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## ROLE OF FINANCIAL SECTOR FDI IN REGIONAL IMBALANCES IN CENTRAL AND EASTERN EUROPE

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### Introduction

Foreign direct investment (FDI), foreign ownership and the transformation of the financial sector in Central and Eastern Europe (CEE) have received considerable attention during the transition, from both a theoretical and empirical perspective.<sup>2</sup> Much less attention has been devoted to the post-transition period and the impact of the crisis, which has become the most serious challenge to transition models in the CEE banking sectors.

This research argues that the FDI development path in the CEE followed the pattern of a dependent market economy (DME) type of capitalism.<sup>3</sup> It shows that there was a

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<sup>2</sup> See: J. Bonin, K. Mizseil, I. Székely, P. Wachtel, 'Banking in Transition Economies, Developing Market-Oriented Banking Sectors in Eastern Europe', Edward Elgar, Cheltenham, UK Northampton, U.S., 1998; P. Wachtel, 'A külföldi bankok szerepe a közép-európai átmeneti gazdaságokban I–II' ('Role of foreign banks in transitional countries of East-Central Europe, I–II'), *Közgazdasági Szemle (Journal of Economics)*, pp. 13-30, 124-141; S. Claessens, A. Demirgüç-Kunt, H. Huizinga, 'How does foreign entry affect domestic banking markets?', *Journal of Banking & Finance*, Vol. 25(5), May 2001, pp. 891-911; C. Buch, S. Golder, 'Foreign versus domestic banks in Germany and the U.S.: a tale of two markets?', *Journal of Multinational Financial Management*, Vol. 11, Issues 4-5, December 2001, pp. 341-361; C. Buch, R. Heinrich, A. Schertler, 'External and Internal Financial Structures in Europe: A Corporate Finance Perspective', *EIFC Technology and Finance Working Papers*, No. 19, 2003, p. 25; A. Berger, Q. Dai, S. Ongena, D. Smith, 'To what extent will the banking industry be globalized? A study of bank nationality and reach in 20 European nations', *Journal of Banking & Finance*, Vol. 27(3), March 2003, pp. 383-415; Z. Gál, 'Spatial Development and the Expanding European Integration of The Hungarian Banking System', *Pécs Centre for Regional Studies Discussion Papers*, No. 45, 2004, p. 75, [www.researchgate.net](http://www.researchgate.net).

<sup>3</sup> See: O. Raviv, 'Chasing the Dragon. East: Exploring the Frontiers of Western European Finance', *Contemporary Politics*, Vol. 14, No. 3, September 2008, pp. 297-314; A. Nölke, A. Vliegenthart, 'Enlarging the

shift of ownership of the banking sector from public to private and at the same time from domestic to foreign owners through privatisation.

### **Role of Financial Sector FDI in the CEE**

FDI inflows have increased in the CEE in the past 20 years to become the most common type of capital flow. FDI inflow into CEE economies has been a vital factor in the first stage of privatisation, and FDI became the predominant type of incoming capital investment in the first stage of the economic transition. This process not only facilitated the restructuring of the formerly centrally planned economies but privatization as well. The banking and insurance sector became the primary target of strategic foreign investors. Similar to global processes, the entry of foreign banks was geographically or regionally concentrated, and the main investor banks came from traditional or strong economies and trading partners (mainly from eurozone countries).

Foreign financial inflows have resulted in dramatic changes of ownership structures. In 1994, in the wake of the early transition crises, an overwhelming majority of financial intermediaries in the post-communist countries were still publicly owned. By contrast, in 2007, more than a decade later, private foreign ownership already accounted for about 80% of financial intermediaries' assets in the CEE region. These figures are especially striking when compared to the just under a quarter of foreign-owned banking assets across the European Union (EU), 15.5% in the euro area, and 50% outside the OECD.<sup>4</sup> This share of foreign banks was relatively large compared, for example, to the level of economic development in the region.

