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FINANCIAL FDI TO THE EU ACCESSION COUNTRIES (*)

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Executive Summary

This study deals with financial foreign direct investment (financial FDI) to the EU accession countries (ACs)[1]. Our examination first places financial FDI in the broader context of capital flows to these countries and then focuses on its main component, namely foreign-led mergers and acquisitions (M&A) in the financial – especially banking – sector. We look both at the ACs taken as a whole and at individual countries. In the latter case, however, we do not consider Cyprus and Malta owing to their comparatively smaller size and different economic characteristics (market, rather than transition economies, and for Cyprus a sizeable offshore financial centre), as well as problems of data availability. Due to the greater weight of financial FDI flows in Central and Eastern European countries (CEECs), the focus of this report is on the experience of Poland, the Czech Republic and Hungary, but we also devote some attention to the other five countries bound to become EU members in May 2004 (Slovak Republic, Slovenia, Latvia, Lithuania and Estonia). Specific references to Bulgaria and Romania are more limited.

Two parallel processes affecting the countries under study, namely accession to the European Union (EU) and transition to market-oriented economies, have led to a substantial increase in net capital flows to the ACs, especially from 1998 onwards. In contrast to a declining trend in other emerging market regions in the aftermath of the Asian crisis, net private capital flows to the ACs increased from 1.7% to 5.6% of their aggregate GDP between 1997 and 2003. The FDI component accounted for the bulk of such flows, increasing from an average of 1.4% in 1994 to a peak of 5% in 2000. Since then, net FDI flows levelled off to 2.8% of GDP in 2003.

While manufacturing is the main sector of activity attracting foreign investors' interest, the share of *financial FDI* increased dramatically in the second half of the 1990s, reaching one third of all net FDI inflows in 1999 in Poland. This upward trend is mainly attributable to the privatisation process, which characterised the restructuring of the banking sector of the transition economies in Central and Eastern Europe. This process was accompanied by heavy involvement of foreign banks and peaked in the period 1996-2000.In those years, ownership of banks was largely converted from public to private and from domestic to foreign, also as a result of banking crises resolved through extensive opening of domestic financial systems to foreign investors. This process, which had been delayed in the first part of the 1990s owing to a combination of factors (e.g. weak banks' balance sheets, opposition from domestic vested interests, and underdeveloped regulatory and supervisory frameworks), can at this juncture be regarded as having been largely completed in nearly all countries. Between 1998 and 2001 the acquisitions of non-

[1] The EU accession countries are: Czech Republic (part of Czechoslovakia until 1992), Hungary, Poland, Slovak Republic (part of Czechoslovakia until 1992), Slovenia (since 1991), Latvia (part of USSR until 1990), Lithuania (part of USSR until 1990), Estonia (part of USSR until 1990), Malta, Cyprus, Bulgaria, and Romania. Ten out these twelve countries (i.e., all but Bulgaria and Romania) are expected to become EU members in May 2004.
Turkey, while enjoying the status as candidate for EU accession, has not yet started negotiations with the EU and, therefore, is not included in this paper.

bank financial institutions contributed to stabilising financial FDI flows at a high level. However, their decline in 2002 and even more so in 2003 confirmed that the process of privatisation is coming to an end also in this area, which could result in lower financial FDI inflows in the period ahead.

As a by-product of the banking sector privatisation, the presence of foreign banks' affiliates in the ACs is now substantial in all countries, with the partial exception of Slovenia. Foreign investors currently own more than two-thirds of the banking system of the ACs taken as a whole. Foreign ownership implies an effective control of over more than one-half of the roughly 300 commercial banks in the region, and is heavily geared towards larger institutions. Foreign banks are mainly present with subsidiaries, the predominance of which over branches is mainly explained by four factors. *First*, acquisitions in the context of privatisation programmes were the most straightforward way to establish an affiliate. *Second*, foreign investors mainly aimed to reap the benefits deriving from restructuring of inefficient banks, rather than to establish new business units, which would then have to compete with local banks. *Third*, the main line of business developed in the ACs was retail and commercial banking, which implied a need to buy local market knowledge. *Fourth*, there was a need to cope with local requirements (e.g. legal constraints), although this problem may have been less pressing for EU banks, given the process of enforcement of the *acquis communautaire* in the area of banking regulation and supervision. All in all, the most relevant consideration in the investment strategy of foreign banks in the ACs has been to take advantage of the opportunities provided by privatisation programmes in order to develop a wide and visible presence in the host markets within a short period of time.

In terms of origin of acquiring banks, the EU banks have undertaken the bulk of M&As in the ACs. At the end of 2001, the share of the local banking sector owned by the 41 major EU banking groups was about one half in the overall banking market of the ACs, with peaks of 100% in Estonia and 76.4% in the Czech Republic. Three main categories of strategic investors can be identified: *(i)* global banks that had identified the ACs as an important segment of their crossover activity given the nature of these countries as both a component of emerging market economies (EMEs) and future members of the EU and eventually the euro area; *(ii)* commercial banks of neighbouring countries looking at the ACs as a natural extension of their home market*; (iii)* major banks for which being exposed to the ACs was a sensible strategic decision.

In the second part of this note, we take a closer look at foreign banks' operations in ACs. We consider several aspects of foreign banks' activity that can highlight the specific role played by these banks in ACs. A first line of investigation is based on the distinction between wholesale and retail activity. Contrary to the predominance of wholesale operations in the majority of foreign banks entering EMEs markets, in the case of ACs retail operations represent the bulk of foreign banks' activity. This peculiarity can be ascribed to both the particular form of entry of banks in ACs, i.e. via subsidiaries

rather than branches, and to the underdevelopment of domestic money and capital markets in this region. This latter characteristic obviously reduces opportunities for foreign banks to conduct wholesale business.

A second line of analysis refers to the impact of foreign banks on the financial stability of host countries. First, although an analysis at time of crisis is prevented by past actual developments in these countries, the study of non-crisis scenarios does not show any significant evidence of less stable lending by foreign banks, pointing out to their positive contribution to financial stability. Second, as contagion across national banking sectors can arise both from the host and the home countries, a case is made for an overall positive assessment for the ACs. In fact, they do not look very likely to suffer from sudden reversals of financial FDI from their major partners, i.e. EU countries banks, and conversely the ACs - given their small relative size - do not represent a major potential threat to the financial stability of the banking sector in EU countries. Moreover, the overall financial stability of the ACs is reasonably sound, given their comparatively low exposure to currency mismatches and the ongoing deepening of their financial sector, as shown by the comparison with Latin American and Asian economies.

In a third section, the impact of foreign banks' entry on the efficiency of the ACs' banking sectors is assessed. The analysis distinguishes between general indicators of efficiency and financial deepening on the one hand, and the way in which changes in efficiency can affect the process of nominal convergence towards euro area' benchmark values. For the first part, foreign banks are shown to significantly outperform domestic banks in the ACs on account of several indicators of efficiency. Moreover, the level of financial deepening is still low in the ACs, given that their liberalisation and integration process has started only less than a decade ago. As for the effect of foreign banks' entry on nominal convergence, two indicators, credit ratings and spread on long-term foreign currency denominated bonds, are reviewed. Both, admittedly limited, pieces of evidence support the notion that a process of macroeconomic stability combined with gradual convergence has taken place over the last years, which has coincided with massive foreign banks' entry.

Finally, a short section discusses the quality of regulatory and supervisory frameworks in the ACs. Given the massive participation of EU banks in the ACs, through subsidiaries, it is clear that there is a strong interest on the part of EU member countries to look for various forms of co-operation in supervisory activities. On this ground, the ACs are most likely going to gain from further implementation of the *acquis communautaire* and the signing of future Memoranda of Understanding with EU countries that should enable closer co-operation among national supervisory authorities.

1. Review of financial FDI to the EU accession countries

In this first part, we review trends in financial FDI to the ACs, with particular emphasis on banking FDI, over the past decade. The first two sections set the background for the analysis conducted afterwards by summarising general capital flow trends. Section 1.1 focuses on *total net private capital flows* by comparing trends in the ACs with those in other EMEs. The same exercise is conducted in Section 1.2 with regard to *total net FDI flows*. Sections 1.3 and 1.4 then focus, respectively, on *financial FDI* to the ACs and its main component, i.e. *cross-border M&A*. While standard IMF-WEO data are used in Sections 1.1 and 1.2, Sections 1.3 and 1.4 adopt a novel database (Thomson SDC and national central banks' statistics) that is meant to shed new light on the properties of M&A in the ACs. Section 1.5 illustrates the main features of *foreign banks' penetration* in the ACs. The data used for this purpose have been collected from Fitch IBCA's Bankscope and from a survey conducted by the ECB and the Banking Supervision Committee of the European System of Central Banks in 2002. Finally, Section 1.6 completes the discussion by briefly *comparing* the degree and patterns of penetration of foreign banks in the ACs with the *experience of several Asian and Latin American countries*.

1. 1 Overview of total net capital flows

The EMEs as a whole[2] have been experiencing a declining trend in net capital inflows from 1996 to 2000, with the first substantial inversion of the trend in 2003, when total flows to EMEs matched the figures last seen in the first part of the 1990s. According to IMF-WEO data, the net flows to a sample of 45 EMEs reached the USD 90 billion level in 1992 and continued to rise through the mid-1990s, peaking at USD 218 billion in 1995 and 1996. Following the 1997 "break", they have recovered from around USD 50 to USD 100 billion since 2000 (see Figure 1). The picture does not change if one uses alternative indicators by *(i)* computing capital flows as a share of EMEs' aggregated GDP and *(ii)* disentangling the official from the private component of flows and focusing on the latter (Figure 2). Looking at the *geographical composition* of flows, however, it appears that, while in 1996 net private flows to EMEs stood at around 4.0% of GDP in all main regions (non-Japan East Asia, Latin America and EU accession countries[3]), trends have diverged dramatically since then. As illustrated in Figure 3, net private flows to emerging Asia dropped in 1997-98 but picked up thereafter, increasing from –2% of GDP in 1998 to a level of around 1% in 2003. In Latin America capital flow retrenchment started only in 1999, with a decline from 3.7% of GDP in 1997 to 0.2% in 2002. In 2003, the declining trend was

[2] Figures 1 and 2 refer to 45 EMEs (including transition economies), and not to the broader group of developing countries (128 countries according to the WEO classification). The 45 selected countries account for the bulk of both gross and net capital flows to developing countries.

[3] Although Russia, Turkey, South Africa and Ukraine are included in the group of 45 selected EMEs, here we do not conduct any specific examination of their capital flows.

reversed with an increase in capital inflows to 1.6% of GDP. Conversely, net private capital flows to the ACs collapsed from 1995 to 1997, when they accounted for only 2% of GDP. Afterwards they followed a marked upward trend, reaching 7.0% of GDP in 2002. In 2003, capital inflows to the ACs contracted somewhat, to 5.6% of GDP.

Figure 1

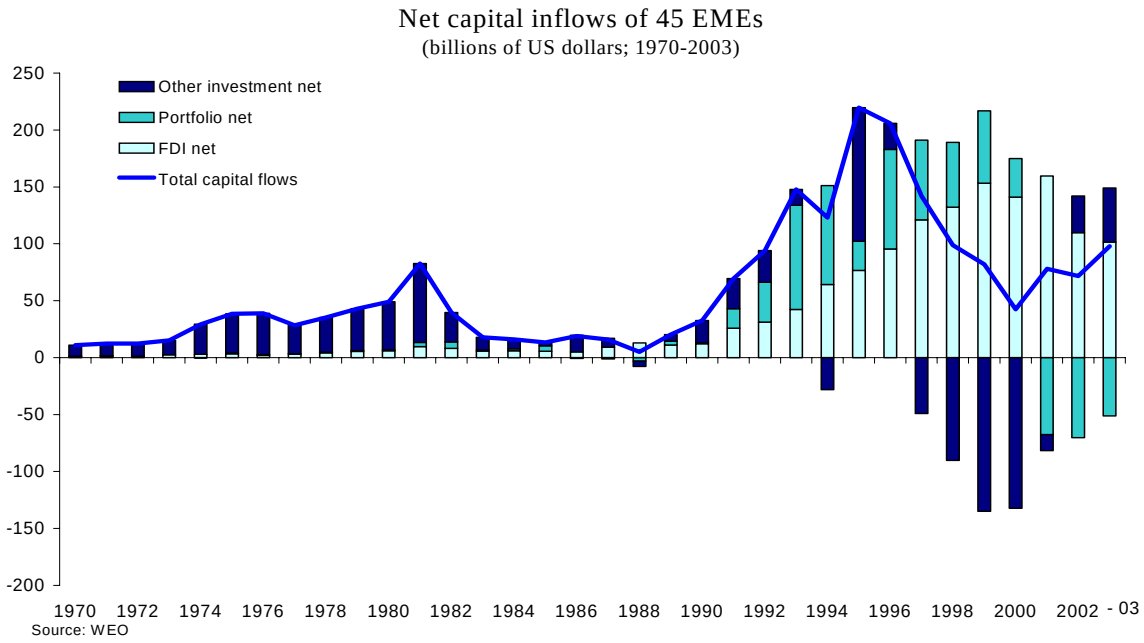


Figure 2

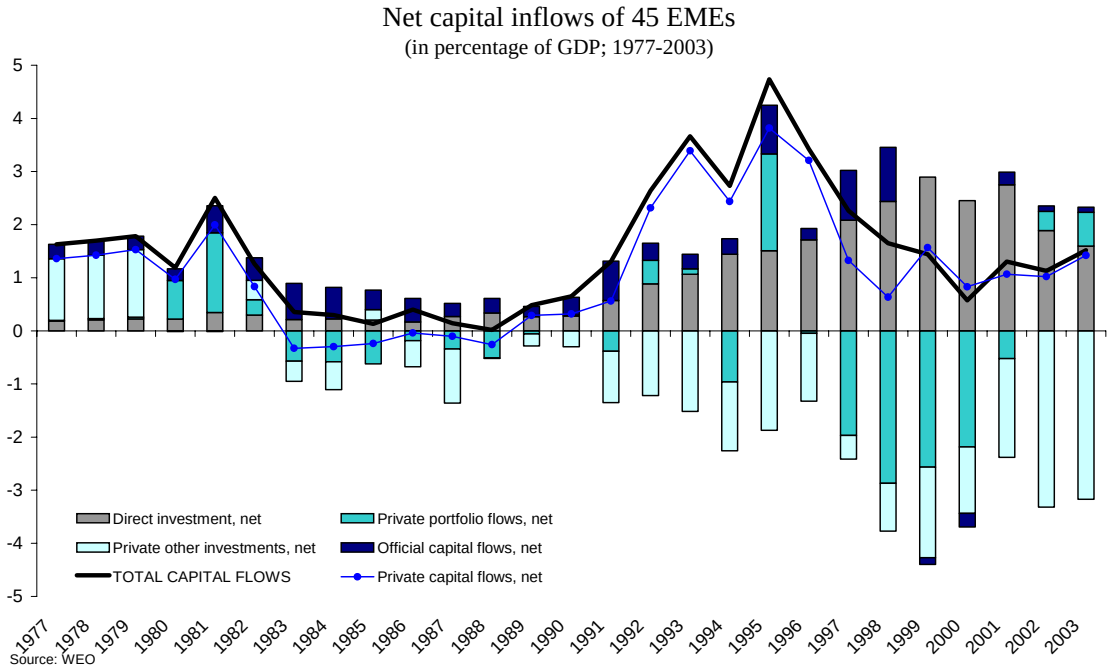
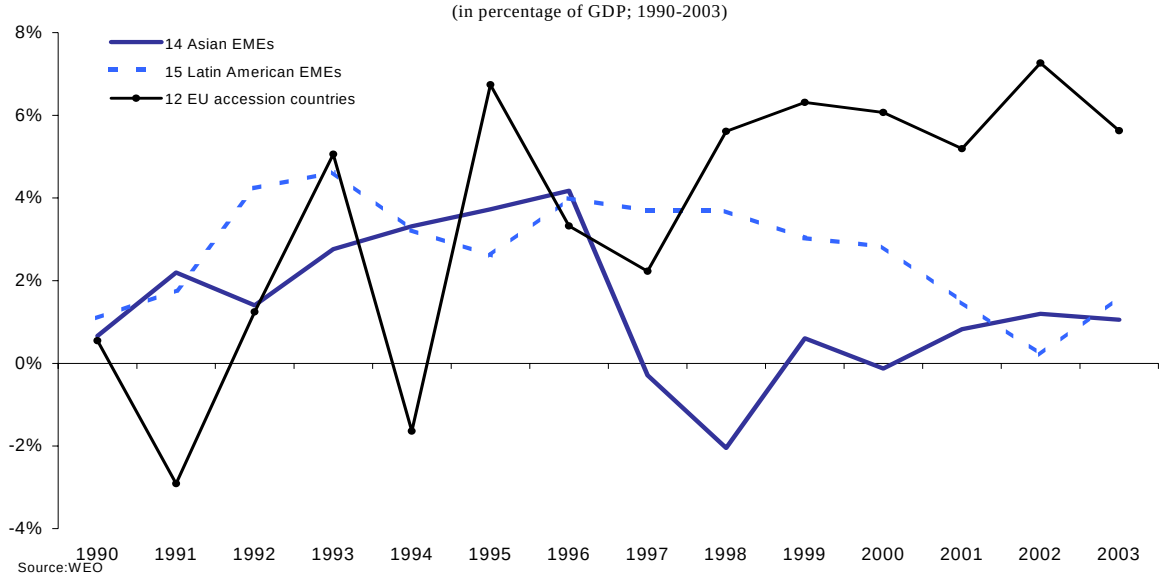


Figure 3

Net private capital inflows to 14 Asian and 15 Latin American EMEs, and to 12 EU accession countries

(in percentage of GDP; 1990-2003)



Source:WEO

While a full analysis of these developments falls outside the scope of this study, two factors should be considered when describing the outstanding performance of the ACs. *First*, the need of transition countries in Central and Eastern Europe to develop market-oriented economies was addressed, inter alia, through an extensive process of foreign-led privatisation, which resulted in sizeable FDI inflows as depicted in Section 1.4. *Second*, it would be difficult to account for the substantial increase in FDI to the ACs without taking into consideration the process of institutional, economic and financial integration with the European Union (EU).

1.2 Overview of total FDI flows

During the period 1997-2003, FDI accounted for the bulk of net capital flows to EMEs taken as a whole (Figure 4). FDI can not be easily divested at times of crisis, so that they become a relatively more stable form of investment. The rise in the FDI share since 1997 is in fact comparable with what occurred during the 1980s, another period of retrenchment of capital flows to EMEs. In the 1980s, however, non-FDI inflows continued to account for around half of total inflows, which has not been the case since 1997.

In this context, two aspects are striking if one compares the trends in the ACs with those in other EMEs. *First*, in percentage of GDP, since 1998 the ACs have attracted more FDI than the other regions under examination (Figure 5). *Second*, although the EU accession countries continued to maintain restrictions on short-term capital flows until 2000-01 and they experienced still positive inflows, both as net private portfolio and "other private investment" (e.g. banking flows, trade credits) (Figure 6). In the following we concentrate on the first aspect.

