

***Financial stability and the reform of regulation & supervision of financial markets – a focus on NMS***

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**1. Introduction: rationales for examining the NMSs' concerns:**

- a. The overall (global) context: not least because of huge/overwhelming externality effects

The negative externalities produced by the financial crisis are huge, in terms of magnitude and the geographic area they cover. Even China and India, which are not mired into economic recession (they only register lower economic growth rates) feel the pinch via, in principal, the compression of international trade and rising protectionism. Negative externalities, which are caused by heavyweights' policies, are not something new. One could make an analogy with the Fed's policy turnaround decades ago, when double digit inflation was brought down by a very severe tightening of US monetary policy. That move threw in disarray countries which had borrowed heavily externally by having been encouraged to do so by negative real interest rates (which followed the recycling of petrodollars). But the current crisis is much deeper, since its roots are structural and embedded in the pattern financial markets have evolved in advanced economies during the past two decades. Waves of deregulation in advanced economies (in the US, UK, in particular) and gross/misleading simplification of the way financial markets operate (including a neglect of systemic risks) have brought about this mess<sup>1</sup>. As Paul Volcker remarked in January 2009 this financial system "has failed the test of the marketplace". NMSs, like all other emerging economies are deeply interested in a reform of the regulation and supervision which should prevent such deep crises.

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<sup>1</sup> Andrew Haldane, the executive director for financial stability at the Bank of England, observes that "Deregulation swept aside banking segregation and, with it, decomposability of the financial network. The upshot was a predictable lack of network robustness. That is one reason why Glass-Steagall is now back again on the international policy agenda" (Rethinking The Financial Network, April 2009, p.31, mimeo)

b. EU specifics: a single market while national prerogatives remain important.

The EU presents peculiarities which complicate the regulation and supervision of financial markets. While monetary policy is unique in the euro area, the regulation and supervision of financial markets stay in national hands. Massive cross border operations bring to the fore the issue of crisis management, burden sharing and resolution schemes. A convergence in the regulation and supervision does make sense (hence the need for common rulebooks), but this is not enough for an orderly functioning of the single market. In addition, the very functioning of the single financial market has to come to grips with its imperfections –which implies that macroeconomic policies would have to be adjusted accordingly. How an acute concern for financial stability would impact on monetary policy construction and implementation is an example in this regard.

c. NMSs' circumstances: size, outside the euro-area (except Slovakia and Slovenia), domination of local financial markets by foreign groups; high euroization (except the Czech Republic).

This crisis has hit the NMSs most severely. From the euphoria of accession and pretty high economic growth rates there is now dismay because of deep recession and much worsened prospects for future economic growth. The presence of foreign banks on local financial markets has brought benefits, but it shows its less favorable side too; the credit crunch is adding to the pains of an excessive reliance on capital imports.

d. The rapid expansion of credit (fuelled by foreign lenders) in NMSs

In the currency board using NMSs, in Hungary, Romania credit grew explosively during most of the past decade; rates of over 40-50% yearly were the norm while most of this credit was foreign currency denominated and taken by the private sector. Most worrisome is that a large chunk of this credit was short term. The financial crisis put a stop to further credit expansion. In addition, a “liquidity trap” has amplified the credit crunch and raised the cost of credit to prohibitive heights.

e. Financial integration and convergence

The current financial crisis has underlined pitfalls of seeing financial integration as a main driver of real convergence. Financial markets are more volatile than all others and are more likely to bring about a boom-bust dynamic. The logic of the single market (in the EU) has predisposed NMS to growing external imbalances –due primarily to their inferior economic development and, thence, perceived substantial positive yield differentials of investment opportunities. But many of these investment have been of a speculative nature, or, have been focused on non-tradeables. There has been a rising indebtedness of households and firms in conjunction with weakened potency of monetary policy and budget policy of restricting growing imbalances. A “Dutch disease” syndrome has also been present in NMSs because of an over-appreciation of their currencies (see also Zsolt's analysis). Some NMS are relatively well integrated into industrial/production

networks of the EU and their external imbalances seem to be more manageable<sup>2</sup>. But even for them a too skewed structure of capital ownership can bring about excessive external imbalances. For peripheral emerging economies, which are less integrated in such networks, financial integration has posed more risks and, as the current crisis makes more than clear, the total opening of their capital account has revealed its dark side. The Great Moderation period has created, arguably, a sense of complacency vis-a-vis the growing external imbalances of most NMSs, and it has obscured unavoidable policy-trade-offs. In addition, financial integration has, probably, been overrated as a driver of economic convergence. The current crisis asks for a reassessment of this vision and for policy readjustments (including industrial policies) –be they at national or EU level.

## **2. Reform of regulation and supervision of financial markets**

The current crisis has reinforced one of Keynes' intellectual legacies, which was enshrined in the Bretton Woods arrangements —namely, that highly volatile capital flows are inimical to trade and growth and that financial markets are unstable. For decades now a mantra has been heard worldwide: that not much can be done, in this regard, because markets would punish a government. But is the complexion of global markets God given? Are n't they, aside from technological drivers, also the product of human beings' decisions to set rules for finance, trade and investment? To claim that nothing can be done about financial flows, when they bring about misery, is unconvincing. Whereas cycles in the motion of markets are to be expected deep crises can be fought against. The bottom line is that well functioning markets, which serve most citizens, are not synonymous with deregulated and un-supervised markets!

European and US political leaders are pushing for a radical overhaul of the regulatory and supervisory structures of financial systems worldwide, including the parallel banking sector and rating agencies. The financial crisis, which has shaken the beliefs of even the most ardent supporters of unfettered markets<sup>3</sup>, cannot be explained by years of cheap money and growing imbalances in the world economy only. Mistakes in macro-economic policy were accompanied by gross abuses of securitisation, abnormally skewed incentives and a loss of moral compass, inadequate risk-assessment models and failures to check for systemic risks<sup>4</sup>, a breakdown of due diligence and an almost blind belief in the self-regulating virtues of markets.

Harmonization of rules is not a sufficient response to the crisis, since the very content of regulation and supervision needs radical overhaul. This is what comes out prominently

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<sup>2</sup> See also Michele Ca Zorzi, Alexander Chudik and Alistair Dieppe, “Current Account Benchmarks for Central and Eastern Europe”, Working Paper no.995/January 2009, ECB

<sup>3</sup> Alan Greenspan, the long-time head of the US Federal Reserve told the US Congress in October 2008, a “risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed...”