The results show that FDI has been substantial in the financial services sector of the Visegrad countries (Czech Republic, Hungary, Poland, Slovakia) and in Slovenia. This analysis covers all sectors, but the focus is on banking. In the Visegrad countries, though with different timing, FDI inflow in the analysed sector had been substantial, resulting in a dominant share of foreign capital (predominantly from traditional partner countries from Western Europe) and a large share of the sector in the stock of FDI already in the pre-crisis era. On the other hand, in Slovenia the role of foreign investors is comparatively much lower, resulting in a predominantly domestically owned financial services sector. There is only one regional player, the Hungarian OTP bank.<sup>5</sup>

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varieties of capitalism: The emergence of dependent market economies in East Central Europe', *World Politics*, Vol. 61, No. 4, October 2009, pp. 670-702; M. Myant, J. Drahokoupil, *Transition Economies: Political Economy in Russia, Eastern Europe, and Central Asia*, Wiley-Blackwell, Hoboken, N.J., 2010.

<sup>4</sup> S. Claessens, N. van Horen, 'Foreign Banks: Trends, Impact and Financial Stability', IMF Working Papers, WP/12/10, January 2012.

<sup>5</sup> Z. Gál, M. Sass, 'Financial FDI in CEECs revisited—in the context of the dependent market economies model', paper presented at the RSA Network Seminar 'Finance in Transition: Lessons for the Future', Bratislava, 16-17 May 2013.

## Asymmetric Power Relations and Regional Imbalances in the Dual-Banking Systems in Central and Eastern Europe

Foreign banks (understandably) followed commercial market principles rather than economic development and were never geared for or ‘diverted’ by regulatory elements towards addressing the development needs of the host CEE. Rather, they were always aimed at redressing the declining profitability of financial institutions operating in the already financialised economies of Western Europe. As a result, foreign financiers emerged as a powerful rentier class in Central Europe, able to extract rent incomes far in excess of their profits in the West.<sup>6</sup> This led not only to an unprecedented transfer of property rights from local society to foreign investors but also to increased imbalances in the financial sector through indebtedness and risk.

If we try to place the CEE in the comparative typologies of capitalism following Nölke and Vliegenthart’s<sup>7</sup> argument, the primary source of investment in the CEE is foreign direct investment, not the stock market as in Liberal Market Economies (LMEs) or domestic credit as in Coordinated Market Economies (CMEs). Although FDI does play a role in the CME and LME models, the degree of external dependency is much more extreme in the CEE. As DMEs are heavy importers of capital, the ratio of inward and outward FDI stock is much higher than in the old EU Member States due to the low level of capital exports (OFDI) from these countries.<sup>8</sup>

Due to the extremely huge volumes of FDI, foreign banks prefer to hierarchically control local subsidiaries from their headquarters.<sup>9</sup> This is an alternative mode of finance and governance rather than to accept financing by international capital markets and outsider control by dispersed shareholders in LME, or to accept financing by domestic bank lending as well as retained earnings and insider control by networks of concentrated shareholders in CME. The hierarchy between the headquarters of transnational corporations (TNCs) and local subsidiaries replaces markets (LME) and associations (CME) as a typical coordination mechanism within these economies.<sup>10</sup>

Financial TNCs in international financial centres have a massive concentration of resources that allow them to maximise the benefits of information and connectivity with other centres and generate asymmetric power relations executed through their affiliates. These power relations mediate strong controlling functions and assess the concentration of controlling functions over the CEE within the international financial centre network, from where these investments are controlled.

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<sup>6</sup> O. Raviv, *op. cit.*, pp. 297-314.

<sup>7</sup> A. Nölke, A. Vliegenthart, *op. cit.*, pp. 670-702.

<sup>8</sup> A. Nölke, A. Vliegenthart, *op. cit.*, pp. 670-702.

<sup>9</sup> M. Myant, J. Drahoukoupil, *op. cit.*

<sup>10</sup> A. Nölke, A. Vliegenthart, *op. cit.*, pp. 670-702.

The research evaluates the inter-linkages within the international financial centre networks through the geographical distribution of subsidiaries and their parent bank locations. It explores the international financial centre function of Budapest, Warsaw and Prague in assessing the preconditions of international financial centre formation. Asymmetric power relations are outcomes of previous FDI transactions and are created between the home and host countries through parent-subsidiary networks of big financial investors.<sup>11</sup> In the financial sector, the eastward market expansion has mainly been to the benefit of West European banks and insurance companies, which control the financial sector in Eastern Europe. They set up their subsidiary networks in parallel in the CEE and it is no coincidence that none of the new Member States hosts a financial centre with full-fledged international functions, partially because Central and Eastern European financial centres are subordinated by Western international financial centres.