Figure 4

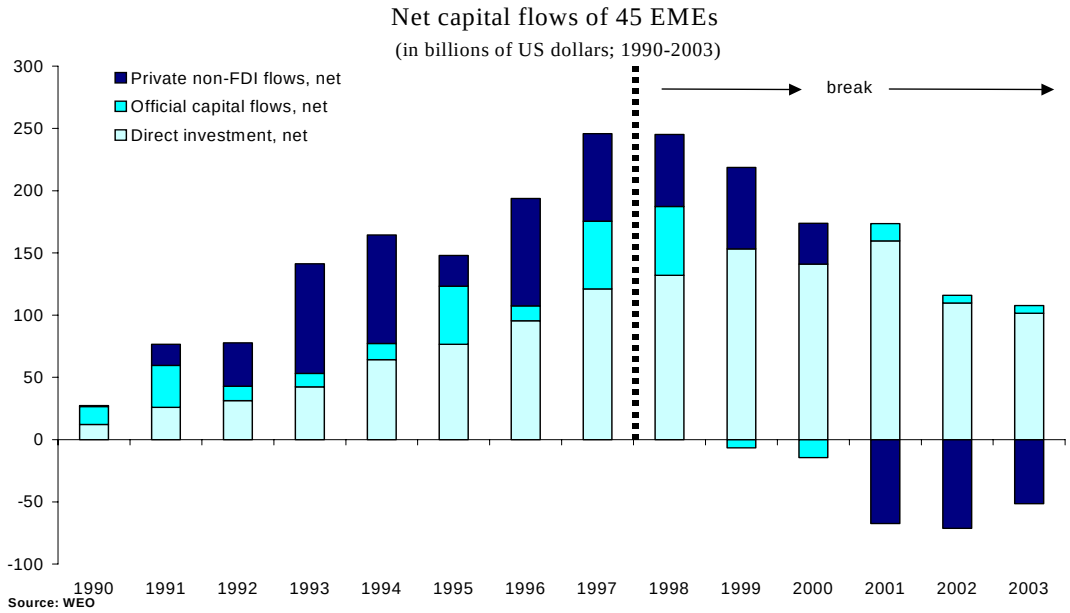
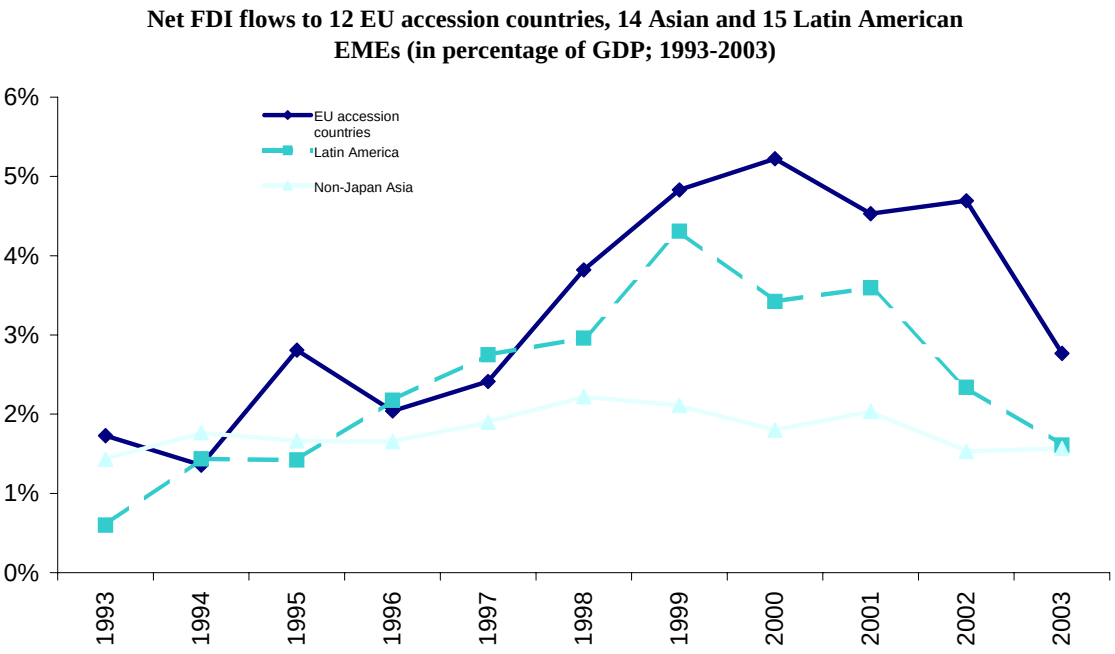
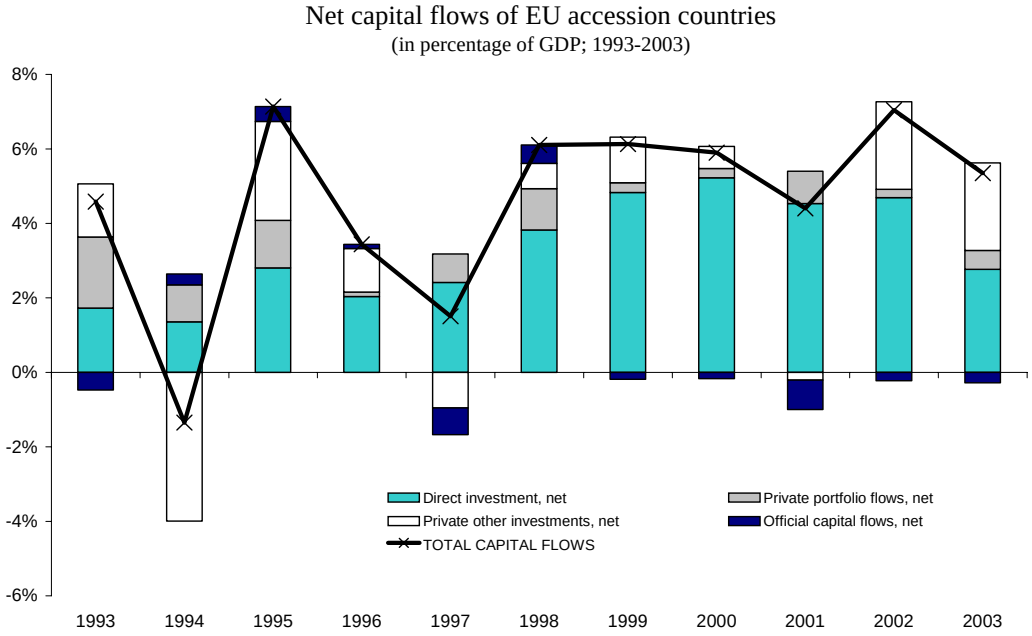


Figure 5



Source: WEO.

Figure 6

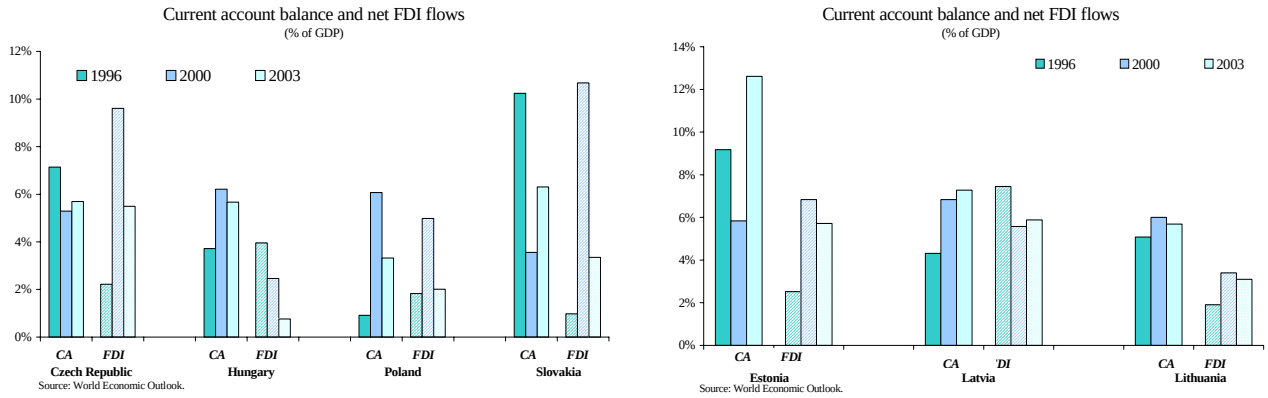


Source: WEO.

As a share of GDP, net FDI flows to all ACs increased from an average of 1.4% in 1994 to 5% in 2000. Since then, net FDI flows have declined to the level of 2.8% of GDP in 2003 (Figures 5 and 6). Before 2002, there were significant differences in net FDI flows patterns across countries. FDI inflows dramatically increased in 2000, both in the Czech Republic and Slovakia, reaching the level of around 10% of GDP. They also accelerated in Estonia and Lithuania reaching the level of 7% and 3.4% in 2000, respectively. The only exceptions to the pattern of increases in total FDI inflows were Hungary and Latvia, which, however, had already attracted very high FDI inflows in the mid-1990s (Figures 7.a and 7.b). Since 2002, all ACs have been experiencing a declining trend in net FDI inflows.

In levels, net FDI inflows peaked to EUR 19 billion in 2000 from EUR 6.5 billion in 1996 and were mainly concentrated in Poland and the Czech Republic. These two countries received 58% of the total FDI inflows in 1996 and 63% in 2000 (see Figure 8).

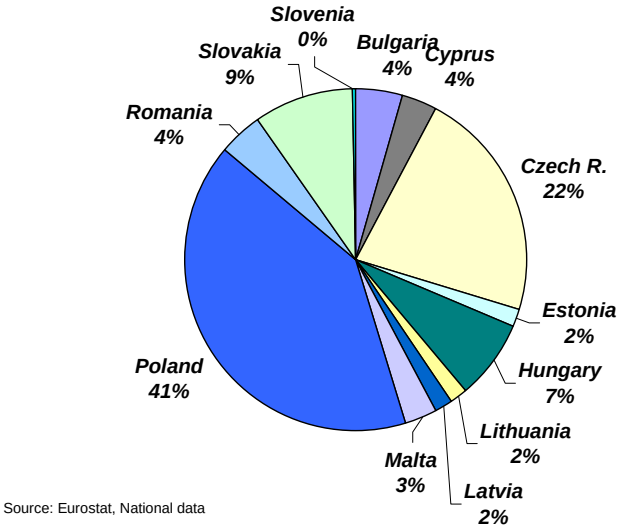
Figures 7.a and 7.b



FDI has been the main financing source of current account deficits in most ACs (Figures 7.a and 7.b). In particular, in the period 2000-2003, average FDI inflows have matched or exceeded average current account deficits in most countries. Even in those countries where FDI has not fully financed current account deficits, it has covered a significant part of them. For example, FDI inflows have covered around two-thirds of current account deficits in Poland and Latvia, while in Lithuania FDI-coverage has been around 50%. In this context, since some retrenchment in net FDI flows to the ACs cannot be ruled out in the period ahead – e.g. because of completion of the privatisation process or increase in gross outward FDI flows – the financing of current account deficits may prove to be more difficult.

Figure 8

Share of ACs in total FDI inflows into the region (2000)



Source: Eurostat, National data

With regard to the countries exporting FDI, Eurostat reports that in 2000 the weight of FDI inflows from the EU Member States was about 80% of the total. The same share was already recorded in the mid-1990s, followed by a temporary decline in 1999. France (26% of FDI flows to the region), the Netherlands (21%) and Germany (19%) are the main investors, accounting for nearly two thirds of EU FDI flows to these economies in 2000. Over the period 1996-2000, German investors directed their FDI to Poland (cumulated EUR 5.1 billion), Hungary (EUR 3.9 billion) and the Czech Republic (EUR 3.5 billion). Also Dutch investors concentrated on the same economies, whereas France showed an ever growing FDI concentration on Poland (in 2000, 88% of French FDI flows to the country).

According to Eurostat, FDI in all ACs doubled in stock terms from around EUR 27.3 billion in 1997 to EUR 52.9 in 1999. In particular, Poland and the Czech Republic made up half of ACs' FDI stock between 1997 and 1999. The only country that did not record a significant increase in FDI stock is Slovenia, where outstanding FDI amount grew by just 14% of its 1997 level.

As for the distribution by sector, manufacturing activities have always been the main interest of foreign investors in these economies, though losing some of its attraction recently in favour of larger investments in financial intermediation and telecommunications.

In terms of GDP per capita, total FDI flows to the Czech Republic and Estonia are clearly ahead of other countries. In terms of stocks, also Hungary stands out (see Table 1).

Table 1

FDI inflows and stock per capita in 8 EU accession countries
(1995-2001; USD)

	1995		1999		2001	
	Inflows	**Stock**	**Inflows**	**Stock**	**Inflows**	**Stock**
Czech Republic	248	712	615	1708	478	2500
Hungary	435	1168	196	1922	240	2243
Poland	95	203	188	870	207	1009
Slovak Republic	38	242	72	834	273	1017
Slovenia	89	886	91	1411	222	1508
Estonia	136	499	212	1844	375	2238
Latvia	72	249	146	880	102	1021
Lithuania	20	95	131	632	121	759

Source: Hunya (2002).

The above-described FDI performance has been mainly driven by *(i)* low costs of production,*(ii)* proximity to the European Union, *(iii)* privatisation and *(iv)* improvement in the business climate. All in all, international companies are likely to continue to find in these countries attractive investment opportunities. According to an UNCTAD survey conducted among 129 major transnational corporations

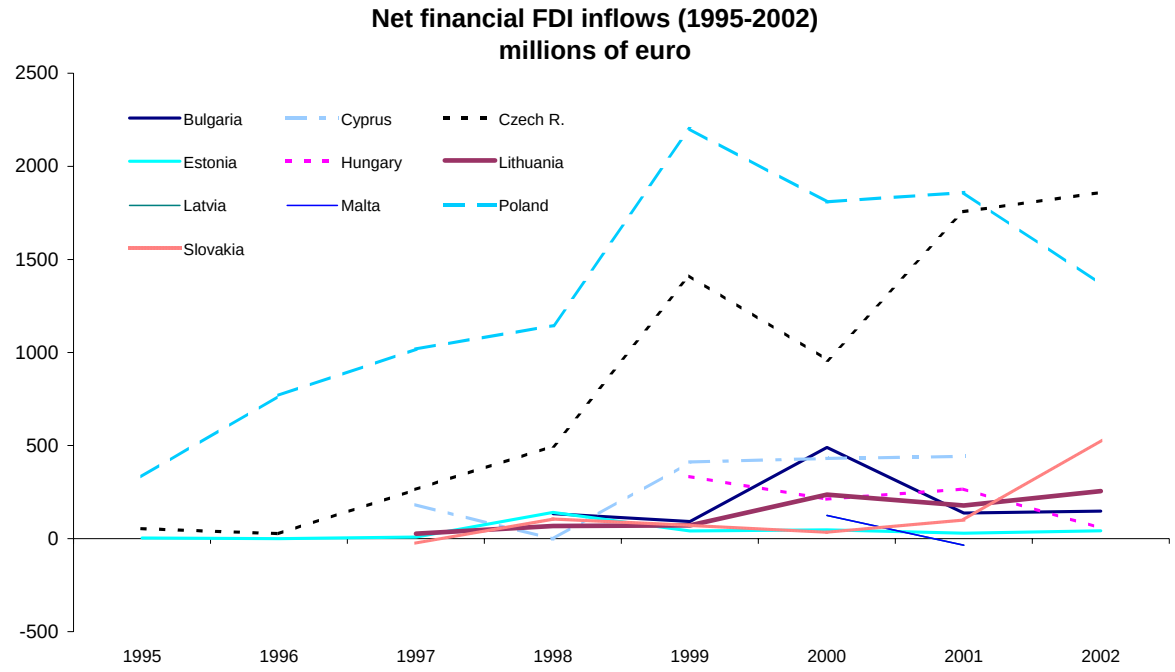
in 2001,[4] the area with best prospects for FDI in the world is Central and Eastern Europe (CEE), with 60% of the answers expecting increasing FDI (China 50%). Among accession countries, the prioritised FDI locations were Poland (33% of responses), Hungary (20%) and the Czech Republic (18%).

Three main general developments are expected in the future according to several observers (see e.g. Hunya (2002)). First, a decline in privatisation is expected to reduce the role of this factor as a major determinant of FDI. Second, the relative importance of takeovers in the private sector – especially medium-size domestic firms – should increase over time. Third, outward FDI is expected to increase, with firms in the accession countries investing mainly in companies further east.

1.3 Financial FDI

As illustrated in Figure 9, based on non-harmonised data provided by the national central banks of the ACs, in the second half of the 1990s net financial FDI inflows – i.e. net FDI inflows in the sector of financial intermediation[5] - sharply increased in most ACs, while in 2000-02 they levelled off or even declined in most countries. In particular, in 1999 financial FDI flows to Poland peaked to EUR 2.2 billion, the highest level ever reached within the ACs.

Figure 9



Source: Eurostat, National central banks, ECB staff calculations.

[4] See UNCTAD Press Release of 3 December 2001.

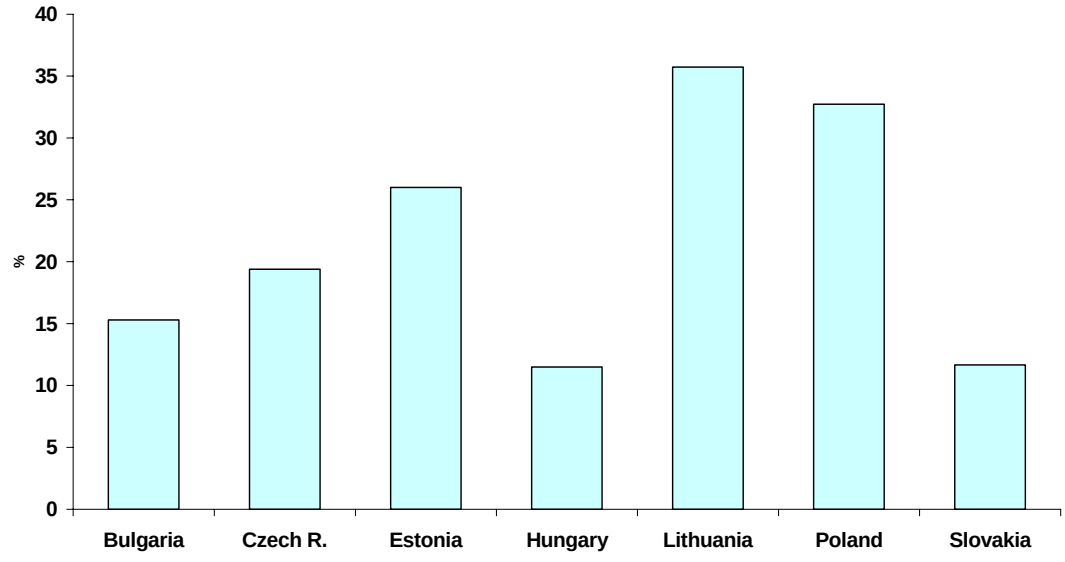
[5] According to the Eurostat definition, financial FDI flows are composed of three items: monetary intermediation, other financial intermediation and insurance & activities auxiliary to insurance.

The upward trend in financial FDI flows is explained mainly by the privatisation process, which, as examined in Section 1.4 in greater detail, characterised the restructuring of the banking sector of the transition economies in Central and Eastern Europe from 1996 to 2001. During that period, ownership of banks and other financial intermediaries in these economies was largely converted from public to private and from domestic to foreign, also as a result of banking crises resolved through extensive opening of the domestic banking systems to foreign investors. While this process had been delayed in the first part of the 1990s by a combination of factors (e.g. weak banks' balance sheets, opposition from domestic vested interests, and underdeveloped regulatory and supervisory frameworks), at this juncture it can be regarded as having been largely completed in nearly all countries. This, combined with an increase in FDI in non-bank financial services, has contributed to stabilising, with some exceptions (e.g. Czech Republic) financial FDI inflows after 2000.

While foreign-led M&A accounted for the largest part of financial FDI flows to the ACs (see Section 1.4), these flows have remained a relatively low share of total FDI to the ACs despite the sharp increase recorded after 1996. In 2002, financial FDI flows to Poland and the Czech Republic accounted for, respectively, 32% and 19% of the total FDI flows to these countries (Figure 10).

