Southeastern Europe: Financial Deepening, Foreign Banks and Sudden Stops in Capital Flows

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Over recent years, rapid financial deepening has been observed in Southeastern Europe. While originally welcomed as a sign of financial development spurring growth, macrofinancial stability concerns emerged as inflationary pressures rose and current account deficits came close to or surpassed double-digit levels. However, until autumn 2008, stability risks remained contained. Since then, Southeastern European countries appear to have been confronted with a sudden stop of capital flows, creating an Asian-crisis-like scenario. While this seems to vindicate warnings that financial deepening had taken an unsustainable course, the drying up of capital flows has largely been reflecting contagion from the financial turmoil in mature markets. Against this background, the most recent events indicate that the strategy of fostering financial development based on fit and proper foreign banks does not automatically provide a guarantee for financial stability.

1 Introduction

More than one year after the start of the financial market turmoil in mature economies, the crisis reached the emerging countries of Southeastern Europe.[2] Given strong credit growth, rising inflationary pressures and large current account deficits, it seems that also for this region the "unsustainable has run its course" (BIS, 2008), validating the macrofinancial stability concerns expressed over the last years.

Against this background, the paper starts out by reviewing the process of rapid financial deepening and the associated vulnerabilities and risks. At the end of section 2, the three main scenarios discussed in the literature with regard to the sustainability of the process are summarized: the "Asian crisis" scenario of a sudden stop in capital flows, the "Portugal" scenario, where rapid credit growth does not lead to a financial and exchange rate crisis, but is followed by a protracted low-growth adjustment process, and the benign scenario of a smooth catching-up (Sirtaine and Skamnelos, 2007). Section 3 focuses on a prominent argument that had been used to predict a more benign outcome, namely the fact that financial deepening has been based on banking sectors dominated by subsidiaries of (mainly) euro area banks. Why should parent banks endanger the profitability of their investments and their reputations by suddenly withdrawing funds lent to the region? As outlined in some detail in section 4, key insights of the modern finance theory did indeed suggest that a sudden stop of capital flows was unlikely. The collapse of Lehman Brothers and its impact on the major euro area banks active in the region changed all this (section 5), as it almost wiped out the macrofinancial stability advantages linked to foreign ownership. Moreover, it laid the ground for a new emerging market crisis scenario, namely contagion from mature economies, as the global liquidity shock hit the very institutions that were supposed to

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[2] *The region is defined as including the following countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the FYR Macedonia, Montenegro, Serbia, Romania and Turkey. Cutoff date for data: December 10, 2008.*

provide insurance against a sudden stop. Thus, section 6 concludes by acknowledging the familiar saying that every financial crisis is indeed different.

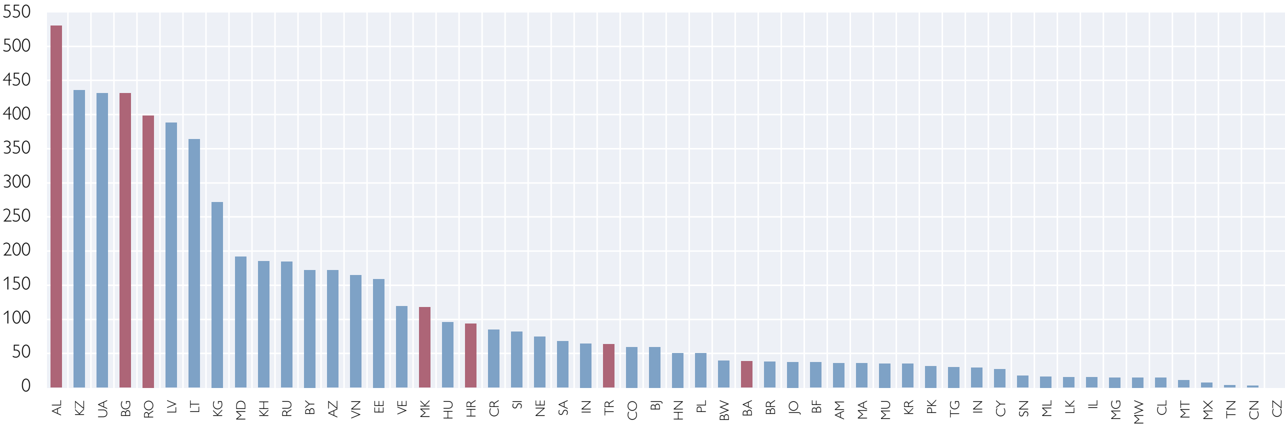
2 Vulnerabilities and Macrofinancial Risk Scenarios

