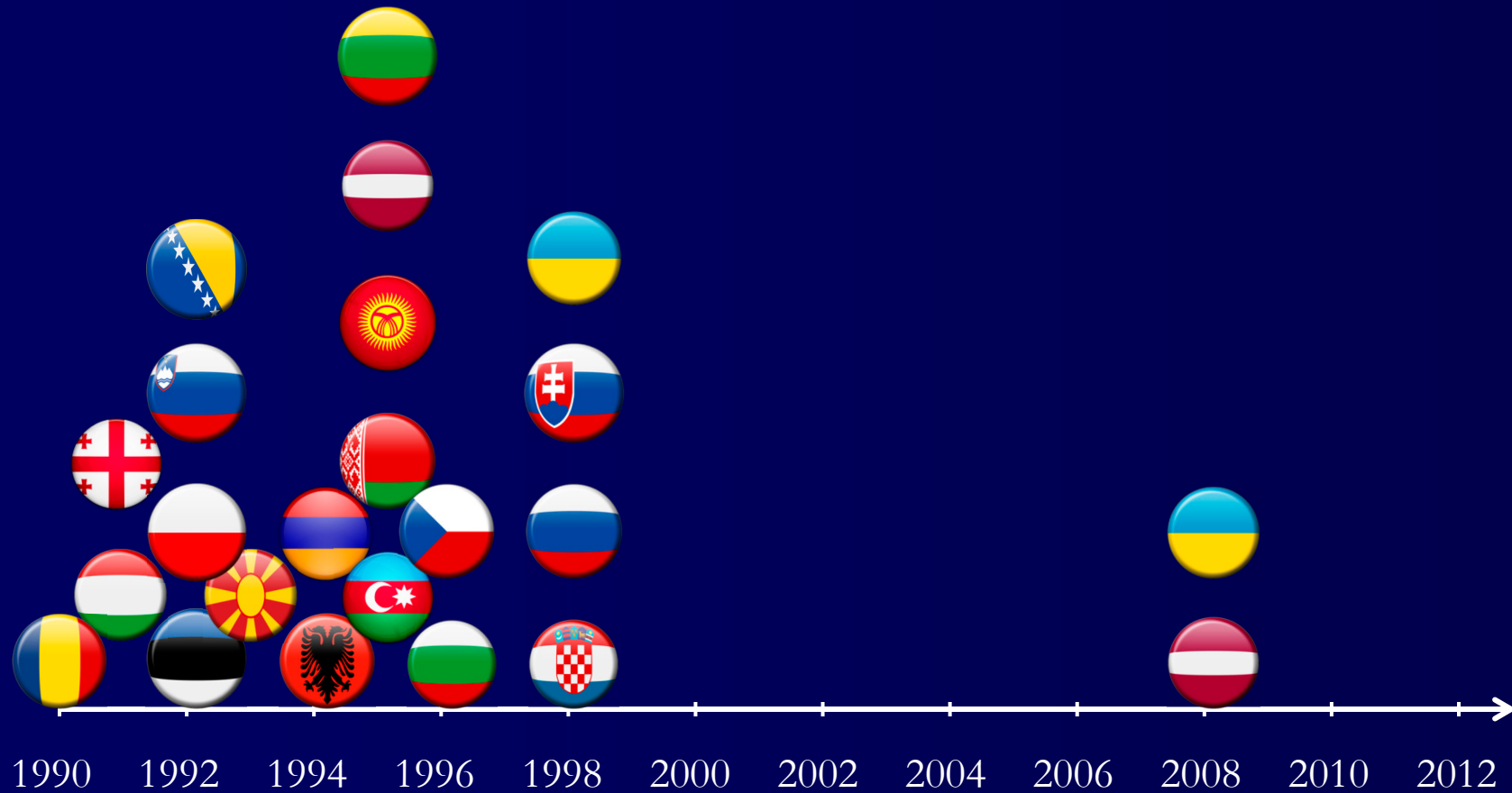
How the system came through the early crisis

- ✓ Parents and their regulators supported banks



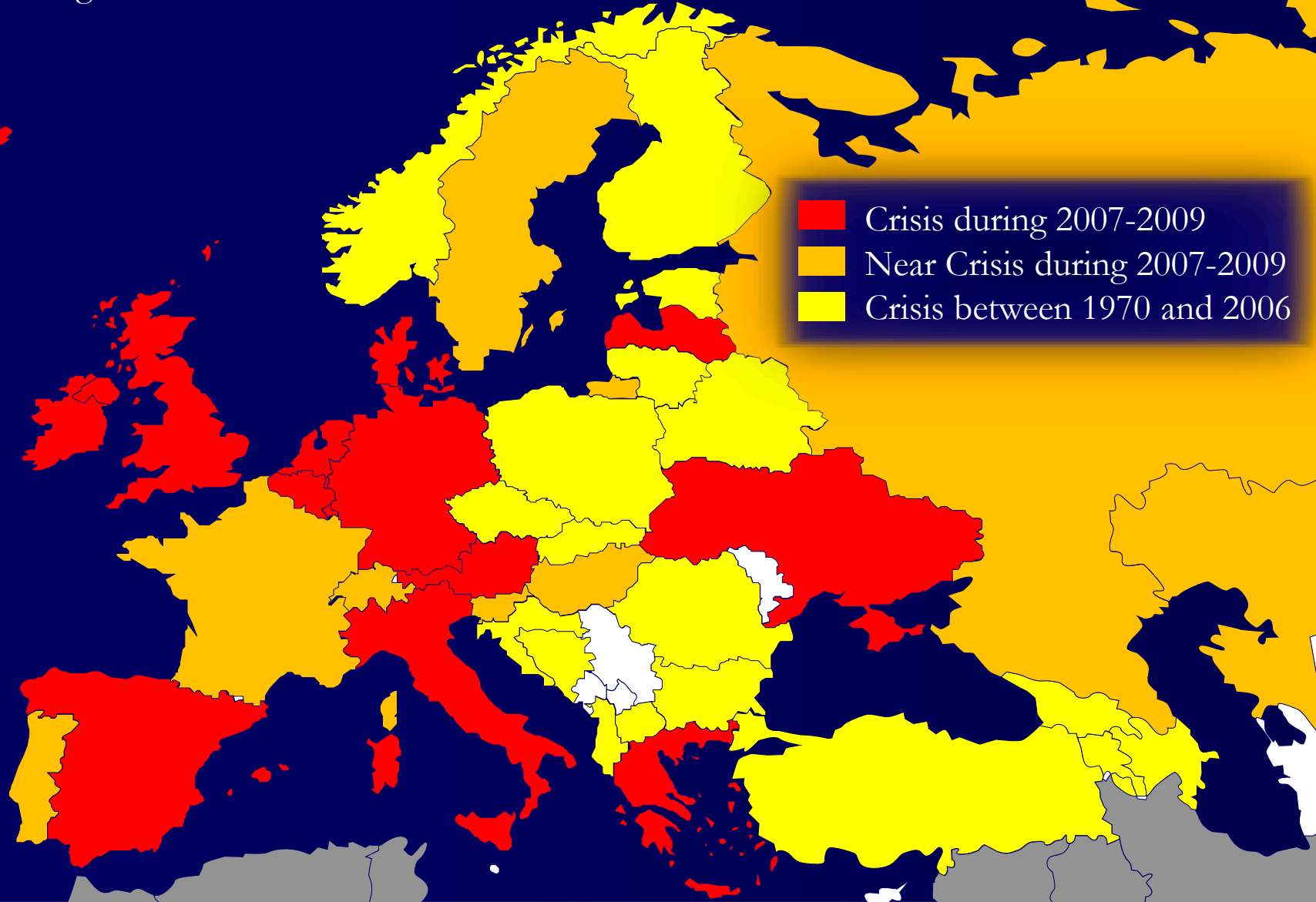
A new round of bank crises seemed imminent




Banking Crises in Transition Economies



But the crises were mainly in parent's countries

Banking Crises 2007-09



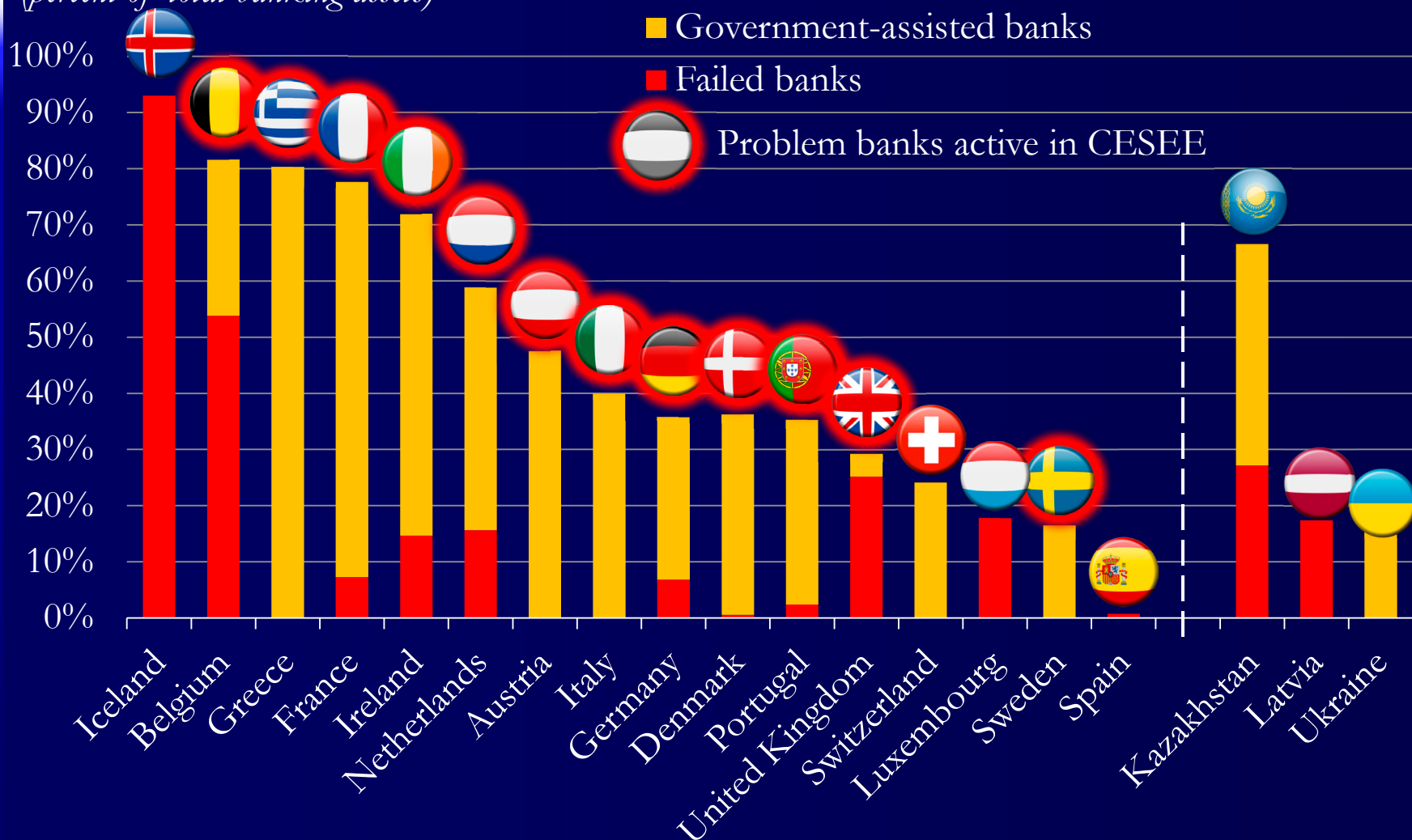
-  Crisis during 2007-2009
-  Near Crisis during 2007-2009
-  Crisis between 1970 and 2006

Source: Laeven, Luc and Fabian Valencia, 2008.
"Systemic Banking Crises: A New Database"