Figure 10

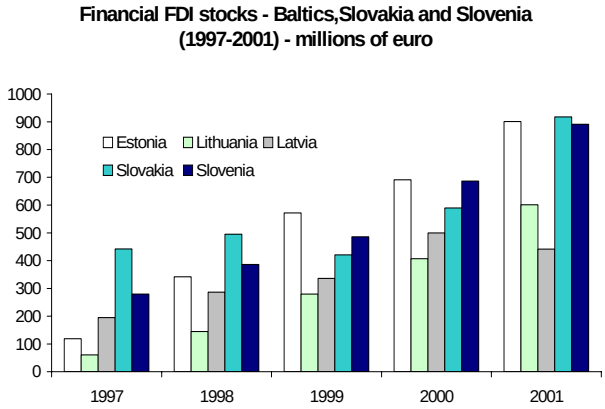
Share of Financial FDI inflows in total FDI inflows (2002)

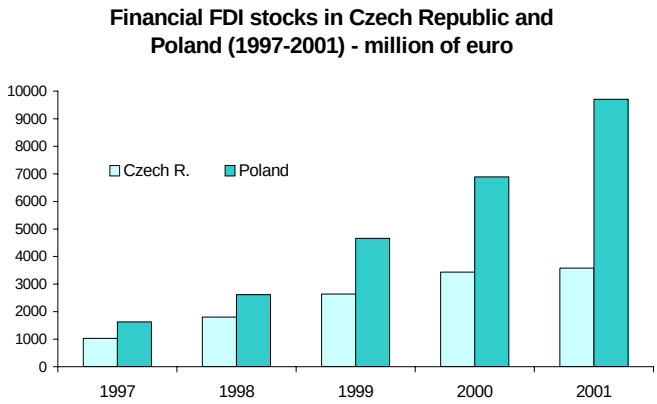


Source: Eurostat, national data, ECB staff calculations

Considering the seven countries for which stock data are available (Czech Republic, Poland, Slovakia, Slovenia and the Baltic countries), aggregate financial FDI stocks increased from EUR 3.8 billion in 1997 to EUR 13.2 billion in 2000. In the Czech Republic and Poland stocks increased three and four times, respectively, between 1997 to 2001. These two countries made up 70% of the seven countries' total financial FDI stock in 2001 (Figures 11.a and 11.b).

Figures 11.a and 11.b





Source: National central banks.

1.4 Cross-border M&A, with focus on financial M&A

In the process of transition of CEECs towards market economies, "*only foreign privatisation could bring about the transformation (…), without greenfield investment being a real alternative*"[6]. Evidence of this phenomenon is here provided by aggregating flow data on individual completed M&A[7] – with breakdowns by host country, country of origin of the acquiring firm, and sector (banks, non-bank financial institutions and other) – collected from the Thomson SDC database. It should be borne in mind that these data exclude corporate transactions involving less than 5% of ownership of a company or less than 3% if the transaction value is greater than USD 1 million. This implies discrepancies in the coverage of M&A and FDI data presented in this paper, since the latter are considered as FDI (i.e., not as portfolio flows) only starting from a threshold of 10% of capital, according to the 5th IMF balance of payments manual. This should be taken into account as a caveat when trying to compare the two time series.

As illustrated in Figure 12, between 1990 and 1994 both total gross FDI inflows and M&A stood below the EUR 5 billion level in the ACs taken as a whole. M&A from abroad explained the bulk of M&A (between 80% and 100%), but their share in gross FDI inflows was very volatile, varying in a range between 17% and 70%. Subsequently, four developments took place alongside the progressive unfolding

[6] Quotation from Kalotay (2001), page VIII.

of the EU accession process. *First*, gross FDI inflows and their M&A component increased dramatically until 2002, reaching the levels of EUR 21 billion and nearly EUR 14 billion, respectively. In particular, the amount of cross-border M&A received by these economies looks impressive if compared with stock market capitalisation (Table 2). Second, since 2002, gross FDI inflows and M&A have significantly declined. Among other reasons, this was a more general sign of a radical change in the structure of the economies in the region (e.g. market financial deepening, privatisation process coming to an end). Third, once the foreign-led privatisation process had reached a critical mass, the domestic component of M&A began growing, while remaining of much lesser magnitude than the foreign one. Fourth, M&A from abroad became a more stable component of FDI, accounting for around 60% of total gross inward FDI flows in the period 1999-2003.

Table 2

Total value of annual M&A deals as a percentage of stock market capitalisation

	1999	2000	2001	2002
Czech Republic	26.2	18.7	26.4	58.9
Estonia	41.2	10.9	9.4	1.7
Hungary	5.4	9.7	12.9	13.0
Latvia	10.1	84.2	6.2	17.4
Lithuania	43.6	15.5	15.3	20.1
Poland	30.0	17.8	18.5	9.9
Slovakia	22.5	257.7	37.5	57.3
Slovenia	1.8	0.7	7.3	30.7
AC-8	22.4	18.9	18.5	24.1

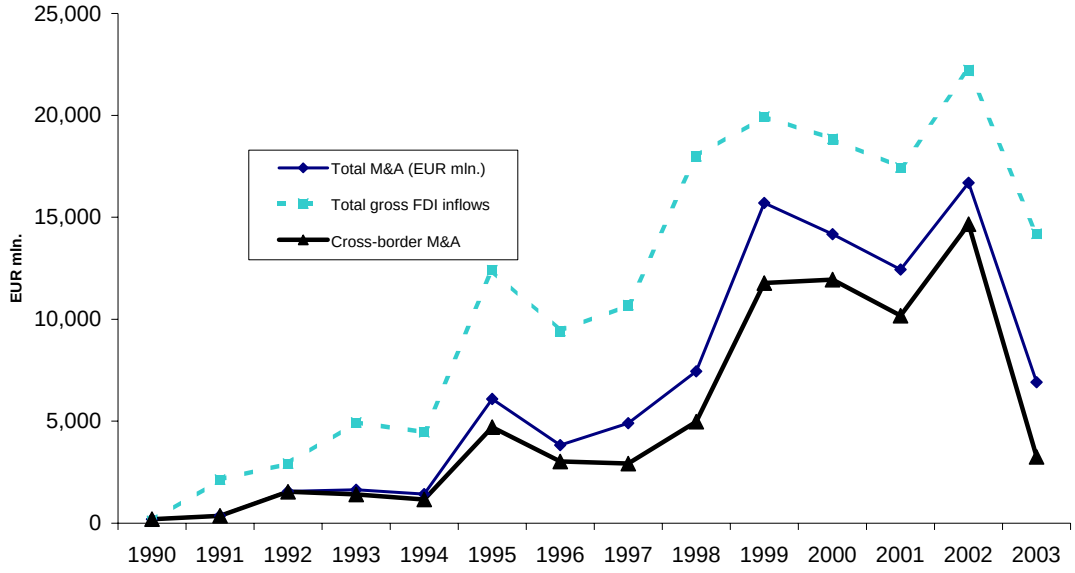
Sources: Thomson Financial Services and World Bank Development Indicators

Figure 13 completes the picture by focusing on cross-border financial M&A in the ACs. This component also started accelerating in 1998, but more rapidly than the others did. As Table 3 shows, the foreign-led M&A in the banking sector, which until 1997 had accounted for no more than 14% of total cross-border M&A, between 1998 and 2001 explained around one third on average. In the same period the acquisitions of non-bank financial institutions also gained some relative importance, while the decline both in the level and the share of financial M&A in the last two years seems to confirm that the process of privatisation in this sector is coming to an end.

[7] Although, in practice, all transactions referred to are acquisitions, we will continue to use the acronym M&A.

Figure 12

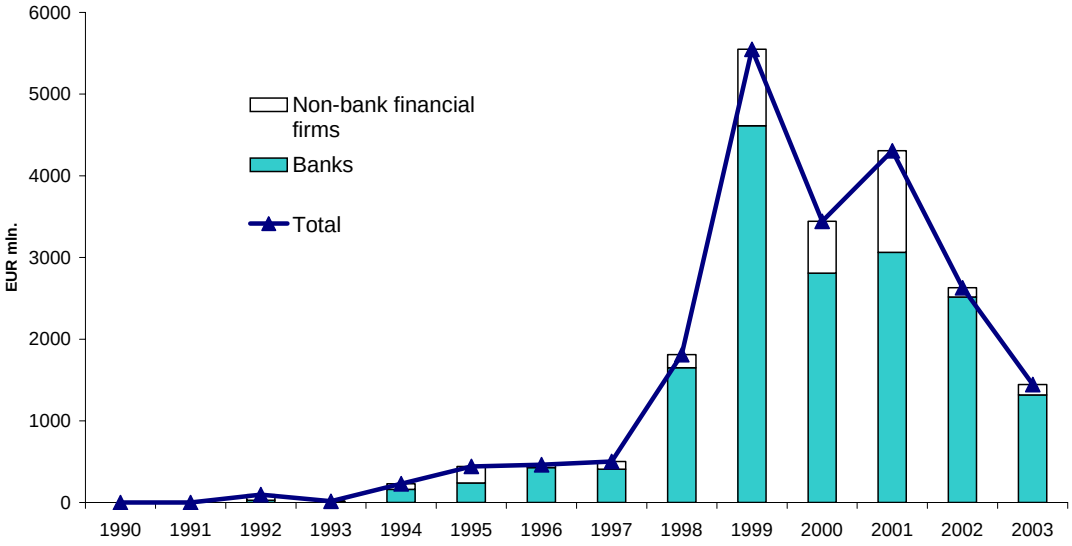
Gross inward FDI inflows and M&A in 12 EU accession countries
(in millions of euro; 1990-2003)



Sources: Thomson SDC and IMF WEO.

Figure 13

Financial M&A from abroad in 12 EU accession countries
(in millions of euro; 1990-2003)



Source: Thomson SDC.

In the remainder of this section we focus on the three largest ACs (Poland, Hungary and the Czech Republic)[8], which, taken together, attracted almost three fourths of total M&As in the ACs.

In Poland 1695 M&A operations were completed between 1991 and 2003, totalling EUR 32.6 billion or 35% of total M&A in the ACs. M&A accounted for a very high share (76%) of this amount *from abroad*. The latter can in turn be broken down by:

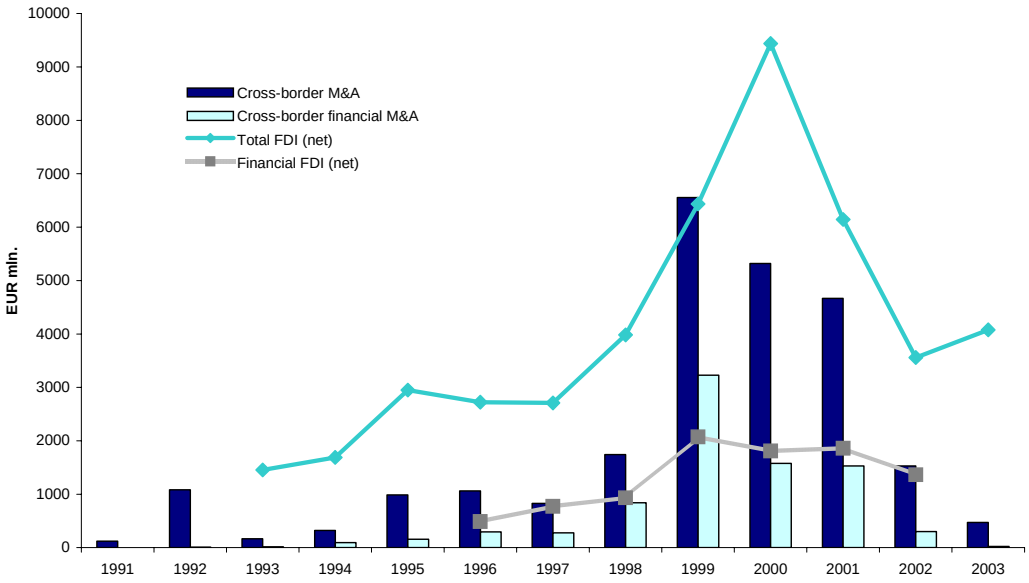
(A) Sector - The weight of *financial-sector M&A* in M&A from abroad was 34% in the period under consideration (i.e., 26% banks and the remaining 8% non-bank financial institutions).

(B) Country of origin of the acquiring firm - 64% of the M&A from abroad involved an acquiring firm located in the euro area, while firms from five countries (Germany, France, Italy, the Netherlands and the USA) participated in 70% of cross-border M&A, and 54% of total M&A.

As shown in Figure 14,[9] in the period 1996-2002 M&A accounted for the largest share of inward financial FDI in all years but 1997[10]. Figure 15 describes trends over time in the level and composition of M&A from abroad. It shows that the bulk of foreign-led privatisation was completed between 1999 and 2001, with a considerable decline in 2002 and 2003. A similar trend was recorded by the financial component.

Figure 14

FDI and M&A in Poland (in millions of euro; 1991-2003)



Sources: National Bank of Poland for FDI; Thomson SDC for M&A.

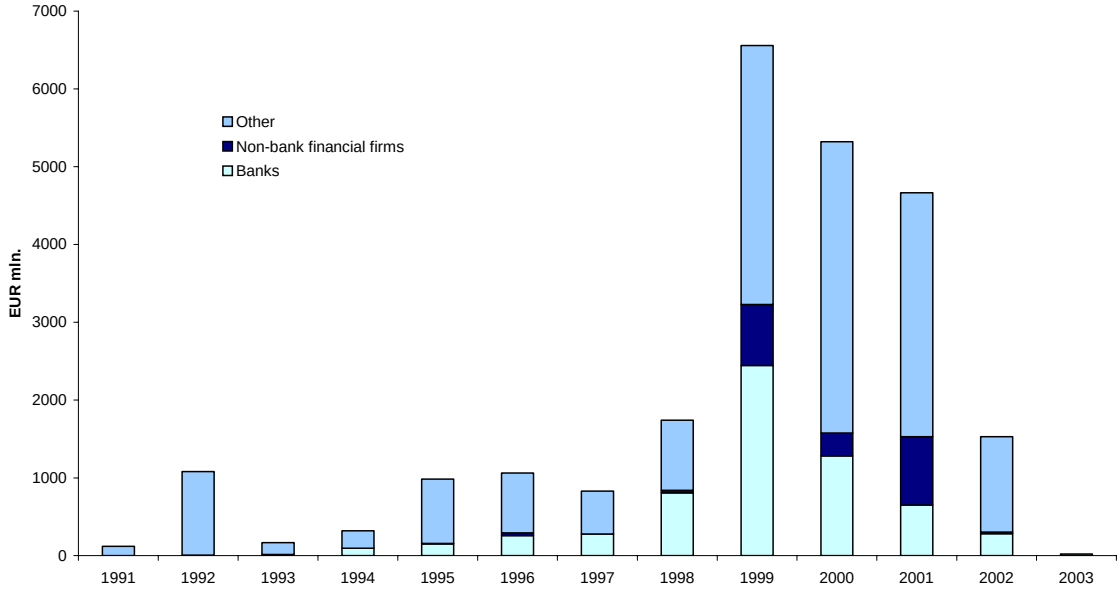
[8] Detailed tables on M&A in each individual AC are available upon request.

[9] Figure 14 compares *(i) net* total FDI and (for the years available) financial FDI data – both considered as *proxy for gross inflows*, owing to the very low gross outflows recorded by Poland – with *(ii)* data on cross-border inward M&A, both total and financial.

[10] According to this evidence, in 1999 the M&A from abroad exceeded net financial FDI inflows. This can be explained in terms of gross financial FDI outflows and/or statistical discrepancies between the two different sources used.

Figure 15

Level and composition of cross-border M&A in Poland
(in millions of euro; 1991-2003)



Source: Thomson SDC.

Table 4 allows a comparison, for the whole period 1991-2003, between M&A in Poland and those in Hungary and the Czech Republic[11]. These two countries, taken together, attracted nearly the same amount of flows as Poland. In particular, the Czech Republic recorded the highest share of *M&A from abroad* on total M&A (85%); almost two thirds of these operations were carried out by euro area firms (mainly from Germany, Austria and the Netherlands), against one half in the other two countries. The weight of *financial M&A* in the M&A from abroad was much lower in Hungary (14%) than in Poland and the Czech Republic (around one third). These summary data are mirrored in Figure 16, which compares annual data on *financial M&A from abroad* in the three countries under consideration from 1993 to 2003. In percentage of GDP, in 1999-2003 the Czech Republic outperformed the other two countries, whereas in Hungary financial M&A inflows never exceeded 1% of GDP in the period under consideration. These flow data, however, should be interpreted together with stock data, as discussed in the next section, where we look at several stock indicators for the banking system.

[11] The latter including Slovakia in 1991-92.

Table 4

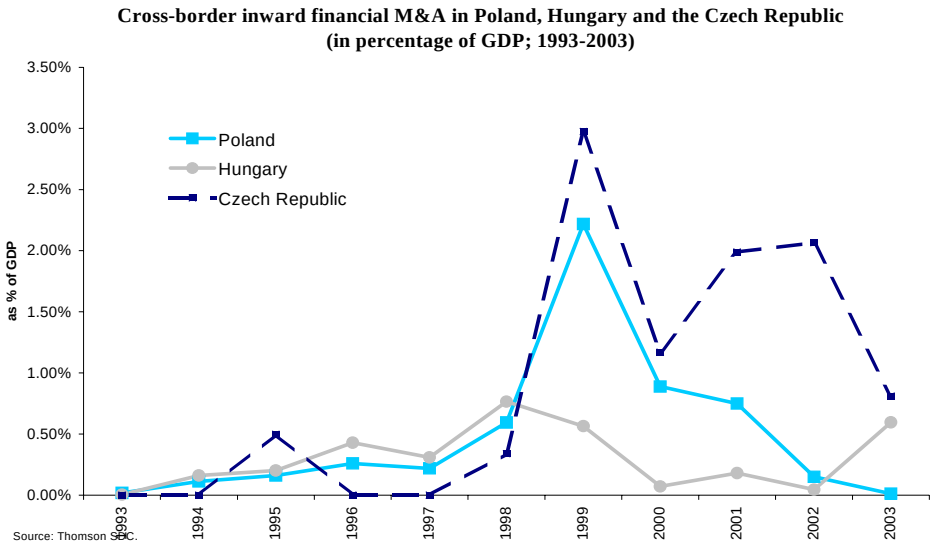
Mergers and acquisitions in Poland, Hungary and the Czech Republic in the period 1991-2003 [1]

		Poland	Hungary	Czech Republic
Number of M&A		**1695**	**1298**	**1224**
Total M&A (EUR mln.)		**32611**	**13031**	**22773**
of which:	Cross-border M&A (% of total M&A)	75	200	75
	Largest individual M&A (% of total M&A)	7	10	18
Geographical composition of M&A (home country of the acquiring firm) *as a pergentage of total M&A*	**Domestic**	**24**	**22**	**25**
	Euro area	**49**	**46**	**53**
	Of which: Germany	10	20	20
	France	15	7	7
	Italy	6	5	1
	Spain	1	0	0
	the Netherlands	9	4	9
	Belgium	3	3	5
	Austria	1	5	11
	Finland	1	1	0
	Other	4	1	0
	Other EU	**7**	**6**	**8**
	Of which: UK	**2**	**6**	**6**
	Other accession countries	**1**	**1**	**3**
	United States	**14**	**12**	**7**
	Other	**5**	**14**	**4**
Composition of cross-border M&A by sector *as a percentage of total cross-border M&A*	Banks	**19**	**11**	**24**
	Non-bank financial firms	**6**	**2**	**2**
	Other	**74**	**87**	**74**
Composition of total M&A by sector *as a percentage of total M&A*	Banks	**23**	**14**	**24**
	Non-bank financial firms	**8**	**3**	**4**
	Other	**69**	**83**	**72**

[1] Flow data relating to completed M&A.

