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Region to outpace west as lenders think local

Pick-up in global trade predicted to accelerate growth and boost outlook for financial sector, with greater focus on local currency funding. By *Neil Buckley*

THE SHADOWS THAT gathered last year over central and eastern Europe have, little by little, started to recede.

This time a year ago, the eurozone debt problems were weighing heavily on sentiment, with talk of a possible "Grexit" – a Greek exit – from the eurozone that could tear the single currency apart.

Much of central Europe was less directly vulnerable to that threat than western European countries. But the spectre sharply depressed economic activity in the eurozone – and by extension across CEE, which is still reliant on the single currency area as its biggest market and source of investment.

Since then, the Greek coalition elected last June has proved to be more stable than expected. The European Central Bank has pledged to do "whatever it takes" to preserve the monetary union. The EU, too, has taken the first steps towards a banking union, tightening the fiscal framework underpinning the euro.

Meanwhile, the exceptional monetary policy measures of the ECB and US Federal Reserve have led to a flood of portfolio inflows into all emerging markets, including central Europe, offsetting lower foreign direct investment and other credit flows.

The eurozone is now better placed to gain from an expected pick-up in global trade later this year – with knock-on benefits for CEE. That, in turn, will boost the outlook for banking and finance in the region.

But any broader CEE recovery is likely to be slow. With high unemployment in many countries and low wage growth depressing domestic demand, any recovery will rely almost entirely on exports.

"There has been a big degree of convergence in gloom [among consumers] within central Europe," says Mateusz Szczurek, chief economist for CEE at ING Bank in Poland. "We are still waiting for some impulse to get us out of this problem, because essentially everyone is saving at the same time."

One hopeful sign is that thanks to stabilising oil and food prices, inflation is moderating – which could boost consumer spending power. It will also give central banks more scope to loosen monetary policy.

The lower public and private sector debts of CEE countries compared with their western counterparts – and the former's earlier embrace of austerity policies after the 2008 crisis – are another positive.

"There is not really a case for a long-lasting debt-deflation spiral, as in many western European countries," says Mr Szczurek. "[In the west] you have companies, households and governments trying to pay back old debt, and at the same time digging themselves deeper and deeper into recession."

With open economies heavily geared to a eurozone recovery and cheaper wage costs, central Europe is still expected to grow faster than western Europe.

"The growth difference still stands," says Herbert Stepic, chief executive of Austria's Raiffeisen Bank International, one of the biggest operators in central Europe. "We see a growth difference for 2013 of about two percentage points between CEE as a whole and the EU."

Other heads of big banks in the region share this cautious optimism. "We still consider CEE to be the driving engine for the growth of our group," says Gianni Franco Papa, head of the CEE division of Italy's UniCredit.

UniCredit has forecast that the CEE banking sector's return on equity, after falling to 8.5 per cent between 2009 and 2011, will average 10.9 per cent between 2012 and 2015.

These reasonably healthy prospects – certainly for banks with strong positions – may explain why few western European banks have withdrawn from operations in the region in recent years, with less consolidation than expected.

"Practically speaking, having gone through this crisis, the banking landscape hasn't changed dramatically," says Tamás Simonyi, Hungary-based head of CEE financial institutions mergers and acquisitions advisory at KPMG, the business advisers. He notes that banks have been reluctant even to sell loss-making subsidiaries in southeast Europe.

One reason, he suggests, may be that banks that have worked hard to achieve, say, top five positions in CEE markets may be reluctant to give them up.

WILLING BUYERS OF EASTERN European banking assets have also proved relatively few. In Poland, Santander of Spain bought Kredyt Bank from KBC of Belgium last year, and Raiffeisen bought Polbank from Greece's Eurobank. Elsewhere, Russia's Sberbank bought the CEE operations of Austria's Volksbank. However, mooted Russian and Chinese bank buyers have largely not surfaced.

The big CEE banks say the pace of lending growth should also pick up again, although that will depend on demand as well as supply.

Raiffeisen's Mr Stepic says a modest slowdown in bank lending growth last year was not caused, as often suggested, by "deleveraging" or the reduction of parent-bank funding to CEE subsidiaries (see panel, right). Mostly, he says, it reflected slowing loan growth in Russia due to regulatory tightening, and the end of the construction boom associated with the Euro 2012 football championship in Poland and Ukraine.

Mr Papa of UniCredit adds that lending growth has also slowed in recent years as regulators in some countries have restricted lending in foreign currencies. That had been widespread before 2008 but left borrowers facing debt-servicing pressures when local currencies weakened.

In Hungary, he adds, 2011 government measures to reduce the foreign exchange mortgage burden on consumers, allowing them to repay loans at discounted exchange rates, reduced overall lending volumes.

But the biggest theme of CEE banking is a shift to a model that might not provide the explosive growth and profits seen up to 2008, but one that will be more sustainable.

Banks are altering lending criteria, says Mr Papa – for instance, by shifting away from asset-based lending, which can create problems if inflated valuations collapse, to cash flow-based credit provision.

Most importantly, banks are shifting their funding model and reducing external liabilities, including wholesale and parent-company funding, as a percentage of assets, but they are taking in more local deposits. Loan-to-deposit ratios, though still high in certain countries – notably Ukraine, Serbia, Estonia and Lithuania – are being brought more into balance.

Most importantly, banks are shifting their funding model and reducing external liabilities, but are taking in more local deposits

Breaking dawn: portfolio investment has flooded into central and eastern Europe, compensating for reduced foreign direct investment Gertty

A recurring plea from bank chiefs as these processes take place is for a more co-ordinated approach by regulators.

"Central banks are requiring more and more capital buffers, and they are requiring higher loan-loss provisions. On the other hand, they are pushing banks to lend more. So we are really between a rock and a hard place," says Mr Papa.

