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East European Exceptionalism

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By 2007, Eastern Europe had the highest penetration of foreign bank ownership of any region in the world. Nine of the 10 post-communist countries that had joined the European Union (EU) in 2004 or after had foreign bank ownership approaching 70 per cent or above. In several cases, foreign ownership in banking neared 100 per cent (EBRD 2009). Foreign domination in finance to this degree was unusual in global perspective and also represented a major structural difference between East and West Europe. In the latter case, most countries had protected their banking markets from large numbers of foreign entrants, preferring instead to maintain preponderant domestic control (Epstein 2014a; Claessens and van Horen 2015).

East European exceptionalism with respect to permitting foreign domination in finance is important for allowing us to test the developmental and political consequences of high levels of foreign bank ownership. A range of prominent academics and practitioners has warned against yielding to foreign entrants in banking markets, citing the extent to which banks inevitably have home biases, which in turn leads to host market vulnerability (Block 1996; Wade 2007; Ortiz 2012). In the 1990s and early 2000s when East European bank privatisation with foreign capital was underway, it was controversial. For proponents of banking nationalism (that is, keeping banks under domestic control) too much foreign bank ownership threatened to limit economic opportunity, curb macroeconomic policy discretion, and introduce economic volatility – not to mention political vulnerability. Debates about bank privatisation therefore mirrored larger transition disagreements about the appropriate role of the state in the economy.

Interestingly, on the question of volatility, East European banking markets mostly do not bear out these arguments regarding the dangers of foreign domination in finance (Bonin 2010; Epstein 2014c; Bonin and Louie 2015; Epstein 2017). Equally important, however, East European market openness, including in banking, has limited the pathways for economic catching-up in the European and global economies (Nölke and Vliegenthart 2009; Epstein 2014b).

The developmental and political consequences of unprecedentedly high foreign bank ownership levels there are intrinsically compelling – especially if one considers the heated controversies at the origins of banking market openness (Epstein 2008a) and more recent attempts in the region to claw back some national control over finance (Naczyn 2015). However, there are also broader, comparative concerns at stake. For one, foreign bank ownership levels across the globe are up sharply, even as most industrialised and major emerging economies have preserved preponderant domestic control (Claessens and van Horen 2012 and 2015; Epstein 2014a). Thus
lessons from Eastern Europe on volatility and development stemming from foreign domination in finance have salience in a growing number of countries (see Table 24.1 for foreign bank ownership levels in Eastern Europe).

Second, a core problem in the European debt and currency crisis was West European insistence on domestic bank control, which had been predicted to undermine a common currency (Eichengreen 1993), and ultimately did through bank-state ties that led to national regulatory forbearance as well as bank-state “doom loops” (Epstein 2014a; Epstein and Rhodes 2016; Epstein 2017). The point is that very high levels of foreign bank ownership in Eastern Europe are probably also required across Eurozone states in order to sustain the common currency. The European Banking Union is indeed structured for this very purpose. Thus in what could be an unusual reversal of fortunes, East European economic organisation today, with foreign domination in finance, could be West European states’ futures, if the European Banking Union succeeds in weakening bank-states ties, harmonising regulation, and mutualising bank insurance. Thus, not only do “emerging” economies around the world have something to learn from East Europe’s experiment with extreme economic openness, but so too do the West European economies that have only recently been forced to cede bank governance to supranational authorities in the EU.

### Table 24.1 Eastern Europe, new member states of the EU: foreign bank ownership

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of Foreign-Owned Banks, Assets: 2008 and 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>84 70</td>
</tr>
<tr>
<td>Croatia (joined the EU in 2013)</td>
<td>91 90</td>
</tr>
<tr>
<td>Czech Republic*</td>
<td>84 85</td>
</tr>
<tr>
<td>Estonia</td>
<td>98 97</td>
</tr>
<tr>
<td>Hungary</td>
<td>84 84</td>
</tr>
<tr>
<td>Latvia</td>
<td>66 65</td>
</tr>
<tr>
<td>Lithuania</td>
<td>92 93</td>
</tr>
<tr>
<td>Poland</td>
<td>77 68</td>
</tr>
<tr>
<td>Romania</td>
<td>88 89</td>
</tr>
<tr>
<td>Slovakia</td>
<td>99 85</td>
</tr>
<tr>
<td>Slovenia</td>
<td>31 34</td>
</tr>
</tbody>
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*Source for Czech Republic is Claessens and van Horen 2015 because the country exited European Bank for reconstruction and Development (EBRD) programmes before this data was collected.