Since the beginning of the decade, Southeastern Europe, like Eastern Europe as a whole, has seen rapid financial development.[3] Chart 1 summarizes the evidence, pointing out that the pace of deepening has been extraordinary, even in an emerging market context. Moreover, a comparison of the most widely used indicators of financial development, the broad-money-to-GDP ratio and the private-sector-credit-to-GDP ratio, indicates that credit growth has been particularly strong. By contrast, monetization has been advancing more or less at a pace similar to that of other emerging markets and developing countries.

Chart 1

Private-Sector-Credit-to-GDP Ratio

Percentage change 2007/2006 versus 2000



Sources: IMF, author's compilations.

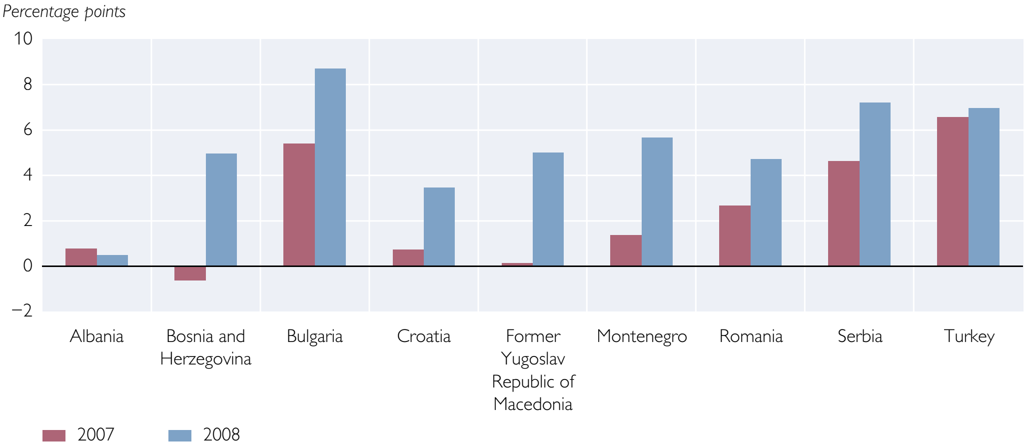
Note: Countries of Southeastern Europe are marked in red. The ranking and the respective percentage changes are sensitive to the choice of the base year. For example, the percentage change of close to zero in the Czech Republic reflects the substantial restructuring and consolidation efforts in the banking sector undertaken by the authorities in the first years of this decade. Over recent years, however, private sector credit as a percentage of GDP has been rising at a pace similar to that observed in other Central and Eastern European countries. Country names in the order of the chart, from left to right: AL = Albania, KZ = Kazakhstan, UA = Ukraine, BG = Bulgaria, RO = Romania, LV = Latvia, LT = Lithuania, KG = Kyrgyzstan, MD = Moldova, KH = Cambodia, RU = Russia, BY = Belarus, AZ = Azerbaijan, VN = Vietnam, EE = Estonia, VE = Venezuela, MK = FYR Macedonia, HU = Hungary, HR = Croatia, CR = Costa Rica, SI = Slovenia, NE = Niger, SA = Saudi Arabia, IN = India, TR = Turkey, CO = Colombia, BJ = Benin, HN = Honduras, PL = Poland, BW = Botswana, BA = Bosnia and Herzegovina, BR = Brazil, JO = Jordan, BF = Burkina Faso, AM = Armenia, MA = Morocco, MU = Mauritius, KR = South Korea, PK = Pakistan, TG = Togo, ID = Indonesia, CY = Cyprus, SN = Senegal, ML = Mali, LK = Sri Lanka, IL = Israel, MG = Madagascar, MW = Malawi, CL = Chile, MT = Malta, MX = Mexico, TN = Tunesia, CN = People's Republic of China (Mainland), CZ = Czech Republic.