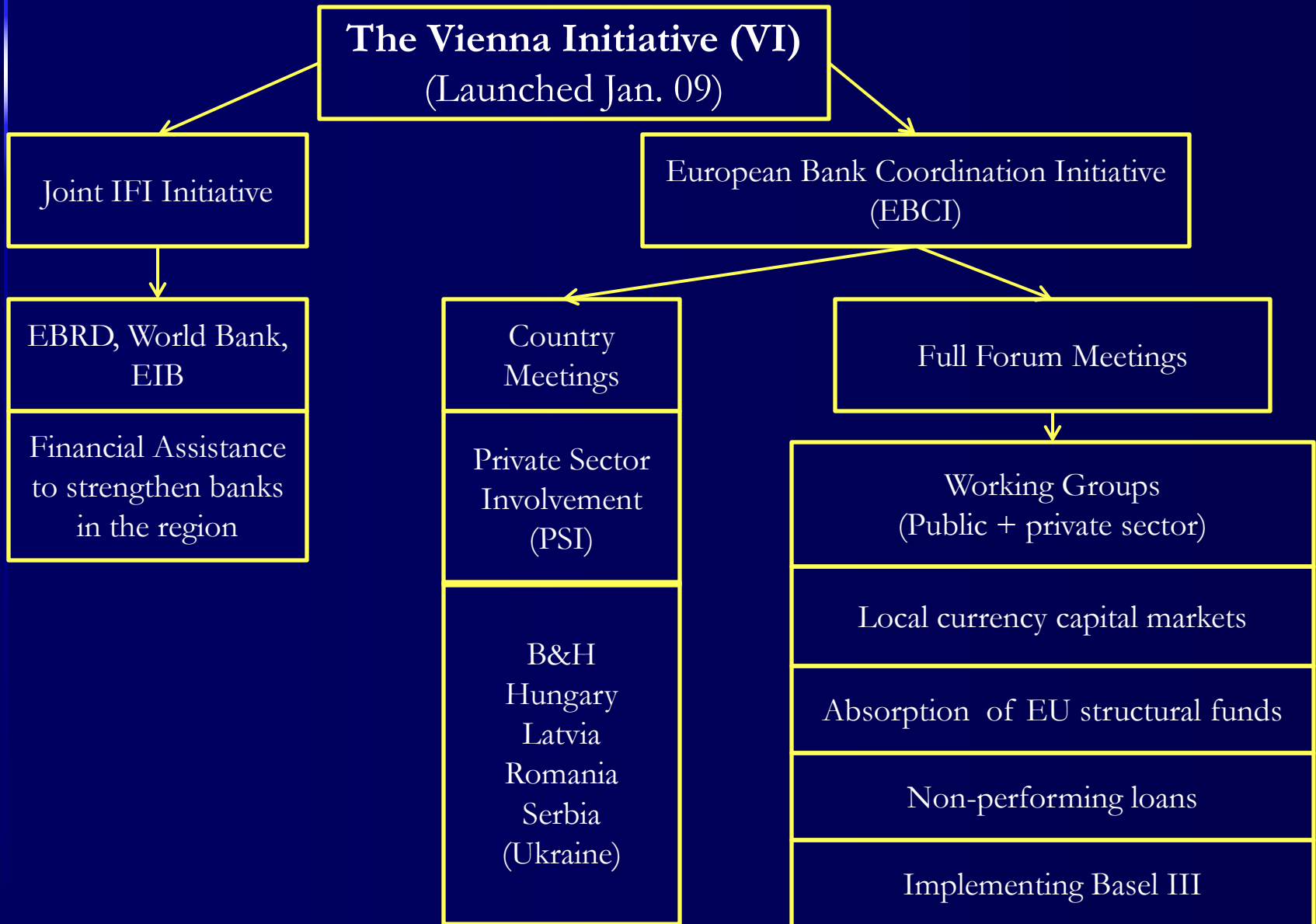


CESEE only had to deal with locally-owned bank failures

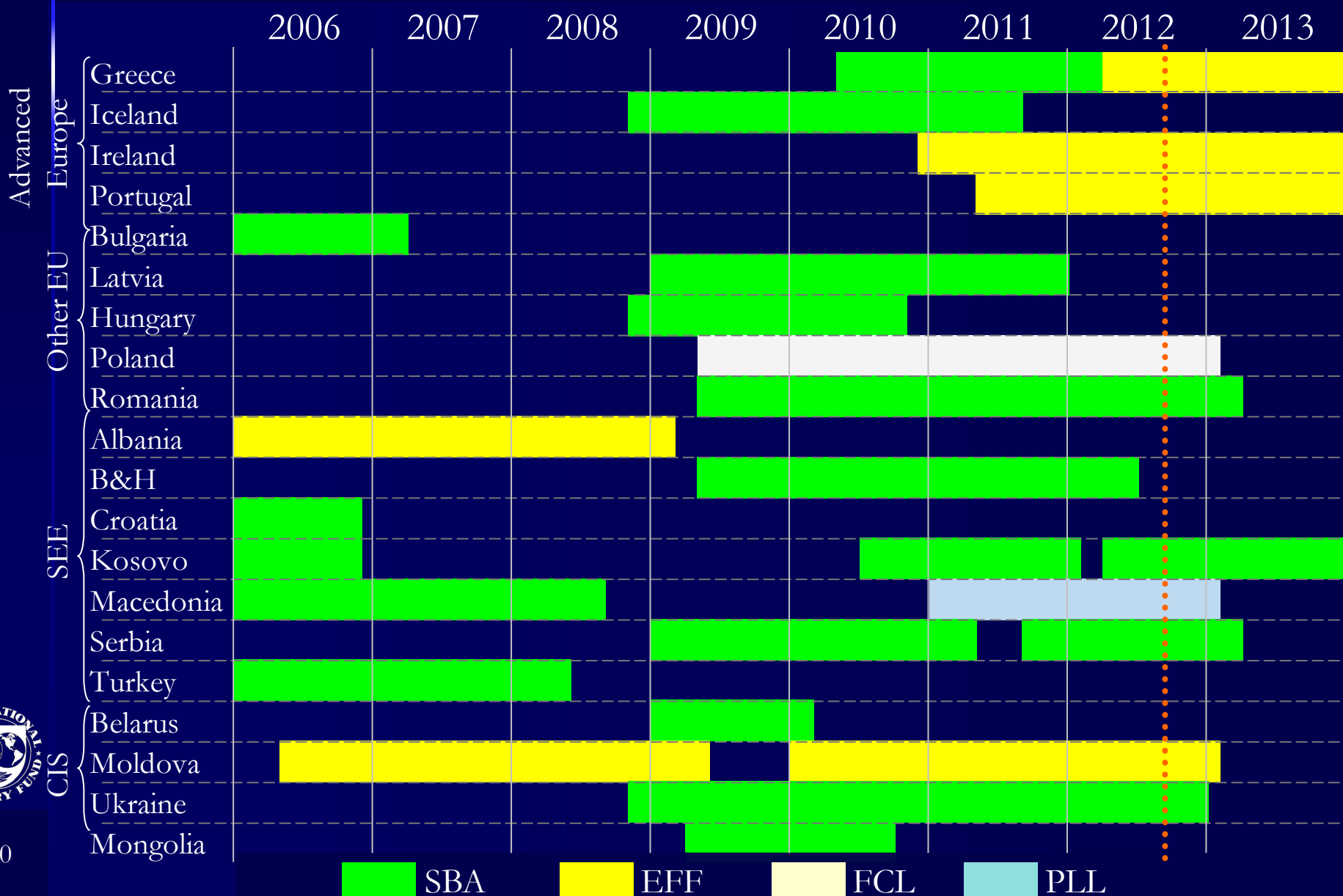
Banking crises in Europe, August 2007 - August 2009
 (percent of total banking assets)



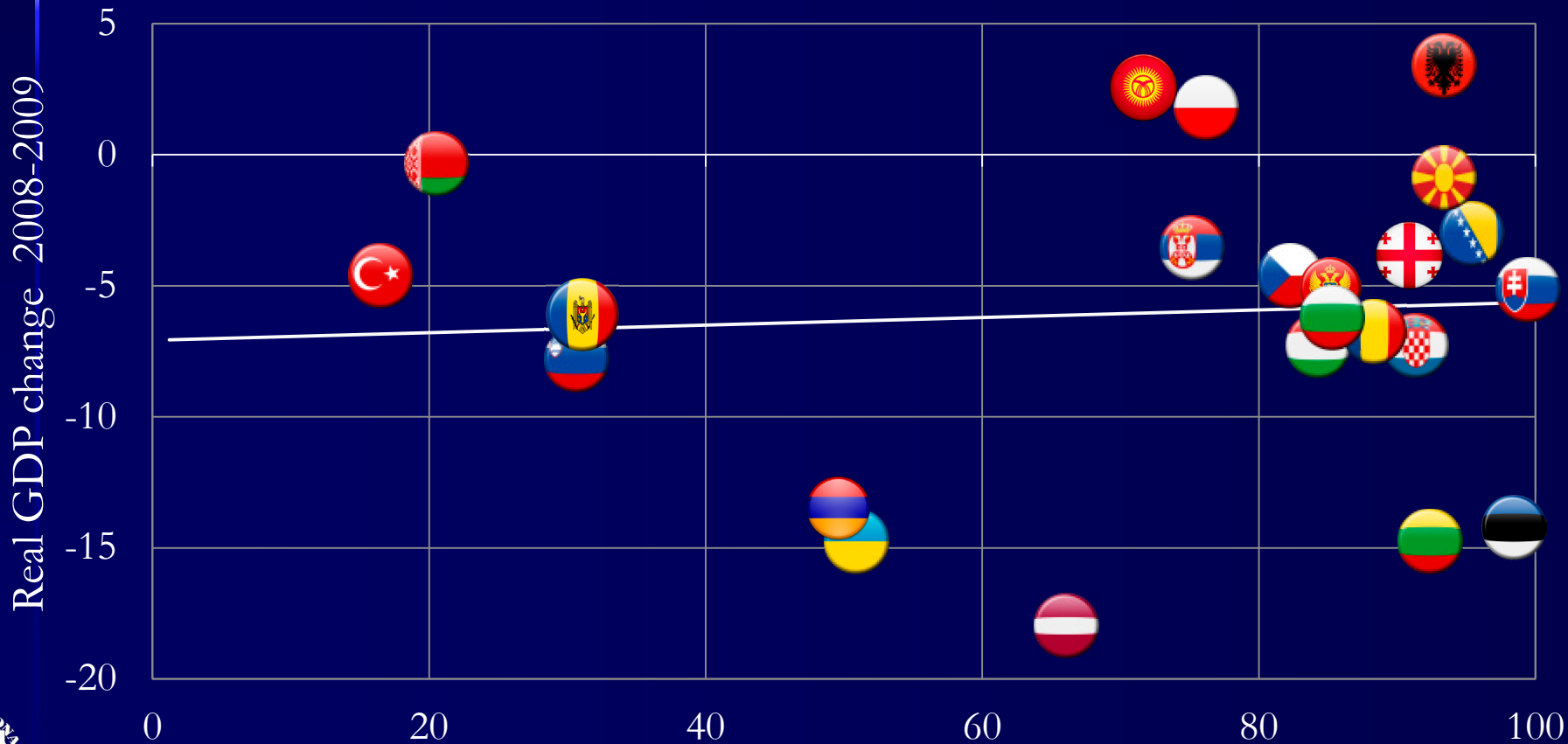
...and Vienna Initiative helped keep banks engaged.



Balance of payments support was also provided.



Bank ownership did not explain the contraction



Foreign bank ownership, 2008
(percent of sector assets)

Source: EBRD; IMF, WEO

Real GDP change 2008-2009



Structure of presentation

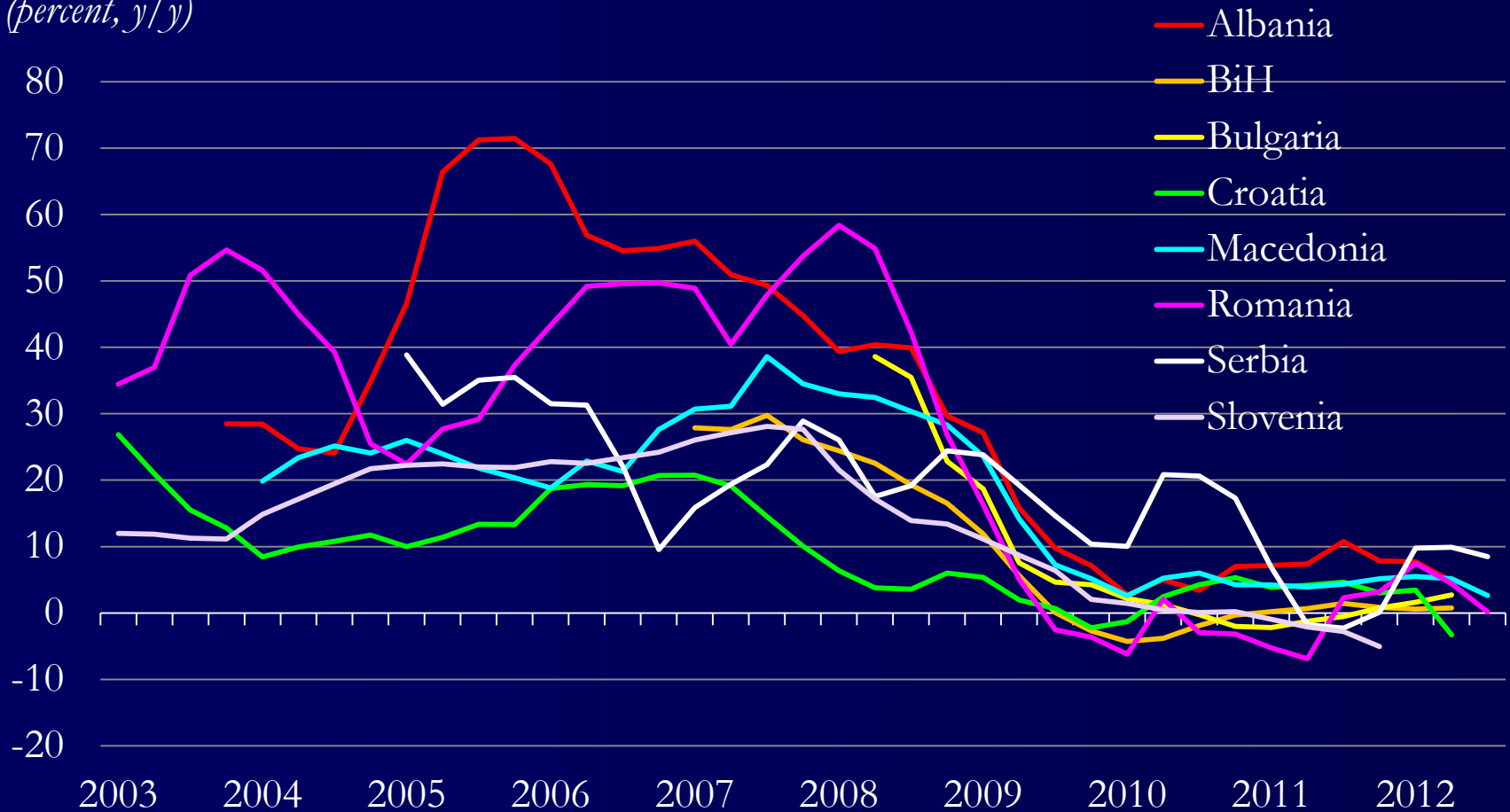
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Credit growth remains very subdued