The origins of foreign domination in finance in Eastern Europe

The political foundations and purposes of banks have been inescapable for states, which means that it has never been easy for states to contemplate ceding control over banks (Pauly 1988; Epstein 2014a; Calomiris and Haber 2014). Banks have historically served as creditors to states. They have been an important tool of macroeconomic management through credit provision or restriction, have been critical to securing domestic political support, and to achieving economic competitiveness. Banks have therefore contributed to (or detracted from) states’ power positions in the world economy. Indeed, financial systems have long been at the root of economic
organisation, leading to longer-term or shorter-term time horizons among actors in an economy, with consequences for numerous other national institutions, including firms, labour markets, educational systems, and welfare states (Gerschenkron 1962; Katzenstein 1978; Zysman 1983; Hall and Soskice 2001; Hancé, Rhodes and Thatcher 2007; Grittersová 2014; Bohle and Gre-skovits 2012; Bohle this volume). Banks have also relied on states – for bail-outs in crises and for various other kinds of subsidies, regulatory forbearance, or restricted competition in normal times (see e.g. Pérez 1997; De Cecco 2009; Clarke and Hardiman 2013; Donnelly 2014; Goyer and Valdivielso del Real 2014).

Given the traditional centrality of banks to states’ political and economic fortunes, it is little wonder that the privatisation of formerly state-owned banks coming out of communism should have proven controversial during Eastern Europe’s transition (Epstein 2008a; Bonin, Hasan and Wachtel 2014). And so it was. Even as post-communist states were transforming their socialist-era “monobanks” into conventional two-tier banking systems more familiar to capitalist economies, they sought initially to retain control over their banks, not least so that favoured enterprises could continue to receive credit. Just as commercial banking was being reorganised under these sometimes conflicting objectives of greater efficiency alongside economic sustenance, central banks too were caught between accommodating the international push for political independence and the perceived domestic imperative to limit the ravages of the transition downturn (Epstein 2008a; Epstein and Johnson 2010; Johnson 2016). Outright collapse of banking sectors was the result in some post-communist countries, while very high non-performing loan volumes were the problem in others. Either way, banking sector crises, in addition to international institutional pressure, paved the way not just for bank privatisation, but also for bank privatisation with foreign capital, mostly from Western Europe, and secondarily from North America.

If there is controversy in the literature about the causes of overwhelming levels of foreign bank ownership in Eastern Europe, it centres on two issues. First is the weight of banking crises against other drivers, including pressure from international organisations; second is the nature of that international pressure – whether materially or socially coercive. Banking crises certainly narrowed the range of appealing policy options (Bonin, Hasan and Wachtel 2014; Grittersová 2016) and in some cases brought new political parties to power who used crises to change policy course – including towards more liberalisation (Vachudova 2005; Epstein 2008a). On the other hand, even states without severe banking crises opted to liberalise the bulk of their banking assets with foreign capital, including in Poland. Moreover, in two important cases, banking crises did not precipitate broad openness to foreign bank investors – in Russia and Slovenia (see Johnson 2000; Lindstrom and Piroska 2007; Epstein 2008b; Spendzharova 2014). These findings point to the scope for choice among states, with the important caveat from the crisis literature that banking failures change the balance of power (see Martinez-Díaz 2009; Stein 2010), and in Eastern Europe, outside advisors were often the chief beneficiaries (Epstein 2008a).

If it was crisis together with international pressure that led to high levels of foreign bank ownership in Eastern Europe, then the second area of disagreement one detects in the literature is the nature of that pressure. A number of scholars point to the power of EU conditionality in general (Schimmelfennig and Sedelmeier 2005; Vachudova 2005) and with specific reference to bank privatisation (Bohle 2014; Medve-Bálint 2014). By contrast, international institutions’ social pressure was more important to securing high levels of foreign bank ownership. While the acquis certainly puts limits on state aid, it is nevertheless restrained with respect to requiring certain forms of bank ownership – it would have to be given that in 2002, over 42 per cent of German bank assets were held by government-owned banks (Barth, Caprio and Levine 2006: 149). A process-tracing strategy revealed instead that a host of institutions, including the International Monetary Fund (IMF), EBRD, and even the US Treasury persuaded East European policy-makers
that state intervention in their economies through banks was too resonant with central planning of the past, and that moreover these transition states would benefit from the capital and know-how that foreign entrants would bring (Epstein 2008a, 2008b; see also Ban 2016). Two cases stand out as exceptions to this: Romania, which did come under more direct EU pressure to privatise with foreign capital (Epstein 2008a); and Slovenia, which, for reasons linked to the continuity in its leadership class, ignored international institutions’ urgings to jettison state control, even in the context of EU enlargement (Lindstrom and Piroska 2007; Epstein 2008b; Spendzharova 2014).