Source: Thomson SDC and ECB calculations.

Figure 16



1.5 Foreign banks' presence

One of the main effects of the process described in Sections 1.3 and 1.4 is that the presence of foreign banks' affiliates – especially subsidiaries – in the ACs is now substantial[12] in all countries, with the partial exception of Slovenia. Dominant foreign ownership is a feature that sets the ACs apart from all current EU members, where cross-border ownership is limited.

Foreign investors currently own more than two-thirds of the banking system of the ACs taken as a whole. Foreign ownership implies an effective control of over more than one-half out of the roughly 300 commercial banks in the region, and is heavily geared towards the larger institutions.

In the following paragraphs, we discuss two aspects of foreign banks'entry:

- First, we provide more detailed evidence of this phenomenon with reference to the process of penetration, between 1993 and 2000, of all foreign banks into seven ACs for which data are available[13], namely Poland, Hungary, Czech Republic, the Baltic Republics and Slovenia. Where possible, this evidence is complemented with more recent information including other ACs.
- Second, we focus on the presence in all ACs of 41 major EU banking groups, which account for the bulk of foreign banks in the ACs, as recorded at end-2001.

All foreign banks

Figure 17 shows that in 2000 the number of "foreign banks"[14] accounted for above 57% of the total number of large banks[15] in six out of the seven ACs under consideration (the exception being Slovenia, where foreign banks were "only" one fourth of the total). This was the outcome of a steady upward trend over the 1990s. Particularly impressive was the increase experienced by Poland (from 10% to 65% of the total in seven years only), while Hungary recorded the highest share (79%). According to more recent evidence (2001 data, although still subject to ongoing changes), in most accession countries at least three out of the top five banks are foreign-owned. In particular, in the Baltic States all major private banks (except for the third-largest Latvian and Lithuanian banks) are controlled by foreign investors. In central Europe, all top five commercial banks in each of the five countries display dominant shares of foreign

[12] As illustrated in Section 1.4, while foreign M&A were also highly relevant for other segments of the financial sector, they were most visible in the banking system. Regarding other segments, it should be recalled that in the ACs a substantial share of government and enterprise financing comes from non-bank investors abroad. Many major firms are listed on stock exchanges outside the ACs – usually in Frankfurt, Luxembourg or Vienna – with some of them even listed on several stock exchanges at the same time. Access to capital markets abroad is significantly alleviating domestic financing constraints. Many of the larger corporations in accession countries are part of multinational companies and receive financing from their headquarters. Furthermore, much of the activity on financial markets, including foreign exchange, stock and bond markets, is performed by foreign participants.

[13] Fitch-IBCA Bankscope data and the statistics of ACs national central banks are the main sources used here.

[14] "Foreign bank" is here defined as a bank where at least 50% of the capital is foreign owned.

[15] It should be stressed that the notion of bank used in Figures 17-21 *excludes* small banks such as saving banks, co-operative banks, mortgage banks and building societies.

capital (65 to 100% of capital), except for one private Hungarian bank, one Polish bank and two banks in Slovenia

Figure 17

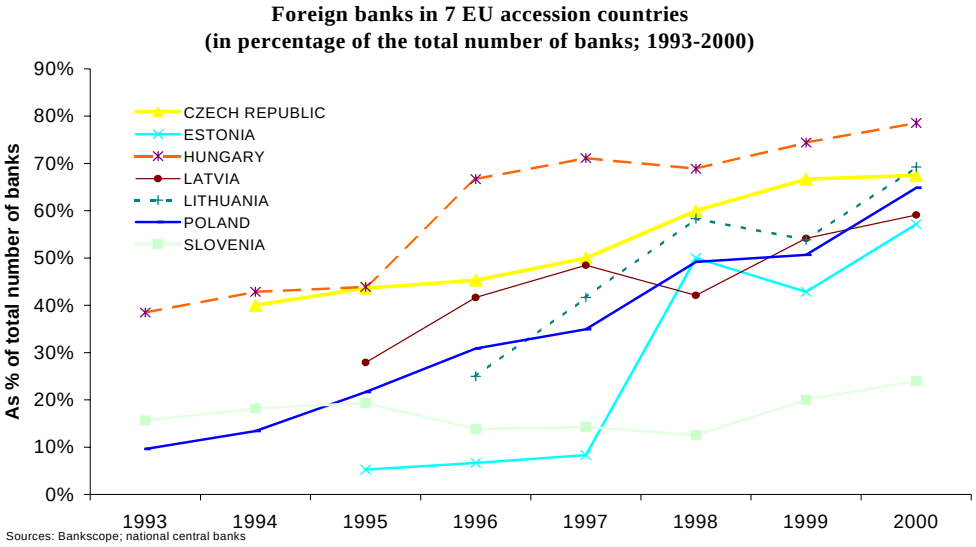
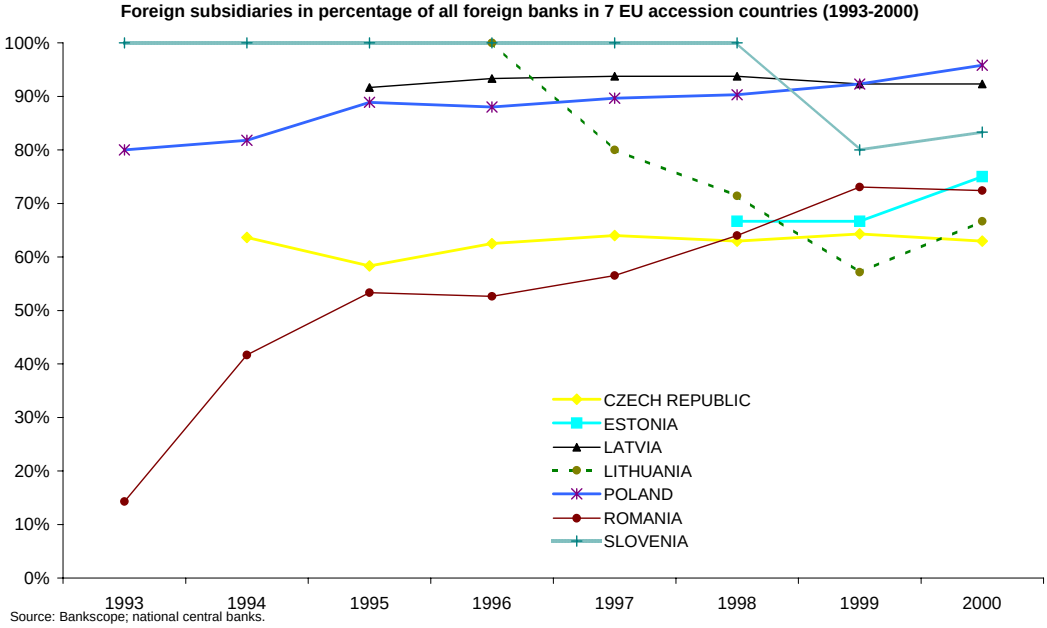


Figure 18



In all seven countries under examination, the share of foreign subsidiaries in the total number of foreign banks exceeded 60% (with a peak of 96% in Poland) (Figure 18)[16]. The predominance of subsidiaries over branches may be explained by four main factors:

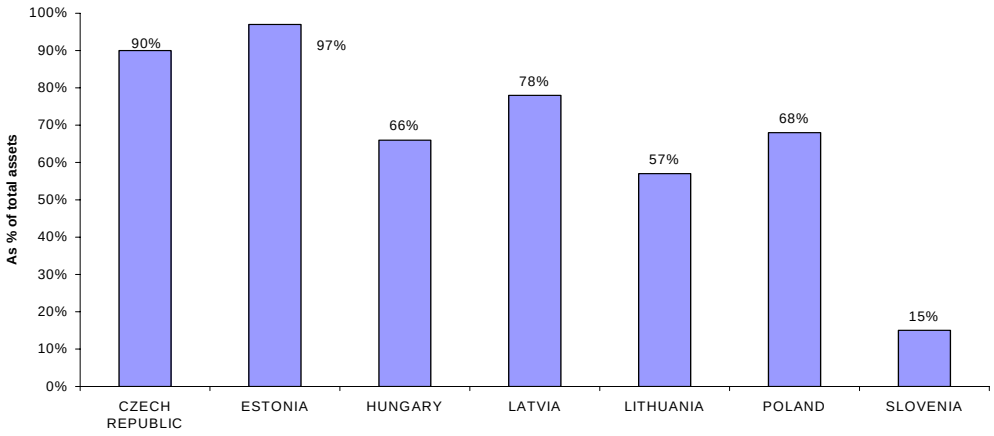
[16] It should be borne in mind that, in the relations with the parent company, a subsidiary is a *distinct* legal entity. Hence, from a legal viewpoint at least, it cannot be taken for granted that the parent company will provide support in the event that the subsidiary experiences financial difficulties. From a supervisory angle – even keeping consolidated supervision into account – the supervision of subsidiaries continues to be the ultimate responsibility of the authorities in the host country, in contrast with branches.

- the way in which banks' affiliates were set up, namely, as discussed in Section 1.4, acquisitions in the context of privatisation programmes;
- the type of business strategies pursued by foreign investors. As discussed in Focarelli and Pozzolo (2000), foreign investors mainly aim at reaping the benefits deriving from restructuring inefficient banks, rather than at establishing their presence by means of new business units that would compete with the local banks. Therefore, they prefer to create subsidiaries where the banking sector is less efficient as in the case of ACs in the 1990s;
- the business being developed (e.g. retail banking) and the related need to buy local market knowledge. Some evidence in this respect is put forward below, when focusing on the behaviour of EU banking groups;
- the need to cope with local requirements (e.g. legal constraints), although this problem may have been less pressing for EU banks, given the process of enforcement of the *acquis communautaire* in the area of banking regulation and supervision.

A more meaningful measure of the presence of foreign banks is given by the volume of foreign bank assets. In 2000, foreign banks held between 57% and 97% of total assets in all countries but Slovenia, at 15% only (Figure 19). As a share of GDP, foreign banks' assets recorded a dramatic increase in the 1990s in the Czech Republic and Estonia, and grew significantly in all other countries under examination, especially Hungary and Latvia (Figure 20).[17].

Figure 19

Foreign bank assets as a share of total bank assets in 7 EU accession countries (2000; 2001 for CZ, HU, PL)



Sources: Bol, de Haan, de Haas and Scholtens (2002), BIS.

[17] It should be mentioned that the Slovak Republic, while starting with a high percentage of foreign banks shortly after its foundation, recorded a significant decrease in their presence during the second half of the 1990s, in conjunction with an increase in non-performing loans and a decrease in domestic liquidity. This negative trend, however, has been reversed since 2000 (EBRD 1998 and Bol et alii 2002).

Figure 21 shows the extent to which foreign banks are involved in traditional financial intermediation by focusing on a specific component of bank assets, namely the credit supplied by foreign banks to residents of EU accession countries. Again, Estonia and the Czech Republic recorded the most impressive increase over time, with a share of GDP above 40% and 30%, respectively, in year 2000. The increase in Hungary, Poland and Latvia was also significant. In all countries but Slovenia, the share of credit to private residents granted by foreign banks exceeds that of domestic banks, although in Poland the two shares are very close.

Figure 20

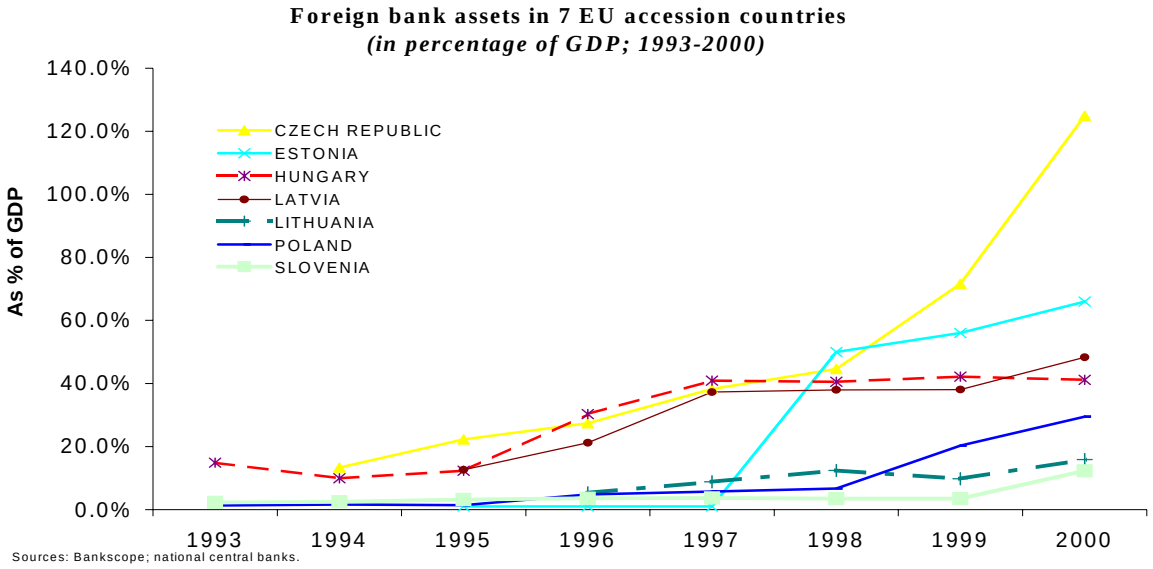
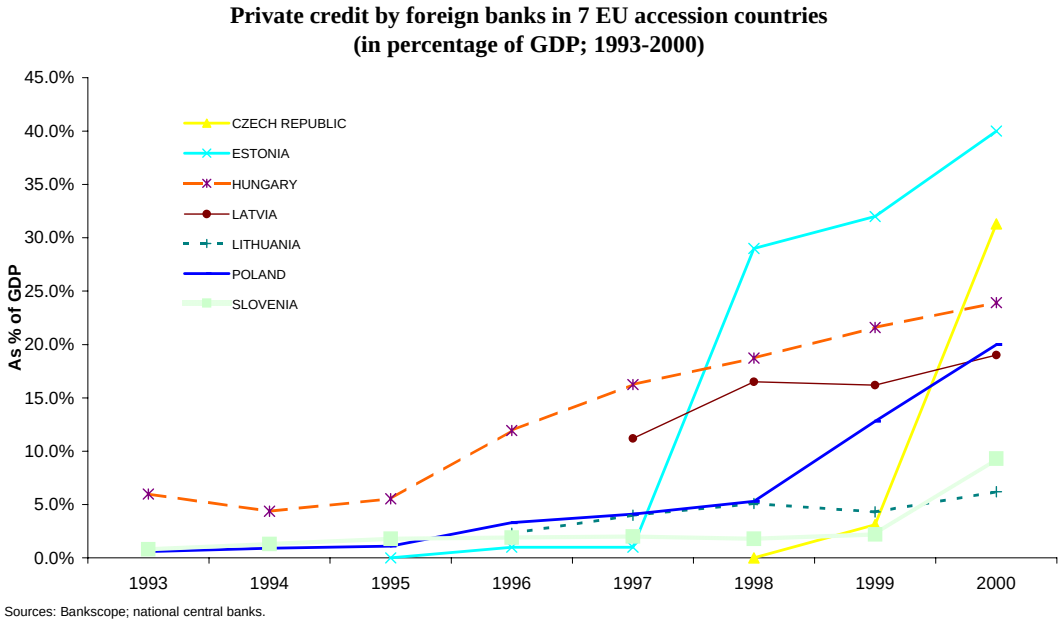


Figure 21



Major EU banking groups

Tables 5 and 6 describe the presence of EU banking groups in the ACs. The sample is large, as it includes 41 major groups from 14 EU countries (all but Luxembourg) with substantial cross-border banking activity.

At the end of 2001, the share of these banks in the overall ACs banking market was about one half, with peaks in Estonia (100%) and the Czech Republic (76.4%). On the EU banks' assets side, most assets of EU branches and subsidiaries were concentrated in Poland (40%) and the Czech Republic (34.1%) (Table 5).

In line with data on all foreign banks presented in Figure 18, also EU banks have a clear preference for being present through subsidiaries (accounting for 83.5% of the total number of affiliates) rather than branches.

Table 5

Presence of 41 major EU-15 banking groups in the EU accession countries [(1)]

(end-2001)

	Total AC	**BG**	**CY**	**CZ**	**EE**	**HU**	**LT**	**LV**	**MT**	**PL**	**RO**	**SK**	**SI**
Number of branches (A)	**15**	2	0	4	1	1	1	1	0	1	3	1	0
Number of subsidiaries (B)	**76**	3	2	12	3	13	4	3	6	19	3	7	1
Total (A)+(B)	**91**	5	2	16	4	14	5	4	6	20	6	8	1
Branches' total assets (in EUR bln) (C)	**9.9**	0.2	0.0	6.6	0.3	0.1	0.1	0.2	0.0	0.8	1.2	0.4	0.0
Subsidiaries' total assets (in EUR bln) (D)	**166.4**	2.5	2.6	53.5	4.2	14.7	2.1	1.7	3.6	69.7	0.8	10.0	1.0
Total (C)+(D)	**176.3**	2.7	2.6	60.1	4.5	14.8	2.2	1.9	3.6	70.5	2.0	10.4	1.0
Share in the banking market (in %)	**49.2%**	42.9%	11.9%	76.4%	100.0%	39.5%	50.0%	31.1%	39.1%	52.0%	15.7%	47.7%	5.1%

[(1)] The banking groups were selected according to the criterion that they had to be major banking groups in the home country with a significant cross-border banking activity.

Source: European Central Bank, Banking Supervision Committee.

The predominance of subsidiaries is even more impressive when looking at banks' assets. As Table 6 illustrates, at end-2001 subsidiaries accounted for 94.4% of the total assets of banking groups' affiliates under examination. Looking at other host countries in the world, this high share of subsidiaries is to be found in Switzerland, in contrast to the UK and Japan where branches of the 41 major EU-15 banking groups are predominant.

The general factors explaining this phenomenon (i.e., privatisation-driven FDI, profit opportunities arising from acquiring inefficient banks, need to buy local market knowledge and cope with local requirements) have been already discussed above as they apply to all foreign banks regardless of their origin. As regards, in particular, the EU banking groups, two other factors are worth mentioning. First, these banks could not yet take advantage of the single passport regime under the Second EU Banking Co-ordination Directive, still to be enforced in the ACs. Second, and more importantly, the ACs'

economies provided the EU banks with the possibility to expand their retail banking activity in a context where the share of such activity was decreasing in the EU domestic market. Further insight into this issue can be drawn from the analysis of the *business lines* developed in the ACs by the 41 EU banking groups under examination. According to the aforementioned survey, retail (32.2%) and commercial banking[18] (33.6%) account for the bulk of their activities in the ACs taken as a whole. This may follow the choice to buy local market knowledge by opening subsidiaries rather than branches. Conversely, corporate finance, trading and asset management[19] explain, altogether, only 28% (that is, 9.8%, 11.2% and 7% respectively) of the overall business conducted by banks' affiliates in the ACs, with the relative importance of other activities, such as agency services and retail brokerage, being negligible. As also confirmed during meetings with market participants, business such as asset management tends to be conducted at the parent company level, owing to economies of scale, predominance of crossover investment on dedicated investment and need to concentrate expertise in units with strong awareness of global trends.

