Panayotis Thomopoulos: The financial environment in Southeast Europe

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at the Second International Banking Forum for the Southeast European Markets Economist Conference, Athens, 4 December 2003.

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It is a great pleasure to address this Banking Forum at this juncture as I believe that the economies are turning the corner and can now start enjoying the benefits of stability and growth within the framework of closer ties with the European Union. After a difficult and hesitant start in the 1990s, there is now clear evidence that the transition economies of Southeastern Europe have improved their macroeconomic management and enhanced their financial systems so that they can look forward to sustained and high-quality growth.

Greece, as the only member of the European Union in the region, has a clear interest in promoting the stability and growth of all our neighbors, and I can be proud that both the public and the private sectors of Greece have played a role in the emerging success story of Southeastern Europe. We see our neighbors' economies mainly as complementary to our own, not as competitors, and the many Greek businesses that are active in the region, especially in the financial sector, are proof of the increasing collaboration between my country and its neighbors. I believe that Greece will continue to make a positive contribution to the economies of the region, but, I must admit, that I draw comfort from the fact that Greece is now surrounded by open, dynamic economies, and I would add friendly countries. It would be an understatement to say that we have turned a page of our history. In effect, the collapse of communism ended not the thirty, or hundred years wars, but more than one thousand years of intrabalkan conflicts and Greece is fully supporting Balkan countries' E.U. membership, which would further strengthen the political and economic ties between all Balkan countries.

Let me start with a short look at the international environment that the countries in Southeastern Europe are facing. The overall economic situation has improved significantly during the last few months. After months when expectations of a recovery were based mostly on so-called "soft data," like surveys of consumer and business confidence, we are now seeing real "hard data" that point to the resumption of growth in all the main regions of the world economy. All members of the EU have now emerged from recession, although the growth rate is not what we would have wished it to be. Growth in the eurozone should accelerate slowly, and within the next year the growth rate should gradually approach its potential, estimated at around 2 ? % per annum. The US, on the other hand, is growing fast, maybe too fast. Certainly, I do not wish to belittle the achievements of the American economy, especially its high productivity growth, but the continuation of the twin deficits are certainly a cause for concern, in that a sudden correction could have far-reaching implications for the international financial system. The US sees with benign neglect its twin deficits. On the one hand, it expects that continuing fast rate of growth would generate sufficient tax revenues over the medium term, which, in combination with the gradual phasing out of some tax relief measures, will reduce the deficit and, on the other hand, they expect the current balanced of payments correction to be realized via a devaluation of the US dollar, which would help the sustainability of the US recovery and generate higher profits in dollar terms from the US investments abroad. In summary, they don't expect an abrupt and substantial rise in interest rates, which would have had adverse effects both on the fiscal deficit and on consumer demand, thus precipitating a cyclical downturn. However, the European point of view, if I am allowed to summarize, is that an unsustainably fast growth rate, based on private and public borrowing is not good for anyone and the US cannot be an exception.

The EU, and especially the eurozone, has played a constructive role in promoting a stable financial environment. The recent appreciation of the euro is an indication of the markets' confidence in our economies. I believe that a strong euro is good for Europe and the world, as it helps fight inflationary pressures and supports the confidence of consumers and producers. It is also clear that the eurozone cannot solve all the imbalances that threaten the stability of the international economy. I do not wish to enter the debate on whether the fiscal stimulus in the US was necessary two years ago, at the onset of the economic slowdown, but certainly it has to be reversed now as the US is growing at an unsustainable rate. At the same time, third countries, especially those in Asia, should contribute themselves by allowing market forces to play a greater role in the determination of their exchange rate, and by abandoning their mercantilistic attitudes. However I should mention that, there is an open debate whether a revaluation of the chinese renminbi is at present appropriate, given, on the one hand, the fact that it will make relatively small difference, as far as it concerns China's trade surplus, if the chinese wage expressed in US dollars from about 10% of the US or EU average wage rises to 15% or 20% as a result of the revaluation, and on the other hand, a revaluation could lead to a deterioration of the already Chinese banks' fragile conditions and would also make more expensive the acquisitions of Chinese factories, commercial sites, etc by foreign investors.

