
Safeguarding Eastern Europe's Economy

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The EBRD wants to safeguard economic progress in Central and Eastern Europe.

Until recently, the European Bank for Reconstruction and Development seemed in danger of obsolescence. Founded in 1991 to blaze a trail for private investment in the formerly Communist countries of Eastern Europe and Central Asia, the multilateral development bank nearly succeeded in driving itself out of business. Private foreign investment flooded into the bank's 30-nation theater of operations. Economic activity took off, with growth averaging more than 6 percent annually from 2004 to 2007. Like Greece and Spain before them, countries such as Estonia, Hungary and Poland appeared destined to catch up to Western European living standards while the former Soviet republics further east made great strides of their own.

Now that progress stands imperiled. The region's economic revival came shuddering to a halt after the worldwide credit crisis intensified last year. Severe recessions in Western economies and a decline in global trade have caused output to drop across much of the region, while financial market turmoil has sparked an outflow of capital and undermined many countries' currencies. Governments have fallen in the Czech Republic, Estonia, Hungary and Latvia. Western European banks, which control 80 percent of the region's banking, could face pressure to cut back in the East and focus on their domestic economies after receiving hundreds of billions of euros in government bailouts and debt guarantees. Two decades after the fall of Communism, a new wall threatens to rise and erode years of hard-won economic progress in Central and Eastern Europe.

Suddenly, the EBRD finds itself with a renewed sense of purpose. The bank is stepping up its lending and devoting more of its resources to combating the crisis in new European Union members like the Baltic states and Hungary, areas from which it had largely withdrawn in recent years. Just as important, considering the bank's relatively modest budget, the EBRD is acting as a catalyst for wider efforts involving the EU and other multilateral lenders like the International Monetary Fund, which has already extended multibillion-dollar assistance programs to Hungary, Latvia, Romania, Serbia and Ukraine.

Bank president Thomas Mirow is determined to step up the EBRD's efforts to combat the crisis and preserve the economic and social gains made since the collapse of Communism. 'Looking back two years ago, the need for all international financial institutions was subject to question,' Mirow tells Institutional Investor in a recent interview at the bank's London headquarters. 'Now it has been shown that you don't abolish the fireman even if you don't have a fire.'

The magnitude of the crisis in Central and Eastern Europe is hard to exaggerate. Banks in the region will need to refinance more than \$130 billion in debt this year, EBRD chief economist Erik Berglöf estimates. The world's eight most indebted emerging markets, relative to GDP, are all in EBRD territory. Latvia is the champion, with combined public and private sector debt equal to 120 percent of gross domestic product. Governments in the region have been reasonably sober in their own financial behavior, with the notable exception of Hungary, but they turned a blind eye as the private sector went on a credit binge.

Compounding the problem is the fact that half or more of all bank debt in key markets like Hungary, Romania and Ukraine is denominated in euros, Swiss francs or dollars, and the real cost of servicing it has soared as local currencies have plunged. The Romanian leu lost 13 percent of its value against the euro from late September to April 30, the Hungarian forint fell by 16 percent, and the Ukrainian hryvnia cratered by 34 percent.

National treasuries, excluding Russia, with its oil-fueled reserves, have few of their own resources for bank bailouts or stimulus packages. 'Of all the regions of the world, emerging Europe is the worst prepared for the global crisis,' says Reinhard Cluse, UBS's London-based senior economist for the area.

The EBRD, which owns stakes in about 100 banks in the region and lends to some 200 others, is rushing to shore up the financial sector in the hottest trouble spots as fast as its resources and sometimes cumbersome internal procedures allow. 'We are looking to assist banks that are systemic on the one hand and viable on the other,' says Varel Freeman, first vice president for banking.

In April the bank bought 25 percent of Latvia's No. 2 lender, Parex Bank, for =82-106.2 million (\$140.9 million). Parex, formerly owned by a Russian-Latvian entrepreneurial team, was taken over by the government in November after clients, spooked by its =82-775 million in eurobond debt due this year, rushed to withdraw deposits.