Table 6

Assets of 41 EU banking groups split up between branches and subsidiaries (in %)

EU (exc. home country)				**AC**		**Switzerland**	
All EU-15		***Of which:* UK**					
Bran.	Subs.	Bran.	Subs.	Bran.	Subs.	Bran.	Subs.
47.0%	53.0%	87.2%	12.8%	5.6%	94.4%	9.5%	90.5%
United States		**Japan**		**NJA**	**Africa**		**Other**
Bran.	Subs.	Bran.	Subs.		Bran.	Subs.	
50.1%	49.9%	79.4%	20.6%	n.a.	27.3%	72.7%	n.a.

Source: European Central Bank, Banking Supervision Committee.

It should be noted that, owing to the major efforts of AC policy makers to restructure and re-capitalise their banking system via privatisation, private ownership of banks in the ACs currently exceeds that of certain important euro area countries.[20]

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[18] According to the classification used in the framework of the new draft Basel Capital Accord, retail banking includes lending and deposits, (traditional) banking services, Trust and Estates with retail customers, investment advice and card services. Commercial banking comprises the following activities for corporate customers: project finance, real estate, export finance, trade finance, factoring, leasing, lends, guarantees and bills of exchange.

[19] According to the classification used in the framework of the new draft Basel Capital Accord, corporate finance also includes municipal and government finance, and comprises the following activities: M&A, underwriting, privatisation, securitisation, research, "debt" (government; high yield), equity, syndications, IPO, and secondary private placements. The four sub-business areas of which "Trading & Sales" consists are "sales", "market making", "management of proprietary positions" and "Treasury"; the activity groups related to each of these areas are: fixed income, equity, foreign exchange, commodities, credit, funding, own position securities, lending and repos, brokerage debt, prime brokerage. Finally, asset management is divided into discretionary and non-discretionary asset management

[20] On average in the ACs private ownership accounts for more than three-quarters of banks' capital, compared with, for example, private ownership amounting to only about 60% of the banks' capital in Germany.

Regarding individual EU acquiring banking institutions[21], the main participants in the M&A process have been either global banks or more focused European commercial banks seeking to take advantage of their proximity to the area. More specifically, three categories of strategic investors can be identified in this process[22]:

1. global banks that had identified the ACs as an important segment of their global franchise - both as a component of EMEs and as future members of the EU and eventually euro;
2. commercial banks for which the ACs are a relatively natural extension of their home market. Best examples can be found in the Austrian, Swedish, German and Finnish banking systems;
3. major banks for which being exposed to ACs appears to be a sensible strategic decision.

As for the EU banking groups that are more heavily involved, the large Austrian banks are very active in the Eastern expansion into the accession countries' banking system. This is due to several reasons, including (i) the strategic interest of Austria vis-à-vis the so-called Visegrad countries (Czech Republic, Hungary, Poland and Slovakia) and other neighbouring markets, and (ii) the potential profitability of the accession countries' markets. Several German banks have been among the first participants in the privatisation of the accession countries' banks. Their evolution seems to be to a large extent a by-product of Germany's strong trade relations with many of these economies. The largest Swedish and Finnish banks found in the Baltic countries the ground for a natural expansion, whereas Italian banks followed an active international strategy towards the whole Central and Eastern Europe.

The EU banking groups currently most actively involved in accession countries' banking systems are Erste Bank (Austria), Unicredito (Italy), KBC (Belgium) and the Bayerische Hypovereinsbank group (Germany). Other banks, such as RZB (Austria), Société Générale (France), Swedbank and SEB (Sweden), ING, or ABN AMRO (Netherlands) also have an active presence in the region. Outside the EU, Citigroup (United States) is the most active bank in the ACs (see Table 7 for an overview).

[21] The information below is mainly drawn from ECB (2002): "Financial Sectors in EU Accession Countries".

[22] See Moody's (2001).

Table 7

Strategic ownership of the largest commercial banks in accession countries (2001)[1]

	Bank	Main shareholder	Share[2]
Bulgaria	Bulbank A.D.	Unicredito (IT)	full
	United Bulgarian Bank	National Bank of Greece (GR)	full
	DSK Bank	Public	full
	Bulgarian Postbank	ALICO/CEH Balkan Hold.s LTD (CY)	full
	SG Expressbank	Société Générale (FR)	full
Czech Republic	CSOB	KBC (BE)	dominant
	Ceska Sporitelna	Erste Bank(AU)	dominant
	Komercni Banka	Societe Generale (FR)	dominant
	Hypovereinsbank CZ	Bayerische Hypovereinsbank (DE)	full
	GE Capital Bank	GE Capital (US)	full
Estonia	Hansabank	Swedbank (SE)	majority
	Eesti Uhispank	SEB (SE)	full
	Sampo Leonia Bank	Sampo Leonia (FI)	full
Hungary	OTP	Dispersed private ownership	n.a.
	Kereskedelmi és Hitelbank	KBC (BE)	majority
	MKB	Bayerische Landesbank (DE)	dominant
	Central-Europ. Intern.Bank	COMIT and BancaIntesa (IT)	full
	ABN-AMRO	ABN AMRO (NL)	full
	General Banking & Trust	Gazprombank (RU)	significant
Latvia	Parekss Banka	Europe Holding (GB)	majority
	Latvijas Unibanka	SEB (SE)	full
	Aizkraukles	Board of Directors	significant
	Rietumu Bank Group	Orchard finance (GB)	full
Lithuania	Vilniaus Banka	SEB (SE)	full
	Lietuvos Taupomasis	Swedbank (SE)	full
	Bank Snoras	Incorion Investments (LT)	majority
	LZUB Agricultural Bank	Nord/LB (DE)	dominant
Poland	Bank Pekao	Unicredito (IT)	majority
	Bank Handlowy	Citibank (US)	dominant
	PKO BP	Public	full
	BPH	Bay. Hypovereinsbk (DE)	dominant
	BRE	Commerzbank (DE)	majority
Romania	Romanian Commercial Bank	Public	
	Banka Romana pentru Dezvolatare	Société Générale (FR)	majority
	Bank Post SA	EFG (GR)	minority
	Commercial Bank Ion Tiriac	Redrum Int. Investments	significant
	Banca Agricola	Public	
Slovakia	VUB	Intesa (IT)	full
	Slovenska Sporitelna	Erste Bank (AT)	dominant
	Tatra Banka	RZB (AT)	dominant
	Citibank	Citibank (US)	full
	Hypovereinsbank	Bayerische Hypovereinsbank (DE)	full
Slovenia	NLB	KBC (BE)	significant
	NKBM	Public (65% share privatised in 2001/2002)	
	SKB banka	Société Générale (FR)	full
	Abanka	Dispersed private ownership	n.a.
	Banka Koper	Dispersed private ownership	n.a.

[1] The information in this table has been collected from various sources and mostly refer to late-2001. Due to sometimes limited comparability between sources and ongoing changes in the ownership structure, the information should be treated with caution.

[2] Ownership shares are defined as follows: full 95-100% share; dominant 60-94%; majority 50-59%; significant 25-49%; minority 5-24%; n.a. = non available.

Source: ECB staff calculations, based on various sources including accession countries' central banks, Bank Austria studies (e.g. "Comparison of banks Central and Eastern Europe 2001") and reports of other commercial banks.

1.6 The degree and pattern of foreign banks' penetration: a comparison with Asia and Latin America

Table 8 compares the market share of foreign banks in the three largest ACs with that of several Asian and Latin American countries at different points in time, as measured by the ratio between foreign banks' assets and total assets. It shows that the degree of foreign banks' penetration in the ACs is currently much higher than in Asia (especially Northeast Asia), with Latin America ranking somewhere in-between. The only countries comparable with the ACs are Hong Kong and Singapore in Asia – owing to their history as British colonies and specialisation as offshore banking centres – and Mexico in Latin America, due to its strong integration with the United States especially after 1994 (i.e. in the wake of NAFTA arrangements and as a result of bank restructuring following the Tequila crisis). The picture at the beginning of the 1990s was, of course, very different, with foreign bank presence not going beyond one fifth (often one tenth) of total assets in most countries. The need therefore arises of identifying the main, probably interacting, factors accounting for different developments over the last decade. Some interpretations are suggested below.

Table 8

Presence of foreign banks in selected EMEs [1]

	1980 (if not otherwise specified)	**1990** (if not otherwise specified)	**2000** (if not otherwise specified)
Czech Republic	…	10 [3]	90 [5]
Hungary	…	10	66 [5]
Poland	0	3 [6]	68 [5]
Argentina	10 [7]	10 [4]	49
Brazil	…	6	23 [2]
Chile	…	19	54 [2]
Mexico	…	0	73 [5]
Peru	2	4	40
Colombia	9	8	26 [2]
Korea	6	4	3 [2]
China	0	0	1
Hong Kong SAR	…	89	72
Singapore	86	89	76 [2]
Indonesia	…	4	7
Malaysia	38	24	18
the Philippines	8	9	15
Thailand	…	5	12 [2]
India	4	5	8 [2]

(1) Total assets (both local and cross-border) of foreign banks as a percentage of total bank assets. Foreign banks are defined as in footnote (14) of the main text. / (2) 1999. / (3) 1994. / (4) Average 1988-95. / (5) 2001. / (6) 1993. / (7) As a percentage of total deposits in 1986.

Source: "The banking industry in the emerging market economies: Competition, consolidation and systemic stability" - BIS Papers No. 4 (August 2001).

A first explanatory factor may be found in shifts in the regulatory environment. While in the ACs and Latin America the legislation allowing for greater foreign ownership was usually introduced already in the mid-1990s, in most Asian EMEs the bulk of liberalisation took place later on, in the aftermath of the 1997-98 crises. Besides Singapore and Hong Kong, which were already open to financial FDI, and with the exception of Malaysia that followed an opposite strategy[23], since end-1997 Asian EMEs have been relaxing or removing restrictions on foreign ownership in order to facilitate, a re-capitalisation of their banking sectors and provision of state-of-the-art financial management skills. This produced significant M&A-related FDI inflows in the 3-year period 1998-2000, especially to South Korea, Thailand and Indonesia. Available evidence shows, however, that the momentum has not been kept in 2001 and 2002. In certain countries this could have been produced by the persistence of certain restrictions. In Thailand, for instance, while foreign ownership in banks is permitted up to 100%, after 10 years the share of foreign-held equity must fall to no more than 49%. In the Philippines, which completed the process of liberalisation in May 2000 only, full ownership is allowed for a 7-year window only. More importantly, the still negligible foreign bank presence in China is attributable to a significant extent to the presence of various regulatory hurdles. However, obstacles may be loosened in the coming years, also as a result of WTO entry. Such a liberalisation could produce significant changes in the overall picture of financial FDI in Asia, especially if one considers that China is currently estimated to attract around 80% of non-financial FDI to this region.

A second factor explaining different patterns across countries is likely to have been economic integration with one or more major mature economies. For instance, according to unpublished estimates by the Bank of England based on the Thomson database, between 1990 and 2002 almost 70 per cent of the banking M&A-related FDI outflows of the United States and Germany were directed, respectively, to Mexico and Poland. This may have been positively correlated to trade and, in line with the "follow-your-customer" interpretation, to non-financial FDI flows. It may also be the case, however, that structural developments in the host markets – including their compliance, respectively, with NAFTA and EU rules – have stimulated both financial FDI and non-financial FDI at the same time[24].

A third factor can be found in the different structure and size of financial systems, coupled with differences in the historical path toward economic development. For example, in Asia banks' capitalisation is usually significantly higher than in the two other regions. This implies, ceteris paribus, higher costs to be incurred by the potential acquiring foreign banks to reach controlling interests. Moreover, the relatively larger foreign bank presence in Southeast Asia in comparison with Northeast Asia can be understood by considering the more important role that foreign corporations played in the

[23] In particular, in Malaysia foreign bank ownership is restricted to a limit of 30% of capital.

[24] In the literature both interpretations can be found. See for instance Brealey and Kaplanis (1996), Yamori (1998) and Buch (2000) for empirical tests confirming the "follow-your-customer" hypothesis. Clarke et al. (2001) and Nolle and Mohanty (1998) reject such hypothesis and present alternative interpretations.

industrialisation of this region and the development of its export-led strategy. This would confirm, at least in this case, the importance of "follow-your-customer" aspects.

A fourth possible factor is given by differences in information costs across regions, as proxied by variables such as geographic distance and cultural similarities (e.g. common language, comparable legal system and social norms, etc.). In this regard it should be recalled that, according to the aforementioned estimates by the Bank of England and consistently with stock data in Table 8, between 1990 and 2002 the bulk of banking M&A-related FDI flows to EMEs went to Latin America (around 60%) and emerging Europe. The latter collected almost one fourth of total flows, which is a very large amount if one considers the initial size of the banking system in these countries, and the fact that the whole Asian region hosted no more than 13% of banking cross-border M&As. One striking feature of these inflows is the degree of geographic concentration of the acquiring banks. We have already described the importance of the EU countries for the ACs, which also reflects the geographic distance and cultural similarities between the two regions. It should be also observed that in Argentina, Brazil and Chile 62%, 63% and 91% of banking cross-border M&As originated from Spain (cultural similarities). In Mexico, the United States accounted for 69% of the total (geographic distance). In all these countries the share of foreign banks increased considerably in the 1990s (see Table 8). Conversely, in Asia information costs for EU and US banks have likely been higher, as mirrored in their relatively low share in cross-border M&As (21 and 29% respectively). Such costs have been lower for Japanese banks, which, however, have not exceeded 23% of the total.

2. The role of foreign banks in Accession Countries

2.1 Introduction

As already announced in the introduction, the second part of this note takes a closer look at determinants of financial FDI to the ACs. The aim is to analyse more in detail in which way foreign banks have changed the financial sector in these countries, and to what effect. Ideally, the analysis should be substantiated by thorough econometric studies, but we must from the very beginning come to terms with the very limited set of available data. This derives from both the small number of countries under consideration (which implies cross-section analysis is not feasible) and the very few years of observations (no time-series analysis either). Additionally, the fact that the entry of foreign banks has occurred at the time when the ACs underwent their transition to market economies makes identification of the effect of foreign banks' entry even more demanding in terms of data. Given these limitations, we will have to restrict our analysis to a discussion of relevant features of the financial sector of the ACs; in particular, we will provide preliminary evidence of the consequences of foreign banks' entry.

Given the areas of research on financial FDI discussed in the our literature review, we investigate the role of foreign banks in the ACs along the following lines:

i. Foreign banks tend to operate mostly in the wholesale market, leaving the retail market to domestic banks;

ii. Foreign banks have an impact on the financial stability of the host country;

iii. Foreign banks can promote efficiency in the host country banking sector;

iv. Foreign banks entry is related to the quality of the regulatory and supervisory framework of the host country.

2.2 Wholesale versus retail market

It is usually thought that banks operating cross-border are large, and usually large banks do most of their business at the wholesale rather than at the retail level (Foccarelli and Pozzolo, 2001). On the contrary, domestic banks are generally smaller than the foreign parent banks operating cross-border and tend to focus on retail activities.

In the accession countries, however, due to the small size of their money market and capital markets more in general, foreign banks seem to have a preference for developing retail banking rather than wholesale activity. In particular, as mentioned above, commercial and retail banking are the most developed business lines (34% and 32% of the total), whereas other banking activities, like retail

brokerage and agency services, are hardly being developed. In 2001, wholesale activity, which – as an approximation - might be represented by the category "Trading and sales", accounted for 11.3% of the total in the region.[25]

However, there are significant differences across countries. Wholesale versus retail banking appears to be more balanced in the Czech Republic (21% and 31 %, respectively) and Poland (14% and 25%, respectively), whereas in most of the remaining countries the small size of the domestic money and capital markets contributes to limiting importance of the wholesale activity.

Table 9: Relative importance of business lines in the banking sector, 2001

% of the total	Corporate finance	Trading and sales	Retail banking	Commercial banking	Asset management	Others
Bulgaria	0.0	0.0	60.0	40.0	0.0	0.0
Czech R.	10.3	20.7	31.0	31.0	3.4	3.4
Estonia	10.0	10.0	30.0	30.0	20.0	0.0
Hungary	9.5	9.5	33.3	38.1	0.0	9.5
Lithuania	0.0	0.0	42.9	42.9	14.3	0.0
Latvia	0.0	0.0	42.9	42.9	14.3	0.0
Poland	13.9	13.9	25.0	25.0	5.6	16.7
Romania	14.3	14.3	28.6	42.9	0.0	0.0
Slovakia	7.7	7.7	30.8	38.5	15.4	0.0
Slovenia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
All Accession countries	**9.8**	**11.2**	**32.2**	**33.6**	**7.0**	**6.3**

Source: Banking Supervision Committee, European Central Bank, 2002.

Overall, the volume of repo operations among commercial banks in accession countries remains particularly low, accounting for only a fraction of total interbank market turnover. The same holds for the Czech Republic, which possesses the most developed interbank money market among accession countries. Repo transactions only account for around 1% of the total interbank market turnover and the average daily turnover remains below EUR 100 millions.[26] In most countries, repo transactions are primarily conducted between market participants and the central bank, whereby excess bank liquidity is in most countries withdrawn by the central banks in exchange for collateral.

[25] Although "Trading and sales" (sales, market making, etc. concerning fixed income, equity, foreign exchange, securities, lending and repos, etc.) is a broader concept than the one of "wholesale", the counterparts of this business areas are mainly represented by other private banks rather than individuals or other private entities in most accession countries.

[26] Figures are taken from the NCBs' Internet sites.

2.3 Financial stability

As far as the issue of financial stability is concerned, several considerations are in order. In the following paragraphs we study the behaviour of foreign banks both at times of crisis and during tranquil periods, the degree of foreign currency mismatch in the ACs' banking sectors, and some more general measures of financial deepening.

2.3.1 Volatility of credit from foreign banks at times of crisis

To begin with, one line of research in the literature tries to find out whether the behaviour of foreign banks is different from the one of domestic banks at times of crisis. In fact, there has been conflicting evidence on whether foreign banks are more likely to "run to the exit" than local banks, i.e. withdraw from the host country.[27] In this respect, the experience of accession countries is somewhat peculiar, given that episodes of distress in their banking sector, if any, preceded the bulk of entry of foreign firms[28]. In the ACs, banking crises were bound to be an inevitable part of the entire reorganisation process of the economy, including the banking sector that these countries went through. Such reorganisation required massive public intervention, recapitalization, consolidation and liquidation of insolvent institutions. Ultimately, at the end of the 90s, substantial entry of foreign banks led to a stable banking sector. Since this development, no major crises have occurred. For this reason, the behaviour of foreign banks in ACs at times of crises is still untested.

2.3.2 Volatility of credit from foreign banks during tranquil periods

A related concern on the role of foreign banks is whether credit offered by them is more volatile than the one extended by domestic banks also during non-crisis periods. Evidence from a paper by Clarke et al (2002)[29] shows that in fact the opposite may be true, given that the coefficient of variation for the ratio of claims on the private sector by deposit money banks to GDP is lower in countries where foreign

[27] See International Capital Markets, Chapter 6, September 2002, IMF.

[28] Most of the ACs have experienced banking crises in 1990s, for the most part in the first half of the decade (e.g. Baltic States 1992-95; Hungary 1997; Czech Republic 1997-98).

[29] In particular, see Figure 6 in their text.