The European Bank for Reconstruction and Development and other international financial institutions last year rebooted the so-called Vienna Initiative – a mechanism established in 2009 to foster better co-operation between regulators. Bank chiefs say the proposed EU banking union should also eventually help with co-ordination.

With bank lending and cross-border funding more constrained, the EBRD and others have also been working on expanding local currency financing, including, for example, corporate bond markets.

That will help the region to replace the cross-border credit flows that were such a big part of its pre-2008 growth model, reducing its reliance on the eurozone. CEE countries will also need to look elsewhere for new investment sources and export markets – which might explain why Hungary and Poland have held big Chinese investor fairs in the past two years.

Longer term, the region needs to beef up innovation and entrepreneurialism, to reduce its reliance on low-cost manufacturing for western European companies and come up with world-beating products and companies of its own.

Meanwhile, says ING's Mr Szczurek, there is still scope for "catch-up" growth. "In the next five to 10 years, there are gaps that are quite easy to fill, in physical infrastructure, in stock of capital. These are going to help [CEE] catch up without a complete change in the growth model."

Fears of western banking capital flight prove excessive

IN LATE 2011, AS REGULATORS tightened capital requirements for western European banks, there were fears that the banks would withdraw capital from their eastern European subsidiaries to help rebuild balance sheets at home.

Since then, data from the Bank for International Settlements show that western parent banks' exposure to central, eastern and southeastern Europe has indeed fallen, although the impact of "deleveraging" has been less severe than feared.

"We contest the fact that there has been deleveraging in CEE," says Gianni Franco Papa, head of the CEE division of Italy's UniCredit.

Indeed, UniCredit says that after a small initial dip, total CEE banking system assets increased fairly steadily from €2.2tn when Lehman Brothers, the US investment bank, collapsed in September 2008 to €2.9tn four years later.

But while banking assets have grown by €700bn, says Mr Papa, they have been financed much more from local currencies. That has resulted in part from regulatory restrictions on lending in foreign currencies.

"There has been a strong effort from every bank to become more self-sufficient," says Mr Papa, "because if banks have to lend in local currency, the only way is to tap the local market."

At the same time, the banking sector's external liabilities, which include parent bank funding, have declined.

But the decline has been more than offset by an increase in local currency deposits, as regulators have also pushed banks to improve their loan-to-deposit ratios.

"Banks have also started collecting more money, either through local markets, through retail or corporate deposits locally, or by issuing bonds in local currency," says Mr Papa.

Central European banks have also increased their capitalisation by some €130bn, he adds.

"This is not deleveraging – it's a rebalancing of the balance sheet structure," he says. "So, [there is] less dependence on the wholesale market – because 2008 taught everybody that the wholesale market can disappear overnight – and more reliance on local funding." *NB*

Reuters

State duopoly maintains its grip

Private sector competition for Sberbank and VTB remains restricted to niches, writes *Charles Clover*

Few openings for rivals: Sberbank and VTB between them account for the vast majority of deposits in the Russian retail banking sector Reuters

WITH TWO BIG state-owned players, Sberbank and VTB, dominating the Russian banking market with 60-70 per cent of deposits, the pickings are sometimes slim for the rest of the pack.

Both HSBC and Barclays closed their retail operations in Russia in 2011, with little hope of making inroads into the market dominated by the two Russian behemoths.

Those private sector banks that have stayed competitive have done so by offering innovative products and finding niches that are too small for the big players.

Rosbank – the Société Générale-owned subsidiary in Russia – is the leader in car loans through its own subsidiary Rusfinance, and is Russia's number three mortgage lender in Russia through DeltaCredit, another subsidiary.

"Everyone is chasing a small pool of deposits," says a western bank manager in Moscow. "Basically, the only Russian banks that have depositors are Sberbank and VTB."

As a result of the lack of access to deposits, domestic banks tend to finance themselves with credit and central bank finance.

"Most banks here in Russia have loan-to-deposit ratios that aren't healthy," says the western banker. "A lot, probably too much, depends on access to cheap central bank credit. Some balance sheets are growing much too fast."

Savings rates are improving, especially after real interest rates turned positive for the first time last year, as inflation fell to a historically low level of 7 per cent.

Sergey Monin, chairman of the managing board of ZAO Raiffeisenbank – one of the largest foreign banks by assets in Russia – says "Sberbank is a very significant competitor", but that "in some instances you can be better than Sberbank, despite the size".

Mr Monin says that targeting the "premium segment" of the market and servicing payrolls for corporate clients are two ways in which Raiffeisen has been competitive, due partially to its high credit rating, which makes it attractive to corporate clients.

The main reason why some foreign banks have not been able to expand their retail operations in Russia is a question of scale, Mr Monin explains. "They could not reach levels of attractive profitability because they could not reach critical mass," he says.

BUT, AS A CHAIRMAN OF ONE OF the large private banks in Moscow says, "there are other, bigger constraints on operating in this market than just the big state banks".

Indeed, when asked about its dominant role in the market, Herman Gref, the chairman of Sberbank, turns the tables, saying that the bank faces fierce competition from its more agile private counterparts.

"We have a great deal of difficulty competing with the private-sector banks," says Mr Gref, who last year oversaw privatisation of a 7.6 per cent stake in Sberbank, bringing the state's holding down to just 50 per cent plus one share.

"It is hard for them to compete with us, and it is hard for us to compete with them," he says. "Some might have the impression that the small players have it really rough, and the big players just sleep. That is not the way it is.

"If I get two Sundays off a month I am very lucky. If someone thinks that the clients just come to us without us doing anything, that is just not true. We fight for every client.

Private sector banks have stayed competitive by finding niches that are too small for the big players

"I am glad we are tough to compete with, [as] it means we are working well. In general, it is hard to survive in a competitive market, and, thank God, we have a competitive financial market."