<sup>4</sup> By emphasizing the neglect of systemic risks Gillian Tett talks about a “silo curse” (Financial Times, 6 October, 2009). The experience of Spain and Canada, where regulators and supervisors have done a much better job than in other advanced economies, is quite indicative in this regard.

from the de Larosiere<sup>5</sup> report and the Turner report (in the UK)<sup>6</sup>, from documents of the EP and directives of the EC. A reformed regulatory and supervisory framework would observe certain basic principles:

- all financial entities should be regulated and leverage be constrained;
- derivative markets should be regulated (products be standardized/simplified and clearing houses be used);
- remuneration be tied to long-term performance and be constrained;
- banks be better capitalized (both the amount and quality of capital, primarily of tier 1) and capital adequacy ratios set in light of systemic risks;
- pro-cyclicality be avoided in macro-economic policymaking and the way banks modify their capital adequacy ratios;
- banks asked to hold equity shares of securitized loans;
- accounting rules should not fuel pro-cyclicality and be standardized globally<sup>7</sup>;
- dealing with the “too big to fail” and “systemically important” entities: the splitting of big groups<sup>8</sup> and a return to a sort of Glass-Steagall<sup>9</sup> legislation are sensible options;
- regulatory arbitrage (including tax havens) be avoided;
- the protection of consumers of financial services;
- transaction taxes (Tobin, or Pigou-type) as a means to help downsize a much over-expanded financial sector (which is extracting an undue rent from the rest of the economy), diminish negative externalities, and create fiscal revenues for increasingly strained public budgets<sup>10</sup>.
- and, not least, a deep rethinking of systemic risks<sup>11</sup>.

### **3. The Financial crisis: implications for policy construction in NMSs**

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<sup>5</sup> “Report” by The High Level Group On Financial Supervision In The EU, chaired by Jacques de Larosiere, Brussels, 25 February, 2009

<sup>6</sup> The Turner Review (a Regulatory response to the global banking crisis)”, London, FSA, 2009

<sup>7</sup> There are still major differences between the standards used by EU countries and those used by the US.

<sup>8</sup> Market power (concentration) leads to market abuse and, in banking, as this crisis has glaringly proved, to heightened systemic risks by the formation of conglomerates which have engaged in the manufacturing of synthetic products, used high leverage and very risky investment strategies. Tom Wolf remarks that “the oligopolistic banking system that has emerged from this crisis is riskier than the one that went into it” (The Challenges of Managing our Post-crisis World, Financial Times, 30 December, 2009, p. 9). Those who claim that size does not matter use a self-serving argument. The British authorities have already taken steps in this field by asking several banks to divest from some of their business components.

<sup>9</sup> However complicated such an undertaking would be it does make a lot of sense. ‘Casino-type’ banking has to be curtailed as much as possible and “proprietary trading” operations of banks be severely restrained. Paul Volcker and Mervyn King are strong proponents of a return to a sort of Glass-Steagall act.

<sup>10</sup> There are two basic issues here: a/ systemic risk, which cannot be divorced from size b/ and allocation of resources and distribution of profits. The intake from such a tax would help the IFIs cope with effects of crises in emerging economies, poor economies in general. Proceeds from such a tax could also help the EU set up a stabilization funds for dealing with crises. It is worthwhile mentioning that lord Turner in the UK and the IMF have added their voices to supporting a Tobin tax.

<sup>11</sup> For an overview of the current thinking on systemic risks see “The Concept of Systemic Risk”, in ‘Financial Stability Review’, European Central Bank, December 2009, pp. 134-142. See also “Global Financial Stability report. Responding to the Financial Crisis and Measuring Systemic Risks”, IMF, April 2009, particularly chapter 3

The current financial crisis compels a deep rethinking of systemic risks and policy responses. Not surprisingly, the EU poses more challenges than any other area in the world in this regard:

- because, as an union of economies, it is the most integrated financially and a single market for financial services is part and parcel of its logic of functioning.
- because regulatory and supervisory prerogatives, as well as the fiscal burden, stay, basically, in the national hands and on the national tax-payers, respectively.
- because intense, highly risky financial innovation has been practiced by European financial groups too, with its highly deleterious effects once the crisis has irrupted.
- because in the case of NMSs (from Central and Eastern Europe) banking markets feature massive cross-border operations (not least because local banking markets are dominated by foreign groups) and euroization is a major feature of local credit,

### 3.1 Systemic risks and rethinking policies

If financial markets are considerably less stable (than what the efficient markets hypothesis posits) how should our policy mix and policy responses be at national and EU wide levels? It is obvious that major changes in the regulatory and supervisory structures are badly asked for and the de Larosiere group and the Turner reports are pointing in a clear direction; likewise do reports passed by the European Parliament as well as new directives of the EC. But is it enough? For new regulation and supervision structures are not sufficient for adapting policy to a new, wake up call reading of the functioning of financial markets. The very policy, itself, has, arguably, to incur modifications. And here the reference is not made to crisis induced responses—such as major fiscal stimuli and monetary quantitative easing.

For instance, how would this crisis change the practice of monetary policy (“inflation targeting” where it is practiced) owing to the new focus on financial stability? One problem regards the control of monetary aggregates when credit expansion is very intense and financial innovation loosens the relationship between the monetary base, M0, and broad money, M2. Over the last three decades, the relationship between M0, over which a central bank has control, and M2, over which a central bank does not have control, has weakened considerably. This has made the task of implementing monetary policy by a central bank more difficult. In hindsight, the increase in M2 in a global low inflation environment has been made possible with increased leverage by the financial institutions – helped by the development of complex financial product and the creation of a parallel architecture to the banking system (the so-called shadow banking system). The size of the latter, which has been basically non- regulated, has been constantly increasing over the last 10-15 years. This evolution brings to memory the Gurley-Shaw report of decades ago, which highlighted the imprecision in distinguishing between credit and money; and, consequently, major hurdles for effective monetary policy. Financial stability, by being added quite explicitly to the objective of price stability, will complicate the conduct of monetary policy<sup>12</sup>; it may impart a deflationary bias to it to

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<sup>12</sup> As *The Economist* put it “The main tenet of the *Jackson Hole consensus* –that central banks earn their credibility by having a simple target which the public understands and to which they are held accountable – will be much harder to maintain” (2009, August, p.87)

the extent pricking bubbles preventively will take precedence. Monetary policy, in general, will likely be more discretionary

One could argue that the question raised above does concern NMSs in an indirect way only, for these are, fundamentally, “policy, rule and market takers”. One example in this regard is the condition, as a EU rule of accession, to open the capital account completely by the time of entry in the Union. Although there are cogent arguments to have had delayed this process in view of peculiar economic circumstances. But a strong belief in a smooth and efficient functioning of financial markets and in an inevitable nominal and real convergence carried the day. Now, with the benefit of hindsight too, we see how one-sided this condition was in the case of most NMSs.