In December the EBRD pitched in to bolster Ukraine's second-largest bank, Raiffeisen Bank Aval, providing a \$75 million, ten-year subordinated loan after the bank's Austrian parent poured in \$160 million in fresh capital. EBRD staff are also seeking board approval for a \$250 million, ten-year subordinated loan to state-owned Ukreximbank, the No. 5 lender. Mirow says the bank plans to devote more of its resources to Ukraine.

The EBRD is also trying to douse fires in Romania. It is awaiting board approval to lend =82-100 million each to the country's largest bank, Banca Comerciala Romana, a subsidiary of Austria's Erste Bank, and the No. 5 lender, Banca Transilvania, which is 15 percent owned by the EBRD. In Georgia the development bank plans to funnel as much as \$70 million in debt and equity to the second-ranked lender, TBC Bank, as part of a \$161 million package that includes financing from the Netherlands Development Finance Co. and the International Finance Corp., the World Bank's private sector lending arm.

In all, the EBRD aims to raise financial investments this year by 50 percent, to =82-3 billion from =82-2 billion, as part of an increase in overall lending, to =82-7 billion from =82-5.1 billion. The bank has the wherewithal to step up lending without tapping its 62 governmental shareholders for more capital. Although the EBRD posted a record loss of =82-602 million last year because of unrealized losses on equity investments, and expects to be in the red again this year, it generated earnings of =82-5.8 billion in the fat years of 2005 to 2007.

Mirow insists the bank is not loosening investment standards, but it is visibly shifting emphasis. Before the crisis hit the region, the EBRD tended to provide financing with relatively few strings attached; in February 2008 it extended a =82-350 million facility to a dozen Russian banks to help them 'continue expanding their operations,' as the bank put it. Recent interventions have been focused on recapitalizing banks, such as Raiffeisen Bank Aval, or enabling them to provide small-business lending. That was the purpose of the credits to two Romanian banks and a \$150

million loan announced in March to VTB24, the retail arm of Russia's state-owned VTB Group.

The EBRD has also postponed the so-called graduation of most Central European countries. Three years ago the bank decided to stop new investments by 2010 in the Czech Republic, Hungary, Poland, Slovakia, Slovenia and the three Baltic states, all of which entered the EU back in 2004. Those countries received just 6 percent of EBRD loans in 2008. This year, however, the bank has already pledged at least =82-500 million, or 7 percent of its projected lending, to financial institutions in those countries.

In addition to providing critical care for wounded banks, Mirow and his team clearly see a role for themselves as advocates for trans-European solidarity during this first serious test of the expanded, post-Berlin Wall continent. The banker is happy to explain why Western European taxpayers should pay, if necessary, for bad loans extended in Poland or Bulgaria. Part of the reason is pragmatic: Eastern Europe has already become the euro area's top export market, surpassing even the U.S. But Mirow stresses a moral imperative too. 'Twenty years after the peaceful revolution in Central and Eastern Europe, we should not send a signal that we don't care,' he says.

When it comes to promoting European brotherhood, the bank has had mixed results. National governments, led by Sweden and Austria, have been generous in allowing banks to channel bailout funds to their Eastern subsidiaries, something the EBRD has championed. 'The risk of having aid targeted for use domestically is small today,' says EBRD chief economist Bergl  f. 'It was huge last fall.'

The \$200 billion in guarantees offered by Sweden, where banks like Skandinaviska Enskilda Banken and Swedbank underwrote the Baltic credit bubble, amounts to roughly 40 percent of Sweden's annual GDP. Austria, whose Raiffeisen International Bank-Holding and Erste Bank led the charge elsewhere in the East, has put as much as =82-100 billion, or 35 percent of GDP, at the banks' disposal. Unicredit, an Italian bank that expanded east largely through its acquisition of Germany's HVB Group and HVB's Bank Austria subsidiary, announced in March that it would seek a =82-4 billion capital injection jointly from the Italian and Austrian governments.

Herbert Stepic, chief executive of Raiffeisen International, says there were 'no strings attached' prescribing the bank's use of a =82-1.75 billion capital increase that the Austrian Treasury extended to his bank's parent, RZB Group, in early April. With this backing, Raiffeisen has committed itself to staying the course in Ukraine and 16 other former East Bloc countries. 'I still consider this region as the No. 1 growth market open to us,' says Stepic.