Mr Gref, a former economy minister and noted economic liberal, says, however, that it is important for state banks not to be granted "privileges" by the state. "The conditions of competition should be the same for all players," he says.

Some point out, however, that state ownership in Russia does come with its share of perks.

Sberbank's counterpart, VTB, the second-largest bank in Russia, received an unprecedented $10bn subsidised 10-year loan from the central bank in July 2011 after it acquired the problem-plagued Bank of Moscow. The loan was apparently to plug holes in the balance sheet of VTB's new acquisition. The affair has become steeped in controversy because of troubling questions it has raised about bank regulation in Russia.

However VTB "has turned the page on the Bank of Moscow story", according to Herbert Moos, deputy president and chairman of VTB's management board, saying the Bank of Moscow is now profitable: "The new management has fundamentally changed the business model."

Mr Moos says it is true that in all countries, including Russia, "there are advantages given to local players by virtue of their client relationships, by virtue of their knowledge of the market and by virtue of their size". By way of comparison, he offers the experience of VTB opening an office recently in New York.

"Of course, large American banks enjoy privileges in their local home markets and we do not complain that VTB cannot take the number one spot there," Mr Moos says. Leading UK banks operate in the UK with lower capital requirements than many foreign banks, he adds.

"Every market and every country has its own competitiveness and its own dynamics. I don't think we derive our competitiveness from the government."

Credit plan offers hope for banks

Loss-making institutions welcome stimulus programme for small businesses. By *Kester Eddy*

THE CAVERNOUS, AIR-conditioned hall of a branch of OTP Bank in central Budapest accommodates 22 cashier desks – an indication of the importance Hungary's biggest commercial bank attaches to meeting clients face to face.

But at noon one weekday in April, as perhaps a dozen customers wait to be served, only about half of the counter positions are open.

The scene is symptomatic of the specific and general woes that are afflicting commercial banks in Hungary in the aftermath of the 2008 global downturn, according to one sector insider, who wishes not to be named.

"The two things that take time in a branch are mortgages and small business loans, but there is no market. What to do with branches that are not being used?" he asks.

Pro-government politicians blame the downturn in lending on the sector's predominantly foreign-owned banks efforts to reduce credit exposure.

The institutions retort that the government's relentless pursuit of revenues through special taxes, combined with the economic recession and weak demand from credit-worthy clients – has inevitably caused the worst deleveraging in the region.

More generally, the combination of economic recession, government-mandated schemes to ease foreign currency loan repayments and special taxes pushed the sector deep into the red for the second consecutive year, with total losses of Ft161bn ($713m) in 2012, according to the Hungarian Banking Association.

As a result, the assets of credit institutions were reduced by almost 10 per cent last year, while corporate and retail loans slumped 13.3 per cent and 16.3 per cent respectively.

Nor are conditions likely to improve. As the HBA states: "The measure of keeping the bank tax fully in force [contrary to the envisaged 50 per cent reduction in 2013] and the introduction of the financial transaction levy [of 0.2 per cent of each financial transaction] represent a more than Ft400bn financial burden in 2013."

Despite the ongoing travails, Mihály Patai, president of the HBA, insists the industry is secure and solid.

"The Hungarian banking sector is one of the most stable in the world, with a capital adequacy ratio of 16 per cent," he told ATV, an independent broadcaster in April this year.

"Foreign parent banks have injected €2.5bn in capital into Hungary in the past two years to strengthen the sector."

This means that foreign ownership (principally by Austrian and Italian parent banks), far from being a disadvantage to Hungarians, can be seen as a blessing.

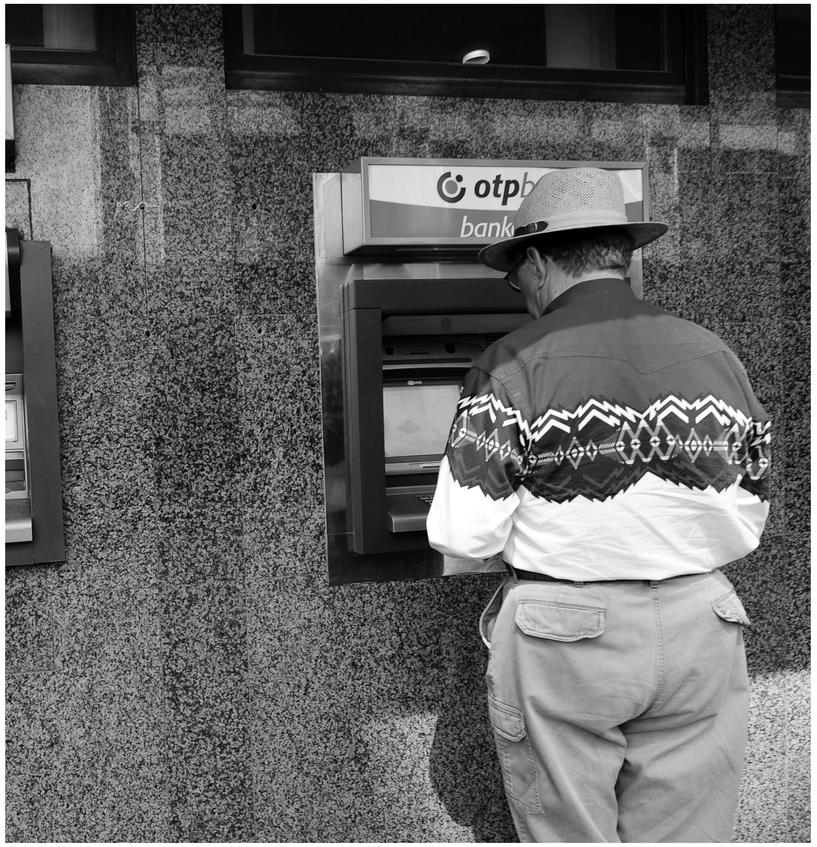
"Although there were banking crises all around us, these capital increases cost the Hungarian taxpayer nothing. This is a massive advantage for Hungary," Mr Patai said.