In the early 2000s, financial deepening was accompanied by strong growth, low inflation – with the exception of countries with a more flexible exchange rate, i.e. Turkey, Romania and Serbia – and current account deficits, which were still modest, given their average range of 5% of GDP. However, until the summer of 2008, inflationary pressures had been intensifying, limiting progress in disinflation or leading to higher inflation rates in countries with comparatively low levels of inflation in the years before. Moreover, rapidly rising current account deficits signaled that domestic demand dynamics had become excessive (charts 2 and 3).

[3] *There is an extensive literature that closely analyzes the process of financial deepening in the region. See for example the contributions in Liebscher et al. (2006) as well as Enoch and Ötker-Robe (2007).*

Chart 2

Inflation Differential to the Euro Area

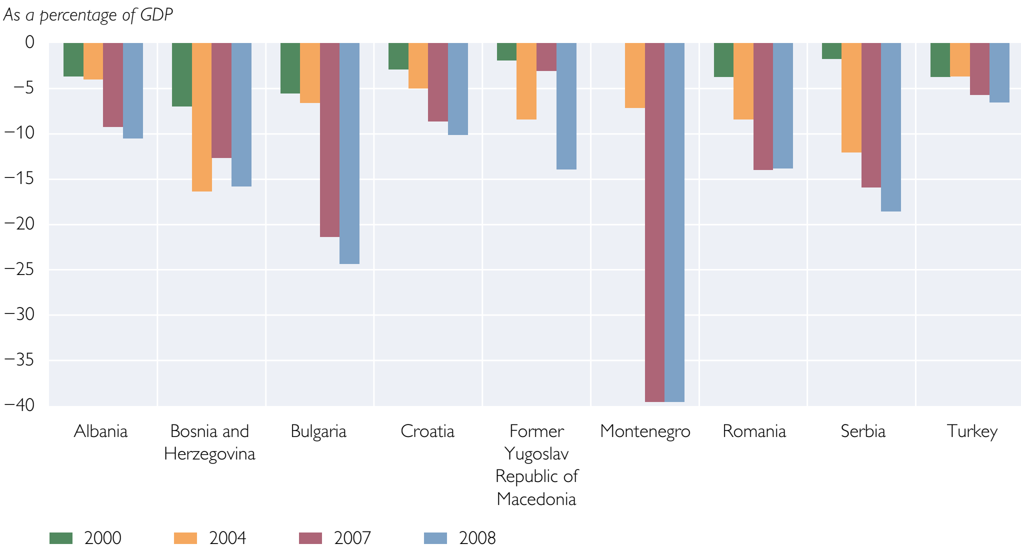


Sources: IMF, author's calculations.

Note: 2008 figures are estimates.

Chart 3

Current Account Balance



Source: IMF.

Note: 2007 (Albania and Montenegro) as well as 2008 figures (all countries) are estimates.

Macroeconomic vulnerabilities were compounded by rising financial vulnerabilities. In particular, the increasing dominance of foreign exchange-denominated loans became a cause for concern,[4] also because overall credit was boosted by soaring household consumer and mortgage credit. Unlike enterprises, which might have earnings in foreign currency via exports, households are barely hedged against foreign exchange risk. The main financial vulnerability, however, was seen

[4] *The extent of euro-based asset substitution in the region has been documented in ECB (2007).*

in the speed of credit growth itself (Kraft and Jankov, 2005), as this speed suggested that banks underestimated the level of risk associated with rapid credit expansion. For example, the debt burden of borrowers had been rising significantly in several countries, even though debt ratios in most countries are still low compared to those recorded in mature economies. At the same time, many borrowers had engaged in borrowing for the first time, raising doubts about credit quality, given the lack of a track record and debt management experience. These doubts were not dispelled by relatively low or declining ratios of nonperforming loans to total loans, as the usefulness of this variable as an indicator of credit risk was impaired by the speed of credit expansion itself, considering that loan performance problems usually materialize only with a significant lag. Finally, it is a well-established stylized fact that credit booms have preceded many financial and exchange rate crises.[5]