- The Vienna accords, which imply a roll over of short term debts of the private sector toward foreign banks, is a means to address a market coordination failure (though, in a narrow sense, it can be seen as a de facto restriction on the free movement of capital).
- a proposal like imposing restrictions on the expansion of bank subsidiaries in certain areas would operate as a restriction on the free movement of capital. For instance, in a report of the Economic and Financial Committee (EFC) of the European Council one can read: “The EU home country authorities should limit the acquisition of subsidiaries in other countries, where appropriate”<sup>13</sup>!
- increasing reserve requirements for banks which fuel lending, especially in foreign currency, could also be used as a tool (in a worst case scenario one can contemplate banning foreign currency lending –be it on a temporary basis.<sup>14</sup> But would it be in compliance with the EU rules of the game, or a waiver would be needed (as it happens with EU mature economies which have restricted labor movement in the EU)

### 3.1.1 Dealing with surging capital flows (The Tosowsky dilemma)

This policy dilemma is not unusual in emerging economies, where there is relative capital scarcity, which would create good investment opportunities. Provided these countries enjoy political, social and economic stability capital inflows would be commonsensical. Essentially, this dilemma refers to the inability of monetary policy to prevent a rise in the current account to, possibly, unsustainable levels irrespective of the stance of monetary policy. This dilemma was highlighted regarding the NMSs owing to their clustering in the vicinity of older member of the EU and their presumed increasing institutional and economic stability following market based reforms –which would have fuelled capital inflows. Even before joining the EU this policy dilemma was pretty obvious and debated<sup>15</sup> since these economies were considered to have very good prospects for durable high economic growth rates under the safety umbrella of the Union.

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<sup>13</sup> “Lessons from the financial crisis for European financial stability arrangements”, EFC, High Level Group on Crisis Border Financial Stability Arrangements, 18 June 2009, p.14

<sup>14</sup> An analogy can be used with the temporary banning of short-selling in some EU countries, in the US, Canada, Australia, etc.

<sup>15</sup> Leslie Lipschitz, Timothy Lane and Alex Mourmouras, “The Tosowsky Dilemma. Capital Surges in Transition Countries”, Finance and Development, September 2002

This policy dilemma is organically linked with the functioning of liberalizing financial markets –when governments no longer have the capacity to restrict, potentially, overwhelming capital inflows. High interest rates would attract capital flows (short term in particular) which would appreciate the local currency ever more (for pegged currencies this would occur via real appreciation entailed by inflation differentials), which enlarge the current account deficit; the latter would also increase when low interest rates (aimed at discouraging capital inflows) would fuel domestic demand too much. Thence the acrobatics the policy makers in NMSs had to undertake. One should underline, in this regard, specific circumstances of NMS before and after accession: lower endowment of capital as against labor (capital/labor ratios are lower than in the rest of the EU), financial markets which are much thinner than in EU advanced economies and a gradual, but steady, process of capital account liberalization (which was a must for joining the EU). The latter process has led to intense euroization in most of these economies (except the Czech republic), which has further crippled the potency of domestic monetary policy. It should be said that euroization was also stimulated by the commitment to adopt the euro after accession.

It is worthy to notice that this policy dilemma was emphasized by the then governor of the Czech Republic, Josef Tosowsky. The Czech republic has evidenced not much euroization during the past two decades (with local lending being done, primarily, in the local currency) and inflation rates have been quite low as against other transition economies in Europe. And, still, the dilemma showed up. Imagine then the situation in other NMSs, where euroization is high and inflation differentials (compared to EU benchmarks) likewise. The capital account liberalization has undermined the monetary policy attempts at cooling down overheating economies. When central banks tried to tighten policy local banks lent in foreign currency at apparently much more convenient rates than for local currencies; the seemingly much more attractive borrowing in foreign currency was reinforced by declining interest rates on world credit markets during the decade of the Great Moderation and the real appreciation of local currencies. Central banks were left with the option of raising reserve requirements as a very crude way of tightening liquidity.

Until the irruption of the financial crisis a substantial real appreciation did occur in all NMSs, which is not surprising in view of the heavy capital inflows which they received during this decade. In both currency board and managed floating arrangements domestic currencies went up substantially until 2008<sup>16</sup>. But fundamentals of this appreciation were precarious, particularly where current account deficits went into the double digit territory and their funding included much speculative capital<sup>17</sup>. Analysts cautioned European transition economies as to the pitfalls of heavy capital inflows and underlined the virtues of prudent fiscal policies when monetary policy is deprived of efficacy. Nonetheless, like in the Asian experience of the last decade, the largest part of the current account deficits was caused, in not a few NMSs, by substantial private sector borrowing. **Actually, the logic of the single market, with its ensuing liberalization of the capital account, is**

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<sup>16</sup> See also Anton Brender and Florence Pisani (Globalised Finance and its Collapse, 2009)

<sup>17</sup> Symptoms of a Dutch disease have emerged due to this over-appreciation.

**arguably, responsible for their rising current account deficits**<sup>18</sup>. It should also be noted that most of the credit drive in the NMSs has been, primarily, the result of foreign banks' expansion policies. This is why Baltic economies, Romania, and Bulgaria, etc should not be totally blamed for “home-made” vulnerabilities. Moreover, this expansion is the product of EU rules of the game, of total capital account liberalization. That fiscal policies, in several NMSs, have been pro-cyclical at a time of high economic growth is a different matter for discussion.

But is this dilemma still valid after the start of the financial crisis? The credit crunch, the loss of appetite for assuming risks and the fear of capital flight seem to have modified the context drastically. From large capital inflows one goes to a situation where liquidity constraints prevail. The skyrocketing value for sovereign CDSs in the early stage of 2009 illustrates this situation. But CDS have recovered their lower previous values since then. And the stabilizing function of IFIs and EC supported plans has also come into operation. Does it mean that the policy makers would revisit the Tosowsky policy dilemma in the years to come too? Several remarks deserve to be made in this respect:

- it is not appreciation which is the main concern currently. Instead, liquidity constraints and pressure toward depreciation are undermining financial stability in NMSs;
- the financial stability concern is reinforced by the foreign currency lending practiced by local banks;
- the currency boards arrangements are under extreme pressure in the Baltic economies, where devaluation has been avoided through very painful cuts of wages and pension (even in nominal terms);
- the financial crisis will have powerful and lingering effects, which would reduce the appetite for risk taking;
- big economies (US, Germany, UK, etc) will exert an intense crowding out effect on global credit markets, that would keep the cost of credit high in the years to come (in spite of massive liquidity injections by central banks);
- local banks will be much more cautious in their lending.

