RESTRUCTURING FINANCIAL SERVICES SECTOR IN CRISIS ENVIRONMENT: International Financial Centre functions in CEE

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Contents

1. Impact of financial reintegration on IFC formation in a transition economies
2. Factors and constraints of IFC formation (role of SSC-s)
3. Impact of the crisis on CEE capitals

Theories on International Financial Centres & on Financial system (re)integration of CEE are revisited

I. Hierarchical view of geography of IFCs needs rethinking (Reed, 1981; Budd 1998)

- Embeddedness of IFCs in relational networks (Faulconbridge 2004, Beaverstock et al. 2005)
- Researches on second-tier European IFC (Engelen, Grote, Faulconbridge)
- Researches on successful emerging IFCs (Poo et al. 2003, Xiaobin Zhao, Sokol, 2007)

II. Reintegration & Transition theory: Banking in Transitions Economies, developing market Oriented Banking Sectors in Eastern Europe. (Bonin et al. 1998)

- How does foreign entry affect domestic money markets? Why do banks establish **foreign subsidiaries**? (Claessen et al. 2001, Buch, 2003, Berger et al. 2004)
- Entry EU banks and FDI in banking (brownfiled & greenfield privatization (Wachtel 1998)
- Modernization theory: Supporting bank privatization by foreign strategic investors vs. state ownership, (Várhegyi 1993, Király 2005)
- Emerging dual banking system and its implication for spatial polarization and uneven development (Alessandrini&Zazzaro, 2009, Gál, 2005)

Changing conditions of Financial Centre formation in CEE

Post-socialist transformation (neoliberal, maket-led, internationalized)

1. Systemic transformation: changing ownership structure
2. Gobal reintegration (into global & EU market; world-city network),
3. Metropolitan transformation (Shift to services)
4. Privatization, de-nationalization of financial sector (almost exclusively by foreign investors)

Integration into the EU market

1. Modernization and better access to services
2. Concentration in the core & capital city regions (highly uneven regional development)
3. EU-wide consolidation: challenging local IFCs & exchanges
4. Attracting financial services jobs that can be „outsourced” from the old EU members in the form of captive SSC and thirdf party vendors

Evolution of financial centre functions in CEE

Stages of transition	Main trends	Elements of financial centre formation	Limits of higher order international financial functions
Systemic transformation	*"outer directed capitalism",* with strong reliance on FDI	Changing ownership structure, strategic foreign investors; strong centralization legacy of CPE (Top-down financial reforms)	Relatively small financial markets As a percentage of EU 15: - GDP 22.5 - Market capitalization: 16.4 - Financial assets: 6.0 - Banking assets: 4.2 (1.8)* - Financial Assets/GDP: 26.7 (147 EU15)
Global transformation: Re-integration into the Global Financial Market and International Financial Centre network	*Metropolitan transformation:* re-integration into the world-city network	– Shift to business services – Exploiting comparative advantages on global market – Interactions & symbiotic metropolitan competition for investors	Subordinated power relations in finance (Under Ifs' control): Strong dependence on foreign investors 1. TNCs built their subsidiaries parallel, rather than promote regional focus 2. Little evidence on internal connectivity within CEE (only OTP bank has built a intra-regional network) 3. Little evidence on regional HQ functions – Low level of inst. Concentration: global investment banks, , assets managers – Low level of specialization: lack of sufficient advisory, equity & debt support – Failure of creation Pan-CEE capital market: Exchanges showing no sign of a regional focus" – Still few core 'controlling point' rather 'gateway' functions – EU-wide consolidation of IFC network prevents RFC formation
	Evidences of national financial centre formation	1. Growing share of financial services, 2. Gateway functions 3. Presence of foreign TNCs, FIs, 4 Expansion of capital market 5 Concentration of HQ functions of subsidiaries,	
Post-Transition: EU-accession, full market integration (GVC)	*Re-positioning/ weakening IFC functions*	CEE: a rapidly growing offshoring hot spot BPOs/SSCs are not IFCs	– Lack of concentration of indigenous FS Firms – Lack of complex range of financial services – Lack of control & command functions

FACTORS & CONSTRAINTS OF IFC FORMATION IN CEE

Factors of IFC formation

Macro-location factors (hard)

- **Large scale concentration of FIs** and related services (attracting foreign institutions)
- Successful economy (size matters, expansion market)
- **Open & international**: embeddedness in relational networks (connectivity)
- **Power relations:** control & surveillance functions/subordinated
- Lenient tax regime

(soft)

- Political & legal stability (EU accession, sound regulatory framework)

Micro-location factors (hard)