The EU and the European Central Bank have turned a deaf ear to EBRD proposals that Central and Eastern European countries be offered a fast-track route for adopting the euro or at least for linking their currencies to the euro in the EU's exchange-rate mechanism. EU officials have firmly backed ECB president Jean-Claude Trichet's stance that prospective euro countries rigorously fulfill the requirements of low deficits, inflation and exchange-rate volatility laid down in the Maastricht Treaty. Mirow and Bergl  f have also made no headway with their calls for the ECB to provide currency swap facilities to central banks in the East, similar to arrangements that the U.S. Federal Reserve Board has made with Mexico and Brazil.

But Mirow, 56, keeps making his case, employing his favorite word,

'cooperation,' every few sentences. 'The situation is serious but manageable if the public sector in the Eastern countries, the public sector in Western Europe and the private sector continue to cooperate,' he declares.

The EBRD chief is aptly cast in the role of consensus builder. He was born in Paris, where his father was a diplomat at the German embassy. Mirow worked across the spectrum of German politics. He started out in 1975 as an aide to Social Democratic leader and former chancellor Willy Brandt, eventually becoming his chief of staff. He moved into the civil service in the city-state of Hamburg in the 1980s, rising to the post of state minister for economics from 1997 to 2001. Mirow dabbled in the private sector from 2002 to 2005, holding advisory roles at accounting firm Ernst & Young and Hamburg-based private bank M.M. Warburg & Co. Chancellor Angela Merkel, a conservative, tapped Mirow as her director general for economic policy in 2005, before moving him later that year to the Finance Ministry to serve as state secretary for international issues. He took the top job at the EBRD a year ago, replacing veteran French financial official Jean Lemierre. Mirow's ability to work with a variety of different parties is crucial for the development bank, which typically invests alongside a number of international financial institutions and governments to maximize its impact. That consortium approach is particularly vital today, given the scale of the crisis affecting Central and Eastern Europe.

A blueprint for the intricate cooperation that the EBRD would like to see has already been sketched out for the badly overextended Baltic countries of Estonia, Latvia and Lithuania, chief economist Bergl f says. The IMF, the EU and Scandinavian countries collaborated on a =82-7.5 billion adjustment loan to the Latvian government. Meanwhile, the government of Sweden, whose banks own most of the Baltics' financial sector, guaranteed more than \$200 billion in new bank debt, most of it implicitly earmarked for recapitalizing the Baltic subsidiaries. The Swedish central bank also agreed to a 10 billion koruna (\$1.1 billion) currency swap with its counterpart in Estonia, effectively adding to that beleaguered country's exchange reserves and rekindling its hopes of maintaining its currency peg to the euro. And the EBRD pitched in with its investment in Latvia's Parex Bank.

All told, Bergl f reckons, nine different treasuries and banking regulators and at least four supranational players have so far been involved in salvaging the three Baltic states, whose joint population amounts to about 7 million. All that remains is to scale that effort to the rest of the EBRD zone, which, even leaving aside giants Russia and Turkey as special cases, encompasses two dozen nations and more than 150 million people.

As one means to this end, the EBRD advocates picking up the pace of euro-zone expansion, a process that both present and prospective members approached skeptically during the good times. Only two small states in the region, Slovakia and Slovenia, have been allowed to join the common currency. The EU rejected Lithuania in 2006 because its inflation rate was 0.1 percentage point above the prescribed norm. 'Some of the problems we're seeing result from countries being integrated in terms of markets, but not in terms of currency or other institutions,' Mirow says.

The IMF endorsed the EBRD's integrationist call; a recent Fund report suggested that the ECB might allow Eastern countries to use the euro but not join the central bank's governing board. But ECB officials have dismissed the idea. 'European monetary union has very clear rules, and these rules have to be followed,' governing council member Ewald Nowotny said last month.

EU leaders have taken a stingy line on requests for direct aid from CEE governments. In March, Merkel rejected a proposal from then-Hungarian Prime Minister Ferenc Gyurcsány for a €180 billion regional rescue fund, an idea that even the EBRD's Berglöf describes as 'a bit premature.' But the EU has found other ways to assist the region. It has more than quadrupled its balance of payments facility, an emergency credit line for non-euro-zone members, from €12 billion to €50 billion in the past six months. Already, Hungary has tapped the facility for €6.5 billion, Romania for €5 billion and Latvia for €3.1 billion. In February the European Investment Bank, an EU development bank, allocated €11 billion to investments in East European banks over the next two years and promised to coordinate its efforts with the EBRD. The World Bank added €7.5 billion to the initiative.