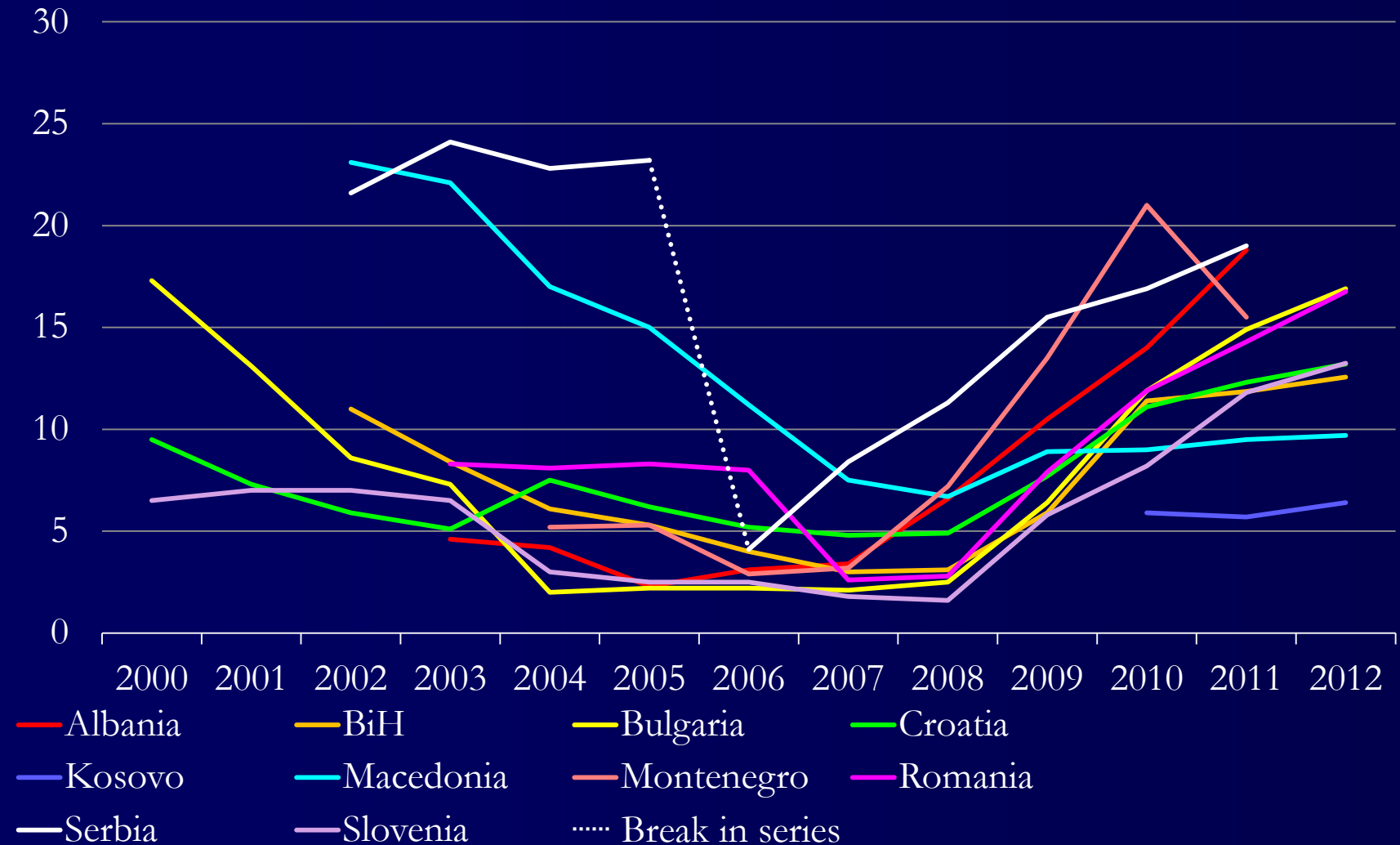
Real Credit Growth

(percent, y/y)



NPLs are rising

Non-performing Loans to Total Loans
(percent)

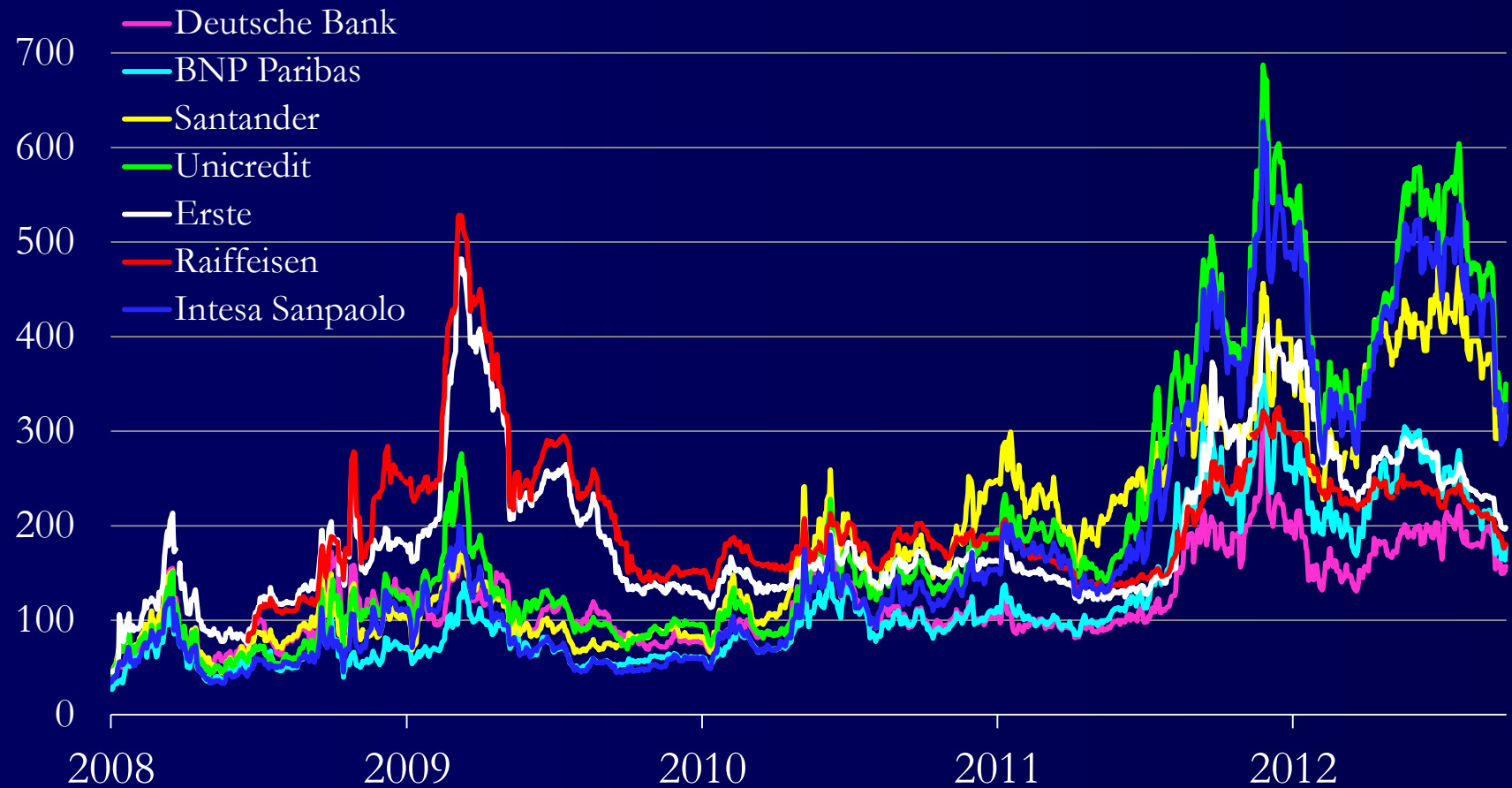


Source: IMF, GFSR.



Parent banks are under market pressure

Banks' 5yr CDS spreads
(basis points)



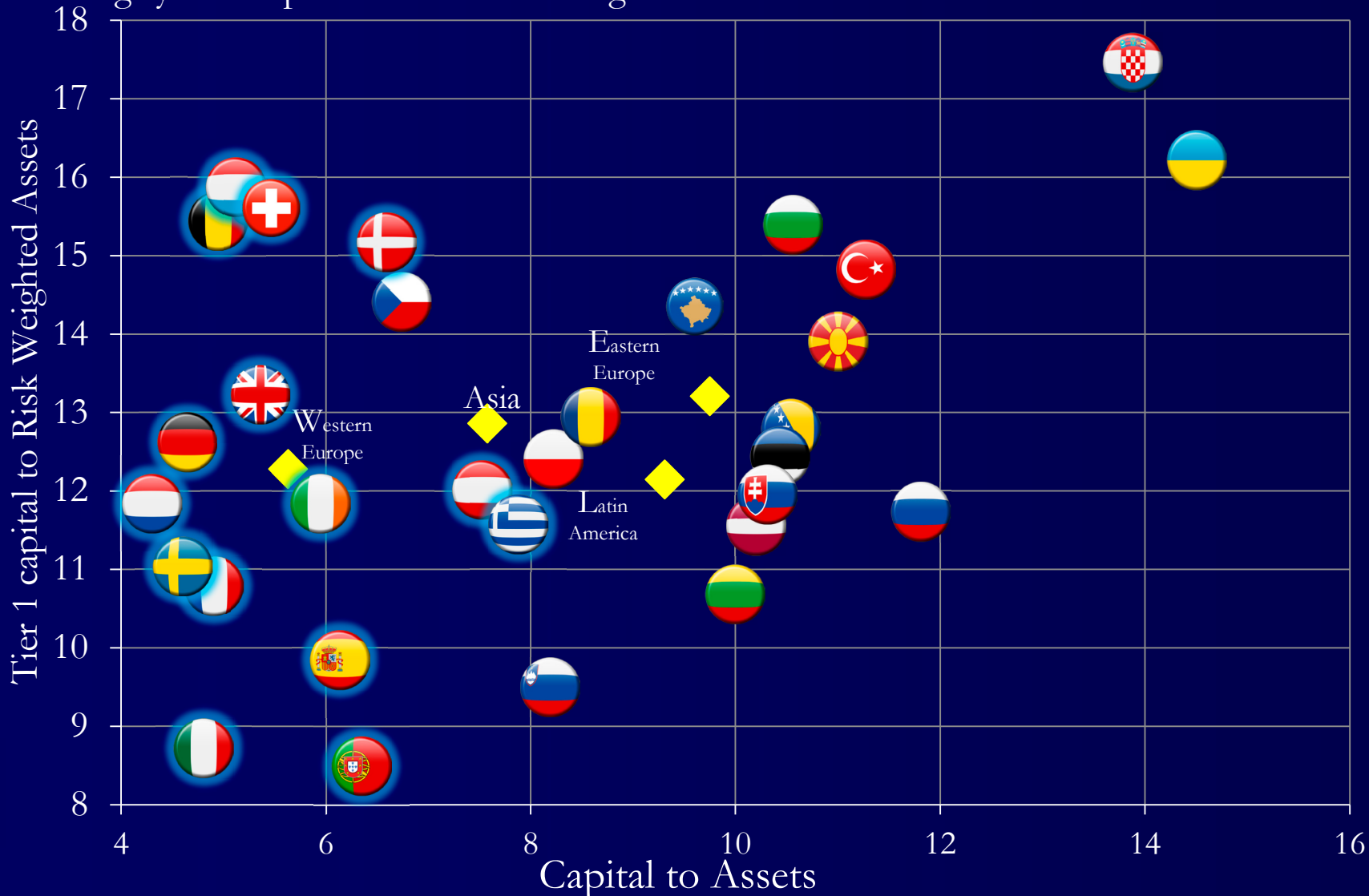
Regulatory pressure on parents is increasing

- ✓ Stress tests and temporary capital increases from EBA
- ✓ Basel III and CRD4
 - Need to raise more higher quality capital
 - Need to reduce funding risks
- ✓ Ad hoc actions to protect sovereign ratings
- ✓ Call for rethinking business models



CESEE banks are less leveraged than parents

Banking system capitalization and leverage:

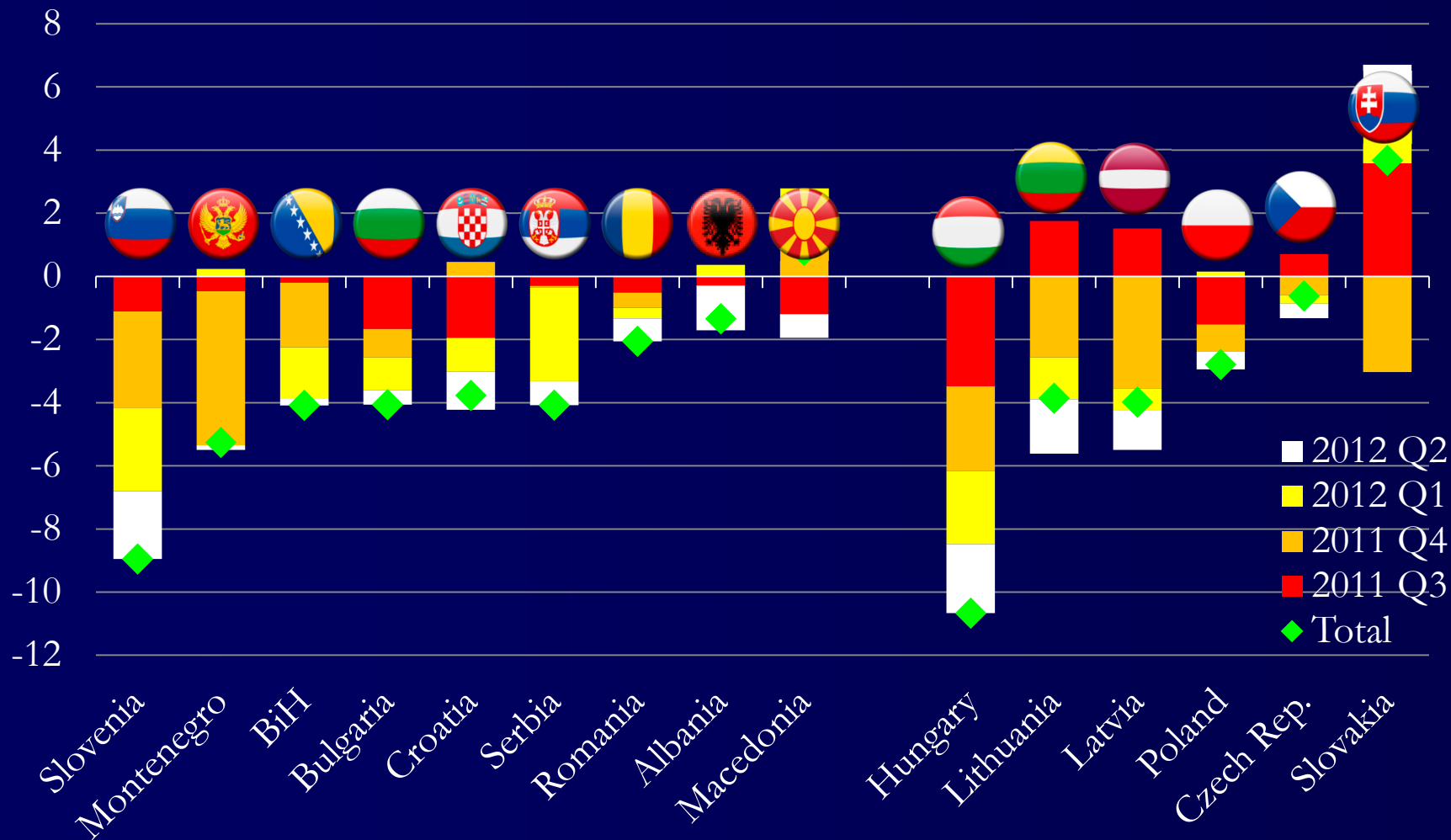


Source: IMF, FSI; IMF Article IV reports.