The factors mentioned above suggest that capital inflows would occur at a considerably diminished pace in the case of NMSs in the years to come, although there will, likely, be a significant differentiation among these countries. Funding limits will be a major concern for the period to come. The Vienna Accords are a clear proof in this regard.

On the side of demand in the NMSs one would range:

- a developing fiscal crisis with ensuing forex constraints, which increases the risk premia for NMS and would keep rates on local credit markets at higher level than in the past;
- diminished potential economic growth rates, that limit investment opportunities

The bottom line is: against the backdrop of the economic crisis monetary policy in NMSs is no longer worried about exchange rate appreciation. Instead, it is focused on combating deep recession simultaneously with averting capital outflows which would cause

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<sup>18</sup> This is blatantly indicated by Bulgaria's experience; for years this country has registered budget surpluses while its current account deficits went above 15% in recent years.

financial instability via a massive (and uncontrolled) exchange rate depreciation, or a collapse of a currency board arrangement.

### 3.2 The distribution of prerogatives between national and EU authorities

The de Larosiere group report and the decisions of the Ecofin meeting of 9 June (2009) set the creation of the ESRB (European Systemic Risk Board) and a strengthening of micro-prudential supervision via turning the Lamfalussy Level 3 Committees into “European Authorities”. These decisions have given an impetus to the creation of a European system of regulation and supervision.

Nonetheless, there are signs that this crisis, instead, tends to reinforce a tendency for more localization of financial activities, for a de facto fragmentation of markets. This may prove to be only a temporary phenomenon. But it may also last by showing limits of globalization (of single markets), a reversal of dynamics of the last decade. This is not necessarily bad to the extent it reflects a *prise de conscience* (on the part of banks and governments) as to the risks incurred by overexpansion of financial operations across borders.

Moreover, the inadequate tackling of the fiscal burden sharing (how to distribute the burden to national tax payers in the case of a multi jurisdictional bank failure) fuels the desire of national authorities to keep things under control<sup>19</sup>.

This crisis shows that the inexistence of burden-sharing arrangements in the case of a crisis is a major handicap for the single market –apart from inadequate regulation and supervision of financial markets. Charles Goodhart’s early warning in this respect is vindicated. For, the safety and soundness of a cross border financial group will be perceived to depend on the capacity of the home country to support the financial group as a whole, or on the operation of ex ante burden sharing agreements (between the home and host countries). Let us keep in mind, in this regard the peculiar situation of NMSs:

- their inferior level of economic development (and limited budget resources), which limits the resources they can summon in order to forge rescue packages for local banks<sup>20</sup>;
- rising budget deficits in MMSs, which may last, even years after the recession will be over in the EU;
- the revealed weaknesses of a growth model that relied heavily on capital imports; the current crisis may have lowered, considerably, the potential economic growth path, which would imply less financial muscle on the part of national budgets;

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<sup>19</sup> As the de Larosiere report says “The absence of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers’ protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place” (pp.76)

<sup>20</sup> It can be argued that EU funds could be used to recapitalize banks in NMSs owing to the paucity of their national budget resources!!!

- the domination of local financial markets by foreign groups; the latter are in a process of deleveraging, which diminishes their propensity to rollover credits and lend; this does not help economic recovery in NMSs. These banks are in a catch-22 situation with regard to credit resumption in NMSs.
- the heavy exposure of some western banking groups to NMSs, which would make them quite reluctant to expand their operations in those markets.

Unless we achieve a clear headway with the fiscal burden sharing (which imply resolution schemes<sup>21</sup> as well) the development of an effective EU wide (unified) system of regulation and supervision would be much impeded. It remains to be seen whether the creation of the ESRB and a turning of the Lamfalussy Level 3 Committees into European Authorities can make a difference, in a positive way, in view of the current “centrifugal” pressures.

### 3.3 The home-host country relationship

The financial crisis has challenged some specific features of the single financial market, with regard to the operation of the single passport based on the principles of a/ home country control of cross border financial services, b/ mutual recognition of MSs competences and c/ minimum harmonization of national laws.

The home-country control principle enabled financial institutions to expand without limit their provision of services across the EU without consideration for the possibility of a financial crisis and related contagion effects –this mirrors the flawed philosophy which has dominated the thinking about the functioning of financial markets and inadequate attention paid to systemic risks.

- the arrangements between home and host country have not included plans covering crisis management, burden sharing and cross border resolution. The establishment of the ESRB and of the new specific authorities would hopefully improve things in this respect.
- the single passport matrix permitted not a few financial institutions to expand across border on the basis of unsustainable business models (such as “the harvest of retail deposits through foreign branches relying on untenable propositions)
- some branches expanded cross-border beyond the capacity of the home country to provide liquidity and solvency support –while there were no ex ante agreements between home and host country in this regard, including the burden sharing.

The experience with the financial crisis suggests that the cooperation between home and host country authorities is undermined in crisis situations because:

- the distribution of tasks between home and host country authorities is not always clear, particularly with regard to the safeguarding of financial stability;
- the lack of burden sharing agreements;
- the host country authorities have limited scope and powers to protect national markets and question the home country decisions in the case of branches<sup>22</sup>. This

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<sup>21</sup> These refer to “living wills” too, which may be part of the solution.

<sup>22</sup> Some voices suggest that branches be forced to turn into subsidiaries

has been also the case for subsidiaries as cross border financial groups are inclined to centralize certain functions such as funding, risk management and liquidity management. Consequently, host country authorities have incentives to engage in “non-cooperative strategies” (EFC Report, p.12) to protect their national financial systems --though the review of the Capital Requirements Directive has requested national supervisors to “duly consider the potential impact of their decisions on the stability of the financial system in all other member states concerned and, in particular, in emergency situations”.