The developmental consequences of high levels of foreign bank ownership

More than a decade after foreign investors took over the bulk of Eastern Europe’s banking assets, it was still not clear whether, on balance, such high levels of foreign bank ownership enhanced the region’s chances for catching up with Western Europe, or were a hindrance. An extensive literature had long focused on the European East–West divide and the sources of political and economic variation (e.g. Gerschenkron 1962; Brenner 1989; Bunce 2000; Janos 2000; Epstein 2014b; Epstein and Jacoby 2014). While every new EU member state had increased its per capita income relative to the “old” EU–15 between 2000 and 2013, even the richest post-communist accession state – Slovenia – was only at half the EU–15 average by 2013, measured in absolute terms (Epstein 2014b: 22). In addition, the US financial crisis and later the European debt and currency crisis had slowed or reversed convergence trends (Farkas 2013).

On the one hand, the upside of foreign bank ownership was that it had been one conduit through which capital arrived in Eastern Europe – to such an extent that for the first time, the expectation that richer countries would fund development in poorer ones was confirmed on a broad scale (EBRD 2009: 63–64). The problem was that much of the funding was not sustainable or not leading to longer-term sources of economic growth, such as indigenous innovation (Deuber 2011; Bohle 2014; Jacoby 2014). Moreover, since many of the most dramatic cases of catching up around the world had relied upon political control over credit allocation (for example, Zysman 1983; Wade 1990; Woo-Cummings 1997; Kohli 2004), sceptics have concluded that between high levels of foreign bank ownership and EU state aid limitations, developing pathways for accelerated growth and away from “dependent capitalism”, had not been achieved in Eastern Europe (Nölke and Vliegenthart 2009; Böröcz 2012; Epstein 2014b).

On the other side of this debate is the argument that foreign direct investment (FDI), including in banking, can be just as an effective catching-up strategy as political control over finance. In support of FDI, there are several countries outside of Europe that have moved into the World Bank’s “middle income” category, largely by attracting FDI (Stallings with Studart 2006). Ireland had, before the European debt crisis, become among the world’s wealthiest countries through a low-tax, high-FDI strategy, and as such became an explicit model for Eastern Europe (Ornst 2012; see also Appel 2011). The World Bank also has argued the Eastern Europe can “innovate through osmosis” and need not “invest much more in R&D [research and development] and the production of knowledge” (World Bank 2012: 16; for the fuller theoretical debate on FDI, see Bandelj 2008).

To a certain extent, work by Bohle and Greskovits (2007, 2012), Bohle (in this volume) and Bruszt and Vukov (2015) support the claim that FDI can lead to substantial upgrading in receiving countries, which in turn leads to growth and supports convergence. Two caveats are in order, however. First, Bohle and Greskovits make it clear that the kind of FDI matters. The greater the share of FDI in tradable sectors, the better it is for upgrading, skills development, growth and convergence. But second, as Bruszt and Vukov point out, the fact that Hungary’s share of
medium-tech to high-tech activity in manufacturing exports is bigger than Germany’s, relative to the respective size of these economies, probably does not reveal the true extent of where value has been added (2015: 27). In other words, returning to Nölke and Vliegenthart (2009), medium-skilled workers in Eastern Europe are labouring on what are essentially assembly platforms. Moreover, there is limited evidence for the “indirect” effects of FDI – that is, the extent to which foreign investment leads not just to greater competitiveness of the receiving firm, but also in the sector overall, including among host-owned firms (Hanousek, Kočenda and Maurel 2011; Farkas 2013: 16–17).

However, scepticism towards Eastern Europe’s prospects for catching up in light of foreign domination in banking should not be interpreted as a call to renationalise majorities of banking assets in the region – at least not outside the context of other, major institutional reforms. The reason is that although domestically controlled banks have been critical to catching up around the world, it is not also the case that all countries with domestically controlled banks have advanced in the global economy. There are as many cases of developmental failure as success. Looking at both foreign and domestic banks in Eastern Europe through the US financial crisis, and then the European debt and currency crisis, for example, it was domestic banks in Latvia and Slovenia that caused the greatest chaos. Meanwhile, domestically controlled banks in Hungary and especially in Poland acted more as counter-cyclical stabilisers (Epstein 2013; Epstein 2017).