But there is a steady reduction in exposure to region

Cumulative Change in Gross Positions of BIS-Reporting Banks, 2011-12
(percent of GDP)



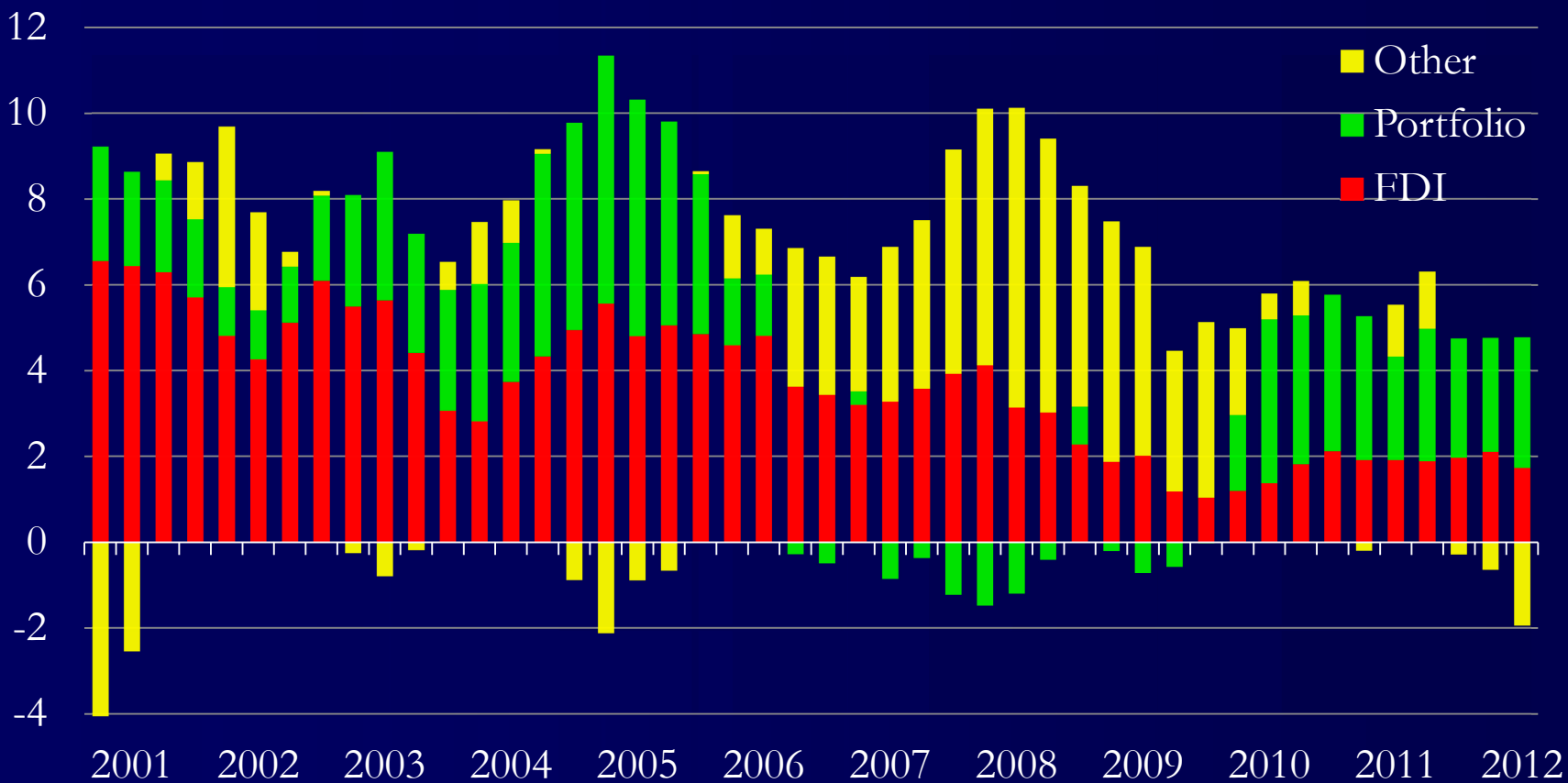
Source: BIS; and IMF staff calculations.



Capital inflows are now primarily non-bank flows

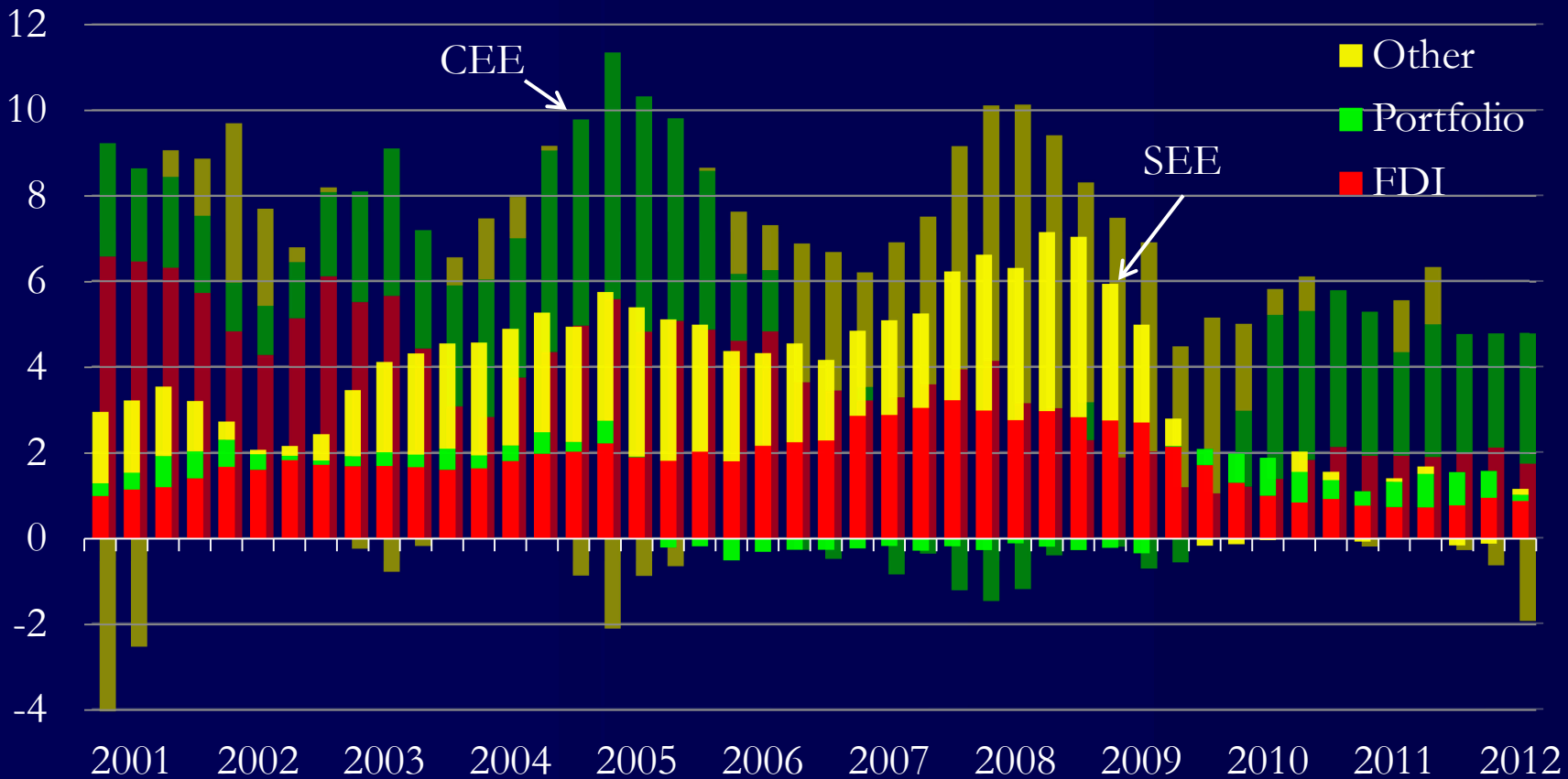
Capital flows to CEE

(4-quarter moving average, percent of GDP)



Capital inflows are now primarily non-bank flows

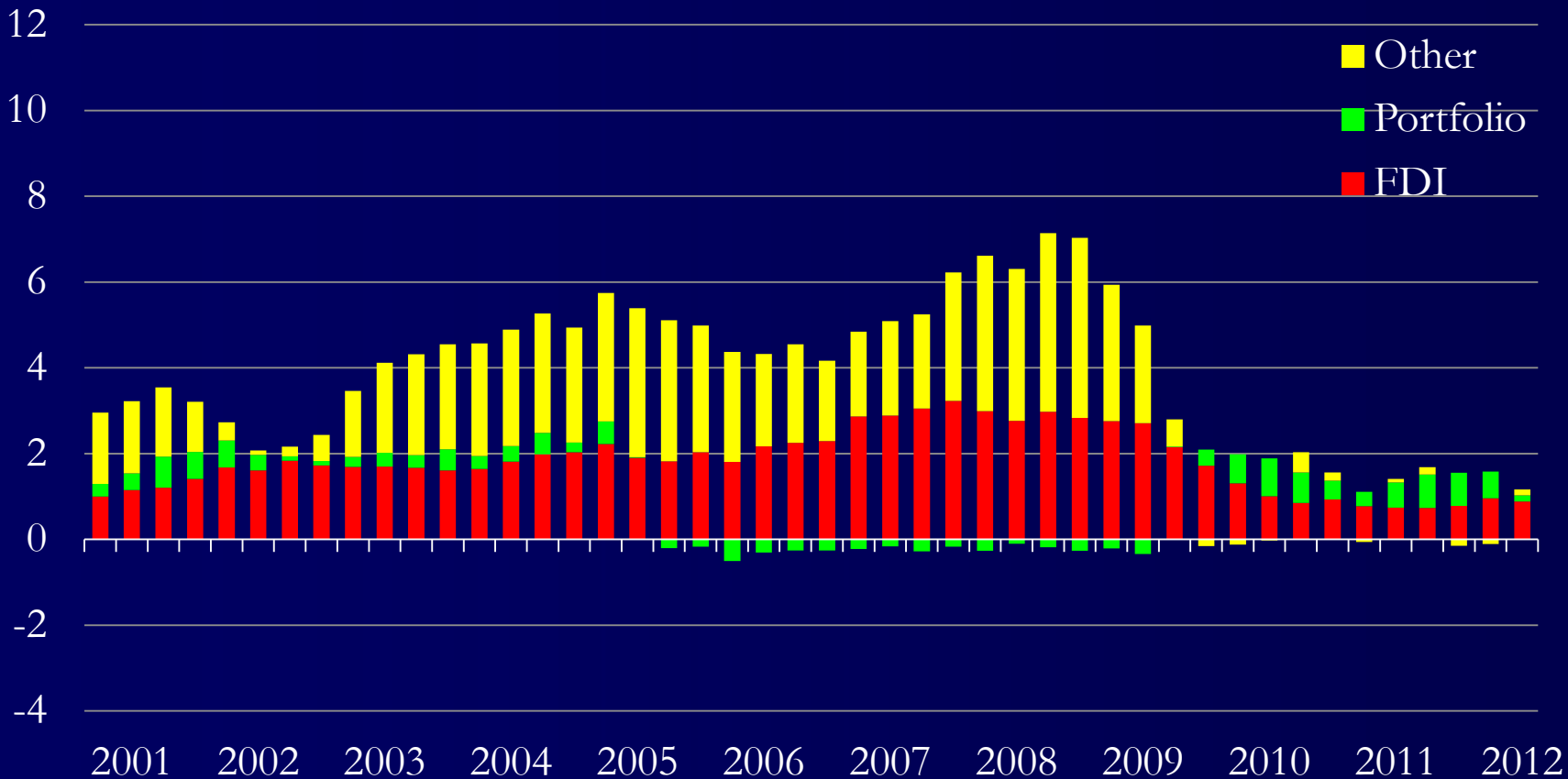
Capital flows to SEE and CEE
(4-quarter moving average, percent of GDP)



Capital inflows are now primarily non-bank flows

Capital flows to SEE

(4-quarter moving average, percent of GDP)



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Challenges ahead

- ✓ Monetary policy may become difficult
- ✓ Cross-border regulatory cooperation will be needed
- ✓ Domestic savings will have to be mobilized
- ✓ Local capital markets will need developing



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Monetary policy may become more challenging

- ✓ Will banks under parent pressure be effective participants in the transmission process?
 - Domestic interbank markets stopped functioning
 - Consolidated supervision requires home country risk weighting
- ✓ Polish-type solutions maybe unavailable
 - Ensuring risk management done locally
 - Requiring subsidiaries to have free float on WSE
- ✓ Experience of Mexico and New Zealand may be worth reviewing
- ✓ Can and should “dollarization” be reversed?