One positive development that I cannot stress enough is the absence of any challenges to the financial stability in Europe and the US. Unlike the situation in the early 1990s, we have recently gone through a period of a prolonged and synchronized slowdown, made worse by geopolitical risks, with no major financial institution being impaired. There have been of course problems, especially in the European insurance sector, exacerbated by natural catastrophes, but all financial institutions have managed through. Undoubtedly, those who make mistakes, or are simply unfortunate, suffer in a market economy. Nonetheless, such problems, whenever they surfaced, were contained and did not have systemic repercussions that could threaten the macroeconomic stability of our economies. Indeed, in our E.U. economies we have long recognized the key role of the banking sector and its health has been a constant preoccupation of the authorities, especially of Central banks which, even those not directly involved in supervision, have a wider responsibility for the good functioning of the financial system as a whole and the payment systems. We have been building sound banks, which not only can withstand successfully cyclical pressures and other kinds of shocks, but also they bring crucial support to the economy when failures appear in other, less important, parts of the financial system. The bursting of the stock exchange bubbles and the subsequent substantial decline in their capitalization, in certain countries amounting to as much as 30 to 50% of GDP, produced relatively little damage and which was, moreover, contained thanks to the banking sector. Likewise, as a result also of what I would say, the least, "not very prudent policies" the significant losses of insurance and re-insurance companies in the last few years have been partly absorbed by the banking sector, which responded promptly to their needs for liquidity and capital injections. The banking sector in some countries has unwillingly assumed the responsibility for the well being of the financial sector as a whole, because it understands the danger of systemic risks, that can wreak havoc.

I cannot pretend that there were not tensions here and there, or losses due to the write-offs of non-performing loans, to plummeting share values and to laying off costs, but only a few banks posted operating losses and, moreover, those, as a rule, were relatively small. Even today, after three years of a downturn, the capital adequacy ratio, has remained well above the minimum 8% in almost all cases, and for the E.U. as a whole the average is above 10%, which underlines the good health of the banking system. Moreover, it is expected that it will continue to improve as the recovery gets underway.

Here, I wish to repeat the very positive role of Central banks, which, almost all were over more than 50 years, and many of them still are the supervisory authorities. Indeed, central banks succeeded in creating a competitive and sound banking system in Europe during the last fifteen years or so, during a period characterized by liberalization in financial markets and intense competition both within Europe and from the US banks. The lesson I draw is that with the help of their natural interlocutor, the central banks, the private sector has become more adept in dealing with risks and the supervisors have learned from the mistakes of the past and improved their vigilance. Looking ahead, the new prudential practices to be introduced under Basel II will further improve our ability to deal with financial risks and better tailor our prudential requirements to each market's special needs.

Another positive development is the diminishing danger of contagion, as we have seen after Argentina's default, which did not lead to widespread withdrawal of funds from emerging markets. This is particularly significant for the emerging market economies in Southeastern Europe, which look to a greater integration in the world economy without the fear of being hit by a crisis that originates elsewhere. All this of course, provided they maintain healthy fundamentals.

Turning now to the developments in the Southeastern Balkans themselves, the present situation is a far cry from the bleak picture at the early stages of transition, more than a decade ago. Apart from often-bloody conflicts, hyperinflation and financial stability seemed endemic in the region only a few years ago. Regarding the financial sector, starting from an initial position with practically no commercial banks, the countries in the region faced problems that were often beyond their administrative and regulatory capabilities. Financial institutions were reformed with insufficient regulation and unclear focus and expansion was associated with improprieties, scandals and fraudulent schemes during the early stages of transition. Therefore, the financial sector was unable to attract deposits and develop extensive client networks. Finally, state banks were compelled to carry a high number of non-performing loans, which had been accumulated by the government subsidization programs to state run enterprises.

The development of the financial sector was hampered at the beginning by inadequate macroeconomic management. Fiscal deficits were mostly excessive, and often monetized, and the inevitable outcome was high inflation. It is encouraging that in the last few years we can see clear evidence of maturity in economic management.

The path to macroeconomic stabilization was different for every country. In the region we can now observe all types of monetary and exchange rate regimes, from formal euro-ization and currency boards linked to the euro, all the way to monetary targeting. This is proof, if proof was needed, that there is no single solution, to economic problems but that the policies of each country should be tailored to its specific needs. Going beyond the diversity of the region, at this point I would like to underline two characteristics of the financial system of practically all countries in the region, which are the result of their past, but will also shape their future developments.

