



# **Stabilising capital flows in crisis and beyond – Lessons from Emerging Europe for Korea**

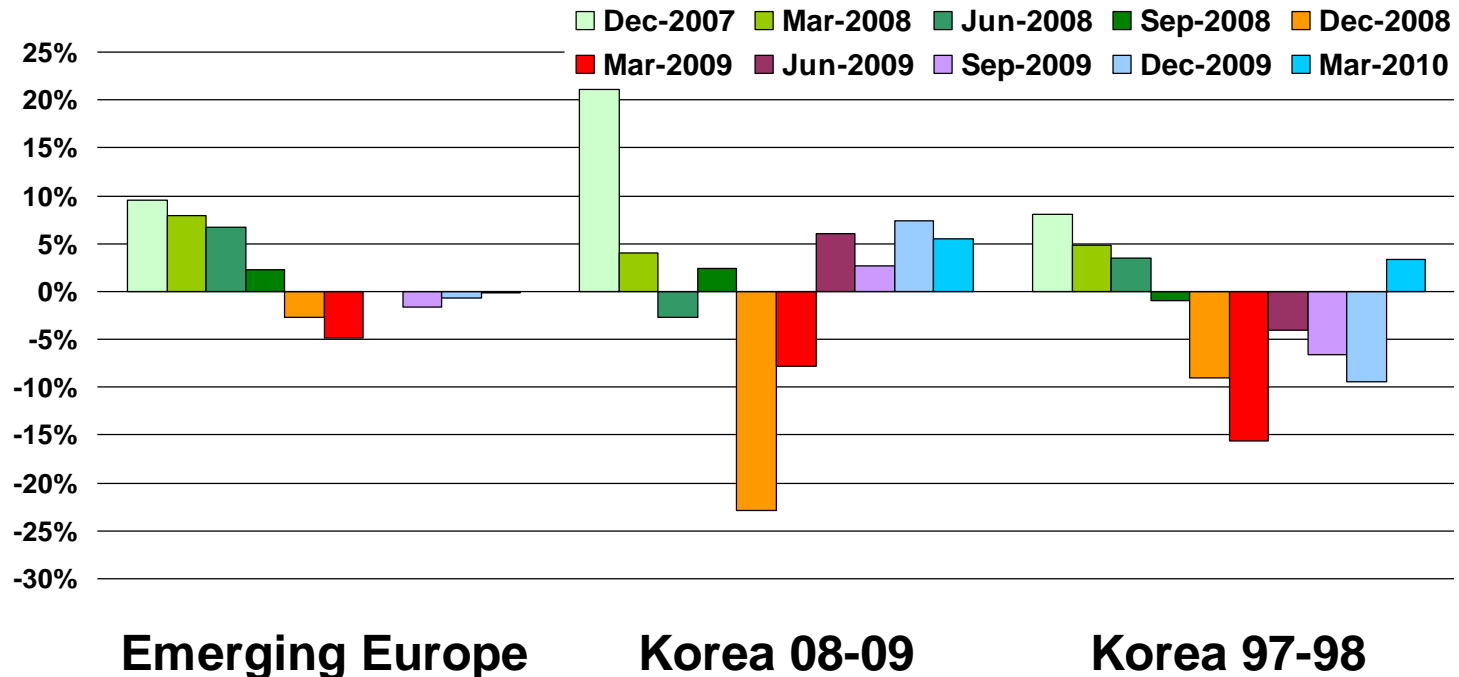
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2 Sept, 2010