Challenges ahead

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Supervisory cooperation has become vital

- ✓ Impact of parent supervisor increasing
- ✓ Banking systems are highly concentrated
- ✓ Ring-fencing by home or host may not be optimal
- ✓ New EU or Eurozone structures are arising
- ✓ Vienna 2 Initiative focuses on these matters



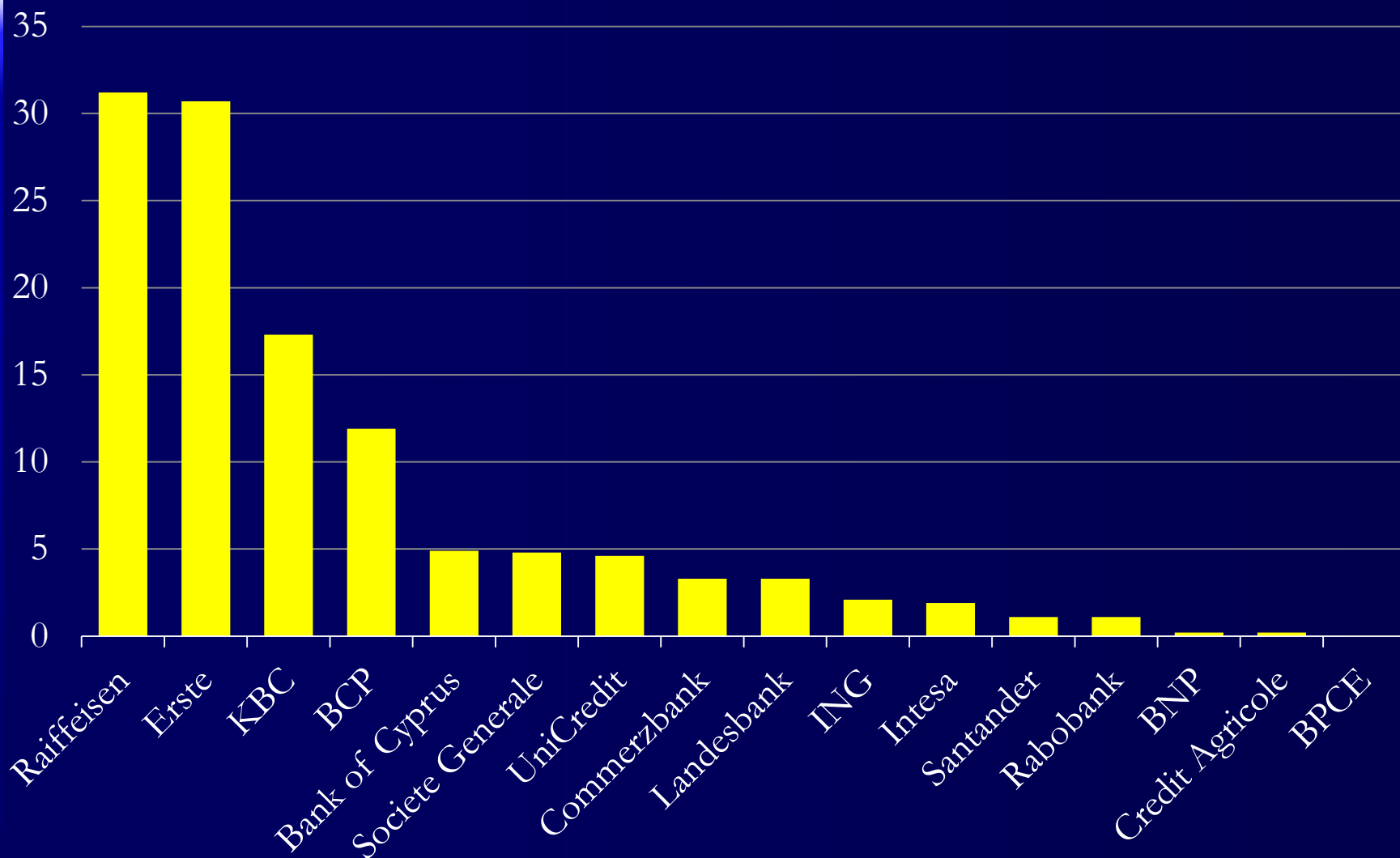
Vienna 2 Initiative differs from Vienna 1

- ✓ Discussion of supervisory cooperation



For most groups, the region is not that important...

Major Euro area Banking Groups With Rated Subsidiaries in Eastern Europe
(Assets of Rated EE Subsidiaries in percent of total group assets)

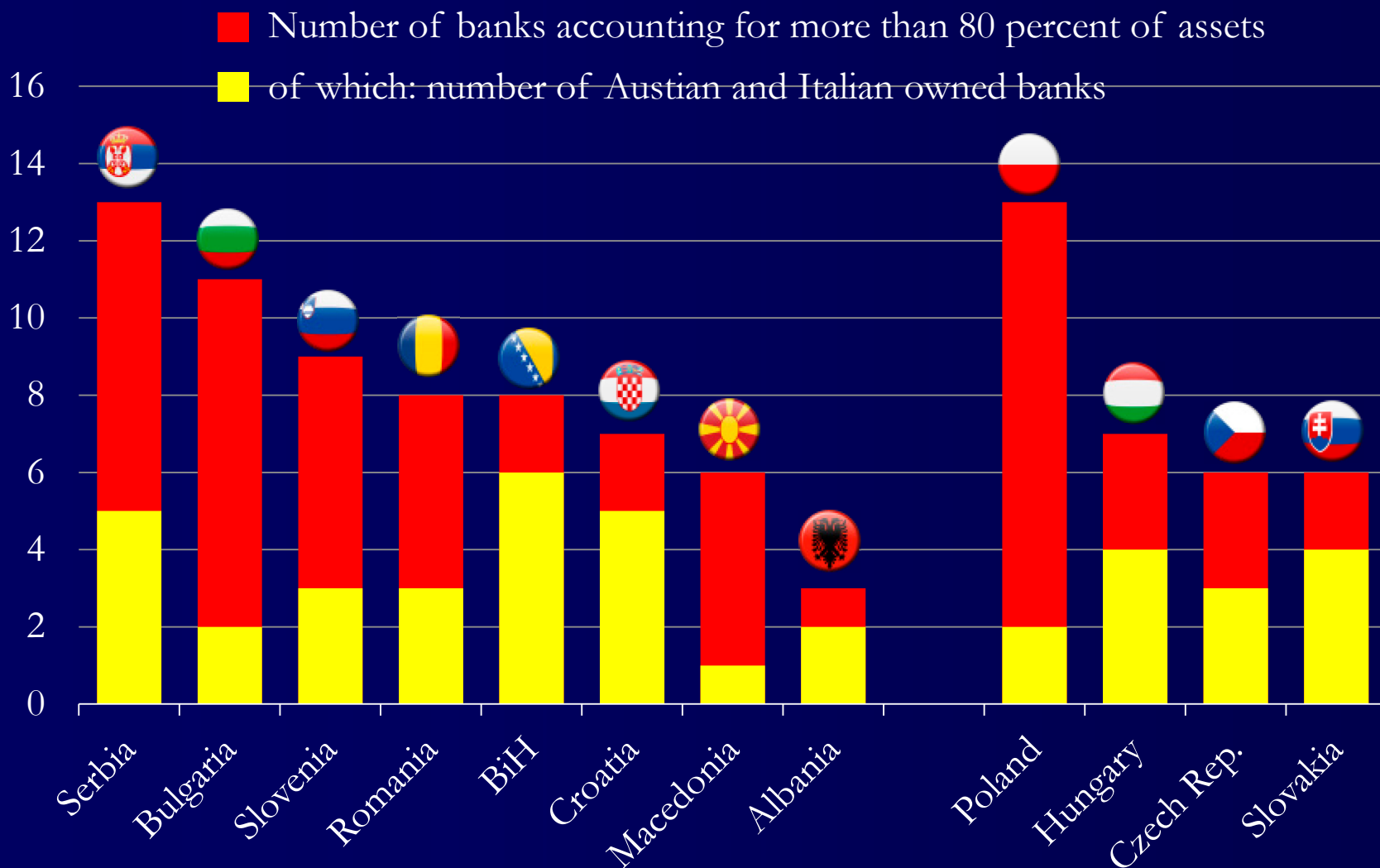


Source: Moody's Investors Service



...even if their subsidiaries are locally systemic

Banking sector concentration



Vienna 2 Initiative differs from Vienna 1

- ✓ Discussion of supervisory cooperation
- ✓ Harder issues of cooperation in resolution
- ✓ New IFI initiative
- ✓ Proposal for Host Country Cross-Border Forums



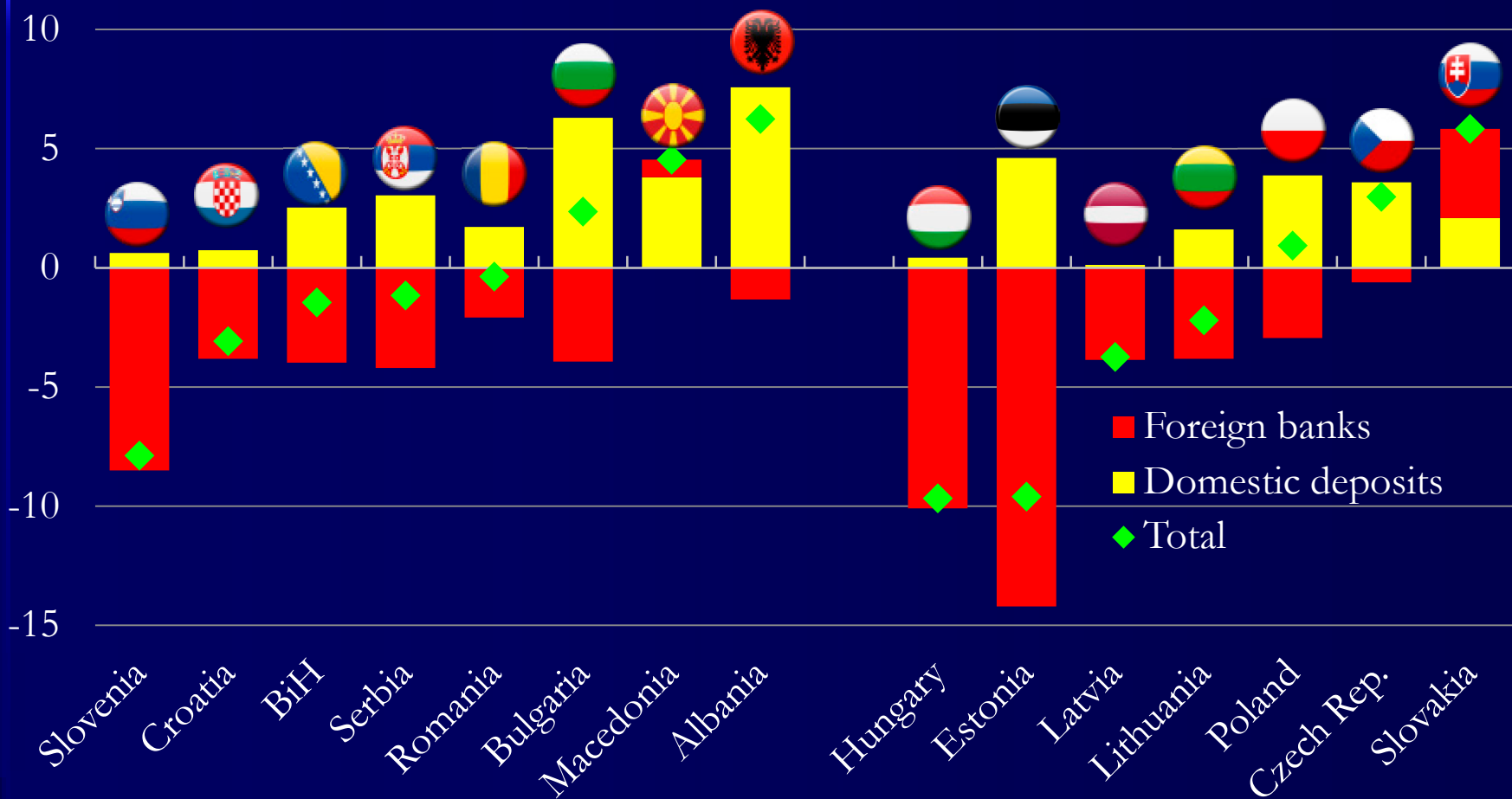
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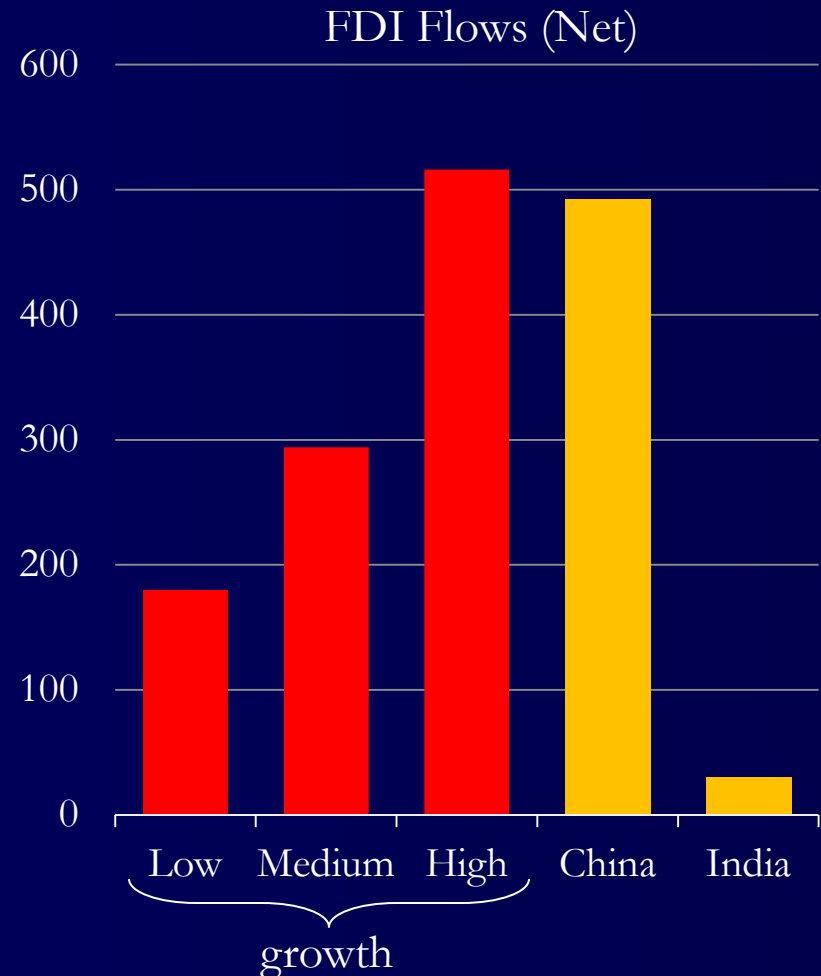
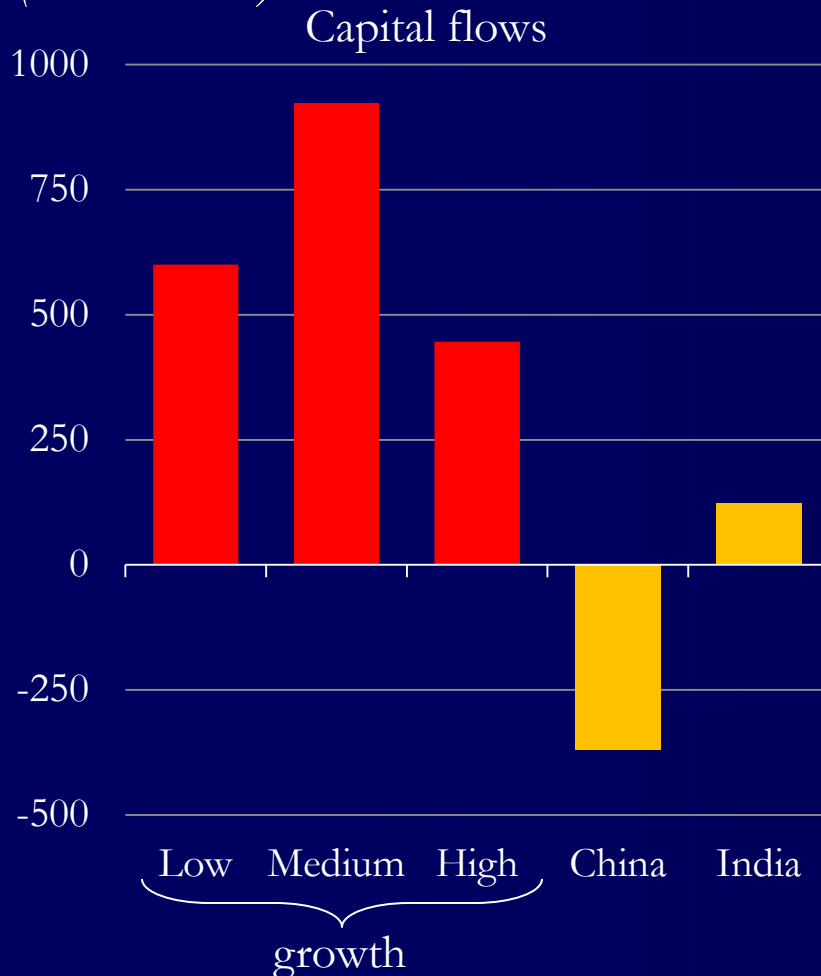
Domestic funding is increasing