Against this background, several observers have been warning that the countries in the region run the risk of facing an Asian-style financial and exchange rate crisis.[6] The trigger could be a sudden stop or a reversal of capital flows that reflects a reassessment by international investors of the macroeconomic outlook in the region. In addition to rising inflation and high current account deficits, fiscal policy slippages have been observed, even though government deficits (surpluses) have been stable or even declining (rising) and most countries have been meeting the Maastricht criterion of a deficit below 3% of GDP. However, given strong domestic demand pressures evidenced by rising inflation and high current account deficits, many countries' fiscal policy stance should have been much more restrictive to contain aggregate demand.[7]

With interest rates on the rise in the United States until August 2007 and in the euro area until July 2008, the profitability outlook of investment projects financed in the period of low interest rates became more and more clouded, increasing the probability that capital flows would dry up. A slowdown or reversal of capital flows would be associated with depreciation pressures, raising the debt burden for borrowers with foreign exchange loans. If the exchange rate were to be defended by the monetary authorities, the associated rise in interest rates would be likely to reduce the quality of loan portfolios. Finally, like in Asia, once one country was affected by capital outflows and depreciation pressures, contagion could transmit the pressure to other countries in the region, given that the economies are fairly open and show a high degree of similarity of macroeconomic and financial sector developments.

The second risk scenario made reference to the pre-EMU experience of Portugal, where the credit boom of the mid- to late 1990s was also associated with a strong increase in the current account deficit. However, in contrast to Asia, the

[5] *At the same time, it has to be acknowledged that most lending booms do not end in a crisis. Much rather, they gradually decelerate, providing for a "soft landing" (Caprio and Klingebiel, 1996 a,b; Gourinchas, Valdés and Landerretche, 2001; Tornell and Westermann, 2002).*

[6] *One of the first papers that explicitly compares developments in the region with those in precrisis Asia is that of Eichengreen and Choudhry (2005). For a more recent example, see Sorsa et al. (2007).*

[7] *This holds in particular for countries with a fixed exchange rate regime. However, even in countries with a more flexible exchange rate regime, fiscal policy should have played a much greater role in macroeconomic stabilization, given the limited effectiveness of monetary policy in an environment characterized by a high degree of financial integration and euro-based asset substitution. For details see Winkler (2008).*

boom did not end in a financial and currency crisis, as the adoption of the euro ruled out external adjustment via the exchange rate. Instead, rapid credit and output growth was followed by a protracted period of slow growth (Sirtaine and Skamnelos, 2007). While most Southeastern European countries still have some way to go to become EU members, much less join the euro area, it could be argued that the high degree of real and financial integration with the euro area would act as a strong incentive for the authorities to avoid the "external adjustment path" and to opt for a course of "internal adjustment" (Martin, Schuknecht and Vansteenkiste, 2007) with imbalances and financial excesses unwinding more slowly.

Finally, there was the most benign scenario, which – while acknowledging the similarities with the Asian and Portuguese examples – stressed a unique feature of the process of financial deepening in the region, namely the dominance of subsidiaries of euro area parent banks in the region's banking sectors. With financial development largely based on fit and proper foreign banks, the catching-up process in the region seemed to have been placed on a sound financial footing, allowing for a crisis-proof process of finance and growth.

3 Foreign, Euro Area Bank-Based Financial Deepening

It is useful to recall that the process of financial deepening of the last decade was preceded by financial crises in many countries of the region. The turbulences marked the end of an approach of financial sector development based on state and domestic private banks with poor governance. Authorities reacted by opening up their financial sectors to foreign investors. With the prospects of EU accession becoming more concrete, foreign banks, mainly from the euro area, seized the opportunity and established subsidiaries or branches in almost all countries of the region. Very quickly, they emerged as the dominant players in the respective banking sectors. At the end of 2007, their share in total banking sector assets exceeded the 70% level in all countries with the exception of Turkey.