# Emerging Europe's outflows more stable compared to Korea's in 97 and now...

**- less outflow in crisis, more drawn out deleveraging**

Percentage changes in external assets of BIS-reporting banks



**Emerging Europe**

**Korea 08-09**

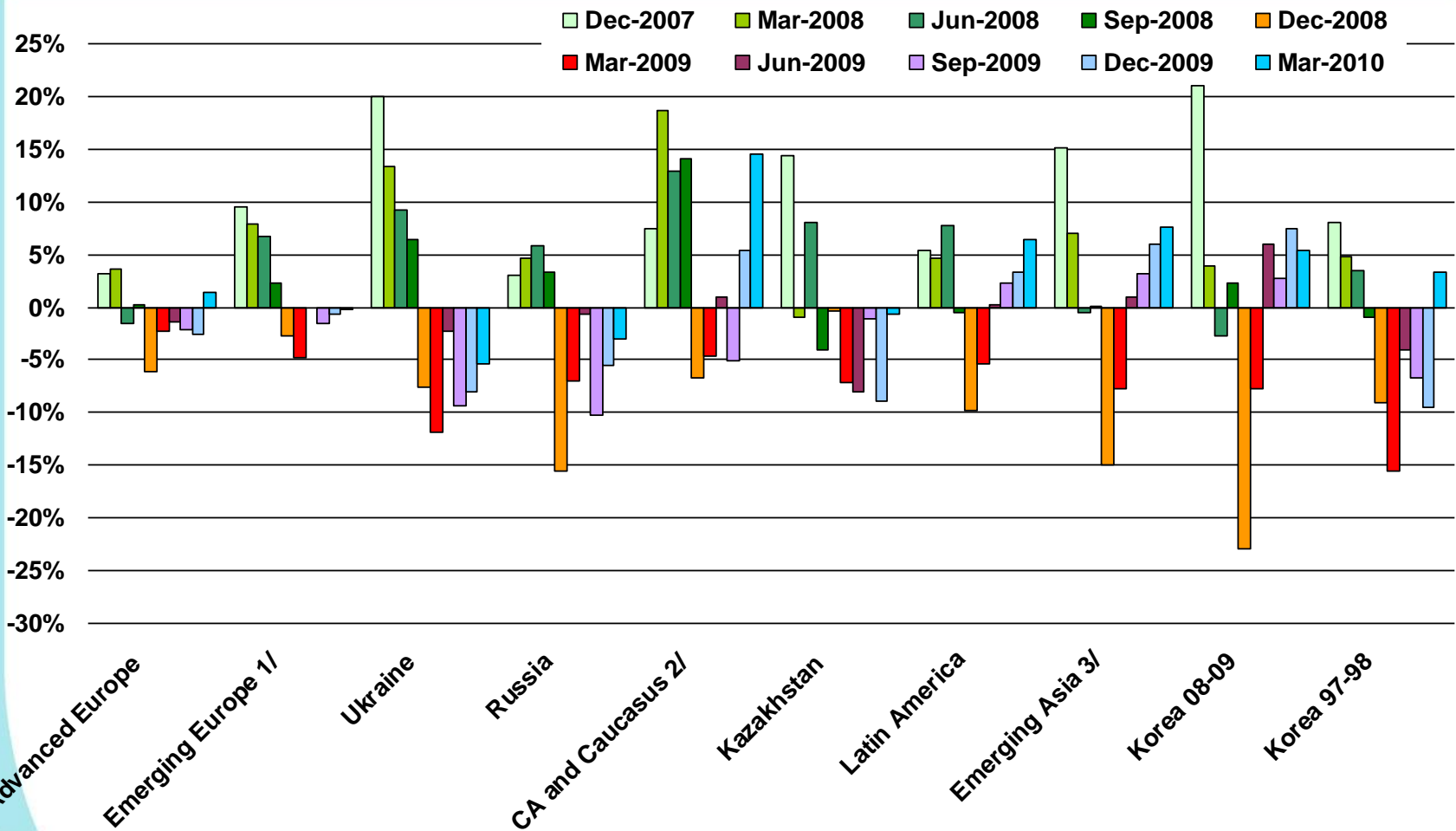
**Korea 97-98**

1/

1/ Emerging Europe excludes Russia and Ukraine



# ... and compared to other countries.



## Some observations from the crisis

- Weaknesses in global financial architecture particularly harmful for emerging markets
- But some countries more vulnerable than others (Korea vs. Emerging Europe)
- Financial integration had stabilising impact in financial crisis, at least in Emerging Europe
- Public-private sector initiative (PPSI) helped to stem outflows in Emerging Europe, but not anywhere else (Korea -97)