Change of Banks' Funding Sources, 2011:Q3-2012:Q2
(percent of GDP annualized, exchange-rate adjusted)



Raising domestic savings may be a better growth model

Allocation of Capital Flows to Non-Industrial Countries 1970-2004
(USD billion)



Challenges ahead

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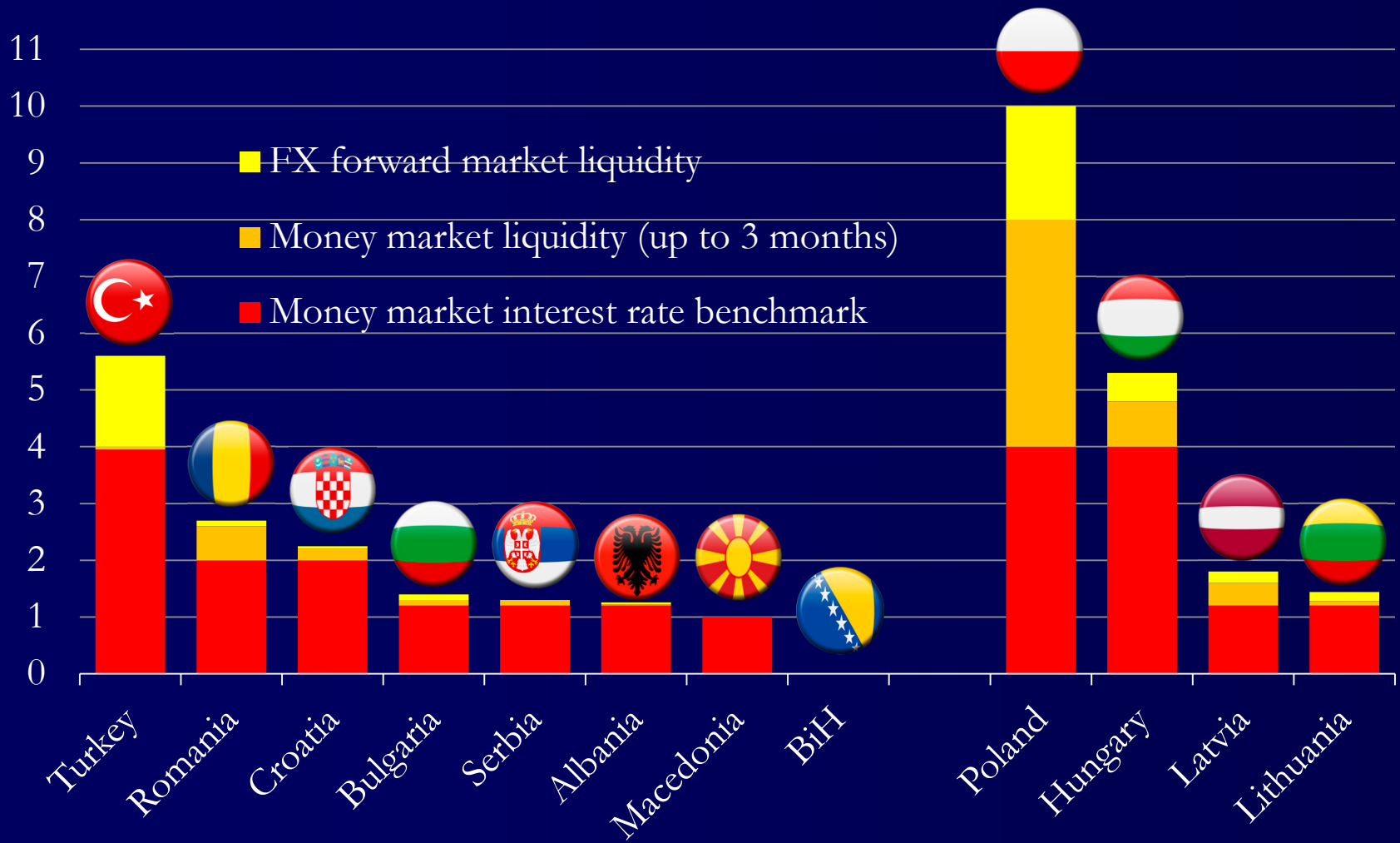
Need to build local currency capital markets

- ✓ Reliance on long-term bank finance is less viable
- ✓ Development of local capital markets is lagging



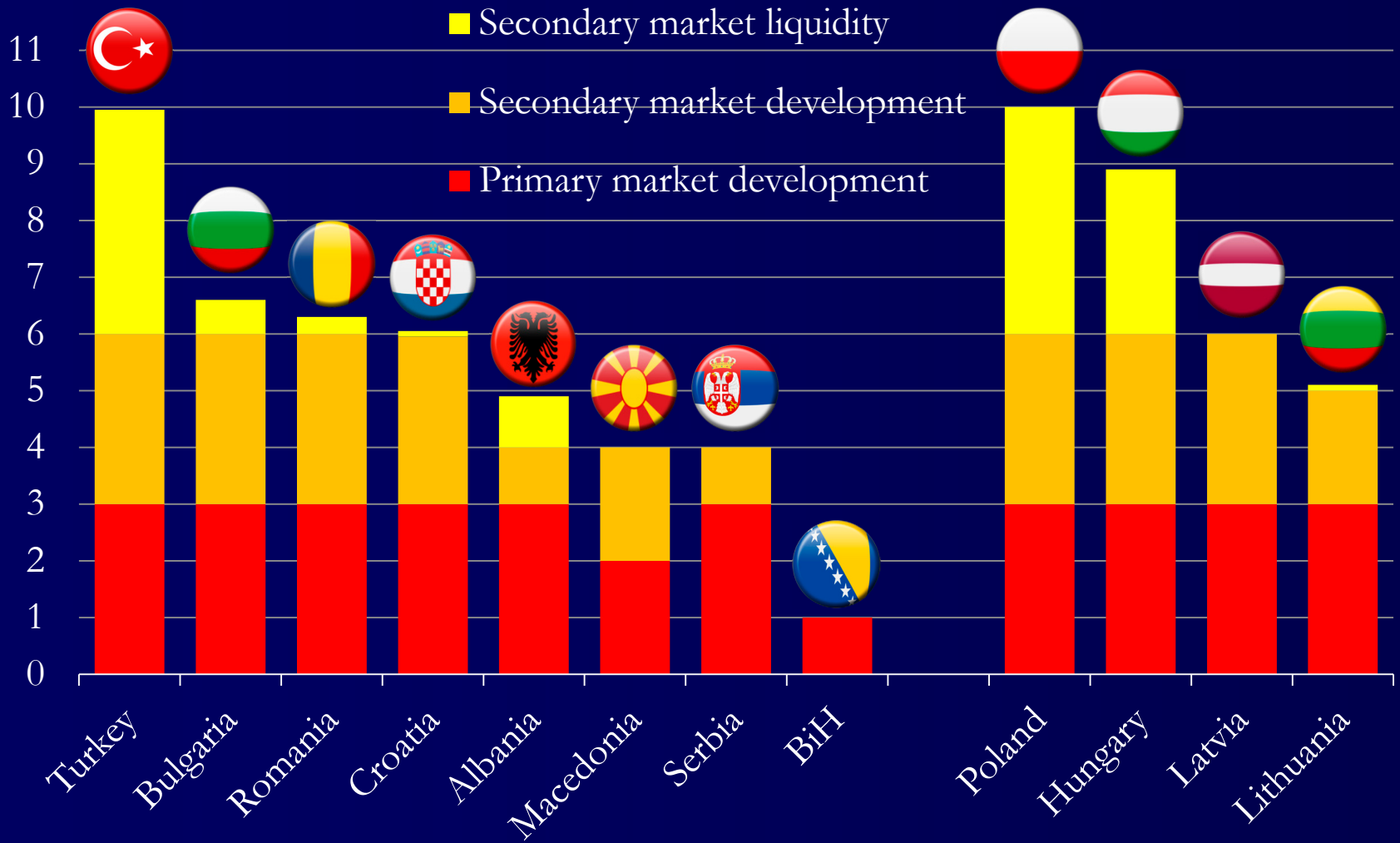
Money markets in SEE lag CEE...

Money market development index



...and so do bond markets.

EBRD bond market development index



Need to build local currency capital markets

- ✓ Reliance on long-term bank finance is less viable
- ✓ Development of local capital markets is lagging
- ✓ Importance of improving business climate
- ✓ Need better legal protections and collateral
- ✓ Need to build market infrastructure
- ✓ Regional cooperation may be essential
- ✓ Role for IFIs



Thank you!



Falemnderit!