Similarly, the banks appear to have taken a new liking to György Matolcsy – the architect of the controversial "unorthodox" policies of the past three years – who was appointed governor of Hungary's central bank (the MNB) in March this year.

Asked if Mr Matolcsy is a suitable leader of central bank, Mr Patai said his "friend of 33 years" is "the best governor of the central bank... Hungarian society should get used to this".

Moreover, Mr Matolcsy's stimulus programme, whereby the MNB plans to provide Ft500bn in cheap credit to commercial banks to boost small businesses, seems to have been welcomed.

Mr Patai, while noting that the sums involved "will not change the world", said the fresh money is "a small step, a good sense of proportion" that has pleased the markets.



Counting the benefits: OTP Bank, above, sets great store by seeing clients face to face, and has branches across central and eastern Europe Gertty

Foreign ownership, far from being a disadvantage to Hungarians, can be seen as a blessing

Sándor Csányi, executive chairman of OTP Bank, similarly has lauded Mr Matolcsy as the first governor for 23 years to consider "the real economy and economic growth", as well as dealing with the bank's primary task of monetary stability.

Mr Csányi says OTP – a profitable bank that has been successful across central and eastern Europe, most notably Russia – welcomes the stimulus programme and pledges to match any funding from the central bank as additional support.

Meanwhile, Hungary's prime minister, Viktor Orbán, has been highly critical of western banks and has called for the domestic banking sector to be at least "50 per cent Hungarian-owned".

Mr Csanyi has said that OTP would consider making acquisitions in Hungary, should any owners be willing to sell.

Whether the stimulus programme succeeds or not, the question remains whether it will solve Hungary's chronic inability to achieve meaningful growth or, given warning that the special taxes will remain until 2016, the banking sector's equally chronic inability to make a profit.

Worse still, with non-performing loans in the sector at between 17 and 20 per cent of assets, the banks can expect "no improvement in the absence of a resumption of economic growth and employment", says Peter Róna, a senior research fellow in economics at the University of Oxford.

As the otherwise diplomatic Mr Patai warned ATV viewers in April: "The sector cannot endure this for ever. The last three years have meant losses, with only a few profitable banks.

"Bank lending in Hungary has shrunk by over one-third in the last four years, and without credit the Hungarian economy cannot grow."

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Sound of overtures in Warsaw and Vienna

Competition from more liquid western markets has led to warmer relations between central Europe's two largest bourses, writes *Jan Cienski*

CENTRAL EUROPE'S WAR-WAR over whether Warsaw or Vienna should be the hub of the region's capital markets is, under the stress of a global downturn and growing pressure for stock exchange consolidation, turning into a case of jaw-jaw.

After years of scorning each other's achievements, the Warsaw Stock Exchange recently opened talks with the CEE Stock Exchange Group, a union of bourses in Vienna, Prague, Budapest and Ljubljana.

"At this stage all strategic options and co-operation routes are being reviewed," said a statement from the CEESEG.

The negotiations are still at a preliminary stage, but the Warsaw exchange has made it clear it has no intention of being taken over by Vienna – the two bourses use different trading systems, which would make a merger difficult – although there has been a marked change of tone.

Adam Maciejewski, who took over as chief executive of the WSE this January, signalled a change of approach to Warsaw's rival in Vienna when he told the Financial Times in March: "I'm putting out my hand, not knocking it away."

The talks have been received positively, with Herbert Stepic, chief executive of Raiffeisen Bank International, which owns a 7 per cent stake in the Vienna bourse, saying a tie-up made "a lot of sense".

The challenge for both is that national or even regional exchanges face increasing competition from consolidating bourses in western Europe, which can provide greater liquidity and make them more attractive for investors.

"We have to watch carefully what is happening in Europe, and exchanges that ignore that are subjecting themselves to irrelevance," says Mr Maciejewski.

The rapprochement between Warsaw and Vienna marks a change of strategy for both bourses.

'Exchanges that ignore western Europe are subjecting themselves to irrelevance'

Vienna has built the regional network of four stock exchanges in central and eastern Europe, which has ties with other smaller exchanges in the region.

"We believe a listing on the respective regional stock exchanges is advantageous for listed companies. They enjoy the highest degree of attention on their home markets, because this is where they are at the focus of attention of investors and analysts, and also as employers and among the general public," says Michael Buhl, chief executive of the Wiener Börse.

Warsaw, meanwhile, has tried hard to make itself the region's leading standalone capital market. The exchange has lured in listings from the region and even has a separate index for Ukrainian companies that prefer to list in the transparent environment of the WSE, which is governed by EU regulations.

"There is a logic for Ukrainian companies to list here. There is no financing in Ukraine and here they have access to Polish institutional investors," says Kojo Asakura, general manager at the Polish branch of KBC Securities, the equity house.

As a result, Warsaw has led European stock exchanges in terms of new listings – it had 105 initial public offerings last year on its main market and its smaller companies NewConnect alternative market, accounting for 40 per cent of all new listings in Europe. However, the value of those companies was small, coming to only €731m, compared with the €5.1bn in new listings on the London Stock Exchange, for example. Vienna, in contrast, had no new listings last year, while Budapest had one and Prague three.

"All European markets are still waiting for a successful IPO to break the ice and send a positive signal," says Mr Buhl.