Though they see shortcomings of having their local banking markets dominated so much by foreign banks NMSs’ governments evince some defiance vis a vis the creation of a EU wide system of regulation and supervision –though they have endorsed the setting up of the ESRB and the three European Supervisory Authorities; this attitude is to be linked, among others, with the unsolved burden sharing issue. The most vocal among NMSs in rejecting a pan-European system seems to be the Czech Republic. Probably this is because the performance of the Czech economy has been quite singular when judged by its low disequilibria, insignificant euroization, quite low inflation over the past two decades. Arguably, the very reticence to adopt the euro in the foreseeable future may originate in this track record –apart from a more nationalistic attitude, which tails British euro-skepticism. Nonetheless even the Czech Republic can not avoid thinking about the intensity of contagion effects in the case of small open economies. In addition, Czech banking markets are controlled by foreign groups quasi-totally. It is true that foreign banks can provide an implicit guarantee to the soundness of local financial markets. But as this crisis proves, what appears to be a strength can easily turn into a vulnerability – especially if capital flight is induced by parent banks. For this reason the Vienna Accords emerged as a policy venue in the case of several NMSs.

### 3.3.1 What lies ahead?

The home-host country regulator/supervisor relationship will be, arguably, even more controversial owing to this crisis. Since, on one hand, this crisis brings ammunition to the idea that more common regulation and supervision (and a common rulebook) is needed not least because of cross border operations and contagion effects, which cast the magnitude of a systemic crisis beyond national borders --thereby, for both systemic risk and avoiding regulatory arbitrage reasons. And on the other hand, the unsolved fiscal issue prompts national governments/supervisors to think more along national lines, in view of their accountability toward national tax-payers.

The Fortis and Dexia cases involved frantic intervention and rescue packages that impact on the budgets of the governments involved. But, it is quite clear that ex ante arrangements (including the “Living wills”), which should deal with such crises in an orderly fashion, are needed so that the logic of the single market be protected, as much as possible. At the same time, banking groups may become much more cautious about their cross-border operations, which would imply a tendency of “localization” of their

operations; deleveraging, which will take quite a while, and less appetite for risk would also induce commercial banks to focus more on their home operations (it may, however, be that the prospects for a resumption of higher economic growth rates in some NMSs could maintain a high interest of foreign banks in NMSs' markets)

A key issue originates in the domination of the financial markets of NMSs by foreign groups. Even before the irruption of this crisis the lead supervisor concept (which was promoted by leading financial groups) was resisted by small countries on both political and financial stability grounds; these countries feared that a loss of final say in the deliberations of the Colleges, because of their host country status, would cripple their capacity to intervene during a crisis<sup>23</sup>. Because foreign groups, that operate multi-jurisdictionally, could be tempted to reallocate capital in a way that might create havoc locally; what would seem optimal for a financial group might be quite suboptimal for a host country. As the Turner report says, if problems emerge there may be a divergence of interest with “the home supervisor wishing to see maximum transferability of liquidity to offset the emergence of group wide liquidity problems, while host supervisors wish to ring fence liquidity at national level precisely because they have growing concerns about the whole group position”<sup>24</sup>. The Report further says:...”even well capitalized local bank subsidiaries are likely to face liquidity crises if the whole group is seen to be in trouble” (Ibid.). And in view of the powerful contagion effects which are likely to operate in the event of a crisis the trouble would extend to whole banking systems. The current crisis has made these worries to increase. The Vienna accords have been made necessary by these very concerns: that foreign (parent) banks would be inclined to transfer capital regionally at a time when credit markets are collapsing. Are the Vienna accords an exception to the logic of the single markets, or are they an indication that the volatility of financial markets, against the backdrop of their shallowness in NMSs, major fiscal challenges in the years to come and a very uncertain external environment pose questions to policy construction answers to which are less to be found in the conventional toolbox.

## **4. Systemic issues and policy venues**

### **4.1 Access to liquidity**

There are traditional channels for enhancing access to liquidity; these involve IFIs' funding (done by the IMF in particular) and ask a country to adopt policy corrections. There is a major distinction to be made in this regard: when policy corrections are necessary because of previous policy blunders of the country that is demanding assistance

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<sup>23</sup> From an international perspective a macro-prudential regime would be subject to four sources of potential leakage arbitrage: lending via foreign branches; direct cross-border operations; foreign lending via domestic non-bank financial firms; and intra-group corporate lending. As a Bank of England discussion paper says “international coordination might be one means of containing potential leakage problems”(“The Role of Macro-prudential Policy”, November, 2009, pp.32). Arguably, this coordination should be undertaken by the ESRB and the EFC (in the EU).

<sup>24</sup> The Turner Review , pp.99

vs. dealing with difficulties which are caused by a shock from outside (such as the negative huge externality caused by the current financial crisis).

For the NMSs, except Slovakia and Slovenia, the liquidity risk is amplified by the currency risk<sup>25</sup>. There are several means to enhance “access to liquidity”:

- the EU balance of payments facility, which has been activated during this crisis;
- swap lines between the ECB and central banks in the NMSs;
- IFIs lines of credit, which may be used for funding budget deficits as well (this is a major novelty in the operations of the IMF);
- debt restructuring as a means to diminish the pressure on the flow of annual payments and, consequently, mitigate the risk perception in the eyes of lenders;
- a EU “Stabilization Fund” , which should discourage speculative attacks on local currencies; this SF could be funded through a tax on financial transactions (a Tobin tax);
- guarantees extended by various IFIs, the EIB (or governments of the EU), which would be a sort of “credit enhancement” facility. But this facility would have to be accompanied by very powerful commitments that policy corrections (budget consolidation) are undertaken. A problem would be here that the a looming big fiscal crisis in Europe would lower the propensity of governments of the better shaped economies and not only of them to extend guarantees to perceived profligate countries.

#### 4.2 Crisis resolution

In this field one can see the intricate nature of financial integration in the EU. Since NMSs’ financial markets are dominated by foreign groups the home country authorities have to work very closely with host country authorities were a case of bank distress appear. Reputation, systemic risks and budget effects are all at stake. Unless subsidiaries of foreign groups comply with the host country specific regulations and, in addition, they resort to ‘externalization” of lending, it would be more than unfair to ask the host country budget to shoulder the burden of a local crisis.

The ECB, the ESRC and colleges of regulators/supervisors should prevent reckless (myopic) conduct on the part of foreign banking groups. It would be useful for governors of the central banks (representing the main regulatory/supervisory bodies) in the Region to keep in close contact and coordinate their measures.