Although there is not significant variation in the structure of new member states’ banking structures, there is nevertheless some variation in the performance of still domestically controlled banks, as the previous paragraph points out. But one can see, from Table 24.1, that in all countries except Slovenia, foreign owners dominate. Thus, for broad trends in production profile development, the legacies and policies highlighted in the Varieties of Capitalism literature may be more important than bank ownership (see Bohle, this volume).

Other kinds of bank variation do exist, however, in other dimensions of ownership and regulatory and monetary regimes. Slovenia and Poland stand out for the continued role of significant state ownership. Hungary’s largest bank, OTP, is also domestically managed, but differs from the largest banks in both Poland and Slovenia insofar as it is actually majority foreign-owned – albeit through dispersed shareholdings, so there is no single foreign strategic stakeholder with overriding management power. The fact that all three Baltic states, Slovenia, and Slovakia were in the Eurozone by 2016 also had implications for bank governance in those countries. These five post-communist countries were automatically included in European Banking Union, which required the conferral of bank supervisory and licensing authority from the national level to the European Central Bank (ECB). While Romania and possibly also Bulgaria would opt in to banking union, Poland, the Czech Republic, and Hungary elected instead to retain domestic supervisory authority over banks operating in their jurisdictions.

Limiting volatility: the “second home market” versus the Vienna initiative

Very high levels of foreign bank ownership in Eastern Europe gave rise to fears that the region would fall victim to “cutting and running” during the US financial crisis, whereby foreign banks repatriate capital and liquidity to their “home” markets at the expense of host ones. Hypothesised vulnerability relates back to banks’ presumed home biases, referred to by Block (1996), Wade (2007) and Ortiz (2012) at the beginning of this article. Funding reversals had had devastating effects over the last twenty years in East Asia, Turkey, Brazil, Argentina, and elsewhere (Roubini and Setser 2004). Given the history of foreign bank retrenchment, East European watchers were writing headlines in late 2008 and early 2009 such as “Eastern European Crisis May Put Us All
in the Goulash” (King 2009) and “Next Wave of Banking Crisis to Come from Eastern Europe” (Engdahl 2009). Everyone from journalists to industry analysts to Paul Krugman believed Eastern Europe was headed for disaster given the confluence of crisis and foreign domination in finance (Epstein 2014c).

Despite the dire forecasts about Eastern Europe in late 2008 and early 2009, the largest foreign banks did not abruptly cut and run from the region as had been widely expected. Instead, scholars and journalists were writing, by the end of 2009, about the banking crisis that never was (Åslund 2010). But herein lies the controversy: while most analysts had concluded that it was a voluntary bank rollover agreement, the “Vienna Initiative” (also known as the European Bank Coordination Initiative), that forced foreign banks to maintain their exposures to Eastern Europe to avoid calamity (e.g. EBRD 2009: 18; IMF 2010a: 63; De Haas et al. 2012; Blyth 2013; Kudrna and Gabor 2013: 556), a minority view held that banks never intended, could, or wanted to leave (Epstein 2014c; Bonin and Louie 2015; Epstein 2017). In support of the Vienna Initiative side of this debate was the fact that the US financial crisis created a collective action problem among foreign bank investors in Eastern Europe. Given the historically well-established propensity of foreign banks to cut and run from their host markets in crises, which in turn reduces currency and asset values and raises non-performing loan volumes in host states, if banks were going to jump ship, it would make sense to be first to leave rather than last. From the international financial institutions’ perspective, then, the trick was to provide reassurance that everyone would stay so that capital flight and all the attending negative economic repercussions could be contained.

A process-tracing research strategy revealed a number of problems with the argument outlined earlier about the power of the Vienna Initiative (VI), however. First, the VI technically only covered five countries, and a number of the commitment letters signed by banks, in which those banks pledged to maintain particular exposures, were signed after the critical crisis period had passed. Second, the commitment letters were voluntary, which had never proved to be a robust guard against capital flight in previous crises. The literature arguing on behalf of the VI’s effectiveness did not specify what set the East European context apart in 2009 from previous rollover agreements that had failed. Third, it turns out that the six largest west European banking groups invested in Eastern Europe were at the origins of the VI. These large banks’ evident desire to improve coordination casts doubt on the notion that international institutions reigned in banks’ worst impulses, and instead points to a very different causal logic in which the banks themselves were running the international financial institutions, and not the other way around.