The WSE began trading in 1991 with a daily turnover on its first day of only $2,000, but since then it has powered ahead, driven by the speed of economic growth in the region's largest country. The WSE now lists stocks with a market capitalisation of €168bn – a significantly higher figure than Vienna's €80bn, and more than all four of the CEESEG bourses combined.

'All European markets are still waiting for a successful IPO to break the ice'

The problem for the WSE is that only a few of the largest companies on the main market – such as copper miner KGHM, insurance company PZU and PKO Bank Polski – are liquid enough to attract institutional interest. Many medium-sized companies have tiny daily trading volumes – something Mr Maciejewski is hoping to change by improving market communications.

The Warsaw bourse is also threatened by government plans to reform the pension system by trimming the amount of money flowing into privatised pension funds.

The funds provide crucial support for the WSE – they hold about 14 per cent of the shares listed on the exchange and are expected to invest about 10bn zlotys ($3.1bn) in stocks this year.

But that amount may shrink if the government cuts obligatory transfers to pension funds. The government is talking about making up any investment shortfall by increasing the amount funds are allowed to invest in stocks – up from the current 40 per cent.

The worry, however, is that funds will be reluctant to take advantage of the greater leeway because they are benchmarked according to industry-wide results, and the funds that fall short are forced to make up the difference out of their own pockets. That makes them very risk averse.

Warsaw's problem is that while it is the largest bourse in central Europe, it is still far behind markets such as Moscow and Istanbul. With the Polish economy slowing, worries over pension reforms, and trading volumes sagging (down 26 per cent between 2011 and 2012), it is difficult to see where rapid growth might come from.

"I am afraid we are losing our emerging market status, so we are looked on and judged by people who view the world as a whole, not just by emerging market specialists," says Mr Asakura.

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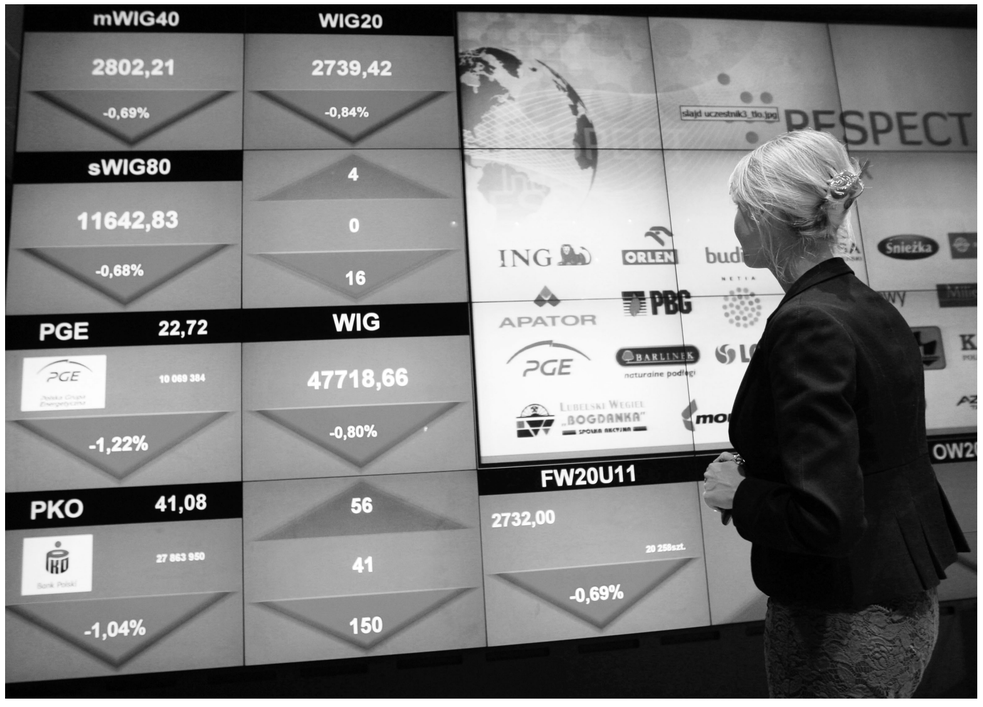


Transparent environment: the Warsaw Stock Exchange, above, is governed by EU regulations Reuters

Plugged in: Moscow Exchange courts global investors

Russia has been working for the past five years on transforming Moscow into an international financial centre. The aim is to plug Russia's capital market into the global financial system.

Much progress has been made. In 2011, Russia's two major exchanges – the dollar-denominated Russian Trading System (RTS) and the Moscow Interbank Currency Exchange (MICEX) – were merged and since February the new Moscow Exchange, as it is called, was hooked up to the international clearing and settlement systems of Clearstream International, whose headquarters are in Luxembourg, and its Belgium-based competitor Euroclear Bank.

The result has been a huge uptick in the number of foreign investors buying Russia's high-yielding domestic debt. Sergei Shvetsov, deputy chairman of the Bank of Russia, told a conference in April that the share of foreign investors in Russia's treasury bond market is now more than 20 per cent, far in excess of the 3 per cent the bank was initially expecting after the reforms were enacted.

"On the stock market, the non-residents' share is even higher," Mr Shvetsov told the conference.

Equities were initially excluded from Euroclear's system for two years, but after Vladimir Putin, Russia's president, announced that the government plans to privatise some Rbs1.2tn ($40bn) worth of companies on the local exchange this year, the inclusion of equities into the system has been accelerated; Russian stocks will probably become tradeable on foreign desks from the start of next year.

In a parallel reform the Kremlin has ordered all state-owned companies to pay out a minimum of 25 per cent of profit (judged under Russian accounting rules) as dividends, but it also plans to impose International Financial Reporting Standards on all its companies in the next few years, which will significantly increase the dividend yield for shareholders. Many of Russia's leading private companies have already made this move.