Many emerging markets and developing countries have seen an increasing presence of foreign banks in their domestic banking sectors over recent years (Mihaljek, 2006; Claessens et al., 2008). However, the impact of foreign banks on financial sector development has been far from uniform.[8] Thus, the Southeastern European experience[9] of rapid financial development largely based on foreign banks from the euro area seems to reflect the favorable conditions for financial integration in Europe (Herrmann and Winkler, 2008). Subsidiaries and branches of parent banks with headquarters in the euro area entered the region because they perceived the host countries as an extension of the single domestic European market (Wiedner, 2005; Wimmer, 2005; Profumo, 2006). Moreover, this approach explains the strong focus on retail activities, an area in which foreign banks have been in the comfortable position of exploiting their comparative advantages, namely their "reputational capital" (Hellman and Murdock, 1998)[10] in expanding

[8] *See for example the evidence provided by Detragiache, Tressel and Gupta (2006), which suggests that in poor countries a stronger foreign bank presence has been associated with slower credit growth and less access to credit.*

[9] *The same applies to the Central and Eastern European countries that joined the EU in May 2004.*

[10] *Grigorian and Manole (2002) compared the reputation bonus of Western banks to a kind of implicit deposit insurance.*

the deposit business, and their superior credit technology, governance structure and capitalization in expanding loans to businesses and households.

4 Sudden Stops in a Highly Integrated Financial Market with Interlinked Ownership Structures

Emerging Europe stands out in representing a foreign bank-based development of domestic financial sectors. This holds when comparing the region with other emerging markets, and it holds when analyzing processes of financial deepening from a historical perspective. Thus, it is not surprising that proponents of the benign scenario, predicting a smooth process of financial deepening and catching-up, based their arguments to a considerable extent on alleged advantages of foreign banks as drivers of financial development from a macrofinancial perspective.

The most widely used argument suggesting that the increasing presence of foreign banks in the region should have strengthened financial stability in the region is based on the view that weak and poorly governed state-owned and private banks were a major cause of the financial and currency crises of the 1990s (Llewellyn, 2002). Against this background, the very fact that reputable and experienced foreign banks entered the market was interpreted as an improvement in financial sector quality and solvency (Mehl, Vespro and Winkler, 2005). The quality of financial intermediation was further enhanced by substantial efforts to upgrade the regulatory and supervisory frameworks. Again, the drive toward better regulation and supervision was at least partly motivated by the European integration process and the need to adopt EU standards. Thus, many of the banking sector weaknesses traditionally characterizing emerging markets and developing countries (Caprio, 1997) seemed to have been eliminated.

Opponents of the benign view did not challenge the general validity of these arguments, but pointed to other, less favorable implications of the strong presence of euro area banks in region. Topping the list was the increasing aggressiveness with which foreign banks were engaging in a fight for market shares in the credit market. Moreover, subsidiaries were strongly supported by external funding from parent banks, given low interest rates in mature economies. This indicates that the expansion of credit in the region was another form of the "search for yield" characterizing mature financial markets until summer 2007 (Hardy and Tiemann, 2008). Indeed, the absence of signs of a market-driven slowdown of credit growth raised doubts about the view that foreign ownership as such will mitigate the risk of financial turmoil. This holds in particular as episodes of financial crises following rapid credit growth have not been confined to emerging markets and developing countries, but have been observed in mature economies as well. Finally, even if the presence of foreign banks may have a positive bearing on financial stability, i.e. on indicators measuring credit quality as well as banking sector capitalization, profitability and liquidity, it does not compensate for weak macroeconomic fundamentals, such as rising inflation, high current account deficits and rising external debt. Thus, foreign ownership by itself does not seem to alleviate major risks of financial and exchange rate crises considered in almost any early warning system model (Berg, Borenzstein and Pattilo, 2005).