- **Localization and urbanization advantages (proximity and accesibility, size of agglomerations)**
- Institutional and information base (developed infrastructure)
- Strong human capital base (scale and quality)

Employment in finance

Strong concentration of financial services in the capital cities

- Higher share in K sector ratio in Warsaw
- Largest K sector concentration within the country in Budapest
- CEE IFCs: Lower general share of high-order services & lower for financial employment (Zürich 16.7%, Frankfurt 15.3%, NY 14.8%, Tokyo 3.8%, Shanghai 2.2%)

Share of financial employment in total employment of capital cities, %

	Warsaw	Share within the Country	Budapest	Share within the Country	Prague	Share within the Country
1995	6.0	-	3.5	-	3.2	-
2001	7.8	22.1%	3.8	52%	4.7	30.3%
2008	**10.1**	27.0%	5.4	**43%**	5.3	30%

Size of the CEE financial market

Bn USD	GDP	Market capitalization	Banking assets	Total financial assests	Total financial assests/GDP, %
Eastern Europe*	3 527	2 417	1820 **(653)**	5,178	146.8
As a percentage of EU-15	**22.5**	**16.4**	**4.2 (1.8)**	**6.0**	**26.7**
EU15	15 688	14 730	43 146	86,098	548.8
Eurozone	12 202	10 040	30 137	63,461	520.1