As Central and Eastern European countries are largely dependent on foreign investors in finance, explicit attention is directed at determining which CEE financial centres attract multinational financial firms, and it is empirically assessed from which international financial centres these investments are controlled.<sup>12</sup> The banking sector in the CEE is predominantly commanded from the financial hubs of the neighbouring 'old' EU Member States. Vienna, Stockholm and Athens, among others, became gateways to the East and host the headquarters of large investors in the CEE, Baltics and Southeastern Europe, respectively. The largest concentration of parent-subsidiary connections forms bridgehead centres (Moscow, Warsaw, Budapest) in the CEE.<sup>13</sup>

The purpose of the future research is to examine the transformation and post-crisis restructuring of the financial/banking sector in the Central and Eastern European countries, not only in the context of the DME approach but also as part of an attempt to develop and verify the existence of a 'dual financial/banking system' model.<sup>14</sup> FDI generates typical core-periphery disparities, not only inside the old EU member countries

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<sup>11</sup> See: B. Kareman, 'Financial Geographies and Emerging Markets In Europe', *Tijdschrift voor Economische en Sociale Geografie*, 2009, 100, (2), pp. 260-266; D. Wójcik, 'Geography and the future of stock exchanges: between real and virtual space', *Growth and Change*, 38(2) 2007, pp. 200-223; Z. Gál, 'Pénzügyi piacok a globális térben: A válság szabdalta pénzügyi tér' ('Financial Markets in the Global Space—the Crisis Distorted Financial Landscapes', Akadémiai Kiadó, Budapest, 2010, p. 780.

<sup>12</sup> B. Kareman, *op. cit.*, pp. 260-266.

<sup>13</sup> Z. Gál, "Impacts of the global financial crisis on CEE: A post-crisis banking reconstruction: The case of Hungary", in: A. Beauclair, E. Mitchell (eds), 'Regional Development and Policy—Challenges, Choices and Recipients: Annual International Conference 18<sup>th</sup> April-20<sup>th</sup> April 2011', Newcastle: Regional Studies Association, 2011, pp. 52-53.

<sup>14</sup> See: P. Alessandrini, A. Zazzaro, 'A Possibilist Approach to Local Financial Systems and Regional Development: The Italian Experience', in: R. Martin (ed): *Money and the Space Economy*, Chichester, John Wiley & Sons, 1999, pp. 71-92; Z. Gál, 'The Development and the Polarized Spatial Structure of the Hungarian Banking System in a Transforming Economy', in: G. Barta, É.G. Fekete, I. Kukorelli Szörényiné, J. Tímár (eds.), *Hungarian Spaces and Places: patterns of Transition*, CRS, Pécs 2005, pp. 197-219.

but also between old and new Member States, which suffer from a ‘de-nationalised dual-banking system’. That model, consisting of large foreign banks and small local/indigenous banks, displays strong dependence on foreign banks and their resources (external liabilities vs. local savings). There is a strong impact of foreign banks on credit creation, cross-border and domestic financial transfers, and financial stability, particularly during a crisis.<sup>15</sup> The general aim is to study the role of the ‘dual-banking system’ in the creation of regional imbalances and in the transmission of adverse shocks in the CEE.

The dependency approach related to financial sector FDI is contrasted by the traditional ‘modernization theory’, which highlights the key role of foreign banks in institutional development, stability and the increase of financial depth of the banking sectors.<sup>16</sup> This latter literature highlights that financial sector FDI increased the host country integration into the global economy through improved general and allocative efficiency and technology transfers. Financial sector FDI can also strengthen the institutional development in the host country through improved regulation and supervision, therefore foreign bank entry into emerging markets reduces the incidence of crisis and contagion, particularly when foreign banks have a stronger subsidiary presence.<sup>17</sup>

Current FDI literature<sup>18</sup> focusing on the impact of foreign bank presence on credit creation and financial stability during a crisis confronts the once dominant approach of the ‘supporting effect’ of foreign banks.<sup>19</sup> Rajan<sup>20</sup> found that non-industrial countries that relied more on foreign finance have not grown faster in the long run and typically have grown slowly.