The point of these reforms is to try and make more sophisticated use of the sea of cash that washes around the Russian economy. The most pressing need is to improve its capital markets to raise trillions of dollars to renovate its crumbling infrastructure.

Powered by the large Russian economy, the Moscow Exchange is easily the biggest and most liquid bourse in emerging Europe, accounting for half of the approximately $2tn of market capitalisation in the region. *Ben Aris*

Erik Berglöf Rebooted Vienna recognises need for change

THE EUROPEAN BANKING SYSTEM IS again under pressure. Eurozone banks are struggling to reduce their exposures to meet the requirements of the stress test scheduled before the banking union comes into force next year. At the short end of the stick are the economies of central and eastern Europe dominated by these banks.

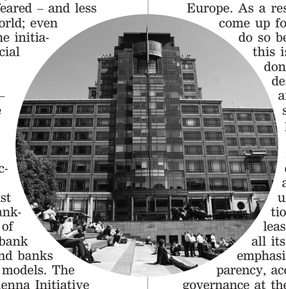
This process of deleveraging accelerated in autumn 2011 with the prospect of a major credit contraction in these economies, many of them already in recession. It was against this background that the European Bank for Reconstruction and Development (pictured), the European Investment Bank, the European Commission, the International Monetary Fund and the World Bank reactivated their joint Vienna Initiative in early 2012.

The original Vienna Initiative was set up in 2009 to prevent a large-scale withdrawal of western European banks from central and eastern Europe. Extensive liquidity support to parent banks and €33bn of investment in their subsidiaries were provided in exchange for commitments to maintain exposures in the region. And it worked. Credit contracted less than feared – and less than in other parts of the world; even countries formally outside the initiative benefited from it. Financial systems in emerging Europe were hit but did not crash.

The relaunched initiative – Vienna 2.0, as it has become known – differs from its predecessor. It is not just about preventing a temporary liquidity shortfall; it recognises fundamental change is necessary. Debt levels must drop further, cross-border banking needs a new framework of regulation and supervision, bank groups need restructuring and banks must rethink their business models. The second incarnation of the Vienna Initiative focuses on managing this adjustment.

Vienna 2.0 is experimenting with a new co-ordination mechanism – the host-country cross-border stability forum – which brings together representatives of the parent banks, the subsidiaries, the home and host authorities, the international financial institutions, the European Commission and the European Central Bank. The purpose of this and other measures under the initiative is to articulate and mitigate systemic risks in the countries that host foreign banks. A new joint international financial institutions' action plan also commits more than €30bn to economic recovery and growth in the region for 2013-14.

The good news is that while parent banks continue to reduce debt levels in western Europe, deleveraging has come to a halt in the centre and slowed in the southeast. Given where the region's banks were in 2011, there are reasons to celebrate, but if the parents come under additional pressure, the process may resume. Increasing non-performing loans in many subsidiaries adds to their vulnerability.



Reuters

The good news is deleveraging has come to a halt in the centre and slowed in the southeast

There is also progress on the framework: the EU banking union, a critical part of the solution for the eurozone crisis, offers co-ordination instruments far stronger than anything contemplated at the start of Vienna 2.0. Important pieces are still missing – primarily a mechanism for resolution of crisis banks and EU-wide deposit insurance – and more efforts must be made to lure non-eurozone EU members to join and co-ordinate better with non-EU countries. But the centralised supervision under the ECB is a huge step forward.

Bank group restructuring is under way. A number of banks have decided or been forced to withdraw from markets in central and eastern Europe. As a result, many subsidiaries have come up for sale and more stakes may do so before long. Needless to say, this is a sensitive process. Abandoned subsidiaries can easily destabilise banking systems, and depositors are already shaky after what has happened in Greece and Cyprus.

The contours of a new model for banking in CEE are emerging

The contours of a new business model for banking in central and eastern Europe are emerging. A banking union should facilitate operations at the group level, but at least until such a framework with all its pieces is in place, more emphasis will have to be put on transparency, accountability and corporate governance at the level of the subsidiaries and branches of the cross-border banks. Capital buffers will be reinforced in subsidiaries and at group level.

The role of parent funding is also under scrutiny. Foreign ownership should not be synonymous with foreign funding. Ownership was key to establishing viable banking systems critical in supporting growth in central and eastern Europe, but the spike in funding from parents came in the period of excess right before the global crisis struck. With more developed local markets for both debt and equity, subsidiaries could reduce their dependency on this potentially destabilising source in favour of funding in local currency.

But we must be careful not to completely strangle capital flows from western Europe and the rest of the world into central and eastern Europe. Cross-border banks have proved to be the most stable channel for these flows. There is still plenty of room for convergence growth, and overall returns on investment are likely to remain higher in these economies. If they had to rely solely on domestic savings, they would take decades longer to converge to western European levels of income – increasing migration pressures and further testing European solidarity.

Erik Berglöf is chief economist at the European Bank for Reconstruction and Development

Eurozone membership pros and cons

Jan Cienski and *Richard Milne* gauge the level of enthusiasm among Europe's emerging economies for the single currency