The first is extensive currency substitution. As a result of past inflation, but also because of the large numbers of people working abroad, foreign currencies, and especially the euro, play a large role and they have often become the main currency in use. One can gauge the degree of currency substitution by noting that in all countries in the region deposits in a foreign currency account for at least half of all bank deposits. One must add to this, money "kept under the mattress" and capital flight. Undoubtedly all these were a vote of no confidence in domestic policymakers. People showed their dissatisfaction with local financial institutions and monetary authorities by moving their savings abroad, or by using other, more stable currencies. This high degree of currency substitution can only be found in some Latin American countries and undermined the effectiveness of monetary policy. The ability of monetary authorities to extract seignorage was severely limited, and this is a partial justification of the high inflation rates. At the same time, monetary management became more difficult, as small shocks had a disproportionately big impact on inflation and the exchange rate.

In some countries, namely Bulgaria, the extent of hyperinflation and currency substitution left little alternative to the authorities but to accept the reality and move to a hard peg in the form of a currency board linked initially to the Deutschemark and now to the euro. Similar regimes were also imposed on Bosnia, after the Dayton Accord, and Kosovo. The euro is an appropriate anchor for an exchange-rate-based policy in these countries, as they are closely integrated with the countries of the eurozone. Most of their transactions, not only trade-related, but also workers' remittances, official transfers and financial transactions are with countries of the eurozone.

A measure of macroeconomic success is the receding level of currency substitution. In 2002, the last year for which we have full data, bank deposits in foreign currencies fell as a proportion of total deposits in all countries in the region, sometimes quite fast in countries with strong performance in the context of monetary or inflation targeting, with only one exception. This is indicative of a growing trust in the domestic currency and the effectiveness of stabilization. It is all the more important that this achievement should not be squandered, and that prudent macroeconomic policies should continue.

Nonetheless, I would like to warn of possible problems, especially in those countries that have tied their exchange rate to the euro, one way or another. The weakness of the euro until last year undoubtedly helped both their growth performance and their external competitiveness. From now, in a period of strong euro they will have to rely more on domestic productivity gains and structural adjustments to maintain their growth rates. In addition, and as growth takes hold in advanced economies, countries in the region will have to adjust to interest rates higher than their current historically low levels.

An area where much remains to be done is the area of developing an efficient and stable financial system. In this respect, the economies in the region lag behind the other transition economies that are due to join the EU next year. The public sector still controls a substantial part of the banking system, and there is an obvious need to continue the efforts to privatize the remaining state-controlled banks. As in most transition economies, state interference has not been a stabilizing factor, quite the opposite. State controlled banks have often lost substantial sums in politically-motivated investments and have contributed to systemic crises in all those countries.

As in other transition economies, we can foresee that an increasing number of banks will been taken over or become affiliated with foreign ones. Setting aside nationalistic prejudices, I think this should be seen as a welcome development as a whole, provided the foreign entrants are strong and well-supervised financial institutions. In the acceding countries of Central Europe foreign banks already play a major role after the crises that hit those countries in the late 1990s, and the overall experience has been positive. (Foreign banks control more than 80% of the domestic market in a few central european acceding countries).

Foreign banks bring with them many advantages, especially in the case of countries with a limited experience with sophisticated financial markets. At first, they have access to better know-how and technology. More importantly, they are mostly immune from political interference. While local participants are often intimidated or pressured to give loans to well-connected borrowers, foreign institutions generally feel stronger to resist such pressures. Also, foreign banks are considered "safer" by local depositors, who recognize that they are not manipulated by the political authorities, and who also understand that foreign banks are supervised by the more experienced supervisors at home. Finally, experience with other emerging markets shows that foreign banks are better able to withstand losses in cases something goes wrong. The international evidence shows that banks affiliated with ones from advanced economies have access to capital at lower cost than local ones and can be re-capitalized faster and more easily than the others.

Of course, foreign banks may have its disadvantages. Foreign-owned financial institutions may lack understanding of how the local market works. Indeed, it has been noted that such banks often tend to concentrate on financing affiliates of foreign firms, or only large local firms. There is thus a danger that local small and medium enterprises may find their access to credit curtailed. There is also the possibility that foreign-owned banks will alter their credit based not on the local conditions, but on the conditions in their home economies.