EU countries are also helping the region through the IMF; they agreed at the Group of 20 summit meeting in London last month to contribute \$100 billion in additional resources to the fund. The IMF in turn has been pouring assistance into Eastern Europe, extending bailouts to EU members Hungary, Latvia and Romania and offering similar aid to Armenia, Belarus, Georgia and Ukraine. Poland last month became one of the first countries to tap the IMF's new flexible credit line, a kind of insurance line of credit, for \$20.5 billion.

About 15 European countries, including Turkey, will seek IMF intervention before the current financial plague subsides, predicts Anders Aslund, an East European specialist at the Peterson Institute for International Economics in Washington.

The EBRD'S ultimate goal is to keep the economic panic from decoupling Western and Eastern Europe and throwing two decades of Continental integration and rising prosperity into reverse. The bank's mission is to keep Eastern financial systems sufficiently intact so that most of new Europe can resume growth when its Western customers do. Are the various aid streams enough to achieve this? Mirow is guarded in his optimism. 'My guess is yes, there will be sufficient funds available,' he says. The near-term outlook remains rocky, EBRD banking chief Freeman cautions. 'There is a lot of negative momentum. The risks are still on the downside,' he says.

As for longer-term prescriptions, the EBRD brain trust insists that the region's dependence on Western capital remains the right strategy, but Berglöf argues for a 'new financial architecture' that would allow home and host countries of the major international banks to work together to curb credit excesses. 'Host countries could not regulate effectively because banks could circumvent them by using their home office, and home countries don't know what is going on in the host country,' he says.

EBRD officials also defend the extension of foreign-currency-denominated loans in many Central and Eastern European countries and reject the idea of imposing limits on them. Rather than proscribing activity, bank officials are working to develop deeper local currency capital markets to give borrowers a wider choice of options. In Russia, for instance, the EBRD helped design a ruble interest rate mechanism called MosPrime in 2005. It has since supported the widespread use of that rate by launching four floating-rate bond issues worth a total of 32.5 billion rubles (\$979 million) that are linked to it. The bank has also extended 85 billion rubles in loans pegged to MosPrime to Russian banks and companies. MosPrime's success is a big reason hard-currency loans in Russia account for only one quarter of all lending, Berglöf contends. The bank has similar spadework under way in Ukraine.

Banks meanwhile are cutting back on hard-currency lending because of the risks that devaluations pose. Raiffeisen International has stopped making Swiss franc loans in Central and Eastern Europe and is cutting back on euro-denominated lending to individuals, says CEO Stepic.

The EBRD's work, combined with the support of other international financial institutions and Western governments, is beginning to have an impact. Western banks and the governments that stand behind them have continued to invest in the East's long-term promise.

In addition, devaluations and the flexibility of the region's young industrial complex could spur a sharp rebound in the financially healthier states. Czech carmaker Škoda Auto, for instance, took quick advantage of neighboring Germany's 'cash for clunkers' program, which gave consumers subsidies for scrapping old cars and buying new ones. Škoda, which is owned by Germany's Volkswagen and had cut working time in response to a drop in demand in September, returned to a full workweek in March and reported sales rising from a year earlier. 'The Czechs and Poles have made more positive transformations on the supply side of their economy than, say, Italy or France,' says Iain Begg, a research fellow at the London School of Economics' European Institute.

Although governments have fallen this year in several countries in the region, their successors look more sober and just as committed to European integration as their deposed predecessors. 'The crisis has made politicians in the region value euro access and other integration steps more as a light at the end of the tunnel,' says Jon Levy, an analyst at Eurasia Group, a research and consulting firm in New York. Unless things get much worse, today's crisis increasingly looks like a contraction that Europe will struggle through together and not an historic cataclysm that will tear the Continent apart.

'These countries are still privileged, in a way, to be so close to the European Union,' says Berglöf. That optimism sounds less incongruous than it did a few months ago.

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