Thus, the alternative explanation to the VI was that large banks invested in Eastern Europe were operating under a “second home market” model characterised by long time horizons, competition for mass market share and tolerance for high volatility (Epstein 2014c). The second home market model was a reflection of the extent to which, underappreciated by many observers in the run-up to the crisis, Eastern Europe truly was exceptional with respect to the uniqueness of its economic model that had foreign domination in finance at its centre. What was unusual, in addition to very high foreign ownership levels, was that foreign investors had overwhelmingly expanded through subsidiaries instead of branches (Cerutti, Dell’Ariccia and Pería 2007). This meant that foreign banks were as or more subject to host regulatory authority as to home. East European states used their supervisory and regulatory authority over foreign-owned bank subsidiaries in the crisis to tighten capital and liquidity requirements and in some cases to restrict the payment of bank bonuses and dividends, leading foreign bankers in the region to declare that “capital mobility in Eastern Europe is dead” (Epstein 2014c; also see Spendzharova 2014 on regulatory measures). In addition, since foreign banks had been in search of mass market share, many of their loans were long-term and could not be called in. Third and perhaps most important, since banks like UniCredit of Italy and Raiffeisen of Austria were coming from over-banked
and relatively small home markets, they had no desire to retreat from a newly established market of millions of consumers back to a comparatively miniscule home one, especially after having spent two decades (in Raiffeisen’s case) building their business and brand in the post-communist world. They were in Eastern Europe for the long term and had no desire to “cut and run” from their markets there.

One might wonder then, why there was a Vienna Initiative. If big banks had no intention of leaving, why sign undisclosed commitment letters promising to stay? By late 2008, the likes of Raiffeisen, Erste Bank, UniCredit, and others had a problem. Because of all the catastrophic reporting referred to earlier, including a blog post by Paul Krugman in October 2008 equating Eastern Europe to Southeast Asia in 1997, there was widespread fear among global investors that Eastern Europe was going to implode. This created funding problems for the big banks invested in Eastern Europe – that is, other financial institutions did not want to extend credit to banks dependent on East European markets. In addition, East European countries were using their regulatory authority over foreign-owned subsidiaries in their jurisdictions to “ring-fence” resources (referred to earlier) – that is, to restrict foreign banks in their use (and particularly their removal) of capital and liquidity (Kudrna and Gabor 2013). The six big banks sent the letter to international organisations in November 2008 to begin a process, the Vienna Initiative, which would ultimately serve as an important signalling device to international markets that East European markets were not on the brink of collapse. The banks also used Vienna to win additional leverage vis-à-vis host regulatory authorities to get them to lighten up. The strategy worked. Fears were alleviated, funding returned, and the IMF used its bailouts in the region to secure macroeconomic and regulatory policies favourable to the large foreign bank investors (see Kudrna and Gabor 2013; Epstein 2014c, especially p. 865).

What is instructive about the East European experience through the US financial crisis is that while states have long been reluctant to allow high levels of foreign bank ownership, they should probably be more concerned about the institutional channels through which funding flows. In other words, states should be more concerned about funding through branches and cross-border bank lending than foreign ownership of bank subsidiaries because there is little “financial friction” in those former instances to prevent large-scale funding retreat. And in fact, comparing Eastern Europe in 2008 to Southeast Asia in 1997–1998, funding reversals in the latter case were largely the result of cross-border borrowing, not foreign bank ownership. Bank subsidiaries owned by the biggest outside investors, over which hosts had regulatory and supervisory authority, proved a relatively stable model of funding in Eastern Europe through the US financial crisis, and even after.