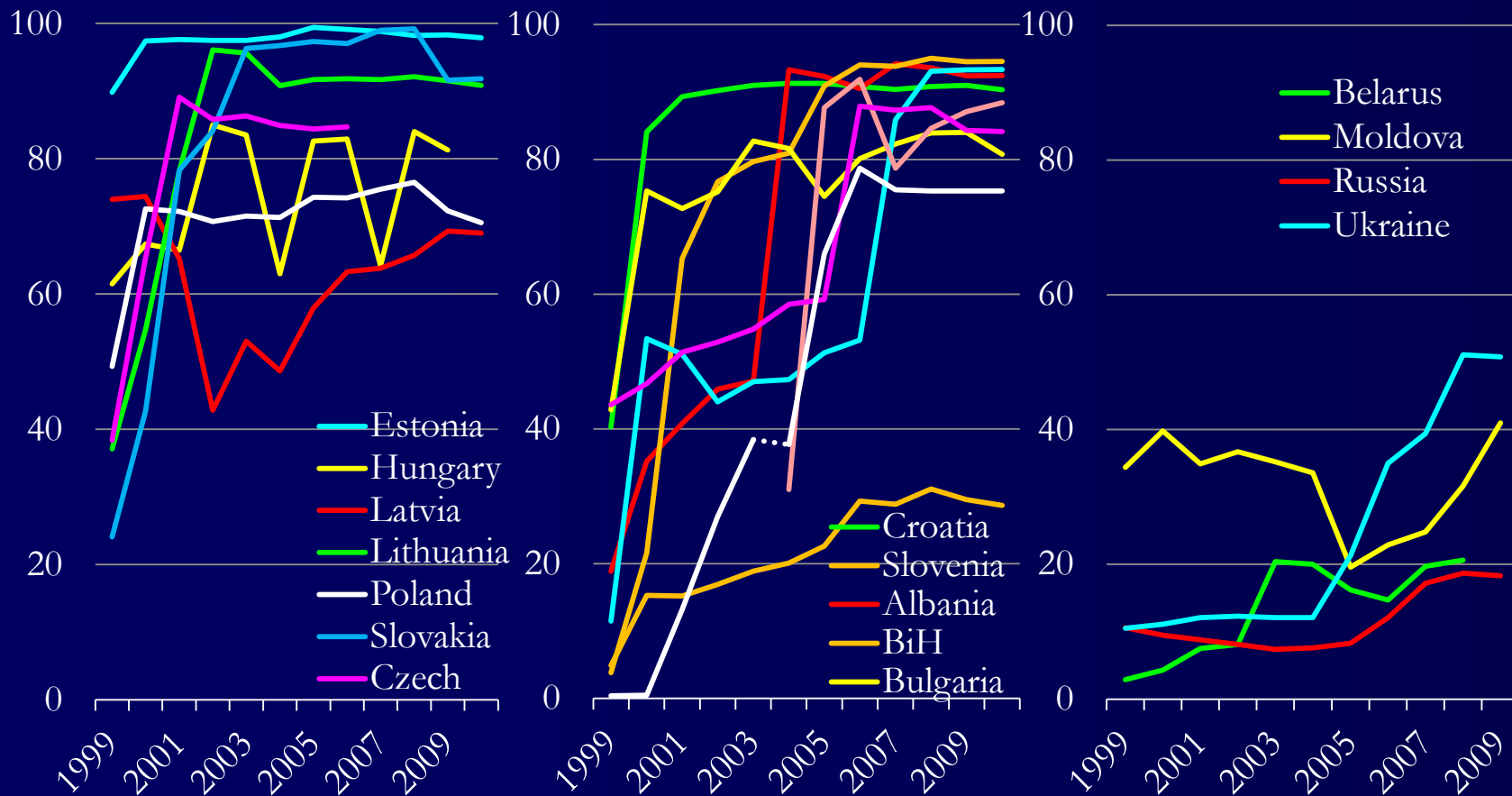


+4 CIS countries



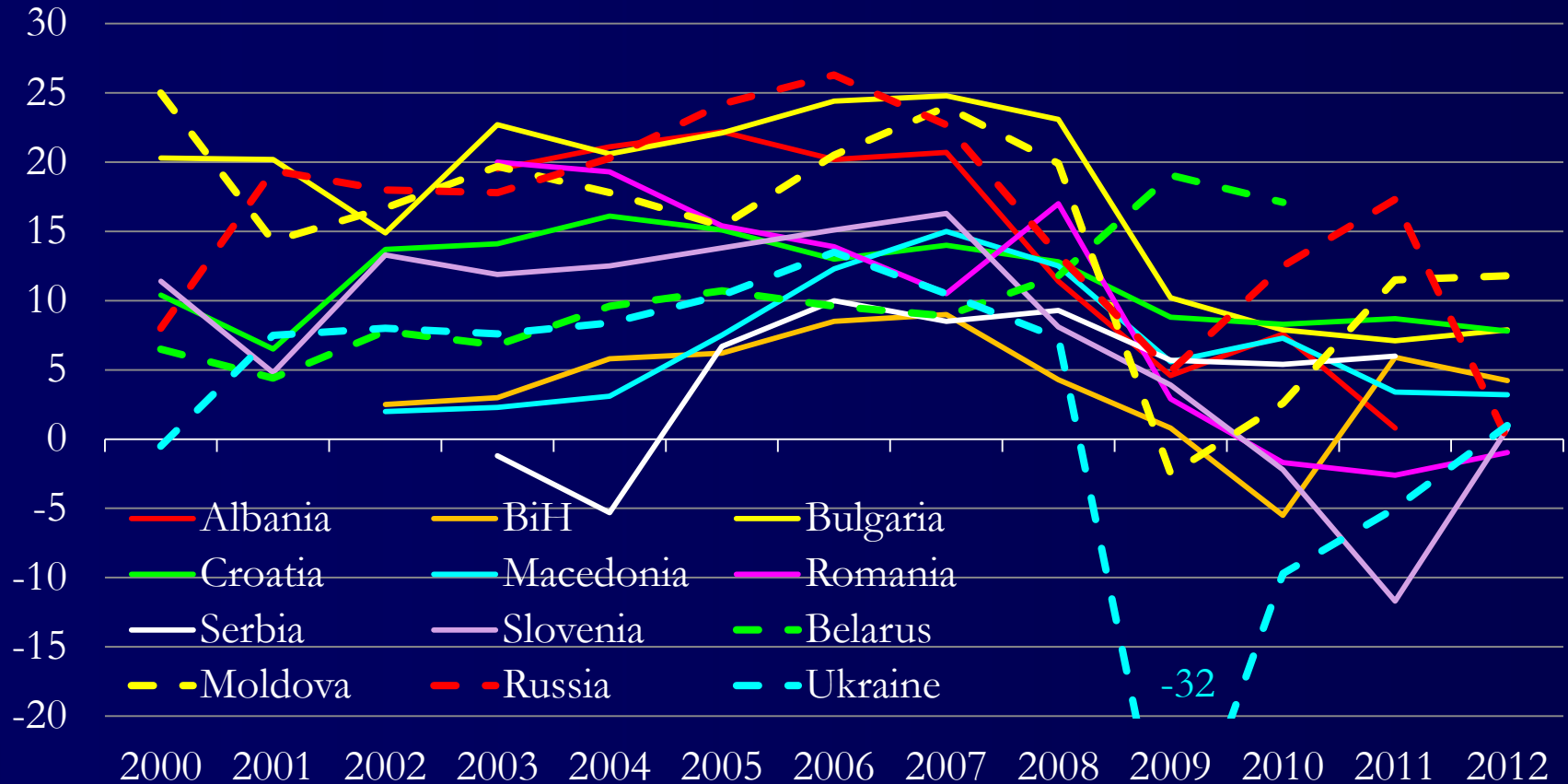
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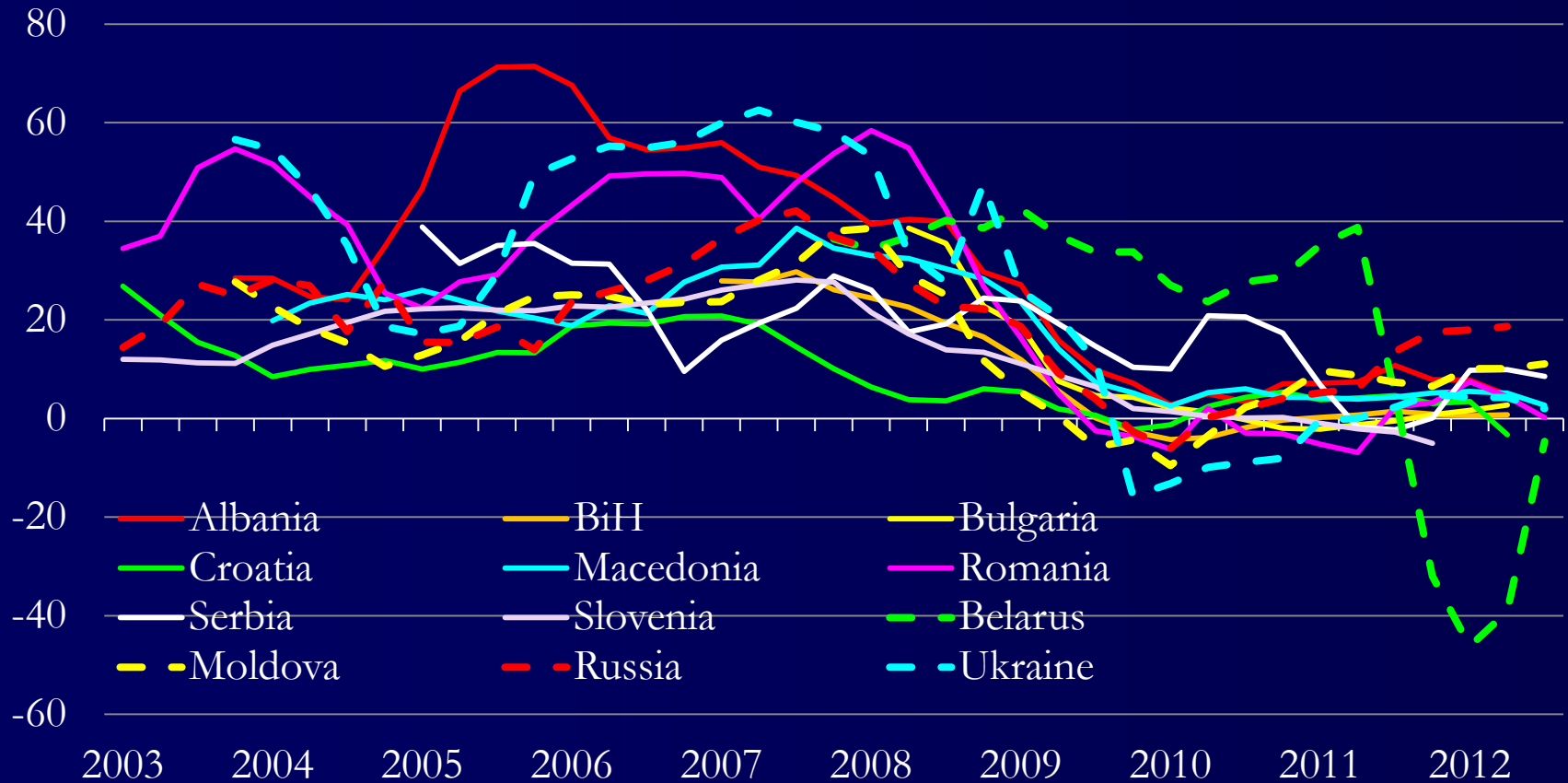
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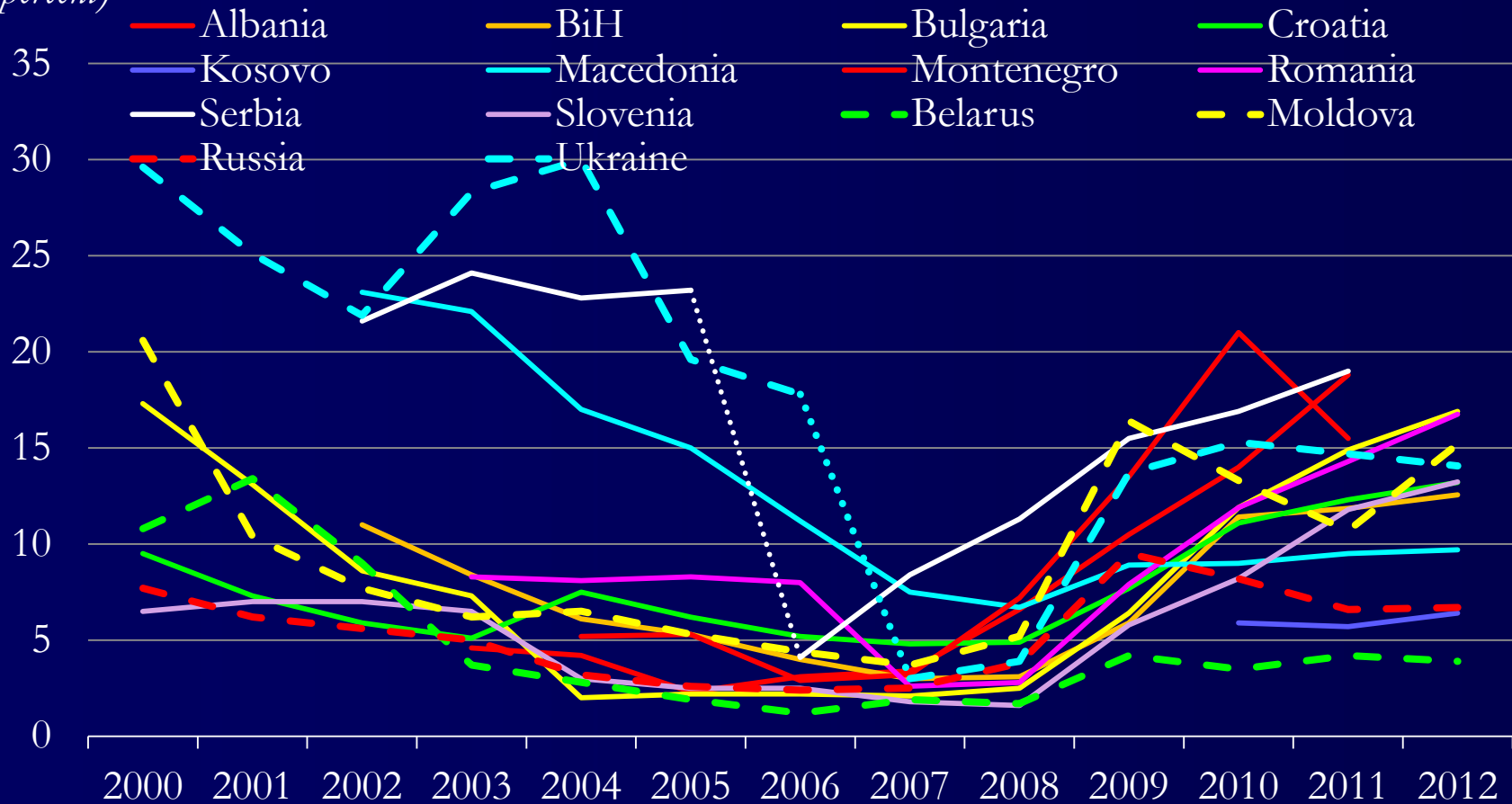
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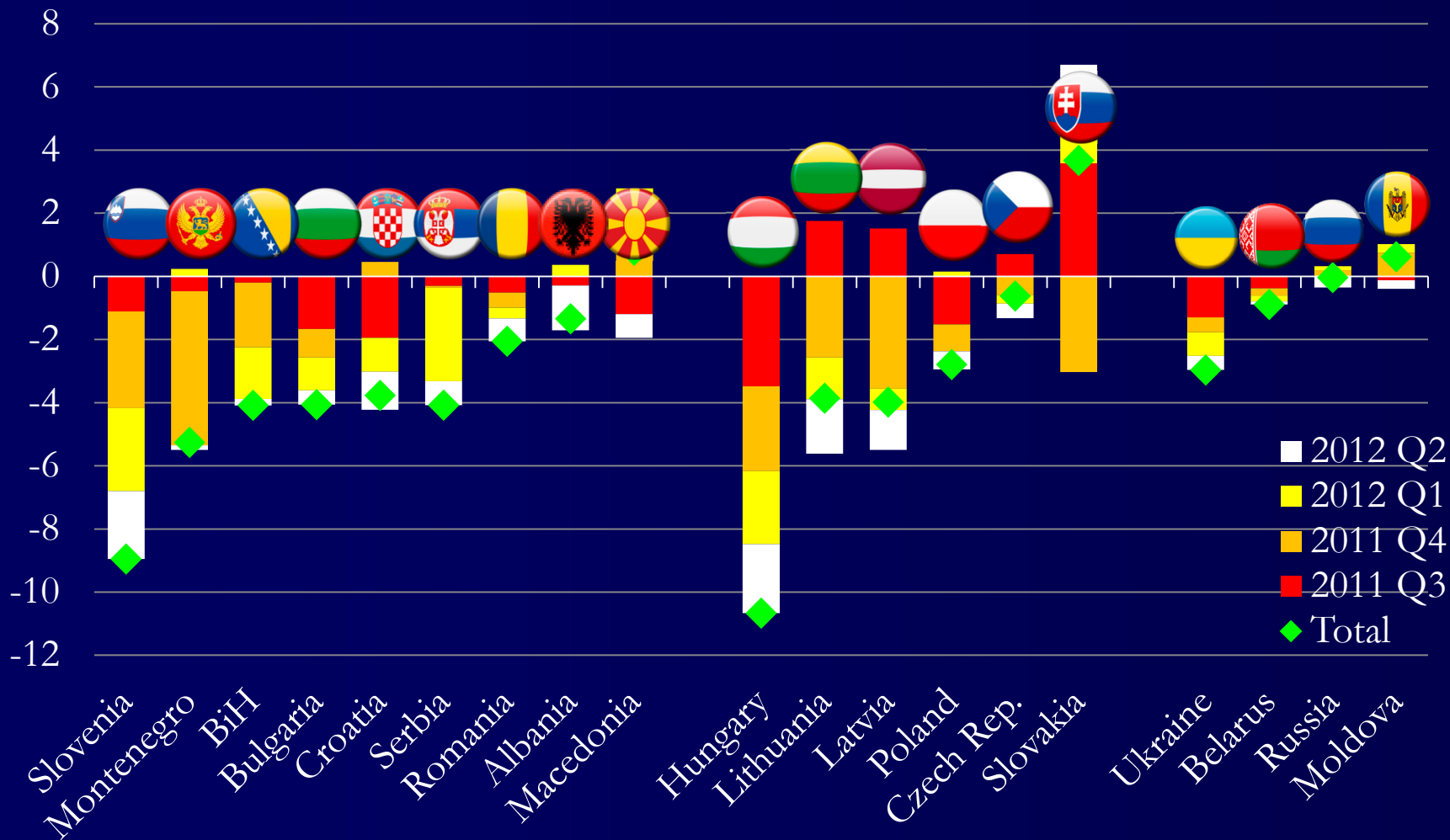
..... Break in series