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<sup>15</sup> *Ibidem*.

<sup>16</sup> See: É. Várhegyi, ‘Hungary’s banking sector: Achievements and challenges’, in: A. Riess (ed.), ‘The financial integration of an enlarged EU: Banking and capital markets’, *EIB Papers*, Vol. 7, No 1, Luxembourg, 2002, pp. 75-91; L. Csaba, ‘Financial institutions in transition—the long view’, *Post-Communist Economies*, Vol. 23, No 1, 2011, pp. 1-14.

<sup>17</sup> L. Goldberg, ‘Financial Sector FDI and Host Countries: New and Old Lessons’, *FRBNY Economic Policy Review*, March 2007, pp. 1-17.

<sup>18</sup> See: R. Rajan, E. Prasad, A. Subramanian, ‘Patterns of international capital flows and their implications for economic development’, a paper presented at the symposium ‘The new economic geography: Effects and policy implications’, Federal Reserve Bank of Kansas City meeting, Jackson Hole, Wyo., 24-26 August 2006;; N. Cetorelli, L. Goldberg, *op. cit.*, p. 33; S. Claessens, N. van Horen, *op. cit.*; p. 22

<sup>19</sup> R. De Haas, I. Van Lelyveld, ‘Internal Capital Markets and lending by Multinational Bank Subsidiaries’, *MPRA Paper*, No. 13164, February 2009, [www.mpra.ub.uni-muenchen.de](http://www.mpra.ub.uni-muenchen.de)

<sup>20</sup> See: R. Rajan, E. Prasad, A. Subramanian, *op. cit.*;

The net assets position and current account balance is more positively correlated with growth. This is due to the limited ability to absorb foreign capital in developing countries. There is now evidence that emerging countries grow fast and run large current account deficits. This was the case in much of the CEE, where inflow of foreign capital was accompanied by large current account deficits, which had an effect on the exchange rate, resulting in a decrease in competitiveness

Cetorelli and Goldberg<sup>21</sup> argue that the adverse liquidity shocks that occurred in the developed countries in 2008 and 2009 have reduced lending in local markets through contractions in cross-border lending to banks and through contractions in parent banks' support of foreign subsidiaries as a result of a shortage of liquidity in developed countries, which spread to the CEE.<sup>22</sup>

Claessens and van Horen<sup>23</sup> argue that foreign bank presence in developing countries is negatively related with domestic credit creation.<sup>24</sup> During the global crisis, foreign banks reduced credit more than domestic banks, except when they dominated the host banking systems. The authors also argue that the impact of foreign banks on financial sector development and financial stability depend importantly on the host country, home country and bank characteristics. In the case of the CEE, the presence of foreign banks highlighted the cross-border risks and contagion as they generally reduced domestic credit temporarily in 2009 to a greater extent than did domestic banks (for example, Hungarian cooperative banks). The research also examines the stages and direction of transmission of these shocks and potential contagion. However, the region is not homogeneous in all these respects and comparisons across countries are needed.

Concerning the crisis years, the findings are more consistent with the findings of the current literature,<sup>25</sup> which focus on the impact of foreign bank presence during the current crisis. Foreign banks (parent to subsidiary) played a significant role in the transmission of contagion to emerging market economies during the current crisis. Due to cross-border financial exposures, the related risks of contagion channelled between West European and CEE international financial centres are resulting in an asymmetric shift in capital flows and contributing to further regional polarisation.

The crisis has modified the incentives for EU countries that are not part of the EMU—such as many of the CEE countries—to access the eurozone. Foreign currency indebtedness<sup>26</sup> channelled through the interlinkages of West European parent banks and their local subsidiaries has an implication for internal and external imbalances within the EU banking system.<sup>27</sup> The 'dual-banking systems' in the CEE are more prone to transmit

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<sup>21</sup> N. Cetorelli, L. Goldberg, *op. cit.*, p. 33.

<sup>22</sup> N. Cetorelli, L. Goldberg, *op. cit.*, p. 33.

<sup>23</sup> S. Claessens, N. van Horen, *op. cit.* P. 2

<sup>24</sup> S. Claessens, N. van Horen, *op. cit.* p. 21-22.