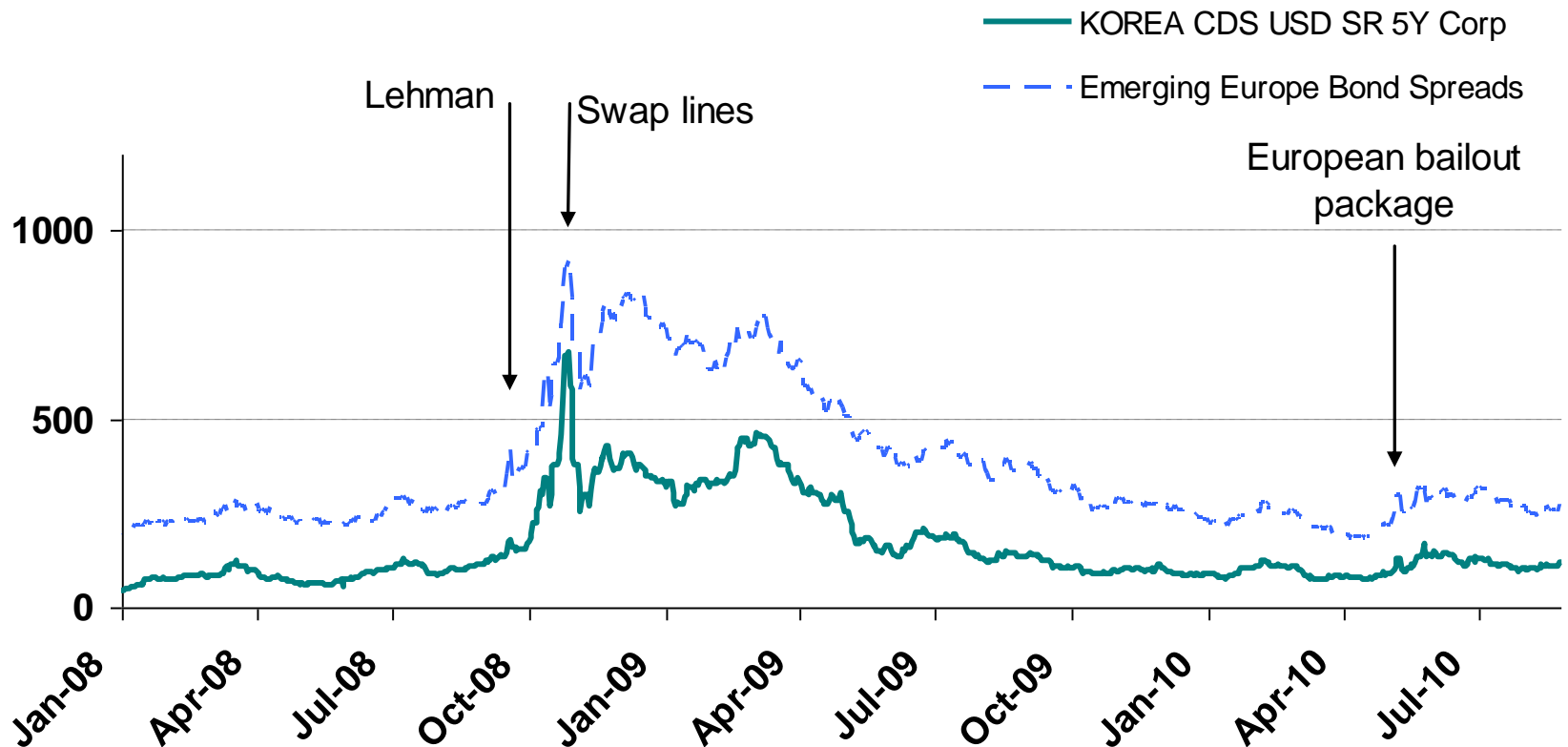


# Key messages

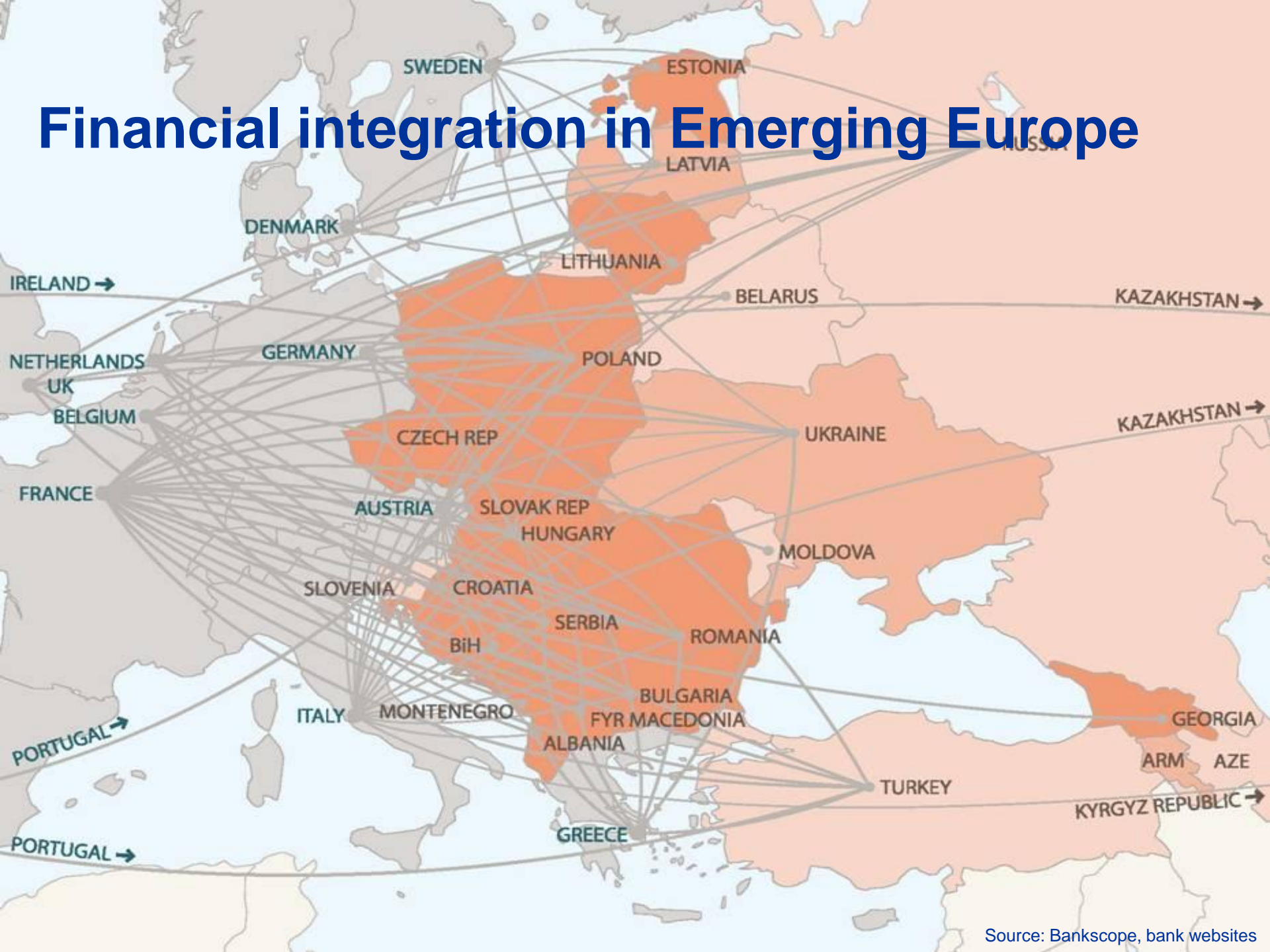
- Encourage financial integration through subsidiary networks and local funding to stabilise capital flows
- Rebalancing architecture to support financial integration
  - “Home country rule” didn’t work and politically unacceptable
  - But “host country rule” and capital buffers not the answer
- Promote public-private sector coordination in crisis and beyond
  - Vienna Initiative – longest-lasting, most formal, and broadest public-private mechanism yet – and it worked: postponed deleveraging at the peak of the crisis