Table 10a: Private credit of deposit money banks

% of GDP	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Std Dev†
Czech R.*	49.9	57.8	58.1	56.1	65.2	57.5	52.8	48.3	41.2	31.5	9.7
		31.1	36.8	41.4	56.3	56.0	52.8	48.2			9.87
Estonia*	11.2	14.1	14.8	19.2	26.3	25.3	26.5	25.4	26.9	29.2	6.5
	13.0	15.0	18.0	24.0	33.0	33.0	35.0	40.0			10.23
Hungary*	28.1	26.1	22.2	21.8	23.9	23.7	25.6	32.2	33.9	35.3	4.9
	32.9	31.4	26.7	23.9	25.0	26.1	28.5	31.3			3.33
Latvia	17.3	18.3	8.9	7.7	10.9	15.2	16.2	19.0	23.1	29.0	6.5
			7.5	8.1	13.9	19.1	20.0	22.5			6.37
Lithuania*	13.8	17.6	15.2	11.1	10.9	11.3	13.0	11.6	11.5	14.2	2.2
	13.8	17.6	15.2	11.1	10.9	11.3	13.0	11.6			2.28
Poland*	12.2	11.2	11.9	14.8	17.0	19.5	23.6	27.7	28.3	28.7	7.1
	21.3	19.8	18.4	20.8	23.1	25.2	28.8	29.9			3.98
Slovakia*	57.0	40.7	36.8	44.0	56.1	53.9	54.6	51.3	37.6	39.7	8.17
Slovenia*	22.1	23.0	27.4	28.8	28.5	32.8	36.0	38.0	40.0	39.2	6.57
	36.2	33.3	38.3	37.4	37.9	42.3	45.8	32.2			4.20
Average											5.40

* Data in first row are from the IMF (IFS, line 32d), while those in second row are from NCBs.

† Standard deviation, computed over the period 1993-2000.

Sources: IMF and national central banks.

ownership is greater. While a similar analysis could be reproduced for the accession countries, we face two important constraints. On the one hand, the usual caveat that the very short time-series may impair the validity of our results applies.[30] On the other hand, the analysis is significant only as long as we can say that the entry of foreign banks has reached a steady state, so that fluctuations in the provision of private credit do actually represent different lending strategies between foreign and domestic banks.

[30] A word of caution should however be mentioned about the informative content of replicating the tables of Clarke et al (2002). Namely, the mere difference in size between two coefficients of variation is not by itself a sufficiently strong indication of a significant difference in the two sets of countries.

Table 10b: Private credit by foreign banks

% of GDP	1992	1993	1994	1995	1996	1997	1998	1999	2000	Std Dev†
Czech Rep.							0.0	3.1	31.3	31.3
Estonia				0.0	1.0	1.0	29.0	32.0	40.0	40.0
Hungary		6.0	4.4	5.5	11.9	16.2	18.7	21.6	23.9	23.9
Latvia						11.2	16.5	16.2	19.0	19.0
Lithuania					2.3	4.0	5.1	4.3	6.2	6.2
Poland		0.6	0.9	1.1	3.3	4.1	5.3	12.8	20.0	20.0
Slovakia										
Slovenia	0.4	0.8	1.3	1.8	1.9	2.0	1.8	2.2	9.3	9.3
Average										5.66

† Standard deviation, computed over the period 1992-2000.
Source: Bankscope.

As it can easily be seen from Tables 10a and 10b above, the presumption of a steady state in the composition of the banking sector of the ACs is at odds with the wave of entry of foreign banks. For this reason, the average standard deviations across countries and over the 1992-2000 period of 5.40 and 5.66 for all banks and foreign banks only respectively are not to be interpreted as strong evidence of any tendency of foreign banks to be less committed to credit in the ACs. In fact, the most valuable information contained in these tables is limited to evidence of the steady increase in the presence of foreign banks in the ACs.

2.3.3 Contagion between ACs and EU banking systems

A line of research on the effects of foreign banks' entry on the financial stability of the host countries has highlighted the link that cross-border operations of international banks create across several countries. This link in turn may open up channels of contagion between the banking sectors of any of the countries of operation of the financial institutions concerned, in the event of a crisis. The direction of contagion could go both ways, with a crisis starting in the EMEs or in the mature economies that host the headquarters of the international banks. In the case of the ACs, as the first part of this paper has amply discussed, the most relevant foreign banks are from the EU, so we restrict our analysis to them.

First, as regards shocks originating in the ACs, when we look at the amount of investment of foreign banks in this region, it is clear that these countries represent only a small fraction of the overall portfolio

of international banks. For this reason, adverse implications of financial stress in ACs for EU banks are likely to remain limited in view of the small role played by these countries in the EU banks' overall cross-border exposures (Table 11).

Table 11: Global foreign exposures of EU banks

	Total foreign claims	Share of total foreign claims in total assets (%)	Claims on developing countries	Share of claims on developing countries in total assets (%)	Share of claims on accession countries in total assets (%)
Austria	53.4	9.6	12.8	2.3	6.4 (50)
Belgium	452.8	59.6	29.4	3.9	19.7 (67)
Finland	43.3	28.1	2.7	1.7	0.9 (33)
France	825.5	22.2	88.4	2.4	5.7 (6)
Germany	2,260.4	36.1	201.0	3.2	53.1 (26)
Greece			n.a.		
Ireland	82.7	20.4	5	1.2	n.a.
Italy	294.5	16.3	59	3.3	18.4 (31)
Luxembourg			n.a.		
Netherlands	435.9	34.8	72.2	5.8	11.3 (16)
Portugal	40.3	11.8	4.3	1.3	0.4 (9)
Spain	355.7	29.7	175.2	14.6	0.6 (>1)

Source: ECB note "Developments in the financial sector accession countries and EU financial Stability". Data as of September 2001.

However, the aggregate figures may be misleading, as they hide some important information concerning regional differences in exposure to credit risk originating in the ACs. In relation to total assets of the individual EU countries banking sectors, there is a high concentration of exposure to Estonia, Latvia and Lithuania for the banks in Sweden, Denmark and Finland. This feature calls for close monitoring, as any shock originating in the Baltic States could have an impact on the balance sheets of the banks of the three corresponding EU countries.

Second, the risk that the ACs may be vulnerable to shocks originating abroad cannot be ruled out. Taking the ACs as a group, it is clear that EU foreign banks cover a large portion of the eastern European domestic banking sector, so that any shock to the lending countries would be very important for the borrowing ones (Tables 10b, 12a and 12b). Since foreign banks' entry in the ACs, no episode of major banking crises in the headquarter countries has taken place, so that a factual analysis of such contagion mechanism is not feasible. However, it should be noted that the issue of direct contagion from EU to AC countries is relevant only as long as the two groups of countries are subject to asymmetric shocks. In the case of the ACs, it stands to reason that the occurrence of strongly asymmetric shocks between the EU and the group of the ACs is bound to become less and less likely over time, as the ACs become progressively more integrated with their EU counterparts. For this reason, the transmission of local shocks originating in the EU may not be a reason for significant concerns in the future. Furthermore, large EU banks with a substantial exposure to the ACs may be reluctant to move out of the ACs at times of crises in the headquarter country due to the ensuing reputational cost. In fact, such a move could be interpreted by market operators as evidence of financial weakness and lead to additional deterioration of the assessment of the headquarter bank.

Table 12a: Number of foreign banks

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Czech Rep.					22	24	24	25	27	28	27	27	27
Estonia						1	1	1	3	3	4	4	4
Hungary				15	18	18	28	32	31	32	33	31	27
Latvia						12	15	16	16	13	13	13	13
Lithuania							3	5	7	7	9	9	12
Poland	1	6	9	10	11	18	25	29	31	39	48	48	49
Slovak Rep.				7	10	13	14	14	14	12	14	13	15
Slovenia			2	5	6	6	4	4	3	5	6	5	6

Sources: National central banks, EBRD Transition Report.

Table 12b: Number of domestic banks

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Czech Rep.					33	31	29	25	18	14	14	12	11
Estonia			42	21	22	18	14	11	3	4	3	3	3
Hungary				24	24	23	14	13	14	11	9	8	8
Latvia						31	21	17	22	11	9	7	9
Lithuania	6	12	21	27	22	15	9	7	5	6	4	5	4
Poland	42	83	94	94	71	65	56	54	32	38	26	16	17
Slovak Rep.				9	8	9	10	11	10	11	7	6	3
Slovenia			28	27	27	25	25	24	21	20	19	14	13

Sources: National central banks.

Finally, it should not be forgot that a powerful argument in favour of foreign banks' entry in (especially less developed) countries is the fact that foreign banks bring with them expertise and human capital that EMEs would otherwise develop only over a very long period of time. It is actually the case that foreign banks operating in the ACs are among the biggest ones in their domestic markets, and are usually among the most efficient banks domestically. For this reason, not only the likelihood of financial instability in ACs stemming out of fragile foreign banks should be very low, but also gains from the transmission of better foreign technology should be very high.

Looking at the contagion from EU countries to the ACs from a more desegregated point of view, we can point out interesting intra-regional variations. Table 13 shows levels of flows from selected EU country to the ACs.

The Baltic countries are mostly exposed to flows of bank capital from Sweden and Finland, and less so from Germany. Such concentration, which mirrors the one remarked about the ratio of Scandinavian banks' total assets made up by the Baltic countries, shows a pattern of regional concentration that could make the Baltic banking sectors more fragile.

In contrast, exposure of the biggest accession countries, i.e. Poland, Hungary and the Czech Republic, is more evenly distributed across the EU countries. For this reason, these three big ACs are less likely to be vulnerable to any EU country specific shock. In addition to their already quite satisfactory supervisory framework, such distribution of their banking links is bound to produce a reasonably stable financial sector.

Table 13: Country by country links between EU and ACs

Host country / Source	Czech R.	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia	Slovenia	Total
Austria	28.4	0.5	20.9	0.1	0.4	35.6	9.8	8.7	104.4
Belgium	155.5	0.2	57.5	0.0	0.1	76.7	17.8	4.3	312.1
Finland	0.0	7.8	0.1	8.8	3.4	3.0	0.0	0.0	23.0
France	59.0	0.0	12.4	0.1	31.0	23.8	6.1	14.3	146.7
Germany	108.1	5.2	160.3	6.4	10.8	222.2	21.8	26.7	561.3
Italy	3.5	0.7	34.1	0.1	0.2	145.6	58.0	3.3	245.5
Netherlands	23.8	0.2	15.0	0.1	0.3	78.0	9.0	1.0	127.2
Portugal	0.1	0.0	0.1	0.0	0.0	0.4	0.0	0.0	0.7
Spain	1.6	0.0	1.6	0.0	0.0	2.6	0.0	0.1	6.0
Sweden	0.4	46.2	0.2	17.6	24.1	14.7	0.8	0.0	104.1
United Kingdom	0	0.02	7.66	0.05	0.1	6.16	0.37	0.05	14.4
Sum	380.2	60.8	310.0	33.2	70.3	608.7	123.6	58.5	1645.3

Source: BIS Consolidated banking statistics, in USD 100 millions at September 2001.

Finally, the recent literature on contagion (Kaminsky et al., 2000), based on the Asian crisis of the late 1990s, has highlighted the role played by major common lenders across a cluster of countries – in that case, the Japanese banks to the South-East Asian countries. Looking at Table 13, it is clear that, in terms of volumes of flows to the ACs, German and Belgian banks are the dominant lenders to the majority of these countries. As a result, it should be worth investigating whether a shock in any of the ACs could lead the lending banks from either Germany or Belgium to retrench and withdraw funds from the other ACs. For this to happen, however, several conditions should be in place. First of all, on the lending side, EU banks in the ACs would be more likely to react in this way if they were heavily exposed to the ACs, as a percentage of their total assets, if they had low capital-to-asset ratios and if their income were not well diversified. Overall, as discussed above, evidence seems to suggest that both German and Belgian banks would not be very vulnerable to shocks in any ACs, although among the banks of either country there are potentially significant differences. Secondly, transmission of regional shocks along the line of a common lender is more likely to occur the more similar countries in a region are. In the case of the Asian countries, similar trade patterns and exports mainly to the same markets, namely, the USA, made the spread of the crisis much more likely. In the case of the ACs, given that their economies are less open

that the Asian ones in the 1990s, trade links should represent a smaller concern to common lenders. Moreover, although foreign banks do represent a large part of the domestic banking sector, the ACs are still less developed in financial terms than the Asian countries in the late 1990s. This in turn reduces the relevance of the common lender channel.

2.3.4 Currency mismatch

As the banking and currency crises in South-East Asia in the late 1990s and more recently in Latin America have shown, when evaluating the health of a national banking sector one cannot ignore the effect of currency and maturity mismatches in banks' balance sheets. Moreover, in order to assess properly the vulnerability of a country's economy to currency mismatches, potential currency risks transferred from the banking system to the non-financial sector – i.e. corporate and households sectors – need to be taken into account. In fact, it is well known that, for banks operating in countries where a foreign currency plays an important role, domestic on-lending of foreign exchange resources creates a trade-off between currency and credit risks. As a consequence, a superficial impression of matching in banks' balance-sheet may not fully reveal their exposure to domestic credit risk and the non-financial sector vulnerability to currency risk.

Table 14: Proportion of foreign currency exposure

	FOREX Assets/Total Assets		**FOREX Liabilities/Total liabilities**	
	2000	**2002**	**2000**	**2002**
Czech Rep.	23.4	17.1	21.3	16.4
Estonia	60.6	70.3	43.7	41.3
Hungary	36.4	27.8	36.5	26.9
Latvia	65.1	64.2	66.2	65.6
Lithuania	54.8	45.3	55.1	44.5
Poland	22.1	22.7	17.1	17.1
Slovak Rep.	18.3	13.02	16.3	15.6
Slovenia	33.5	33.0	34.9	33.9
Average	**39.3**	**36.7**	**36.4**	**32.7**

Source*:* BSCEE (Banking Supervisors from Central and Eastern Europe), *Review*, 2003. Data are averages for all financial institutions, including large, medium-sized and small banks, foreign bank branches, credit unions, savings and credit cooperatives.

In this respect, data show (Table 14) that banks in the ACs are indeed exposed to exchange rate movements, given that a large part of their assets and liabilities is actually denominated in foreign currency.

However, there is an overall balance in the proportion of foreign currency in assets and liabilities, which may lead to the preliminary view that currency mismatch, by itself, is not a major concern. This assessment, however, suffers from the limitation in data availability, as mismatches in individual currencies can not be measured.[31] In particular, information on the maturities of both assets and liabilities in the various currencies of the balance sheet should be provided, as aggregate figures could hide underlying maturity mismatches. Needless to say, such figures are not available. The IMF Article IV publications of Country Reports help to clarify the foreign currency exposure of countries under consideration, although a breakdown by various foreign currencies is not available.

In the case of the ACs, however, we cannot avoid to focus on a specific currency: we take a closer look at the role played by the euro in banks' balance sheets, as this currency will ultimately become legal tender once the accession process is completed. In this respect, a growing share of the euro in assets and liabilities denominated in foreign currencies is to be expected, for at least two reasons. Participation in ERM2, if supported by a sustainable convergence progress, is likely to contribute to reducing over time the exchange rate risk between ACs currencies and the euro. Moreover, as the euro will become the national currency in the period ahead, once a sustainable degree of convergence assessed on the basis of the Maastricht criteria has been achieved, private sector agents may have an incentive to increase their assets and liabilities in this denomination. On this account, the only data available are the ones on the amount and percentages of local deposits denominated in euro (Table 15). Of course, given the short period of time elapsed since the introduction of the euro, it is impossible to draw any firm conclusion.[32] However, the data do suggest that the euro is becoming the most important foreign currency for bank deposits in a number of ACs.

Although not directly related to the banking sector, a consideration on the exposure to foreign exchange changes through public debt is in order. An important lesson of the recent currency crises in Latin America[33] is in fact that the vulnerability of the financial sector was not completely independent of the fiscal position of the Government. In particular, the devaluation of the domestic currency, induced by a loss of confidence in the sustainability of the fiscal accounts, generated a systemic crisis in the domestic banking sector (both foreign and locally owned banks), due to the latter's exposure to sovereign debt in

[31] Although IMF/World Bank's FSAP documents (FSSAs) do contain information on the foreign currency composition of banks' balance sheets, a break down by currency is not available. BIS data can only cover inter-bank activities from the counterparty banks in the EU area, as banks in ACs are not reporting-banks. On the limited volume of inter-bank flows across countries, as retrieved through the BIS from Balance of Payments data, a breakdown by currency is available upon request.

[32] Preliminary data do show however an increase in the volume of euro-denominated bank deposits over the period December 2001-December 2002 for all ACs. (ECB, *Review of the International role of the Euro*, December 2002 and December 2003)

[33] The case of the Asian currency and banking crises in the late 1990s is somewhat different, as in this case it was not so much the imbalances in the fiscal accounts that lead to the crisis. Government's involvement was produced only indirectly through the role of the Central Bank as the lender of last resort.

Table 15: Outstanding euro-denominated bank deposits*

	Total (€ millions)		% of total deposits		% of foreign deposits	
	End-2001	*End-2002*	*End-2001*	*End-2002*	*End-2001*	*End 2002*
Czech Rep.	3,522	3,564	7.4	6.7	50.9	59.6
Estonia	603	1,017	19.2	26.2	50.4	62.7
Hungary	3,029	2,686	11.2	9.4	41.0	58.1
Latvia	592	879	11.6	14.4	15.7	19.4
Lithuania	53	…	1.9	…	4.5	…
Poland	4,034	3,557	4.7	4.6	27.2	28.3
Slovak. Rep.	1,121	1,686	8.5	8.2	43.3	59.6
Slovenia	3,006	…	37.9	…	83.6	…

Source: ECB, Review of the international role of the Euro (2002).

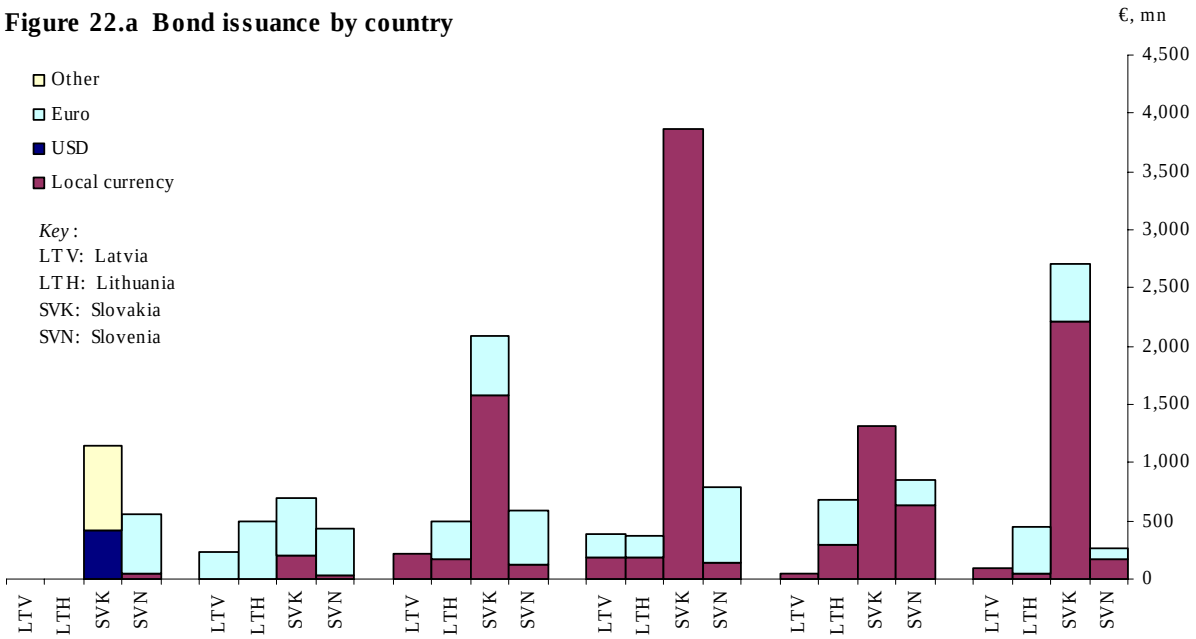
foreign currency. As the Government went into default, the banks found themselves insolvent[34]. However, the case of the ACs seems to be somewhat different. The risk of a liquidity crisis stemming out of a shortage of foreign exchange is likely to be less of an issue for the ACs, in comparison to Latin American or Asian economies, as local foreign currency deposits are small in magnitude (low ratios of foreign currency deposits to GDP) and are less close substitute for assets held abroad (IMF, 2003). Secondly, the overall level of public debt is on average low, and even more so the amount denominated in foreign currency. As Figures 22.a and 22.b show, emissions were of limited size[35]. Moreover, foreign currency denomination, of which the dominant one is by far the euro, seems if anything to have lost ground over the few years of issuance. In fact, in the initial issuances of 1999 the euro was the most frequent denomination. Later on, domestic currency became the most important component. How this change came around is beyond the scope of our research[36], but it seems likely that such a change could result in a more stable financial sector.