The example of the Asian crisis showed, however, that it has become difficult to identify the severe macroeconomic imbalances suggested by the currency crisis literature. Thus, financial and currency crises in emerging markets have been increasingly interpreted as the familiar bank run problem facing any banking system engaged in maturity transformation (Diamond and Dybvig, 1983). In such an environment, foreign-based financial deepening, in particular with subsidiaries and branches of parent banks operating in mature economies, may have financial stability advantages that go beyond the already mentioned solvency aspects.

At the core of the Diamond-Dybvig model is a bank engaging in maturity transformation. The bank issues short-term deposits to finance long-term loans, as the profitability of long-term loans exceeds the return on short-term loans. The model predicts a bank run if depositors fear that other depositors may choose an early withdrawal of their deposits. In such a scenario, it is rational to join the herd, regardless of the profitability of long-term loans, given the short-term illiquidity of the bank. Thus, the model sees the trigger for a bank run in a self-fulfilling prophecy unrelated to economic fundamentals. However, the empirical evidence on banking panics in mature economies suggests that runs are often caused by reasonable doubts about the long-term solvency of a bank or the banking system, for example reflecting the impact of a macroeconomic shock (Calomiris and Gorton, 1991).[11]

The Diamond-Dybvig model has been designed for a closed economy. However, it can be transferred into an "international setting" defined by one (or both) of the following features (Chang and Velasco, 2000):

– Fixed exchange rates. Under a system of fixed exchange rates, any demand for liquidity in domestic currency can be transformed into demand for liquidity in the anchor currency. Thus, banks engaging in maturity transformation in domestic currency are de facto also engaging in maturity transformation in foreign currency.
– Asset substitution (unofficial dollarization or euroization). Banks engage in maturity transformation on the basis of foreign currencies, by granting foreign currency loans to domestic residents on the basis of either foreign currency deposits or foreign currency short-term debt issuance on international capital markets.

In principle, banks engaging in maturity transformation based on foreign currencies face the same risk of illiquidity as banks providing asset transformation services in domestic currency. Thus, the key difference between a closed economy and an international setting is not the fragility of the banking system as such. Instead, it is the absence of a lender of last resort with unlimited resources in the international setting, which raises the incentive for any depositor to withdraw funds when doubts about the banks' solvency arise, thus making the system as a whole more crisis-prone (Winkler, 2001).

Southeastern Europe has been featuring both types of "international setting," as several countries have been operating fixed or quasi-fixed exchange rate regimes. Moreover, banking sectors of basically all countries have engaged to a significant extent in maturity transformation on the basis of foreign currencies, not only, but most importantly, in euro, inter alia reflecting the strong presence of

[11] *For example, in the current financial crisis, holders of short-term commercial paper refused to fund "banks," i.e. special purpose vehicles, because they had a rational fear of loss, given the decline in U.S. house prices (Gorton, 2008).*

foreign banks in the region (Basso, Calvo-Gonzalez and Jurgilas, 2007). However, the risk of "international illiquidity", i.e. facing a sudden stop of capital flows, was apparently mitigated by two features:

– First, parent banks have been the main foreign currency "depositors" of their subsidiaries in the region, as they have been funding a large part of the foreign liabilities that banking systems in the region have accumulated over the last years to finance rapid credit growth.
– Second, parent banks have enjoyed an information advantage with regard to the solvency of their subsidiaries compared to external creditors.[12]

The first factor deals with the liquidity risk caused by a self-fulfilling prophecy, as this risk is linked to the existence of a sufficiently large number of investors that form expectations on the behavior of other investors. In the region, however, the subsidiaries were relying to a large extent on only one major investor, namely their respective parent banks. With the herd basically consisting of one (big) sheep, it was difficult to imagine herding behavior on a large scale. The second factor has to do with concerns on early withdrawals caused by fears of losses. The risk of early withdrawals seems to have been mitigated, as parent banks should have been aware of the credit risks subsidiaries have been underwriting over recent years.[13] With the parent bank as the main depositor not being exposed to an asymmetric information problem, the risk of a run by small retail depositors could be considered very small, as a massive withdrawal by many agents would have been required to trigger herding behavior, given the size of the well-informed depositor. Thus, liquidity risks seem to have been contained not only because parent banks may engage in support lending in times of crisis (De Haas and van Lelyveld, 2008), but also due to the overall large-scale equity and debt investment of the parent bank.

