

# 63<sup>rd</sup> East Jour Fixe

## Financial Deepening and Macrofinancial Stability in Southeastern Europe

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On October 13, 2008, the Oesterreichische Nationalbank (OeNB), the central bank of Greece (Bank of Greece – BoG) and the largest Greek commercial bank (National Bank of Greece – NBG) jointly hosted the OeNB’s 63<sup>rd</sup> East Jour Fixe on the topic of “Financial Deepening and Macrofinancial Stability in Southeastern Europe.” In her opening remarks, *Doris Ritzberger-Grünwald*, Head of the OeNB’s Foreign Research Division, pointed out the OeNB’s strategic interest in strengthening the dialogue with Greek banks and the BoG, given that Greek banks have been vigorously expanding their activities toward Southeastern Europe (SEE) in recent years. Therefore, the OeNB’s Foreign Research Division had actively sought to coorganize this East Jour Fixe with Greek partners. While the program for the 63<sup>rd</sup> East Jour Fixe had been designed in the summer of 2008, the aggravation of the financial crisis in September 2008 had a strong impact on the whole event.

In his keynote lecture, *Adalbert Winkler*, Professor at the Frankfurt School of Finance & Management, stressed that the foreign (euro area) bank-based financial deepening in SEE – as opposed to capital market-based financial deepening in e.g. the CIS (for instance in Russia and Kazakhstan) – substantially lowered the risk of “sudden reversal”, as parent banks can be expected to support their subsidiaries as long as they have faith in their long-term solvency and profitability and as long as they have the financial means to do so. He concluded that a repetition of the Asian (liquidity) crisis in SEE was unlikely and that the baseline scenario was rather that credit expansion would continue at a lower speed or even stop and the growth slowdown would have a negative impact on credit quality. However, there would be a risk of negative multiplier and financial accelerator effects (also via the slowdown in the euro area), in case of which fiscal policy would be the key instrument to avoid the “Portugal” scenario of protracted growth slowdown due to adjustment needs.<sup>1</sup>

### Risks to Macrofinancial Stability on the Catching-Up Route

The first session addressed risks to macrofinancial stability on the catching-up route and was chaired by *Emmanuel Zervoudakis*, Director-Adviser to the Governor (BoG). The first speaker, *Ion Drăgulin*, Director of the Financial Stability Department of Banca Națională a României (BNR), focused his presentation on the risks to macrofinancial stability in Romania. After describing the current economic developments, which are characterized by strong economic growth, rising inflationary pressures, widening external imbalances and increasing external financing needs, Drăgulin highlighted the importance of the ongoing rapid financial deepening in Romania’s catching-up process. He emphasized that – despite rapid credit growth (both in absolute and relative terms) and somewhat deteriorating solvency – liquidity and profitability indicators as well as credit quality were still

<sup>1</sup> *Winkler’s study “Southeastern Europe: Financial Deepening, Foreign Banks and Sudden Stops in Capital Flows,” which is published in this issue on p. 84, is based on this presentation.*

adequate. In light of the corporate sector's weakening financial position, deteriorating soundness indicators of the real estate sector (which heavily relies on external financing) and the rapidly rising debt levels of the household sector (coupled with high exposure to foreign exchange risk), Drăgulin identified the rising liquidity and credit risks as the main challenges ahead for the Romanian banking sector.

The second speaker, *Giorgio Pradelli*, Head of International Activities at Eurobank EFG, presented the opportunities, risks and challenges that foreign banks face in SEE. On the one hand, the opportunities for EU banks, which dominate SEE banking markets, are seen in the region's strong economic growth, the EU accession/convergence process and the still low penetration rates in banking. On the other hand, the main macrofinancial risks are associated with strong inflationary pressures, high external imbalances and, in some instances (e.g. Romania and Turkey), also with a high exchange rate volatility. In the context of the ongoing financial turmoil, risks emanating from an increase in risk premiums and funding costs need to be closely monitored as well. Against this background, Pradelli put enhanced risk management in banks on the top agenda and called for promoting the quality of human resources, modern and uniform IT platforms and the adoption of an appropriate organization model by finding the right balance between centralization and decentralization forces.

Finally, *Nikolaos Stavrianou*, bank examiner in the BoG's Banking Supervision Department, commented on Greek banks' activities in SEE from the home country supervisor's perspective. In this context, Stavrianou stressed the prominent role of Greek banks in SEE, where by now they account for some 10% of total banking sector assets. At the same time, some 15% of Greek banks' total assets and 20% of their profits before tax stem from their activities in SEE. Against this background, the BoG has been closely monitoring the expansion of Greek banks into the SEE region, inter alia by authorizing greenfield investments, acquisitions and capital increases, conducting on- and off-site supervision and imposing special requirements on banks' risk management processes and internal control systems. Stavrianou stressed that a proper risk assessment and macroprudential analysis requires taking into account all the relevant information on the respective region/country, group and subsidiary levels. The main macrofinancial risks in SEE are associated with the high and rising current account deficits, the strong dependence on external funding, rapid credit growth and the high degree of foreign exchange risk. Finally, Stavrianou pointed out that the impact of the current financial turmoil on Greek banks had so far been limited, with BoG stress tests also suggesting a high resilience of Greek banks to potential credit shocks in SEE.