[34] Exposure to foreign currency denominated bonds is a key factor, as there is in principle no limit to the Government's ability to repay in domestic currency.

[35] Data are reported only since 1998, as the number of issuances before that date was very low - not surprisingly, given that these countries began receiving ratings from internationally recognised rating agencies only at that point in time

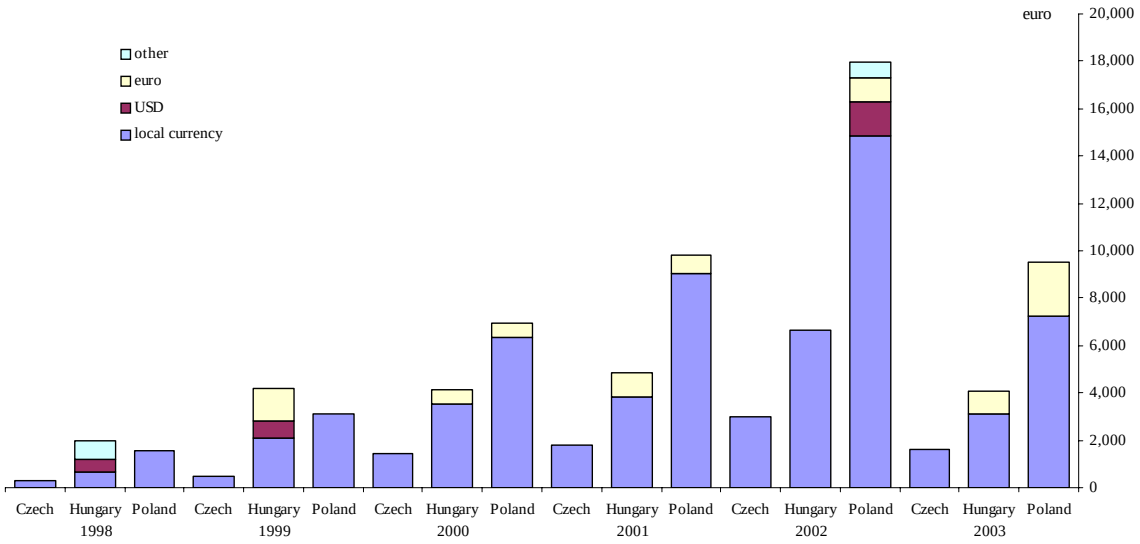
[36] A common problem to EMEs issuing sovereign debt in the 1990s has been the inability to use the domestic currency, the so-called " original sin". As a consequence of a better understanding of the risks associated with this choice of funds and possibly also of a change in investors' risk aversion, issuance in domestic currency has become more frequent at the end of the 90s and the beginning of the 00s.

Figure 22.a Bond issuance by country



Source: Capital Data Ltd.

Figure 22.b



Source: Capital Data Ltd. Data up to end-May 2003.

Although we do not distinguish locally versus internationally issued bonds, it is a good approximation to assume that foreign currency denominated bonds were held by foreigners and not by banks operating domestically. Therefore, banks in the ACs are unlikely to be exposed to big swings in the value of their assets even at the time of high volatility in the exchange rate.

2.3.5 Financial Deepening

As we are mostly interested in the stability of the financial sector, we should also look at broad measures of financial deepening. The reason why we extend our analysis to more general features of the financial sector is twofold. First, effectiveness of monetary policy is linked to the degree of financial development of a country, and at times of crisis in the banking sector, monetary policy could be a useful instrument. Second, banks' efficiency also relies on their investment opportunities, and a deep financial sector offers better risk diversification and profit making. As for the role of foreign banks, it is not unlikely that their entry has accelerated the pace of financial deepening in the ACs.

Table 16 : Coefficient of monetisation of the economy (ratio of M2 to GDP)

%	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Argentina	22.7	26.5	28.7	31.4	31.8	27.1	27.9
Brazil	27.7	29.3	30.7	31.2	28.9	29.7	32.1
Chile	38.6	40.4	42.1	44.0	42.9	40.9	38.7
Mexico	26.5	28.2	27.3	26.1	20.6	22.4	29.8
Czech R.	73.7	69.9	66.0	65.5	72.8	74.5	71.3
Estonia	28.3	32.0	29.0	34.6	38.0	42.3	42.0
Hungary	48.1	46.5	45.5	46.7	45.5	46.9	47.2
Latvia	23.4	27.5	26.7	26.7	30.3	33.2	36.5
Lithuania	17.2	19.0	19.4	21.0	23.2	26.5	29.2
Poland	35.2	37.3	39.9	42.8	43.0	46.9	42.7
Slovak R.	65.2	62.9	60.4	62.5	66.2	68.0	63.9
Slovenia	39.2	42.5	45.4	46.5	49.7	55.1	55.6
Indonesia	52.7	56.0	59.9	58.4	58.4	56.7	n.a.
Korea, Rep.	42.6	44.9	58.2	68.2	79.1	85.8	87.0
Malaysia	92.3	97.6	95.7	105.3	101.8	106.7	102.1
Philippines	56.3	62.0	61.3	64.2	62.4	58.8	58.7
Thailand	80.8	91.7	102.9	108.3	105.8	104.0	99.2
Euro-area	n.a.	n.a.	88.8	88.3	87.5	88.2	89.3

Source: IFS (lines 34-35).

As it is hard to produce any absolute standard in terms of financial deepening, we compare the ACs with other EMEs in the following tables. The comparison with the selected Latin America and Asia countries is meaningful in two respects. First, Latin America is a region where foreign banks' presence, although not as massive as in the ACs, is noticeable, while in the Asian region, which shows comparatively high

levels of financial deepening[37], foreign banks' penetration is substantially lower.

Table 17: Coefficient of monetisation of the economy (ratio of M3 to GDP)

%	**1996**	**1997**	**1998**	**1999**	**2000**
Argentina	15.8	19.2	21.6	23.9	24.9
Brazil	23.0	24.1	25.4	25.3	22.4
Chile	34.8	36.1	39.3	41.2	40.0
Mexico	20.7	22.6	22.5	20.5	15.3
Czech Republic	44.9	45.0	44.1	42.3	48.3
Estonia	6.8	10.1	11.2	12.0	14.6
Hungary	30.2	28.6	27.8	27.9	27.8
Latvia	8.1	10.1	10.0	10.2	12.8
Lithuania	5.7	5.6	6.4	8.7	10.6
Poland	21.7	24.3	26.9	28.5	30.9
Slovak Republic	39.1	40.8	42.8	45.3	46.8
Slovenia	31.6	34.6	36.5	36.6	40.1
Indonesia	42.5	44.5	50.4	47.3	45.3
Korea, Republic	68.8	73.9	82.2	84.8	88.8
Malaysia	90.9	94.5	107.4	110.8	106.4
Philippines	50.5	56.0	55.1	54.9	54.7
Thailand	75.0	89.6	102.8	100.6	101.2

Source: World Bank Development Indicators (2002)

Secondly, the comparison between ACs and other EMEs shows that the Asian region is the most developed one in terms of money indicators (both M2 and M3). However, the ACs are a close second, while they fare worst in terms of stock market capitalisation. This is a well-known fact, as in the ACs the bulk of the still fledging financial sector is dominated by banks. Obviously, this fact may have a significant impact on the profitability of banking in the ACs, making the judgement over their financial stability somewhat less optimistic. Such limitation for domestic investment opportunities is relevant also for foreign banks, as they are mostly involved in the retail business. The choice of operating mostly at the retail level reduces the additional benefit that foreign banks could derive from their network of international activities, and exposes their revenues much more to swings in the performance of the local economy than in more financially developed EMEs.

[37] Financial depth can be measured in several ways: either liquid liabilities to GDP (or M2) (McKinnon, 1973 and Levine, 1992), commercial banks to central bank assets (Levine et al, 1999), or commercial bank credit to the private sector relative to

As for the limitations that a less developed financial sector has for the management of monetary policy, the ACs are a case in point as the most effective and most widely used monetary policy tool is still the exchange rate (European Central Bank, 2002).

Table 19: Stock market capitalisation

% of GDP	1996	1997	1998	1999	2000	2001
Argentina	16.42	20.23	15.16	29.61	58.28	71.66
Brazil	28.00	31.65	20.44	43.06	37.98	37.06
Chile	96.17	95.70	71.13	100.76	85.62	85.38
Mexico	32.06	39.04	22.04	32.13	21.79	20.49
Czech Republic	31.32	24.13	21.17	21.61	21.67	16.12
Estonia	n.a.	23.76	9.96	34.92	37.15	26.67
Hungary	11.68	32.75	29.82	33.96	26.34	19.97
Latvia	29.4	59.8	62.9	58.7	78.8	91.01
Lithuania	11.40	17.66	9.99	10.68	14.03	99.98
Poland	5.83	8.43	12.91	19.08	19.83	14.71
Slovak Republic	110.4	8.9.5	45.3	36.7	38.8	26.30
Slovenia	3.51	8.93	12.51	10.86	14.05	14.77
Indonesia	40.03	13.49	23.16	45.35	17.51	15.83
Korea, Rep.	26.69	8.79	36.14	75.98	32.51	54.97
Malaysia	30.458	9.345	13.655	18.402	13.04	13.51
Philippines	97.35	38.09	54.19	63.17	68.98	29.85
Thailand	54.73	15.57	31.19	47.82	24.14	31.68

Source: World Bank Development Indicators (2002)

Finally, we may compare ACS' banks with their EU counterparts. As many ACs banks are owned or controlled by EU banks, differences in the level of total domestic credit between the two regions are likely to be good indicators of underdevelopment in the ACs financial sector. As Table 18 shows, figures for ACs vary considerably across countries, but overall they point out to the gap between EU and accession countries. Although this evidence highlights the development potential of the ACs, it may also depict obstacles to profitable business in these countries. This should not be surprising, as ACs are still undergoing a deep transformation in their transition to fully developed market economies.

GDP (Levine and Zervos, 1998). We include also stock market indicators in order to take into account their development in Asia, where on the contrary banking sector development is less advanced.

Table 18: Total Domestic Credit

% of GDP	1997	1998	1999	2000	2001	2002
Lithuania	16.3	17.0	19.1	18.9	19.9	22.9
Latvia	15.4	18.0	20.3	25.1	33.1	40.3
Hungary	35.7	35.8	35.6	35.6	44.1	47.1
Poland	33.5	34.8	36.5	35.3	37.0	38.9
Estonia	36.5	35.6	37.3	42.7	45.2	52.5
Slovenia	41.8	45.9	48.8	49.0	51.4	52.2
Czech Rep.	78.1	67.9	62.7	62.2	51.0	47.9
Slovakia	71.8	65.8	63.6	63.5	67.5	66.0
Euro Area	129.2	129.2	133.0	134.9	136.1	136.7

Source: IFS (lines 22) and ECB Staff calculations

However, what stands out from all of these tables is that all indicators of financial deepening have improved in the last few years, something that is inevitably associated to the contemporaneous entry of foreign banks.

2.4 Efficiency in the banking sector

2.4.1 Key indicators of efficiency of the ACs' banking sector

Next, we look at whether foreign banks can promote the efficiency of the local banking sectors. The common intuition is that banks that extend their operations abroad are among the most efficient in their own country, and when such banks start to operate in an EME, they are bound to outperform the local banks. As a consequence, those domestic banks that manage to remain active are under pressure to increase their efficiency. Eventually, the overall level of efficiency should increase in the national banking sector as a whole.

Overall, the strong presence of EU foreign banks in ACs implies that bank's assets and income in these economies already approach EU figures although they remain diverse in the structure. In particular, as a common feature, most foreign and domestic banks appear to be adequately capitalised with cost/income ratios that are also found with EU banks. Interest income remains the dominant source of revenue in all banks while profitability of foreign banks put under pressure most of the domestic banks. Some EU banks have benefited in the recent past from their investment in ACs, which bolstered their profitability.

The structure of banks' activities differs across banks and countries if measured by the relative importance of loans versus more liquid assets and the size of off-balance sheet items, the latter reaching a multiple of asset values in the most extreme cases.

There are several ways in which we can look at the effect of foreign banks' penetration in ACs. As discussed in Part 1 of this note, foreign banks' entry in ACs took place in the second half of the 1990s, and we can look at various indicators of banks' efficiency after that date, depending on data availability. One clear fact is that foreign banks in ACs are in fact more efficient, either in terms of return on assets (ROA), return on equity (ROE) or overhead costs. However, we should also check for the effects of their entry on the corresponding indicators for domestic banks (Tables 19a, 19b, 19c).

Table 19a: Return on assets (ROA)

Percent	**1994**		**1995**		**1996**		**1997**		**1998**		**1999**		**2000**	
	F.B.	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**
Czech Rep.	0.3	0.3	0.5	–0.5	0.5	0.2	0.8	–0.5	0.6	–0.7	0.6	–0.8	0.8	0.1
Estonia		0.0	–2.0	2.0	–1.0	2.0	1.0	2.0	–2.0	–24.0	2.0	–1.0	1.0	1.0
Hungary	2.4	0.6	4.9	0.9	4.1	0.9	1.9	0.5	0.8	–7.0	0.1	1.3	1.1	1.4
Latvia							n.a.							
Lithuania	0.0		0.0	–2.9	2.9	–2.4	1.5	–2.3	1.5	0.4	2.1	–1.0	1.2	–0.4
Poland			5.0		6.6									
Slovak Rep.							n.a.							
Slovenia	–0.8	0.5	–0.1	1.1	0.5	1.1	0.9	1.1	0.7	1.2	–0.1	0.8	0.1	1.3

Table 19b: Return on equity (ROE)

Percent	**1994**		**1995**		**1996**		**1997**		**1998**		**1999**		**2000**	
	F.B.	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**
Czech Rep.	4.2	2.9	8.5	–6.5	9.4	3.1	13.3	–7.3	9.1	–10.9	7.9	–14.1	10.6	1.9
Estonia		5.0		19.0		23.0		23.0	–10.0	–207	14.0	–9.0	9.0	9.0
Hungary			44.6	12.4	31.3	20.8								
Latvia							n.a.							
Lithuania			0.0	–52.7	21.7	–63.9	12.9	–91.0	8.2	3.7	14.9	–13.4	11.3	–5.3
Poland			315.3		51.0									
Slovak Rep.							n.a.							
Slovenia							n.a.							

Note: F.B. (foreign banks), D.B. (domestic banks).
Sources: National central banks.

Interpretation of these data requires some caution, however, as the sample of banks that we call "domestic banks" has changed over time, as more and more of the domestic banks have been bought by foreign banks. It is not unlikely that the best banks, or at least the ones with the best potential, are the ones to be bought by the foreign banks, so that discrepancies between domestic and foreign banks' performance could be overstated by these tables. Nonetheless, it is quite clear that foreign banks show a better performance than domestic banks, in all ACs. [38]

Against this background, one could highlight that domestic banks have substantially improved their profitability from 1999 to 2000, while foreign banks have not been able to achieve the same size of improvement. In this regard, one could argue that the increased competition of the banking sector in all ACs implies more substantial efforts for domestic banks than for foreign banks. Furthermore, the uneasy international economic environment in 2000 might have affected more heavily the profitability of foreign banks than domestic banks.

Table 19c: Overhead costs as share of total assets

Percent	**1994**		**1995**		**1996**		**1997**		**1998**		**1999**		**2000**	
	F.B.	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**	**F.B.**	**D.B.**
Czech Rep.	2.2	1.9	1.6	2.0	1.5	2.1	1.4	2.1	1.7	2.2	1.9	2.2	1.9	2.5
Estonia		6.0	3.0	5.0	3.0	4.0	2.0	3.0	3.0	1.0	3.0	0.0	3.0	0.0
Hungary	2.6	3.3	2.4	3.6	2.8	3.7	3.2	3.8	3.6	3.8	3.6	3.8	3.4	3.6
Latvia							n.a.							
Lithuania			0.0	6.5	5.8	6.3	4.1	5.5	4.0	4.2	3.6	4.0	3.1	3.7
Poland							n.a.							
Slovak Rep.							n.a.							
Slovenia	4.6	2.7	3.8	3.3	2.4	3.4	3.4	3.4	2.7	3.3	3.4	3.2	3.2	3.1

Note: F.B. (foreign banks), D.B. (domestic banks).
Sources: National central banks.

One additional indicator of increased banks' efficiency is given by the amount of non-performing loans in banks' balance sheets. If foreign banks have forced the remaining local banks to become more efficient, we would expect to see the overall figures for non-performing loans to fall over the last part of

[38] Slovenia is an interesting case study. This is the country with the lowest level of penetration by foreign banks. Slovenia, as any other AC, has recently undergone a process of consolidation and recapitalisation of its domestic banks, but contrary to the other ACs, not many banks have been sold to foreigners. Essential to the comparison is the fact that in those ACs that have actually opened up to foreign banks the form of the latters' entry has been through subsidiaries rather than branches. Subsidiaries can then be directly compared to the domestic banks of Slovenia in terms of their strategic and profitability profile. Such a comparison of the performance of the banking sector in Slovenia and the one in the other ACs, starting from the late 1990s, can provide us with a better understanding of what is the actual impact of foreign banks entry versus the mere restructuring of the domestic banking sector.

the 1990s. On this point, the table below (Table 20) shows that, with the exception of Poland and,

Table 20: Non performing loans over total loans

% of total loans	1998	1999	2000	2001	2002
Czech Rep.	20.3	22	19.9	13.7	10.6
Estonia	1.4	1.7	1.0	1.3	0.8
Hungary	4.9	4.2	3.0	2.2	2.0
Latvia	6.0	6.0	4.6	2.8	1.9
Lithuania	12.9	12.5	11.3	8.3	6.5
Poland	10.5	13.3	15.0	17.9	21.1
Slovak Rep.	31.6	23.7	15.3	15.4	11.2
Slovenia	5.4	5.2	6.5	7.0	7.0
European Union	4.7	4.5	4.2	4.0	3.9

Sources: GFS Report, various issues.

to a lesser extent, Slovenia, banks in ACs have improved the quality of their loan portfolio. This piece of evidence then supports our claim that entry of foreign banks has increased overall efficiency of the banking sector (although the overall level remains below the on reached in the European Union).

Table 21: Credit spreads

	1996	1997	1998	1999	2000	2001	2002
Czech R.	5.8	5.5	4.7	4.2	3.7	4.1	4.0
Estonia	8.8	5.6	7.0	6.9	3.7	3.7	4.0
Lithuania	7.6	6.5	6.2	8.1	8.3	6.6	5.1
Latvia	14.1	9.4	9.0	9.2	7.5	5.9	4.7
Slovakia	4.6	5.2	4.9	6.7	6.4	4.8	3.6
Hungary	5.1	3.2	3.1	3.1	3.0	2.9	2.8
Slovenia	7.5	6.8	5.5	5.1	5.7	5.2	4.9
Poland	6.1	5.6	6.3	5.8	5.8	6.6	5.9
Euro area	4.8	4.2	3.5	3.2	3.2	3.3	3.3

Source*:* IFS.