In precrisis Asia, by contrast, domestic banks had engaged in maturity transformation financed by short-term loans from many western banks on the basis of an arm's length relationship. Thus, "depositors" did not have excellent information about the long-term solvency of the borrowers – the Asian banks – nor were they particularly interested in acquiring such knowledge, given the short-term maturity of their engagement.[14] When facing the risk that other depositors would withdraw their funds, all of them had the incentive to withdraw, triggering the panic.

The relevance of financial structure arguments for macrofinancial stability in emerging markets became visible in August 2007, when the current financial crisis started. As is well known, until fall 2008 spillovers to emerging markets, including the countries in the Southeastern European region (Bracke et al., 2008), were contained. However, there were some exceptions. For example, contagion

[12] *See also the discussion in De Haas and van Lelyveld (2008).*

[13] *Parent banks should have been able to assess the financial performance of their subsidiaries in Southeastern Europe because the process of rapid financial deepening in the region was based on the "buy and hold" model of retail banking. Following Diamond (1984), banks engaged in financial intermediation by monitoring loans, building up relatively diversified loan portfolios and keeping loans on their books. Thus, the "originate and distribute" model, i.e. the decoupling of loan "production" from holding assets and their associated risks, was basically absent in the region.*

[14] *As shown in Diamond (1984), short-term deposits and loans under which the borrower incurs substantial nonpecuniary costs in case of failure serve as a substitute for loans that are heavily monitored by the lenders.*

effects were recorded in Kazakhstan (De Haas and van Lelyveld, 2008) and – to a lesser extent – in Russia. In both countries, domestic banks had engaged in significant maturity transformation in foreign currency based on traditional short-term capital market borrowing. When risk aversion rose, international investors started to withdraw their funds, requiring massive interventions by the monetary authorities. These interventions were possible because both oil-rich countries had been accumulating substantial foreign exchange reserves in the past. Thus, authorities could make extensive use of reserves to avoid "international illiquidity" of their banking systems and to calm the markets (IMF, 2008a).

Summing up, foreign euro area banks have been the major driver of financial deepening in Southeastern Europe, as parent banks have been providing a substantial share of the funds for the ongoing credit expansion over recent years. Strong capital flows and credit growth engineered a growth process based on domestic demand, investment and consumption that increasingly showed signs of overheating, as evidenced by rising inflation and large current account deficits. At the same time, however, the risk of a sudden stop of capital flows seemed to be low, as it was assumed that foreign banks had done reasonably well in analyzing and managing credit risk. Moreover, risks of international illiquidity were contained due to the interlinked ownership structures. Against this background, the region seemed to be heading for a soft landing, as the impact of the turbulence in the financial markets of mature economies was noticeable, but limited. Indeed, there was some reason to believe that the increase in risk aversion following the events of August 2007 would lead to a decline in credit growth, mitigate overheating pressures and push growth and current account deficits to more sustainable levels.

5 Contagion from Mature Economies: The Return of International Liquidity Risk

The collapse of Lehman Brothers and its impact on mature economies' money markets and financial institutions radically changed the environment for financial deepening in the region, as it caused a severe U.S. dollar and euro liquidity shock to hit the global financial system. The shock was so large that huge rescue packages of the U.S. and EU governments (comprising enhanced deposit insurance, interbank lending guarantees and recapitalization measures) as well as strong money market interventions and monetary policy reactions by the Federal Reserve and the ECB were needed to contain doubts about further bank failures and to prevent bank run-like phenomena in mature economies.