* Incl. (CEE), SEE,CIS

Size of the financial sector

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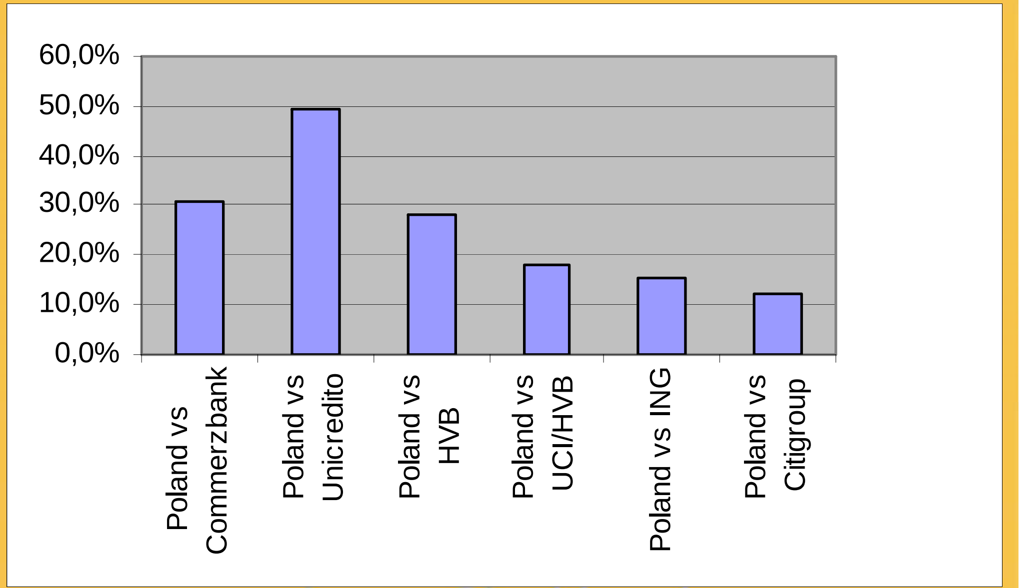
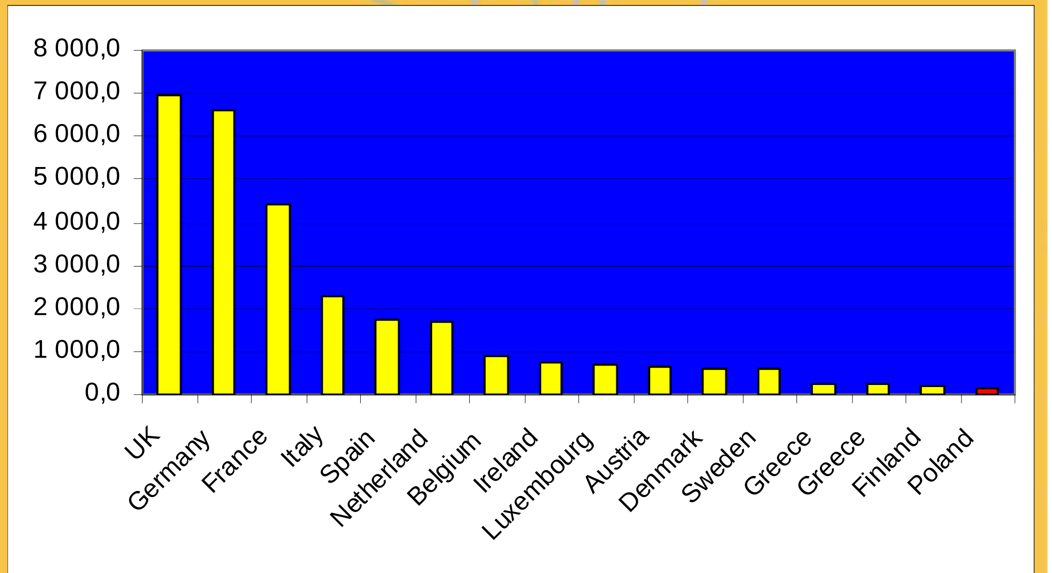
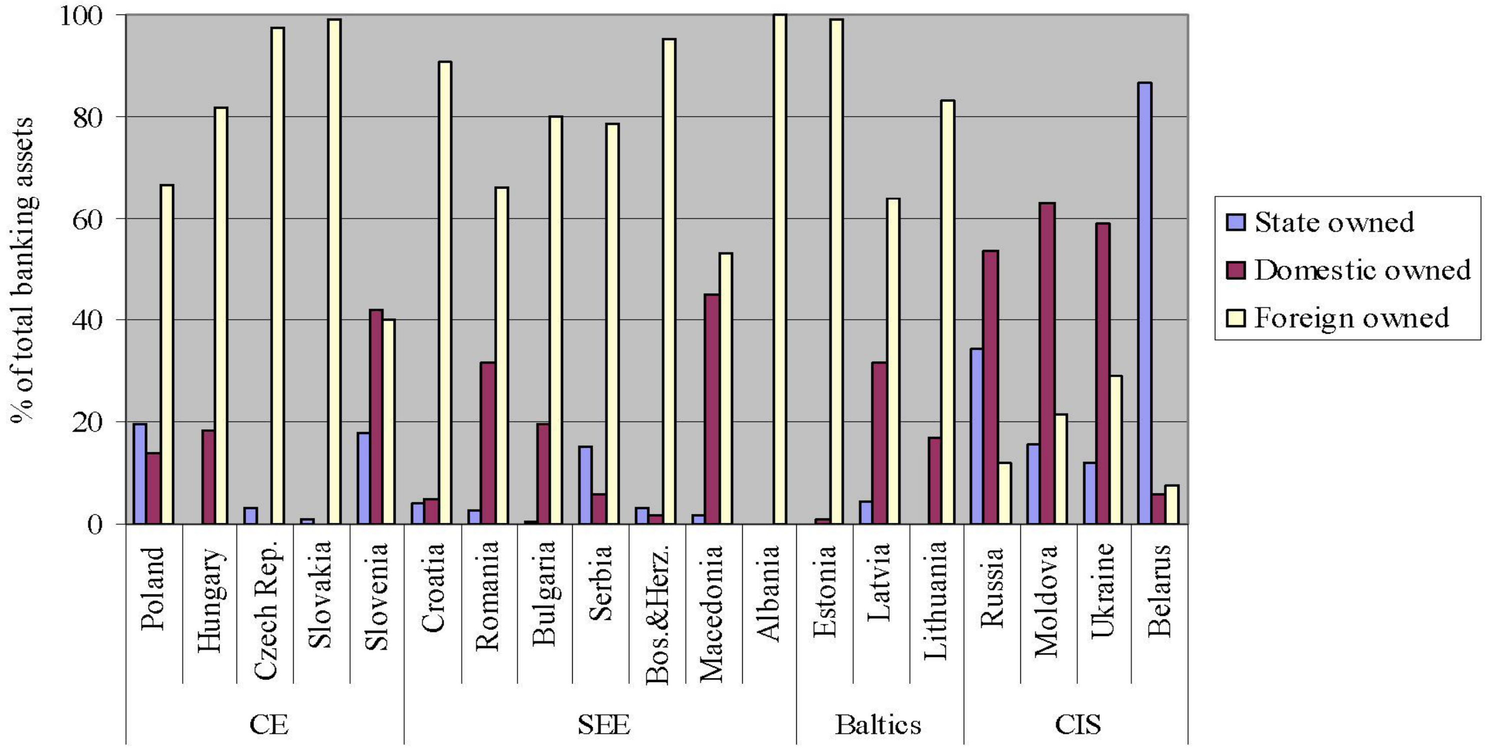
- Banking still dominates within finance (~60%)
- Banking assets /GDP: 83% (EMU: 250%)
- Assets of overall Polish banking sector are smaller than assets of a single foreign parent bank, 2006
- Banking profit growth was the highest (globally) in CEE: by 20%/y, in Russia by 40%/y between 2000-2008





Presence of foreign banks

- Domination of foreign banks as a financial intermediaries
- Foreign banks control the majority of assets (mainly West European), and penetrated very early in retail segment



Source: Raiffeisen Research (2007) and local central banks.
Note: Data as of year-end 2006.