Czech Republic

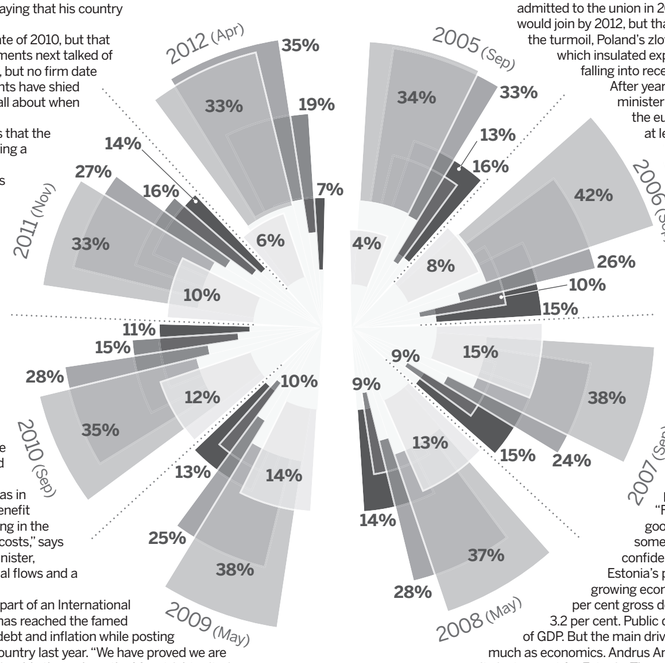
The Czech Republic is cautious about joining the euro, with political elites on both the left and the right sceptical about the need to give up the koruna. New president Miloš Zeman recently bucked that trend, however, saying that his country could make the transition by 2018.

The country did once set an entry date of 2010, but that was ditched as early as 2006. Governments next talked of joining by 2012 and then later by 2015, but no firm date was set and in recent years governments have shied away from making any predictions at all about when the Czech Republic would join.

One reason for Czech ambivalence is that the country has a long reputation for running a credible monetary policy. The Czech Republic traditionally has interest rates below those in the eurozone; the country's benchmark rate is currently 0.05 per cent. That makes it different from other central European countries such as Poland that have experienced bouts of hyperinflation in past decades. *Jan Cienski*

Attitudes across new EU member states towards the euro

Extremely positive
Rather positive
Neither positive nor negative
Rather negative
Extremely negative
Source: Flash Eurobarometer



Poland

Poland is starting to cast sidelong glances at eventually joining the euro, despite the continuing crisis in the common currency area. The country, as well as other new EU members, committed to join the euro when admitted to the union in 2004. The country did pledge in 2008 that it would join by 2012, but that plan was derailed by the global crisis. During the turmoil, Poland's zloty depreciated significantly against the euro, which insulated exporters and helped prevent the economy from falling into recession in 2009.

After years with little action, the government of prime minister Donald Tusk reopened the debate over joining the euro a few months ago. The rationale for joining is at least as much political as economic.

"We are part of continental Europe and we want to and have to – also for political reasons – be part of the inner core," says Marek Belka, the central bank governor.

For the moment, Poland does not meet most of the criteria for joining, and deputy prime minister Jan Vincent-Rostowski has said that the country will only be ready to join in seven to 10 years. *Jan Cienski*

Latvia

Latvia is next in line to join the euro but, like its neighbour Estonia, it is on the verge of doing so at a time of considerable turmoil in the single currency. Nonetheless, Latvia's government is still keen on entering the euro in January even if it knows it could harm the country in the short term as public opinion is more hostile than it was in Estonia. "If you look at it from a cost-benefit perspective, the long-term gains of being in the eurozone far outweigh the short-term costs," says Daniels Pavļuts, Latvia's economics minister, pointing to gains such as trade, financial flows and a lack of currency conversion costs.

Latvia underwent brutal austerity as part of an International Monetary Fund bailout in 2008, but it has reached the famed Maastricht criteria for the euro of low debt and inflation while posting the best economic growth of any EU country last year. "We have proved we are capable of achieving the almost unachievable these days: the Maastricht criteria. Adhering to them has become a macroeconomic message in itself," says Mr Pavļuts. Difficulties remain: procedurally, the European Commission and European Central Bank still have to sign off on euro entry and public opinion is an issue. However, the lats has been pegged to the euro for nearly a decade and 80 per cent of loans are denominated in the single currency. *Richard Milne*

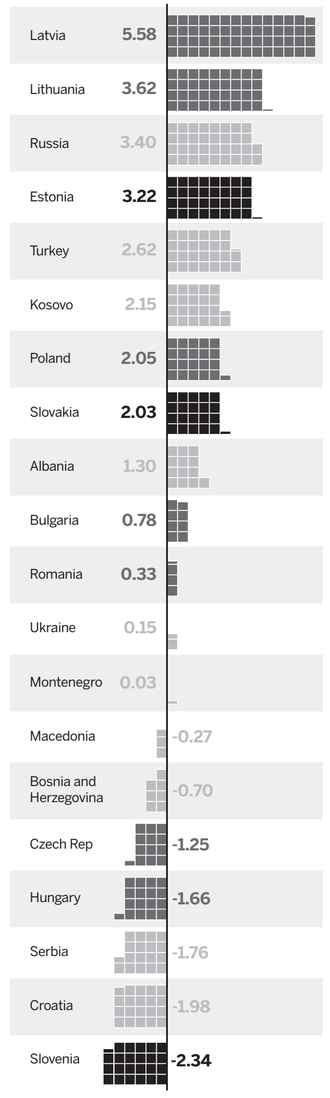
Estonia

Seven months before Estonia joined the euro, Greece sought an international rescue for its beleaguered economy. And barely a month before the Baltic state's accession in January 2011, Ireland went cap in hand to other eurozone countries and the International Monetary Fund. But despite the seemingly inauspicious start, Estonian policy makers are satisfied with their choice.

