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Taming the herd? Foreign banks, the Vienna Initiative and crisis transmission ☆

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ABSTRACT

We use detailed data on over 350 banks in emerging Europe to analyze how bank ownership and the Vienna Initiative impacted credit growth during the Great Recession. As part of the Vienna Initiative, western European banks signed country-specific commitment letters in which they pledged to maintain exposures and to support their subsidiaries in emerging Europe. We show that while both domestic and foreign banks sharply curtailed credit during the financial crisis, foreign banks that participated in the Vienna Initiative were relatively stable lenders. We find no evidence of negative spillovers from countries where banks signed commitment letters to countries where they did not.

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1. Introduction

The start of emerging Europe's transition from communism to capitalism in 1989 heralded the large-scale entry of foreign banks into the region. Western-European banks with saturated home markets were attracted to emerging Europe for its ample growth potential and scope for financial deepening. Policy makers and development institutions stimulated financial integration because of its presumed positive impact on the efficiency and stability of local banking sectors. The empirical evidence that has emerged over the last two decades suggests that foreign banks indeed stimulated competition (Havrylchyk and Jurzyk, 2011) and contributed to stability during local financial turmoil (De Haas and Van Lelyveld, 2006).

The global financial crisis put this model of intense cross-border banking to the test. The crisis was unique in that it emanated from the *home* markets of the banking groups operating in emerging Europe. Although few of these large banks had direct US sub-prime exposures, many of them were affected by the sharp reduction in interbank liquidity as of the second half of 2007. Banks started to deleverage both at home and abroad, a process that accelerated after the collapse of Lehman Brothers in September 2008 (Cetorelli and Goldberg, 2011/12; De Haas and Van Horen, 2013). It became increasingly uncertain whether multinational banks, now battered by problems elsewhere, would keep funding Eastern European customers through their local subsidiaries.

In response to these mounting pressures, Western governments supported various banks with guarantees, capital, and liquidity towards the end of 2008. This alleviated concerns about a credit crunch 'at home' but did not mitigate worries about a retrenchment of banks from emerging Europe. On the contrary, concerns were raised that government support came with strings attached. Anecdotal evidence suggests that banks were indeed asked to focus on domestic lending. For instance, French banks that received state support had to increase domestic credit by 3–4% annually and Dutch bank ING announced it would lend US$ 32 billion to Dutch borrowers in return for government support (World Bank, 2009, p. 70).

Tightening funding constraints and biased government interventions raised concerns about the possibility of an uncoordinated rush of banks out of emerging Europe. Although many banks confirmed their commitment to the region during the early stage of the crisis, there was no formal policy framework or coordination mechanism in place to ensure these commitments were credible. The concern was that this lack of coordination could lead individual banks to withdraw, thus causing a 'run' on the region, even though it would be in their collective interest to roll over debt. The absence of agreements on how to share the burden of a defaulting subsidiary between the fiscal authorities in the home and host countries further exacerbated the risk of such a run. The accompanying reversal in financial flows could not only have had dire consequences for local firms and households but also have led to disruptive exchange-rate fluctuations and balance of payments problems.

In response to this emerging institutional vacuum, the Austrian government and various multinational banks with high exposures to emerging Europe started informal discussions towards the end of 2008. The goal of this 'Vienna Initiative' (VI)[1] was to avoid collective action problems (Pistor, 2012a) and to guarantee macroeconomic stability in emerging Europe. Soon the VI meetings also included the main International Financial Institutions (IFIs), the European Union, the European Central Bank, as well as the Ministries of Finance, central banks and bank regulators from multinational banks' home and host countries.

In February 2009, the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), and the World Bank Group launched within the context of the VI a '*Joint IFI Action Plan in support of banking systems and lending to the real economy in Central and Eastern Europe*'. The goal was to mobilize resources from these institutions to avert a banking crisis and support bank lending in the region. This support was integrated with IMF and European Union macro-financial support programs to Bosnia and Herzegovina, Hungary, Latvia, Serbia, and Romania.

In return for financial support under the Joint IFI Action Plan and countries' commitment to keep their support programs on track, a number of multinational banks signed country-specific

[1] The name later changed to European Bank Coordination Initiative. Levinger (2010) provides a historical overview of the VI.