**Conclusions: Eastern Europe as Europe’s future**

Three main arguments about foreign bank ownership in Eastern Europe were explored in this chapter. The first is that foreign bank ownership levels are unprecedentedly high stemming from the peculiar pressures of banking crises together with international institutions and EU enlargement. The second is that in historical comparative perspective, foreign domination in finance limits the pathways through which Eastern Europe can catch up, in terms of per capita income, to its West European counterparts. The third, however, is that the particular institutional form that foreign bank ownership has taken in Eastern Europe, through preponderant foreign ownership of subsidiaries and a “second home market model”, has been a relatively stable source of funding. Linking points two and three is the fact that to a greater degree than at any previous juncture, neoclassical expectations that rich countries should fund economic growth in poorer ones has been confirmed on a broad scale.
The findings outlined in this chapter are not completely settled, however. In particular, the developmental consequences of foreign domination in finance require further investigation. One general observation is that foreign-owned banks are not as good as their domestic counterparts at locating and funding promising local entrepreneurs, which may hinder economic growth – especially if indigenous innovation is stifled by inadequate access to finance. A rival hypothesis, however, is that funding to small and medium-sized enterprises in Eastern Europe has been weak because entrepreneurship is limited. A second but related pair of questions is that given high levels of foreign bank ownership in Eastern Europe, where has indigenous high value-added innovation nevertheless taken place and how was it financed. Further research along these lines would tell us whether Eastern Europe has better prospects to catch up through channels other than control over finance. It would also suggest constructive policies going forward – including whether more domestic control over banking would serve any of the post-communist countries well, or whether more political influence over credit allocation would simply increase related-party lending and excessive risk-taking.

By way of conclusion, it is important to stress that lessons from Eastern Europe about high levels of foreign bank ownership are not confined to the region, or even to other middle-income or “emerging” economies around the world. Rather, the effects of foreign bank ownership are increasingly pertinent to the rich industrialized states of Western Europe, and especially to those in the Eurozone. This relevance is generated by the notable role that banking sector protectionism there played in extending and exacerbating the European debt and currency crisis (Epstein 2014a; Epstein and Rhodes 2016; Epstein 2017). In brief, West European insistence on domestic control over banking sectors, very much unlike the East European posture during post-communist transition, allowed the introduction of a common currency in the context of still nationally fragmented banking systems. Political ties between banks and states in the run-up to and during the US and Eurozone crises led to multiple problems. These included the linked economic vulnerabilities of banks and states referred to earlier as “doom-loops”; national regulatory forbearance in the interest of protected domestic bank consolidation and outward bank expansion; domination by banks in funding at the expense of other, more diverse sources, which limited economic recovery; and national retrenchment in funding during the crisis, undermining the effectiveness of the ECB’s monetary policy setting for the Eurozone.

Here again, there is debate – about whether the European Banking Union, which relocates regulatory and supervisory authority over banks from the national to the supranational level in the ECB – sufficiently weakens the bank-state ties that undermined the euro in the crisis (see Epstein and Macartney 2016; Howarth and Macartney 2016). Supposing that it does, however, as some analysts speculate (Véron 2015; Epstein and Rhodes 2016), the entire point would be to limit political impulses for protectionism. It means, particularly with centralised bank supervision, licensing, and the mutualisation of bank insurance schemes linked to deposits and resolution, that foreign bank ownership levels are likely to rise, also in Western Europe. Judging from Eastern Europe, cross-penetration in banking markets is likely to limit economic policy autonomy and make economic adjustment more difficult (Hardie and Howarth 2013). On the other hand, intra-European volatility might well be curbed – both because national retrenchment in funding would be less pervasive and because the euro and the ECB would be on firmer, single-market footing. In this sense, high levels of foreign bank ownership in Eastern Europe could well be indicative of all of Europe’s economic future.

Notes
1 Croatia, another post-communist new member state that joined the EU in 2013 also followed this pattern, with foreign bank ownership over 90 per cent.
2 A “doom loop” during the European debt and currency crisis refers to the linked vulnerabilities of states and banks that emerged because banks were lending disproportionately to their own sovereigns. While this strategy was intended to keep states’ borrowing costs down, it was failing to do so in Italy, Spain, and Slovenia by 2011 and 2012. Thus when bank lending to governments was insufficient to control borrowing costs, banks’ balance sheets also suffered because of previously accumulated government debt. The dynamic effectively pushed governments’ borrowing costs higher because of investor fears that states would again have to bail out their banks (Gros 2013).

3 The “Old EU 15” refers to those member states who had joined the EU prior to 2004.

4 Note that all of the new member states from Eastern Europe under consideration here are already either “high income” or “high middle income” countries by the World Bank’s categorisations. Thus, the outcome of interest in the literature described is really convergence on West European levels of wealth.

5 See the letter from 27 November 2008 addressed to the European Commission, among others, which resulted from a meeting among the six largest bank investors in Eastern Europe at the Raiffeisen headquarters earlier that month: www.ebrd.com/downloads/research/economics/events/Banks_letter.pdf.

6 Krugman’s blog post can be found here: http://krugman.blogs.nytimes.com/2008/10/31/eastern-europe-2008-southeast-asia-1997/?_r=0.

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