Under these circumstances, the risk of a sudden stop returned to the region in a new disguise, as parent banks scrambled for liquidity.[15] Several indicators provide evidence of the sudden stop of capital flows, like the substantial rise in interest rates and risk spreads (chart 4), the strong decline in stock prices, depreciation pressures on currencies as well as sales of foreign exchange reserves by central banks (Coricelli and Revoltella, 2008). While these phenomena have been characterizing the emerging market universe as a whole (Canuto, 2008), in Southeastern Europe they turn the question whether parent banks will support

[15] *The risk has been emphasized in the IMF's Global Financial Stability Report of April 2008.*

Chart 4

Sovereign Bond Spreads of Selected Southeastern European Countries and JP Morgan Emerging Market Bond Index Global Sovereign Spread

Source: Bloomberg.

their subsidiaries in case of a financial crisis in the host country (De Haas and van Lelyveld, 2008) on its head: Will parent banks be able to support their subsidiaries, given the significant deterioration of financial conditions in the home country (Aydin, 2008)?

It is almost self-evident that in this situation the beneficial effects of interlinked ownership structures between banks in mature and emerging markets are put to the test. This is because uncertainties may emerge among the other investors of parent banks' subsidiaries, including retail depositors, on whether the "main depositor," i.e. the parent bank, will indeed choose not to withdraw. While this uncertainty may reflect concerns about the quality of the subsidiaries' lending activities in the host country or concerns about the sustainability of current account deficits, "rational fears" about the liquidity situation of the parent bank in its home market may become a large enough incentive for small-scale depositors to withdraw funds. Thus, they might trigger a run on the subsidiary, thereby further aggravating the liquidity shortage for the multinational bank as a whole. In a financially integrated world, international liquidity risks can hardly be avoided when the global financial system is facing a liquidity crisis.

However, even in such a global crisis, there is – from a macrofinancial stability point of view – one final advantage of having financial development based on subsidiaries of parent banks headquartered in a mature economy, here the euro area: the access to the lender of last resort in the very foreign currency in which deposits and short-term debt of the banking sector are denominated. In this respect, the actions taken by the ECB and by the EU governments to stabilize the euro area financial system have been good news for macrofinancial stability in Southeastern Europe, as they should reduce uncertainties about the stability of the parent banks' subsidiaries and the above-mentioned risks. By contrast, liquidity challenges are likely to be most severe for banks in Southeastern Europe, but also in other emerging markets, that have engaged in substantial maturity transformation in foreign currency but cannot rely on such a support.[16]

6 Summary and Conclusions

The financial crisis reached Southeastern Europe in a way predicted by many observers: by provoking a sudden stop of capital flows into the region. However, the mechanism triggering the crisis was somewhat different from the one expected, given the process of rapid financial deepening and the associated macrofinancial vulnerabilities. Neither has there been a financial crisis in the region caused by a rise in nonperforming loans that would have revealed reckless lending by banks, nor has there been a currency crisis in the form of a speculative attack challenging exchange rate regimes in countries with extraordinary high deficits. Instead, the crisis reached the region when the financial turmoil that started in mature economies in the summer of 2007 turned global after the collapse of Lehman Brothers. In this respect, the saying that every financial crisis is different has again been validated.

With the crisis having become global, it is also difficult to assess whether the unique financial structure characterizing the region, namely the dominance of foreign euro area-based banks in domestic banking sectors, would have really made a difference in containing the macrofinancial vulnerabilities and risks associated with the rapid process of financial deepening over recent years. The current crisis reveals, however, that a strategy of financial development based on foreign entry from the anchor currency area is no guarantee for a smooth process of finance and growth. Moreover, given that growth in the region had been fostered by capital inflows, rapid credit growth and domestic demand, the fallout from the crisis may be more severe than in other emerging countries that had been pursuing an export-led growth strategy. The reason is that rising interest rates and slower growth might lead to a significant deterioration in loan portfolio quality in the region, compounding the credit crunch triggered by the turbulences in mature economies.

Against this background, some form of fiscal expansion would be helpful to counteract the expected decline in demand, like in mature economies. However, many countries in the region have missed the opportunity of the "boom years" to build up a fiscal reserve that can be used in times of need. Thus, it may turn out that an insufficient degree of fiscal tightening was the most severe policy failure that occurred in the period of rapid financial deepening.

[16] *Since September 2008, the ECB has concluded agreements with several non-euro area EU central banks to support the provision of euro liquidity, thereby mitigating tensions arising from such liquidity challenges.*

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