Source: IMF, GFSR.



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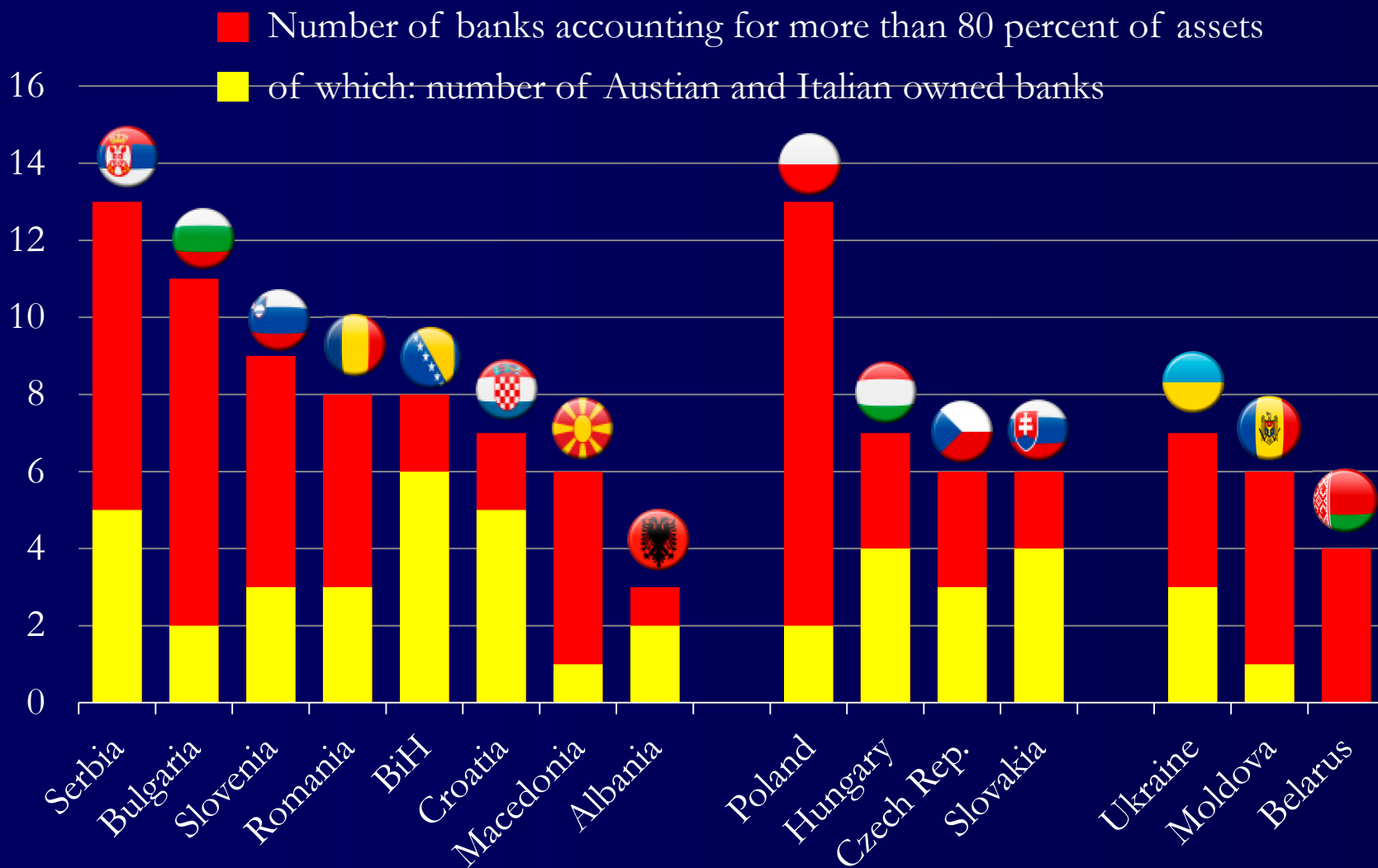


Source: BIS; and IMF staff calculations.



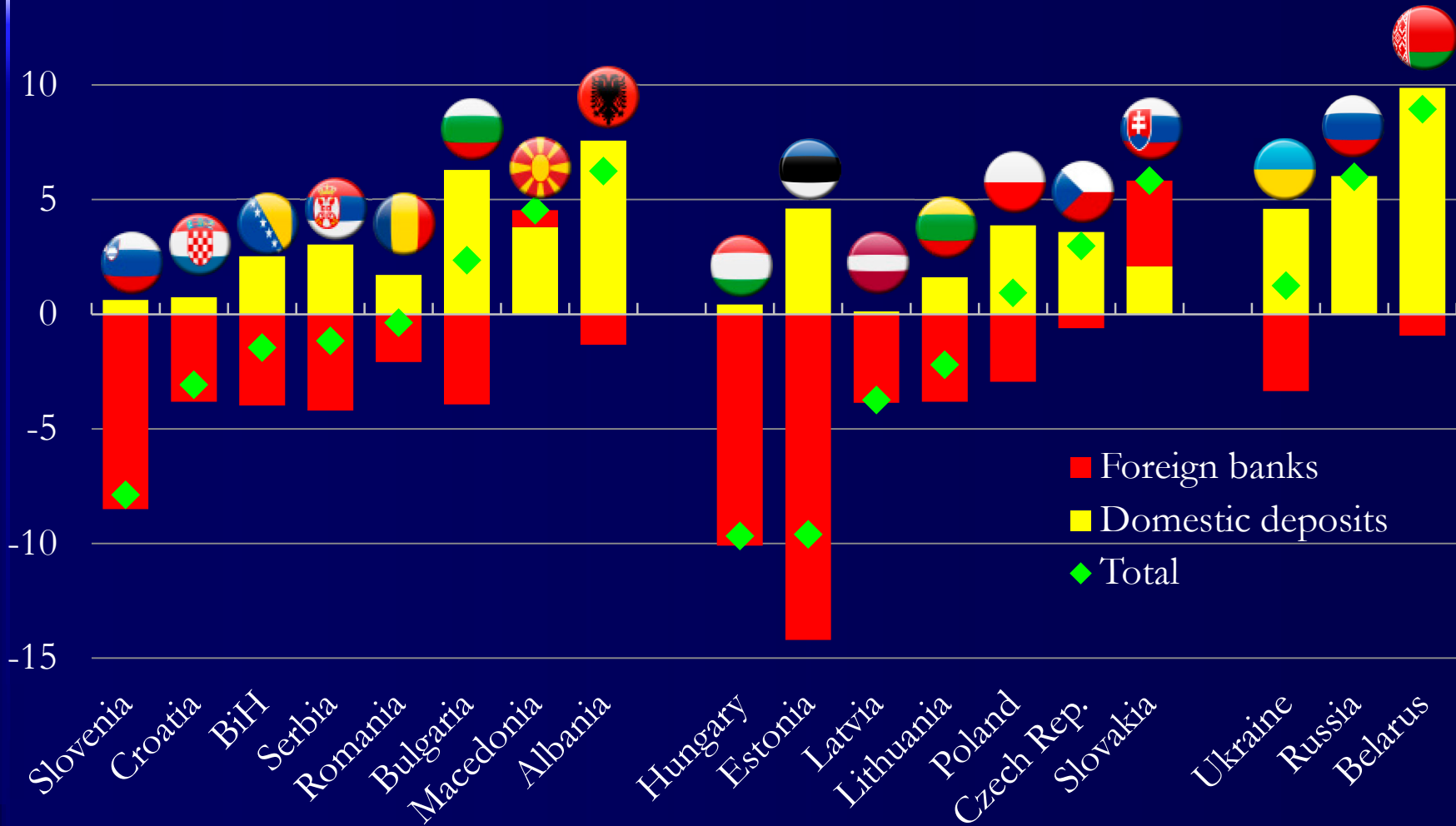
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Banking sector concentration



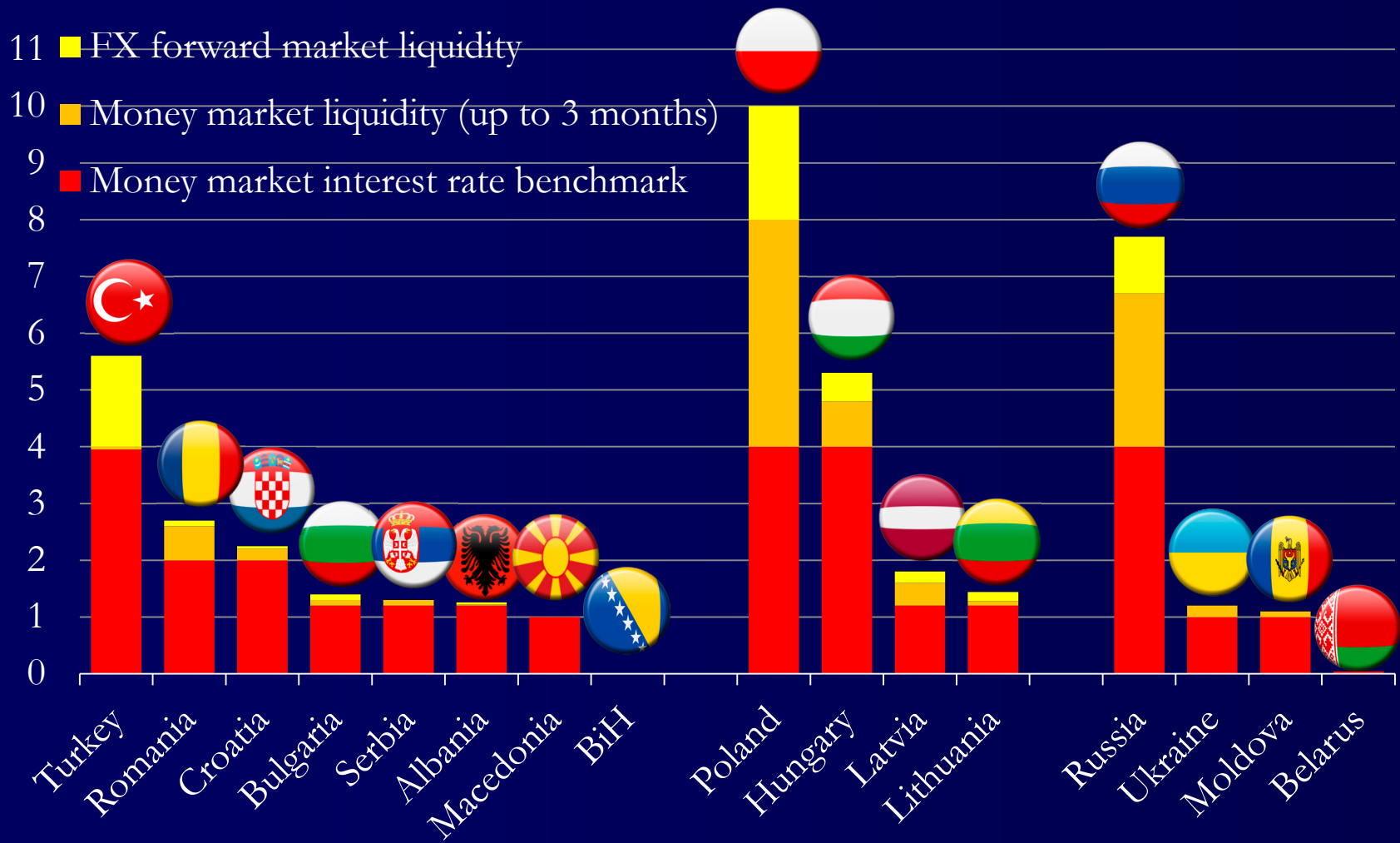
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