

Results of the OeNB Workshop

“Macrofinancial Stability in CESEE: Have We Learned All the Lessons?”

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On June 21, 2010, the Oesterreichische Nationalbank (OeNB) hosted a workshop entitled “Macrofinancial Stability in CESEE: Have We Learned All the Lessons?” More than 50 invited participants took part in the event, including representatives of commercial banks operating in Central, Eastern and Southeastern Europe (CESEE), home and host country supervisory authorities, EU institutions and international financial institutions. The workshop focused on three issues related to macrofinancial stability in CESEE: (1) recent developments in cross-border lending and cross-border capital and liquidity allocation, (2) implications of the credit cycle for banks’ business models and credit risk management as well as (3) foreign currency lending in CESEE. Each session featured valuable presentations, followed by questions and answers as well as open and frank discussions, in which participants also put forward policy suggestions.

In his introductory statement, OeNB Governor Ewald Nowotny pointed out the lessons to be learned from the boom and the crisis in CESEE and addressed current risks and challenges for the banking sectors in the region. In the longer term, the main risks are the re-emergence of overheating and bubbles during the catching-up process and the failure to learn from the crisis and the previous boom (moral hazard). The main challenge consists in striking a balance between coping with the current temporary contraction of private sector credit demand and a potentially sluggish recovery on the one hand and addressing the long-term structural deficiencies (i.e. enhancing prudent lending policies, developing domestic currency markets and decreasing the reliance on foreign funding) on the other hand.

The workshop reached the following conclusions on macrofinancial stability in CESEE and the lessons to be learned from the market developments in recent years:

- The rise in *direct cross-border lending* in CESEE before the outbreak of the crisis received a rather critical assessment by several participants. These loans were largely denominated in foreign currency and, on average, more difficult to monitor, supervise and regulate than loans by local subsidiaries. Bank representatives argued that the cross-border channel was primarily chosen for large loans and due to the lower costs of funding.
- Refinancing considerations are now playing a bigger role in banks’ *capital and liquidity allocation* than in previous years. Bank representatives pointed out the following funding trends in the CESEE banking business: (1) a renewed focus on local deposit gathering activities (partly in already highly competitive deposit markets), (2) a trend toward centralizing wholesale funding activities on the parent level, (3) a stronger reliance on secured bond issuance activities and (4) the longer-term refinancing of foreign currency positions via currency swaps and other instruments.
- The years preceding the crisis were characterized by a *boom in foreign currency lending* in most, though not all, CESEE countries. This development could have been partly fuelled by foreign bank ownership, the banks’ funding structure and several macroeconomic parameters (high domestic interest rates, volatile inflation, etc.). In addition, recent empirical work on the subject has identified

two “contagion” effects that have affected foreign currency lending by banks in the region: contagion within multinational banks (i.e. foreign currency lending levels of subsidiaries were converging toward the group average) and contagion within countries (i.e. foreign currency lending levels at banks were converging toward the country average).

- A *panel discussion* explored the question whether foreign currency lending poses a threat to stability in CESEE and suitable policy options. The panelists expressed quite different views on the issue. While it remained highly debated whether foreign currency lending was beneficial or undesirable, the participants agreed that foreign currency lending to unhedged borrowers (especially households) should be discouraged given the existence of reasonable alternatives. Thus, policymakers should pursue a differentiated approach to foreign currency lending, promoting the establishment of proper local currency markets and improving cross-border cooperation, not only to curb foreign currency lending but to avoid excessive lending in general.
- The economic recovery in the CESEE region is likely to be gradual, uneven and coupled with continued high volatility in financial markets, while banks are set to proceed with balance sheet restructuring and the gradual resumption of lending. However, the consensus view at the workshop was that the *long-term growth potential in CESEE remains intact* and that the EU convergence anchor continues to be of paramount importance for the region. In this context, a higher disbursement rate of EU funds for infrastructure projects was suggested as a concrete policy objective to support economic growth, in particular in the SEE region.