To this end it would be useful to set up a Financial Stability Initiative (FSI) which should focus on the systemic problems of the non-eurozone NMSs and report back to the ESRB and the EFC . As a matter of fact, the de Larosiere report recommends that special issues and events should prompt the “Authorities” to create and lead groups of national

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<sup>25</sup> The currency risk is to be judged in conjunction with the systemic risk (alias “liquidity risk”) high euroization engenders. The currency risk can reinforce an “evaporation” of liquidity as it has occurred during this financial crisis (see also Claudio Borio, “Ten Propositions about Liquidity Crises”, BIS Working Papers, no.293, November 2009)

supervisors which should tackle those issues (pp.54)<sup>26</sup>. Likewise one could think of having the ESRB, in liaison with the three Authorities, setting up a group mandated to monitor and deal with systemic problems pertaining to the NMSs which do not belong to the eurozone; such a group would demand close cooperation among supervisors and central banks in the Region. We believe that the FSI, as such a group, would broaden the concerns which have motivated the establishment of the Vienna accords.

#### 4.3 Controlling the expansion of credit<sup>27</sup>

How to limit unhealthy boom creating lending has always been a concern, all over the world. It is currently spreading again in Asia and in some Latin American countries (like Brazil) where economic growth has not been impaired by the global financial crisis and following the cheap money policies practiced in the US and Europe<sup>28</sup>. In NMSs this concern has been put on the shelf owing to the current credit crunch which they are undergoing and the funding constraints of government and corporate budgets. But, after NMSs would have recovered from the current crisis and, particularly, in those economies which will be quite attractive for investments again, containing excessive capital inflows would, arguably, be again a policy concern.

In the EU policy recommendations to deal with destabilizing surges in capital flows refer to regulation and supervision instruments; capital controls, since they would, arguably, infringe the rules of the single market are not talked about officially.

##### 4.3.1 Regulatory instruments

- countercyclical capital and reserve requirements (including capital surcharges), which should take into account aggregate/systemic risk<sup>29</sup>;
- capital requirements could be applied at varying levels of granularity, so that lending to non-bank financial entities be not favored to the detriment of the real economy;
- dynamic provisioning against expected losses (Spain's experience is frequently cited here);
- stricter regulations on leverage (limits), maturity mismatches and the rate of expansion of lending;

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<sup>26</sup> The de Larosiere report, when arguing in favor of creating such groups, refers, in particular, to "bankruptcy of a third country systemic group"(pp.54)

<sup>27</sup> Commercial bankers have kept arguing that since the share of credit in GDP in NMSs is low one should not worry too much about its expansion. What they and their supervisors seem to have underestimated are several factors: there is a hell of a difference between funding consumption vs. investment (with the latter being more useful when it is oriented toward tradeables); the maturity of funding does matter a lot; and, not least, the speed of credit expansion. The faster the expansion the more destabilizing it can be!

<sup>28</sup> There is a resurgent carry trade, in which investors borrow in low interest rate countries and place their investments in higher interest rate emerging economies.

<sup>29</sup> Brunnermeier, Crockett, Goodhart, Persaud and Shin ( "The Fundamental Principles of Financial regulation", 11th Geneva Report on the World economy, preliminary draft...2009) argue that countercyclical regulatory measures should become a standard instrument in order to fight credit booms in both mature and emerging economies.

- foreign owned subsidiaries should be “subject to the same capital requirement calculations, and hold that in domestic assets, as the domestic banks”,<sup>30</sup>
- measures which favor local currency denominated credit; one could even resort to the prohibition (be it temporary) of foreign currency denominated lending (but this would trigger an ‘outsourcing’ of lending).

The bottom line is that financial institutions (banks) would be required to hold more capital and liquidity and vary them upwards during periods of high economic growth (but in the EU would central banks do this according to national/specific conditions, or harmonization will happen?)

The free capital movement is a major feature of the EU, which can impair the ability of host country authorities to control the expansion of credit. For instance, foreign subsidiaries can transfer part of their lending to other members (located in other national jurisdictions) of the banking group. Or they can relocate excess liquidity within the group by trying to capitalize on yields differentials. The latter can put pressure on a local currency and increase volatility of floating exchange rates. This is why some NMSs prohibit this “optimization” of the use of excess liquidity. Is this prohibition a restriction on free capital movement? Arguably, it is, but it is useful from the perspective of national regulators/supervisors.

The “externalization”(outsourcing) of lending to “brothers”, or the mother bank, does obscure the amount of indebtedness of local firms, which shows up in the balance-sheet of the domestic banking system; it also underestimates the external indebtedness of the host country. In addition, as against the proposal made by Brunnermeier et, al (p.65) the conversion of foreign assets of foreign subsidiaries in domestic assets (when it comes to capital requirements) may not be possible –keep in mind also the heavy euroization of NMSs. Therefore, owing to outsourcing of lending one would have to consider a range of additional means for limiting lending:

- use the college of supervisors for coming to an agreement with the home country supervisors regarding a responsible and accountable conduct of foreign banks’ external lending operations. This coming to an agreement should be made easier in view of the common interest both home and host country supervisors should have in mitigating systemic risks (provided they perceive it similarly);
- the home and host country supervisors should compare the exposure of various banking groups toward a host country as it is illustrated by their consolidated balance sheets as against those of the subsidiaries in the host country; they should also assess the attempts to optimize the use of liquidity on a regional basis, which may harm local currencies;
- the ESRB and the EFC should address this issue and ask the home country supervisor to “internalize” in its policy requirements the host country’s risk judgment and worries regarding the expansion of credit and the “optimization” of the use of excess liquidity.
- one could apply the logic of the Vienna accords in reverse: deal with the “capital surges risk” via a market coordination device.

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<sup>30</sup> Brunnermeier et al., 2009, p.65

One could say that non-uniform and variable capital and liquidity requirements in the EU member countries are de facto restrictions for the free movement of capital? On the other hand, they are in tune with the maintenance of national prerogatives fiscal policy-wise and in the domain of macro-prudential regulation.

Financial Times of 30<sup>th</sup> November mentioned names which are likely to be on the list of the 30 systemically important groups to be monitored in the EU. SoGen and Unicredit apparently are on this list, but not Austrian and Swedish groups. In NMSs the domination of local financial markets by foreign groups is so overwhelming that one wonders about the criteria which define what is "systemically important". Interconnectedness should be judged not only on a global basis. Arguably, the ECB (ESRB) the EC and the Council (through the EFC) should replicate a "list" for the regionally systemically important players; systemically important Austrian, Italian, Swedish and Greek banks should be on this list.