<sup>25</sup> See: R. Rajan, E. Prasad, A. Subramanian, '*op. cit.*,'; N. Cetorelli, L. Goldberg, 'Globalized banks: lending to Emerging Markets in the Crisis', Federal Reserve Bank of New York Staff Report, No. 377, June 2009, p. 33; S. Claessens, N. van Horen, 'Foreign Banks: Trends, Impact and Financial Stability', *IMF Working Papers*, WP/12/10, January 2012.

<sup>26</sup> In a few CEE countries, catching up in the first half of the 2000s was generally accompanied by macroeconomic stability, but most countries in the region became increasingly vulnerable due to the unsustainable trajectories of huge credit, housing and consumption booms, high current-account deficits and quickly rising external debt (a large proportion of it denominated in foreign currencies).

<sup>27</sup> G. Gorzelak, C. Goh (eds.), 'Financial Crisis in Central and Eastern Europe: From Similarity to Diversity', *Scholar*, Warsaw, 2010.

adverse shocks across borders and serve as a propagation channel for potential regional shocks that might be transmitted throughout the CEE.

In the run-up to the global crisis, the countries in Central Eastern and Southeastern Europe attracted large capital inflows and some of them built up large external imbalances. Previous studies on external imbalance in the CEE show the positive and significant impact of foreign capital on the investment rate in the CEE and on growth. However, the crisis years caused not only a deterioration of capital inflows but also a deterioration of domestic and foreign demand, which led to a deep economic depression in much of the region. Śliwiński<sup>28</sup> argues that there is no positive correlation between increased domestic savings and domestic investment in crisis-hit countries (Estonia, Latvia, Hungary) and thus this lack of correlation follows the expectation set by the Feldstein-Horioka puzzle. Increased domestic savings (dramatic fall in consumption) were spent for debt repayment rather than investment and consumption. This was the case in some countries that experienced negative or zero growth in 2008 and 2009 (Latvia, Hungary, Romania). In Hungary, accumulated imbalances required huge external adjustment as all indebted economic players were deleveraging. In 2012, the global banking sector reduced its external position in Hungary by about \$18 bn, or 14.2% of Hungarian GDP compared to Spain, with 14.3% of GDP. In some countries in the region, funding availability and cost remain a constraint for CEE banking, and the accelerated deleveraging in the banking system led to a more severe decline in bank lending in Baltic states and in Hungary than the eurozone average (measured by loans to the nonfinancial corporate sector).

Summing up, I argue that the role of foreign savings in promoting economic growth in the CEE-10 countries was undoubted in the short run and in a growth environment but challenged in the long run, particularly during crisis times. Since the outbreak of the crisis, not only have FDI inflows decreased but also the role of foreign capital in promoting economic growth has been revised.

## Research Outlook

The research aim is on one hand to develop and verify the existence of the 'dual-financial/banking system' model<sup>29</sup> in the analysed countries in terms of weak or missing local banking structures and strong dependence on foreign banks and their resources (external liabilities vs. local savings). On the other hand, it examines how foreign ownership and the related evolution of a dual financial and banking system impacted the economies in question during the crisis years in terms of financial stability. The research identifies to what extent the banking system integration of the CEE contributed to the

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<sup>28</sup> P. Śliwiński, 'External Imbalances In CEE-10 Countries and Feldstein-Horioka Puzzle In 1994-2008', Poznan University of Economics, 2009, p. 22, <http://management6.com>.

<sup>29</sup> P. Alessandrini, A. Zazzaro, *op. cit.*, pp. 71-92; Z. Gál, 'The Development and the Polarized..', *op. cit.*

regional imbalances within the European Union and the eurozone. The research relies on various indicators of the financial services and banking sectors of the analysed countries (macro data) and on information from the balance sheets of dominant banks (microdata). It compares the pre- and post-crisis periods. The paper argues that the role of foreign savings in promoting economic growth in the CEE-10 countries was undoubted in the short run and in a growth environment but this is rather not true in the long run and in crisis times. Financialised growth escalated in the years up to 2008 in those countries that lacked domestic deposit bases. This, was a transient phase that ended with the world financial crisis, leaving a number of countries, and among them the analysed ones, with uncertain futures.