Looking at the issue of financial development from a different angle, another indication of the change in the level of efficiency of the banking sector in ACs is offered by the reduction in the credit spreads. A breakdown by foreign versus domestic banks is not available, but at least the overall pattern of reduction in these spreads over time may be analysed. Since a large proportion of banks in ACs has come under

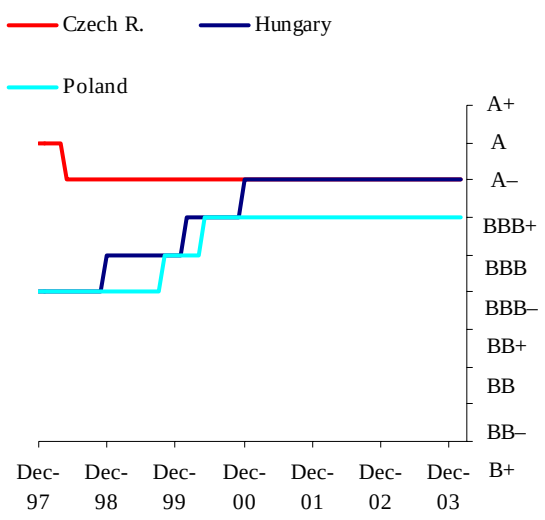
foreign control in the late 1990s, it may be argued that at least part of the contraction in spreads is due to foreign banks' entry. Table 18 above illustrates this point.

2.4.2 How changes in efficiency of banks in ACs affect the process of convergence

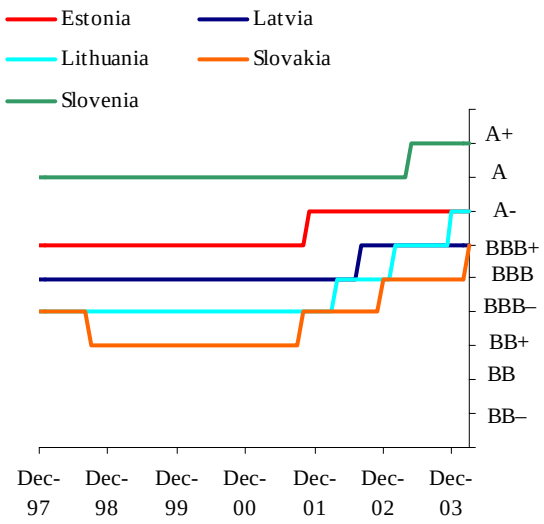
A related issue to the one of the increased efficiency as a result of foreign banks' entry is the one of nominal convergence towards macroeconomic conditions of the euro area. We address this issue by looking at market indicators, such as convergence in rating levels, on the one hand, and convergence in yields over sovereign bonds, on the other. Such market indicators can show the confidence that markets have in the improvement of the overall macroeconomic performance of ACs, and can offer some broad evidence of ways in which foreign banks entry has at least indirectly had a positive impact on ACs' nominal convergence process.

Figure 23: Long-term foreign currency ratings

(*a*) Czech Republic, Hungary and Poland



(*b*) Others



Source: Standard & Poor's.

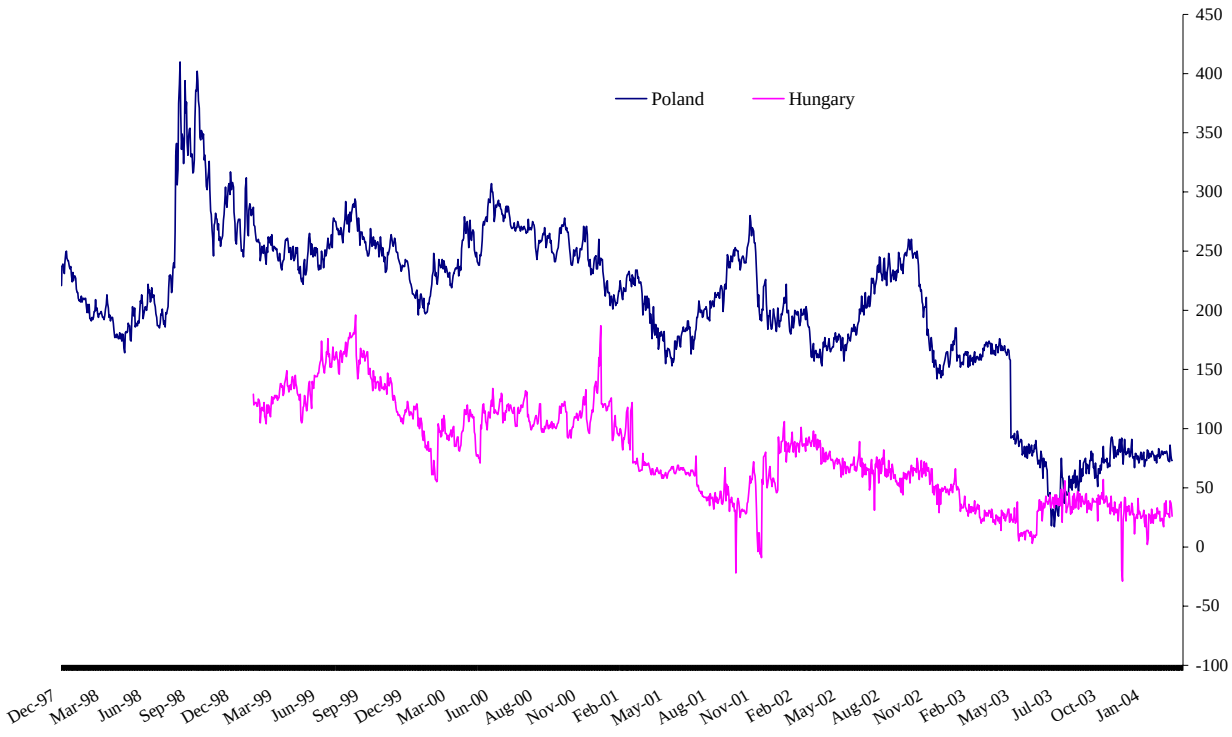
As ratings[39] for long-term foreign currency denominated sovereign bonds show (see Figure 23), ACs have systematically improved their ratings from the mid-90s onwards. They all are at or above investment grade, and the only country with a downgrade in the period under examination is the Czech Republic.

Additionally, we look at yields on long-term foreign currency denominated sovereign bonds. This choice has both advantages and disadvantages. The obvious benefit of using foreign currency denominated

bonds is that they allow us to abstract from exchange rate risk. This may seem appropriate given the fact that at this juncture ACs have very different exchange rate arrangements, ranging from currency boards to fully flexible exchange rates.[40] The drawback is that very few of these countries do issue foreign currency denominated debt, so that the market for domestic currency denominated debt may be more representative.[41]

With these caveats in mind, the available evidence does seem to support our view that, as one important element of the process of liberalisation and overall restructuring of the economies of ACs, foreign banks' entry has coincided with a lowering of sovereign spreads.

Chart 24: Spread on long-term foreign currency denominated bonds



Source: EMBI Global, JP Morgan

Nonetheless, the impact of foreign banks' entry needs to be qualified. In fact, at the same time that banks in ACs were being recapitalised and sold to foreigners, a number of other macroeconomic and structural policies were implemented to accelerate the process of ACs' economic development and their

[39] Values are reported for Standards & Poor's, but values for Moody's ratings are broadly consistent. S&P offers a slightly longer time-series, and for this reason it has been reported here.

[40] Additional research on bonds' yields convergence will be taken up in future work, where domestic currency denominated bonds will be used, and conditioning for exchange rate fluctuations will be controlled by including a study on implied forward exchange rates.

[41] They are Hungary, Poland, Lithuania, Slovenia and Slovakia.

reorganisation as market economies. In addition, one needs to be very cautious in reading these results. Both the fact that ACs are transition economies, and the fact that they will become members of the EU make their case a very special one. For this reason, disentangling the effect of foreign banks' entry from the other two relevant economic factors mentioned above is difficult at this stage.[42]

2.5 Regulatory framework

Finally, we are left with the issue of the regulatory and supervisory framework, i.e. of how foreign banks and local supervisory authorities interact, and whether foreign banks do have an impact on the quality of the institutional framework. Once again, ACs stand out as an exception to the more general conditions of EMEs hosting foreign banks, given that their successful application to become members of the European Union also implied that they had to adopt the *acquis communautaire*.

Table 19: Qualitative assessment of the regulatory framework

	Extensiveness of supervision	Effectiveness of supervision	Banking reform and interest rate liberalisation	Securities markets and non-banks
Czech Rep.	3+	3	4–	3
Estonia	4–	4	4–	3
Hungary	4–	4–	4	4–
Latvia	3	3	3+	2+
Lithuania	3+	4–	3	3
Poland	4	3	3+	4–
Slovak Rep.	3	3	3+	2+
Slovenia	4	4–	3+	3–

Sources: EBRD 2001 Transition Report and national authorities

Nonetheless, as the following table shows, and several IMF FSAP documents confirm, the present stage of the ACs' regulatory framework is broadly satisfactory. In fact, the EBRD Transition report (2001), from which the table below is taken, shows relatively high marks for ACs, where scores range from 1 to 4+, with the latter representing standards of advanced industrial economies.

[42] Moreover, it is quite likely that the accession process itself caused stronger interest on the part of foreign banks in ACs. As a consequence, an empirical analysis with both foreign banks' entry level in any AC and a dummy for accession it-self as explanatory variables may be impaired by the correlation between the two regressions.

According to the regular assessment of the Commission on progress towards accession[43], all ACs have aligned their regulatory frameworks with EU legislation to a sufficient extent that enables them to join the EU. However, the domestic regulatory and supervisory framework does not yet guarantee in most ACs an effective implementation and enforcement of the *acquis*. In addition, during EU negotiations, a number of transitional arrangements and exemptions were concluded, namely as regards deposit insurance schemes. These may become relevant from the point of view of consumer protection. Therefore, further progress need to be made by ACs in a number of areas, including further strengthening of supervisory agencies' operational independence and regulatory powers and/or further improvement in the actual supervisory practices.

Overall, further challenges remain for the ACs particularly after having joined the EU. These challenges also stem from the fact that a substantial part of the relevant legislation is currently under review and new legislative procedures, namely the Lamfalussy Procedure, are being introduced. The transposition and implementation of the substantial reform process within the EU that has started in 1999 under the Financial Services Action Plan (FSAP) presents an additional challenge for ACs. Whereas many ACs have already addressed a few issues that are also dealt with under the FSAP such as supervising capital based pension funds, substantial challenges remain.

Furthermore, the supervision of subsidiaries may give rise to a potential overlap of competencies between domestic and foreign supervisory agencies. Given the massive presence of EU banks in ACs, it is reasonable that there be an interest on both the EU and ACs authorities to move towards deeper co-operation on this issue. The presence of foreign banks, in fact, may generally increase capital flows and magnify exchange rate risks. Also, the EU member states need to better understand the risk exposure of their financial institutions in ACs.

In this context, for ensuring adequate supervision, an effective co-operation between home-country and host-country supervisory bodies is called for. While such cross-border co-operation may be organised through informal channels of communication, the conclusion of Memoranda of Understanding with the EU countries may be in a number of cases a necessary condition for establishing an effective exchange of information with foreign supervisors.

[43] 2002 EU Commission's Regular Report on the Progress towards Accession.

3. Conclusions

Our paper discusses the flows of financial FDI to a selected group of ACs in Eastern and Central Europe.

In the first part of the paper, we describe the major characteristics of capital flows to the ACs. We first consider total FDI in the broader context of capital flows to emerging market economies, then narrow the scope of the analysis first to the ACs only and then to the specific sector of financial FDI to the ACs only. Evidence shows that, starting from the second half of the 1990s, the two processes of accession to the EU and transition to market-based economies led to a substantial increase in net capital flows to the ACs. The FDI component accounted for the bulk of such flows. In particular, while manufacturing was the main sector of activity attracting foreign investors' interest, the share of financial FDI increased dramatically in the second half of the 1990s. As a by-product of the banking sector privatisation, the presence of foreign banks' affiliates in the ACs has become massive in all countries - with the partial exception of Slovenia - leading to foreign ownership of more than two-thirds of the banking system of the ACs taken as a whole. The main component of flows to the financial sector is foreign-led mergers and acquisitions (M&A) – especially in the banking sector. As a result, foreign banks are mainly present with subsidiaries rather than branches.

In the second part of the paper, we take a closer look at foreign banks' operations in the ACs. We consider several aspects of foreign banks' activity that can highlight the specific role played by these banks. A first line of investigation is based on the distinction between wholesale and retail activity. Contrary to the predominance of wholesale operations in the majority of foreign banks entering EMEs markets, in the case of ACs retail operations represent the bulk of foreign banks' activity. Next, we show that foreign banks are likely to have contributed to overall financial stability in Eastern Europe. Given that the ACs have not experienced banking and currency crises, in contrast to the ones that affected a number of Asian and Latin American countries in the recent past, an assessment of foreign banks' behaviour at times of crisis is not feasible. However, a qualitative analysis of non-crisis scenarios indicates that the risk of a less stable provision of credit from foreign banks would be rather low. More importantly, potential for contagion through the banking sector links between the Eastern European and EU banking systems is reasonably low, confirming the likely benefits stemming from foreign banks' entry. As an additional indication of the overall stability of the financial sector in the ACs, a section on currency mismatches in both the financial and non-financial sectors points to a comparatively low exposure to either credit or currency risk. Finally, indicators of financial deepening highlight the modest degree of financial depth of the ACs, implying that not only they stand to benefit from further financial development, but also that, at the present stage, their relative underdevelopment may insulate them from financial instability. Among the benefits that can be ascribed to the entry of foreign banks in the ACs, an increase in the efficiency of the local banking sectors should be included. Even if data limitation makes a precise quantitative assessment hard, foreign banks' entry has been associated with an overall increase in

the efficiency of the ACs' banking sectors. Lastly, foreign banks' involvement in the ACs has been sustained by the adoption of the regulatory and supervisory frameworks of the European Union. This feature has likely contributed to the strengthening of the local banking sectors, further supporting financial stability.

In sum, even if preliminary due to data limitation, our assessment of foreign banks' entry in the ACs is broadly positive. Although the experience of this wave of capital flows to the ACs may not yield lessons relevant to other countries, given the specific nature of both the transition to market economies and the EU accession process, some limited conclusions may be drawn. First, the choice of subsidiaries rather than branches as vehicle for financial FDI may provide a more stable form of entry, as it tends to lengthen the foreign banks' time horizon when evaluating the potential for cross-border operations. Second, an important qualifier is the financial stability in the ACs at the time of entry of foreign banks. At the time when these banks were beginning to buy large shares of the domestic banking sectors, public funds were being used to speed up financial consolidation among domestic banks and liquidation of insolvent institutions. Such public intervention in the ACs favourably contributed to the positive effects of foreign banks' operations. Third, the selected ACs offer on average a comparatively stable financial environment due to the current low exposure of their non-financial sectors to currency mismatches. Finally, the adoption of sound regulatory and supervisory frameworks is an additional factor behind not only foreign banks' entry, as they considered the institutional and legal setting as being sound and stable, but also their ability to operate effectively.

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Appendix 1: Transitional arrangements (TAs) agreed with the EU in the area of factor mobility

	Chapter 1: Free movement of goods	Chapter 2: Free movement of persons	Chapter 3: Freedom to provide services	Chapter 4: Free movement of capital
Cyprus	Until 31/12/05 - TAs on marketing authorisation of medicinal products (Directives 2001/82/EC and 2001/83/EC)	none	Until 31/12/07 - TA on Co-operative Credit Institutions, in particular on the taking up and pursuit of business credit institutions	Five-year of TA during which it can maintain its national legislation regarding the acquisition of secondary residences
Czech Republic	none	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TA should in principle come to an end; but it may be prolonged for a further two years in specific cases	none	Five-year of TA during which it can maintain its national legislation regarding the acquisition of secondary residences Seven-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests. Extension of this period by a further three years in case of serious distrubances can be granted by the Commission
Estonia	Until 31/12/06 - TAs on the maximum levels of dioxin allowed in the market Baltic fish (Regulation 466/2001/EC)	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TA should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/07 - TAs on the Deposit Guarantee Scheme, in particular to reach the minimum level of guarantee Until 31/12/07 - TAs on the minimum level of the investor compensation (scheme)	Seven-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests. Extension of this period by a further three years in case of serious distrubances can be granted by the Commission

Hungary	none	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TA should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/07 - TA on Co-operative Credit Institutions, in particular on the minimum capital requirements (not below the highest level reached with effect from the date of accession) Until 31/12/07 - TAs on the minimum level of the investor compensation (scheme) Until 31/12/07 - TAs on the Investor Compensation Scheme, in particular on the level of cover provided in Hungary by an investment firm from another Member State	Five-year of TA during which it can maintain its national legislation regarding the acquisition of secondary residences Seven-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests. Extension of this period by a further three years in case of serious distrubances can be granted by the Commission
Latvia	none	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TA should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/07 - TAs on the Deposit Guarantee Scheme, in particular to reach the minimum level of guarantee Until 31/12/07 - TAs on the minimum level of the investor compensation (scheme)	Seven-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests. Extension of this period by a further three years in case of serious distrubances can be granted by the Commission
Lithuania	Until 01/01/07 - TAs on marketing authorisation of medicinal products (Directives 2001/82/EC and 2001/83/EC)	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TA should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/07 - TAs on the Deposit Guarantee Scheme, in particular to reach the minimum level of guarantee Until 31/12/07 - TAs on the minimum level of the investor compensation (scheme)	Seven-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests. Extension of this period by a further three years in case of serious distrubances can be granted by the Commission
Malta	Until 31/12/06 - TAs on marketing authorisation of medicinal products (Directives 2001/82/EC and 2001/83/EC); Until ??? - Authorisation of using the term "milk chocolate" under certain conditions (Directive 2000/36/EC)	No TAs, but a safeguard clause allows Malta for recourse to Community institutions, in case of difficulties in relation to free movement of workers	none	On a permanent basis, Malta is granted the right to maintain its national legislation regarding the acquisition of secondary residences

Poland	Until 31/12/08 - TAs on marketing authorisation of medicinal products (Directives 2001/82/EC and 2001/83/EC) Until 31/12/05 - TAs on marketing authorisation of medical devices (Directive 90/385/EEC)	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TA should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/07 - TA on Co-operative Credit Institutions, in particular on the minimum capital requirements (not below the highest level reached with effect from the date of accession) Until 31/12/07 - TAs on the minimum level of the investor compensation (scheme)	Five-year of TA during which it can maintain its national legislation regarding the acquisition of secondary residences Twelve-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests.
Slovakia	none	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TAs should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/06 - TAs on the minimum level of the investor compensation (scheme)	Seven-year of TA, during which it can maintain its national legislation regarding the purchase of agricultural land and forests. Extension of this period by a further three years in case of serious distrubances can be granted by the Commission
Slovenia	Until 31/12/08 - TAs on marketing authorisation of medicinal products (Directives 2001/82/EC and 2001/83/EC)	From 5 to 7 years of TAs: two-year period during which national measures will be applied; after five year the TAs should in principle come to an end; but it may be prolonged for a further two years in specific cases	Until 31/12/04 - TAs for saving and loans undertakings established before 20 February 1999, for full compliance with the acquis Until 31/12/05 - TAs on the Deposit Guarantee Scheme, in particular on the level and scope of the cover provided in Slovenia by an investment firm from another Member State Until 31/12/05 - TAs on the Investor Compensation Scheme, in particular the level and scope of the cover provided in Slovenia by an investment firm from another Member State	Up to maximum of seven years after the date of accession - TAs on the real estate market, in particular the possibility to resort to the general economic safeguard clause provided for in the Accession Treaty