# Time line of the crisis: Korea vs. Emerging Europe



# Financial integration in Emerging Europe



# Foreign bank penetration in Korea now looks much more like Emerging Europe

	Total financial system assets (% of GDP)	Share of banks	Share of non-banks	Share of foreign-owned banks (% of assets)
<b>Korea '96</b>	<b>210</b>	<b>76</b>	<b>24</b>	<b>9</b>
<b>Korea '08</b>	<b>253</b>	<b>74</b>	<b>26</b>	<b>64</b>
Czech Rep	146	75	25	84
Estonia	141	89	11	99
Poland	97	75	25	70
Romania	74	83	17	88
Slovak Rep	95	89	11	96
Kazakhstan	74	82	18	16
Russia	158	33	67	17





# Financial integration mitigates impact

(de Haas, 2009; and De Haas et al., 2010)

- Subsidiary lending more stable than cross-border lending *and* domestic bank lending
- Syndicated lending more volatile than other cross-border lending
- Syndicated lending and subsidiary lending complement each other
- Local funding of subsidiaries helped reduce impact of financial crisis



# Financial integration requires supporting architecture

- “Home country rule” didn’t work and politically unsustainable
- “Host country rule” now the trend, but less reliable, reinforces reserve buffers, and reverses financial integration and development
- Existing supranational arrangements little impact, but need complement to home and host country rule



# Cross-border banking requires coordination

- “Rush for the exit” by banks in crisis
  - Accelerated deleveraging
- Financial protectionism
  - Home country restrictions bank support programs
  - Host country “ring-fencing” or discrimination
- “Beggar-thy-neighbour” policies
  - Increased capital requirements, deposit insurance...

**=> *Public-Private Sector Initiatives (PPSI)***



# Vienna Initiative: longest-lasting, most formal, broadest PPSI

- Earlier Public-Private Sector Initiatives (PPSIs):
  - **Korea (1997)**: European, Japanese, and US banks committed to roll over cross-border loans to Korean borrowers for 3 months
  - **Brazil (1999)**: Large foreign banks committed informally to maintain their interbank and trade credit exposures for 6 months
  - **Turkey (2001)**: Monitoring of international exposure and loose commitment to maintain interbank exposure
- **Vienna Initiative (2009)**: Large foreign banks agreed to maintaining exposures and sufficient capital in 5 countries for 6-11 months; monitoring by central banks



## **Vienna Initiative results: No rush for the exit**

- No restrictions on home country bank support packages + very little host protectionism + effective burden sharing
- Public parent bank commitments in IMF/EU programs respected – maintained exposures and no foreign subsidiary failed
- Helped stabilise individual countries (Romania, Serbia etc.) and built market confidence
- Lowest outflows - despite largest output shock



# Vienna Initiative: Why more successful?

- Initial conditions different
  - Deep financial (and political) integration in Europe;
  - Banks more committed through subsidiaries.
- Massive and coordinated macroeconomic and micro (IFI) financing incentives
- Measures voluntary and public → public and peer pressure, name-and-shame devices
- Longer in duration and more formalised



# Vienna Initiative offers role for the IFIs

- IFIs critical in identifying coordination problems and convening public and private stakeholders
- Complementary roles
  - Different constituencies
  - Investing and non-investing IFIs
- Need to think about IFI incentives
  - Example EBRD portfolio: one (very exposed) region, 1/3 financial sector, 1/3 equity



# Conclusions

- Financial integration **and** policy response explains slower, more drawn out outflows in Emerging Europe
- Financial integration helps stabilise capital flows; encourage foreign bank subsidiaries
- Need supporting financial architecture: “Host country rule” the short-term response, but need complement at supranational level
- Vienna Initiative – a public-private sector initiative for coordination that seemed to work in the crisis...but could also offer platform to reduce vulnerabilities and manage future crises





**Thank you!**