#### 4.3.2 Capital controls

Capital controls have resurfaced after the Asian crisis and are increasingly talked about nowadays. In spite of the paradigm which was propounded by IFIs until not long ago and was in tune with the financial markets hypothesis, contrarian, Keynesian-type views have come to the forefront in several emerging economies (mainly in Asia, following the crisis of a decade ago) and capital controls were resorted to. At the same time, there is a line of reasoning which says that capital controls, in the end, are not effective. Then, why should governments use them? But the evidence is more than in the eye of the beholder (the interested parties). There are studies which show that capital controls, if used smartly, can help macroeconomic policy in small open economies. Thus contrary to the common perception that capital controls can be easily evaded, they do affect the cross-market premium in a sustainable way.<sup>31</sup>

In NMSs the use of capital controls is made harder by what may be seen as a clash with the logic of the single market, with the accession treaties –which ask for total removal of restrictions on financial markets by the time of accession.

There are, arguably, several qualms to have vis-à-vis a rigid interpretation of the accession treaties. One is linked with the existence of waivers, which operate on other markets (for example, restrictions which regard labor movements in the EU). Why shouldn't waivers apply when it comes to the single financial market, when circumstances may justify them. An additional reason for questioning a rigid interpretation of the accession treaties is the wake up call caused by the current financial crisis. If financial markets can produce so much havoc, since they are inherently unstable,

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<sup>31</sup> Controls on capital inflows put downward pressure on domestic markets relative to international ones, generating a negative premium. The opposite happens with controls on capital outflows. This signals the inability of market participants to engage in perfect arbitrage (Eduardo Levy Yeyati, Sergio L. Schmukler, and Neeltje van Horen, "Crises, Capital Controls and Financial Integration", ADB Institute Working Paper, no.121, November, 2008)

to consider them, in an unqualified manner, as a main driver of real economic convergence is quite inappropriate; and sand to throw in their wheels is needed.

There are leading experts who argue that the use of capital controls could help in the case of European emerging economies (NMSs)<sup>32</sup>. It may be that renewed capital inflows in some NMSs and the relative ineffectiveness of regulatory measures would force governments to implement measures as are being applied in other emerging economies – where there is an attempt to restrict speculative capital inflows by taxing currency, equity, debt and real estate transactions<sup>33</sup>.

Some remark that “the capital controls that are now being proposed are more in the spirit of “macro-prudential regulation”, to be taken in response to capital flows surges that have the potential to create bubbles in asset prices, including exchange rates”<sup>34</sup>. Such measures would therefore be taken during an upswing of the cycle and not at all times. They may also be applied in coordination, by several emerging economies which may be flooded by short term capital inflows at the same time. Some NMSs may face such a situation in a few years time and a coordinated response, with the blessing of the Council and the Commission, would make sense in this respect.

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<sup>32</sup> Willem Buiters (The Return of Capital Controls, 20 February, 2009, on his blog). Dani Rodrik says : “Prudential controls on capital flows make a lot of sense. Short-term flows not only wreak havoc with domestic macroeconomic management, but they also aggravate adverse exchange-rate movements. In particular, “hot” capital inflows make it difficult for financially open economies to maintain a competitive currency, depriving them of what is in effect the most potent form of industrial policy imaginable”(The IMF needs a fresh rethinking of capital controls”, Project Syndicate, 2009.

<sup>33</sup> In Brazil a 2% surcharge was imposed on purchases by foreigners of equity and debt  
Russia and India, too, are contemplating such restrictions.

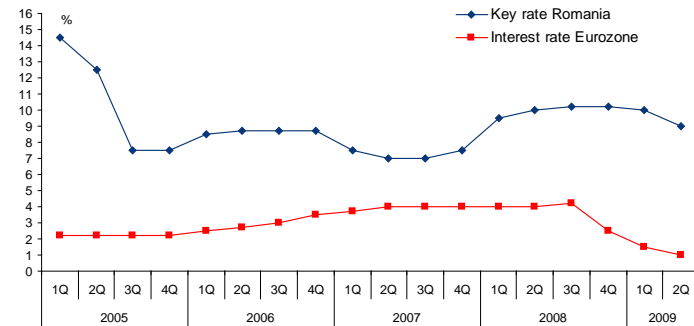
<sup>34</sup> Arvind Subramanian, “Coordinated capital controls: A further argument in favor”, Real time economic issues watch, 2 December, 2009. He notices that, in contrast, the initial Tobin tax and the Turner variant would be structural, in the sense that would tax all financial transactions irrespective of the state of the macroeconomic cycle.

## Appendix: The Tosowsky Dilemma

Romania is quite a good example on how the Tosovski dilemma operates, although the current international context has changed some of the variables; a pretty strong conflict between the necessity of *low interest rates* to discourage hefty inflows of *hot money* and the need for *high interest rates* to fight inflation – a real problem in Romania for many years – and balance saving with investment so to avoid a widening current account deficit.

- After the full liberalisation of the current capital in September 2006, RON started to appreciate in nominal terms visibly in the next 3 months (+3.2%); hot money increased significantly during October-December 2006, while

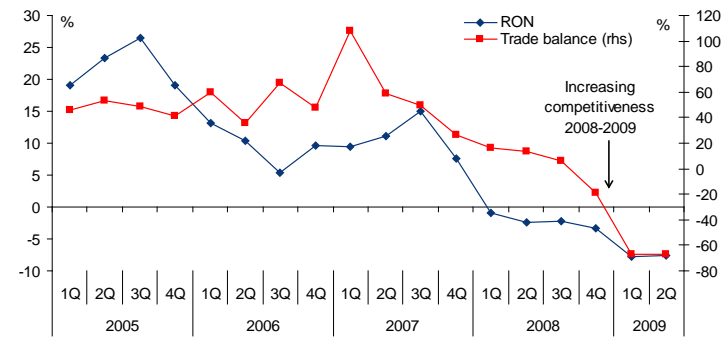
**Interest rate differential in favour of Romania**



high interest rates in the local money market were a catalyst for speculative capital; non-resident deposits started to grow significantly and remained so until recession started to loom large.