Indeed, in Greece we have observed that foreign banks have entered the market and subsequently they expanded or left in a haphazard way, not on the basis of local conditions or profitability, but mostly on the basis of wider strategies whether to expand globally or not. Formally, we can say that this increases the correlation of emerging markets with the outside world. Research shows that the operations of financial multinationals are becoming a major channel for the transmission of business cycles. For that reason, economies in the Southeastern Europe will find that their economies are more and more affected by what is happening in the rest of Europe than with what is happening locally. Although at times of local euphoria you may regret being held back by the European business cycle, over time the benefits of becoming tied to the more stable economy of the eurozone will become overwhelming. This is especially so for countries that are applying for EU membership. Greater synchronization with the European cycle will smooth their path towards full membership. Foreign ownership of banks will also allow a greater risk diversification than what might be achievable by small local banks whose whole portfolio is locally invested. Foreign banks can thus behave in a less risk-averse way than local ones.

The issue of financial stability and proper supervision is very important for us, at the Bank of Greece, as Greek firms have invested heavily in our neighboring countries. In most of them Greece is among the five biggest suppliers of foreign direct investment. Of course, this has to some extent caused delocation of greek companies, with a negative impact on investment and employment in Greece over the short to medium-term, but for an economy growing at almost 4% p.a. since 1997 and with an investment GDP ratio of 24% delocation does not pose a serious threat to its long term performance. Looking at the data in preparation for this speech, I was amazed by the number of branches of Greek banks in our neighboring countries. This shows that Greek banks have entered planning to offer a wide range of services and they see their future closely linked to the evolution of the host economies. They are not entering in order to concentrate in just a few lucrative activities and offer services to other Greek firms.

The positive effects of the presence of foreign banks predicted by theory are supported by the experience of Greek banks in the countries of Southeastern Europe. Greek banks are already well-established in Bulgaria, Romania, Serbia-Montenegro, Albania and FYROM, representing at least 20 percent of the banking system according to assets and in some of them their share is between one-third and two thirds. Overall, they are better capitalized than their competitors, something that could be expected as they have access to a more diversified source of funds. Their better capitalization allows them to take somewhat higher risks, as shown by the fact their loans to the private sector are generally a higher share of their assets than for the average bank. Although they take somewhat more risk, they are profitable overall, more than their average competitors. This signifies that Greek banks in the region have some comparative advantage, either in the form of access to capital markets, or because of superior organization and know-how, and good understanding of local conditions.

While Greek banks play a major role in the neighboring economies, their exposure to these economies is generally small. For no Greek banks does the exposure to Southeastern Europe exceed 3 percent. This is simply a reflection of the different levels of development in Greece and nearby countries. The result is that while Greek banks face little risks from their exposure to these economies, they themselves are important for the stability of the financial system in the Balkans. In the Bank of Greece we are well aware of this, and we take our responsibilities to our neighbors very seriously indeed. As home country supervisors we recognize that our ability to exert prudential supervision has effects beyond Greek borders.

In recent years we have signed several agreements, in the form of memoranda of understanding, and we are discussing some further ones with other supervisors in the region in order to enhance our ability to ensure the stability of the banks under our jurisdiction. What is needed, beyond formal agreements, is the confidential and frank exchange of all information among supervisors in order to identify problems early on, before they become threatening. In this era, we should also be vigilant to avoid abuses of the financial system for illegal activities, such as money laundering and terrorism financing.

Of course, we take comfort from the fact that the Greek banks that have expanded in the Balkans are quite strong, well above the necessary prudential ratios. Actually, the fact that Greek banks have been able to retain a very high share of their local market is also an indication that they have some comparative advantages that allow them to thrive in an internationally competitive environment.

I must admit that our interest in the stability and growth of our neighbors is to some extent a reflection of selfish instincts. We realize that strong and growing economies in this region are not only useful for the Greek economy, but also a prerequisite for the political stability of the Balkans. I mentioned before that the presence of foreign financial firms in the Southeastern Europe would transform their business cycles. But it works the other way round. Greece's orientation toward the dynamic economies in our region has helped us somewhat weather better than most the recent economic slowdown. In a very specific way, one can see the growing interlinkages in the Balkans as evidence of how trade in goods and financial services can help growth and stability.

Looking ahead, the challenges for our neighbors remain formidable. Now that the first steps towards stabilization and growth have been taken, what lies ahead is the more difficult issues of managing an emerging economy. Top of their priorities I would like to put the improvement of their governance structures, the further deregulation and privatization and the strengthening of the respect for property rights. I should end by saying that they can count on our continued support.