### **Opportunities and Major Risks for Banking: Views from Austrian Banks Operating in SEE**

The second session focused on opportunities and major risks for banking and presented views from Austrian banks operating in SEE; it was chaired by *Thomas Reiningger*, Senior Expert in the OeNB's Foreign Research Division. *Debora Revoltella*, Head of CEE Strategic Analysis at UniCredit Group Bank Austria, stressed that convergence will continue, but at a more moderate pace and accompanied by a repricing of risks, as SEE economies' dependence on capital inflows ("import" of external savings) will be the main challenge. Also, the banking model

pursued in this region implies the need for external funding. In SEE, about 85% of the banking sectors assets are foreign owned, with UniCredit Group, Intesa, Erste Group Bank, Raiffeisen International, Volksbank, Bayern LB, Eurobank EFG, National Bank of Greece, Piraeus Bank, Alpha Bank and Société Générale as the main players. In recent years, banks' double-digit profit growth in this region outpaced that in Central Europe, but was accompanied by higher risks, which are further increasing now. In the new context, financial penetration will continue, but moderate to ratios of new business to GDP of between 5% and 10% both on the loan and deposit sides (from previously 10% to 15%).

*Rainer Münz*, Head of Research & Development at Erste Group Bank, demonstrated that compared to both duration and depth of various previous crises, the current crisis is the worst to ever hit financial industry earnings. "Yes, there is a crisis," he said, "but there are still plenty of CEE opportunities, as the convergence story is not over yet." Münz stressed that the lower the penetration rate of a banking market, the weaker the link to GDP growth, which means that GDP growth is not a key driver in the early stage of retail banking market development. Usually, retail customers have an average monthly income that is above the local average. Moreover, as long as trust in long-term convergence remains intact, the short-term volatility of interest rates and currencies has a limited impact on loan demand. While the risks are obvious (negative effects on the real economy, massive deleveraging, reduced foreign exchange liquidity constraining foreign exchange lending, higher costs of capital), there are opportunities in particular for banks whose business is based on an extensive retail customer base rather than on leverage and which have a favorable loan-to-deposit ratio, as the deposit side still holds market potential and the share of persons without a bank account is particularly high in SEE.

*Martin Grüll*, CFO at Raiffeisen International, confirmed the significance of a broad customer base, as this constitutes a clear funding advantage compared to banks that need wholesale funding. Corporate as well as retail deposits gained importance in times of dry markets, according to Grüll. Moreover, direct client access enhanced the quality of risk assessment. In general, risk management will be the key success factor in his view. In this context, Grüll underlined the important role of concentration limits for unsecured exposure by "group of connected clients" and portfolio granularity (i.e. average exposure per borrower) as well as of a prudent approach to collateral (conservative valuation, internal haircuts depending on the type of collateral).

### Special Focus on Turkey

The last session focused particularly on Turkey and started with a brief contribution by session chair *Michael Loufir* (NBG), who pointed to similarities rather than the often illustrated differences between Turkey and five SEE countries (Albania, Bulgaria, FYR Macedonia, Serbia and Romania). In particular, in all six countries strong growth over the past years was driven by investment and growth in export market shares. As a consequence, the surge in inflation will prove to be temporary. Another feature common to all countries of the region is the concurrent increase in imports along with successful exports and the resulting widening of current account deficits. This situation in itself does not pose a problem, but deficit financing proves difficult. The short introduction was followed

by a very informative presentation of the history and reforms in the Turkish banking sector and of financial deepening in Turkey since the early liberalization efforts in 1980.

*Kenan Alpdündar* (Türkiye Cumhuriyet Merkez Bankası) agreed to the recently observable similarities in economic developments, but also stressed that there are major differences: Turkey has always been a market economy and as such does not have a transition country's history; but it has a long-standing history of economic crises. The 2000/01 currency and banking crisis marks a turning point for the financial system in Turkey. Major precrisis reforms include the gradual liberalization of the capital account from the early 1980s onward. This led to financial deepening without producing the expected growth effects – a development that was mainly due to the still weakly developed banking sector, a high public deficit, high inflation as well as inadequate risk management and internal control activities. The restructuring of the banking sector since the latest major crisis (with major legal reforms such as the establishment of the Banking Regulation and Supervision Agency and a new Central Bank Law) resulted in further financial deepening, more activities directed to the private sector and substantially higher foreign participation. Despite these impressive achievements, there is still ample room for further improvement in Turkey's financial infrastructure and with respect to raising the financial literacy of the general population. According to Alpdünar, financial stability and price stability also remain an issue.

In her presentation of growth developments, *Gülsüm Yazganarikan* (Undersecretariat of Treasury) expressed the view that inflation is likely to become less of a concern in the future. In her very rich discussion of all aspects of economic development in Turkey, which she starting by illustrating the most recent trends of increased volatility in financial markets, she also particularly stressed Turkey's impressive export performance and a potentially less severe current account deficit (adjusted for the oil price impact). Along these lines, a further decline in the Turkish current account deficit is to be expected, given the current downward trend in energy prices.

*Banu Kivci Tokali* (Finans Invest) concluded the round of presentations with a mixed scenario of the macroeconomic forecast. Low growth expectations arise from weak domestic demand coupled with drastically worsening external conditions. In line with all previous speakers, she also stressed the importance of continued tight monetary policies as pursued by Türkiye Cumhuriyet Merkez Bankası.