- Real appreciation of RON against EUR was observed in 2005, 2006 and 2007 which affected even more exports competitiveness and led to increased negative foreign trade balance;

**RON real appreciation and foreign trade developments y/y change**

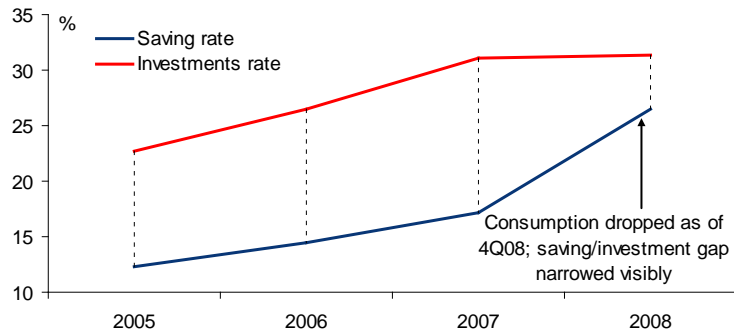


- Real exchange rate appreciation and the imbalance between savings and investments

led to widening current account deficits, while foreign indebtedness increased at a rapid pace after 2005; the competitiveness started to improve in 2008 and was supported to a good extent by the RON real depreciation.

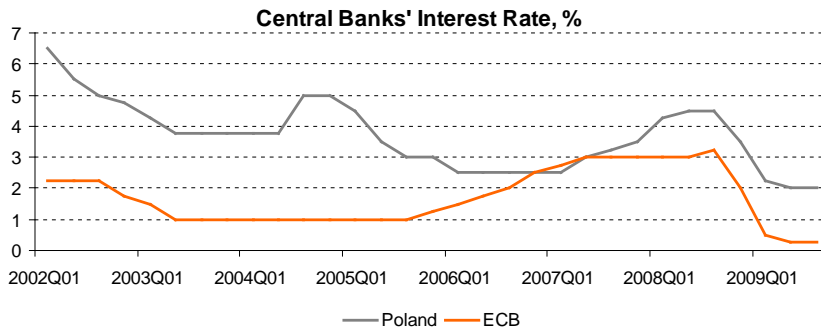
- Although high, interest rates on the local market were not high enough to stimulate savings, so the gap remained high throughout 2005-2007;
- Instead, the investment process accelerated strongly supported by FDIs, while Romania

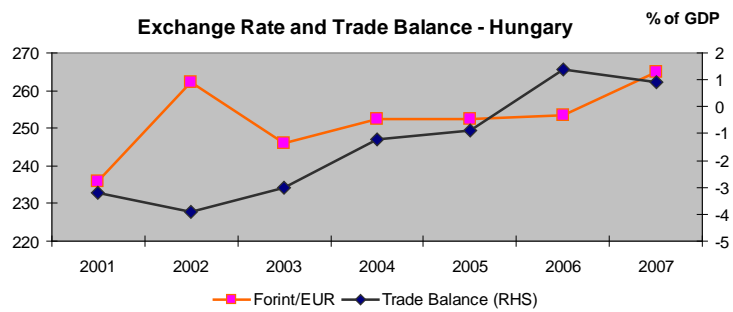
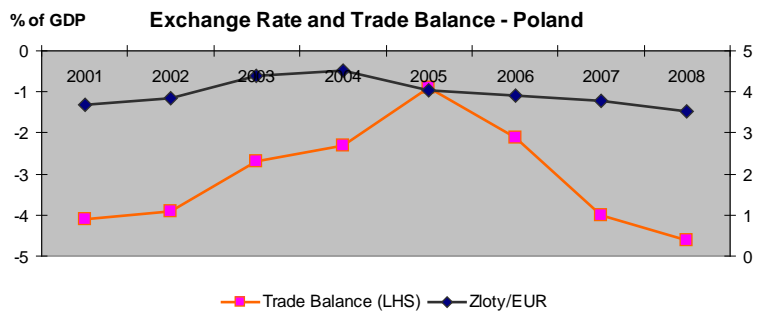
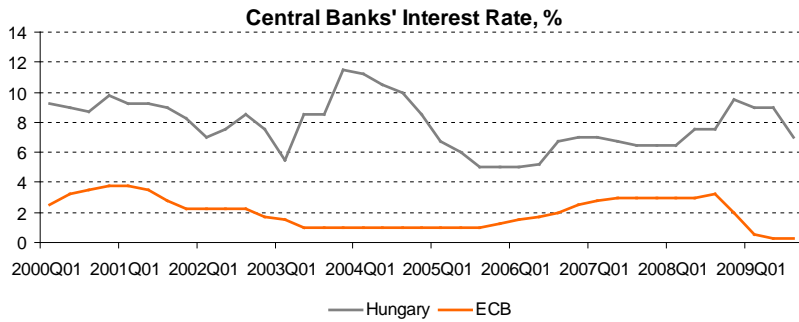
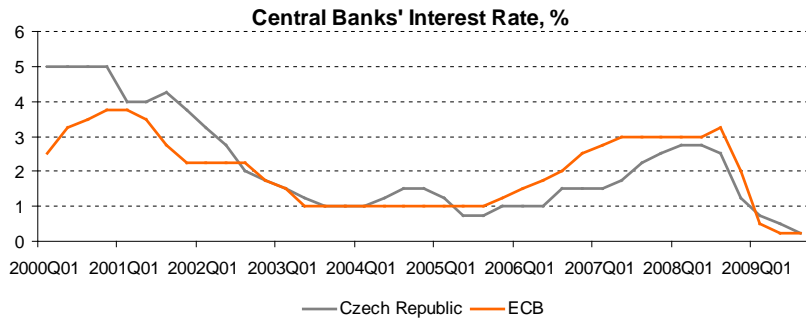
**Saving rate vs investment rate in Romania**

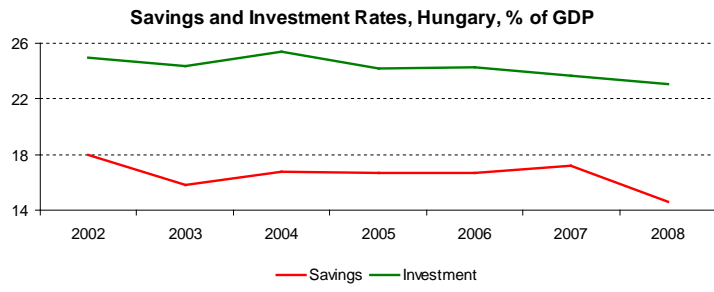


continued to increase its capital/labour ratio; another key factor with an important impact on the investment process in Romania, besides FDIs, were cheap credit lines from abroad which local banks managed to attract and place in a rapidly growing economy.

- As of 2008, things began to change as recession spread out becoming visible first in well developed economies and then in transitions economies such as Romania; consumption and investments were affected by the global liquidity crunch as of 4Q08; household loans began to lose steam as consumption dwindled away and the prospects of higher unemployment became clearer.







Source: IMF and EC data