"From our perspective, the euro has been very good. The absence of transactional costs is already something that boosts the economy, and investor confidence is much higher," says Toomas Hendrik Ilves, Estonia's president. The country is one of the fastest-growing economies in the EU. It ranked first in 2011 with 8.3 per cent gross domestic product growth and third last year with 3.2 per cent. Public debt is the lowest in the EU at just 10.1 per cent of GDP. But the main driver behind euro entry was foreign policy as much as economics. Andrus Ansip, Estonia's prime minister, says: "The euro is a security instrument for Estonia. The main aim in our foreign policy was to join all kinds of international institutions. It was really important for us to be integrated." The big negative before euro entry was public opinion. It has risen after entry, but just 46 per cent of Estonians in 2012 thought the euro was a "good thing" – the lowest of any euro member and down from 59 per cent a year earlier. *Richard Milne*

GDP growth (%)
2012
Source: IMF Database

In the EU and in the eurozone
In the EU but not in the eurozone
Not in either



* Individual figures have been rounded up, so in certain years the numbers total 101 as opposed to 100

GRAPH BY RUSSELL BIRKETT

"Latvia's currency has been pegged to the euro since 2005, so we have all the disadvantages of being in the eurozone with none of its advantages. Joining will serve as a strong signal for financial markets and investors about the stability and trustworthiness of our economy. We don't want to be on the periphery, or in some grey zone on the EU's eastern border. Joining the euro is another way of strengthening our commitment to Europe."

Valdis Dombrovskis, Prime minister, Latvia

"At the moment, the risk of eurozone instability clearly outweighs the benefits of joining. The degree of flexibility that having our own currency gives us is a comparative advantage against the eurozone countries. Yes, joining the euro will lower our borrowing costs, and is probably important from a political perspective, but far more important for the real economy were the free trade agreements, and the EU accession itself."

Ernest Pytlarczyk, Chief economist, BRE Bank, Poland

"The eurozone has some inherent weak spots that Europe is trying to cure. The probability that the currency will disappear is fairly low. On the contrary, in my view the eurozone will become stronger after this crisis. The problem is that countries and investors overestimated its security, which is why both countries and investors behaved inappropriately during the crisis. The key lesson is that having a single currency requires more rather than less fiscal discipline."

Ksenia Yudaeva, Chief, presidential experts' directorate, Russia

Miroslav Singer Hurdles remain high for banking union

THE PROPOSED EUROPEAN BANKING union, which would place eurozone banks under the supervision of the European Central Bank, strives to address some of the institutional deficiencies of the eurozone.

This monetary zone features at least the same – and probably a higher – level of national diversity as the US. Consequently, it needs, in principle, tax collection and redistribution channels to be on a similar scale to those in the US.

Yet it is clear that fiscal transfers of a comparable magnitude to the US federal budget are unacceptable to many eurozone constituencies.

The banking union is, therefore, essentially an attempt to build transfer channels that are capable of breaking the harmful relationship between the financial sector and sovereign debt, and acceptable to warier member states, particularly Germany.

To be successful, the union needs to consist of three elements.

First, there must be common supervision to prevent slippage of quality due to national complacencies and/or interests.

Second, risk must be shared – in the form of quasi-fiscal transfer channels, the European Stability Mechanism and potential sharing of national guarantee funds.

Finally, there has to be a common approach to resolving bank collapses and their related costs.

It is worth noting that while common rules are presented as something that is necessary for a banking union, they are in fact necessary for greater unity – in other words, for a common EU market.

Alongside the acceptance of such a scheme, however, there are two obvious problems with the creation of this union within the current eurozone.

Common rules for a banking union are necessary for greater unity – for a common EU market

The first is how to ensure banking systems are well capitalised across all the eurozone countries. The straightforward solution would be to pool the resources of the northern nations and the ECB. I suspect that was the initial plan, but the clear reluctance of the countries in the north to play along is making this very difficult to achieve.

The second is how to achieve supervision that is of a high enough standard to guarantee that transfers through these newly created quasi-fiscal channels do not trouble the northern member states, rather than creating a fully fledged federal tax system for the eurozone.

While the first problem is hampering the establishment of the banking union, the second needs to be solved if the union is to be sustainable over the long term. I have my doubts about whether a solution can be found to the second problem, as it may require supervision of a standard that has never before been attained.

Hopefully, however, other measures to reduce banking risks, such as stronger buffers, can remedy this situation.

We are keen to retain our own domestic regulations

Ultimately, there are three mains points to consider.

First, the banking union will benefit mainly the eurozone. The Bulgarian lev or Swedish krona currency zones, for example, do not need it, as they exist within the borders of single nation states.

Second, the combined resources of all the EU countries outside the eurozone will not be sufficient to restore the euro area financial system to health.

Third, for the Czech National Bank, one special feature of our banking system is that while it is restricted to the country's borders, it is solvent and liquid, and a provider of credit to the eurozone banking system.

Consequently, the Czech National Bank will do its best to support the creation of the banking union while working to eliminate the risk of being pulled into the transfer channels via non-market price transactions and risk sharing.

Our well-capitalised and liquid banks should not be used to fund their parent or sister institutions at rates below the market rate for such funds or assets in a situation where group interests prevail over the interests of subsidiaries in the decision making.

We are not needed in – and do not intend to become a party to – quasi-fiscal transfers, even in crisis situations. In particular, we do not wish to become a party to any common funds or any loan-sharing scheme between deposit guarantee funds or anything with similar redistributive effects.

We are also keen to retain our own domestic controls and regulations as well as the current balance of power in the European Banking Authority. I cannot help but wonder whether the failure of advocates of the banking union to respect the similar positions of many non-eurozone countries are complicating its creation. These negotiations are difficult enough in the eurozone countries alone.

For us, joining the Single Supervisory Mechanism (SSM) would involve a loss of supervisory powers. We see no reason to cede such powers, not least because the Czech National Bank has a strong track record on supervising the domestic financial market, and has been able to maintain good working relations with the relevant Czech supervisory bodies.

What is more, some key pillars of the SSM have not even been drafted yet. We do not feel able to draw any conclusions about the quality of SSM supervision until the system has been up and running for a while.

Ultimately, it is a case of wait and see. We wish the eurozone every success in creating the banking union, but it would be better for us to see how the creation of the SSM works in practice.

Miroslav Singer is governor of the Czech National Bank

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