Lower presence of global investment banks

Presence of the largest investment bank within the CEECs, 2004

		Warsaw	Prague	Budapest
1)	J.P. Morgan	X	X	-
2)	Merill Lynch	**X**	-	-
3)	Morgan Stanley	-	-	-
4)	Goldman Sachs	-	-	-
5)	Deutsche Bank	X	X	X
6)	Citibank	X	X	X
7)	Bank of New York	-	-	-
8)	Barclays	-	-	-
9)	State Street	-	**X**	-
10)	UBS	X	-	-
11)	Nomura	-	-	**X**
12)	CSFB	**X**	-	-
13)	Shroeders	-	-	-
14)	Lehman Brothers	-	-	-
15)	HSBC	X	X	X
16)	Brown Brothers Harriman	-	-	-
	Total	7 (2)	5 (1)	4 (1)

(1) Single presence o fan investment bank witin the region

Fragmented capital markets

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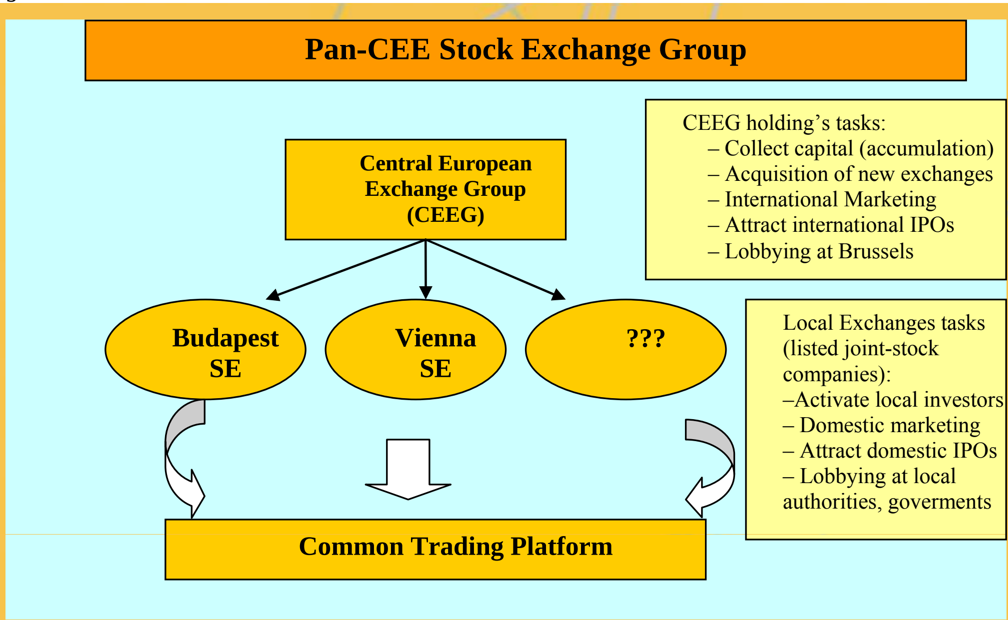
- Bank finance still has a priority over capital market finance
- At 2007 market capitalization of Warsaw,Prague and Budapest was **2% of the total capitalization** of all European exchanges
- Future of CEE exchanges:
  - Self-survival strategies: too smalls to „stand alone” WB, WSE, BSE large enough to offer sufficient liqudity
  - Creation of a Pan-CEEC exchange & common trading platform (Warsaw-Sibiu?)

2007	**Budapest**	**Warsaw**	**Prague***	**Vienna**
Capitalization (million USD)	46 195	211 000	101 772	236 448
- % of GDP	41	63	86	76
Listed companies	41	375	n.a	119
- of which foreign	2	23	n.a	17
Percentage of cross-listed companies **	74	29	36	n.a.
Market turnover (million USD)	47 586	87 962	50 115	129 974

*2004; ** 2001

Forrás: a szerző számításai a World Federation of Exchanges alapján, Corporation of London; *Future of stock exchanges in EU accession countries*, 2003



Implications for IFC formation: transnational network connectivity with unequal power relations

- Parent-subsidiary relations (outcome of previous FDI)
- Power relations: CEE centres in subordinated by West European IFCs
- Connectivity through parent-subsidiary network
  - Concentration of outdegree connections forms Western gateways to CEE (Investors' hub: Vienna, Paris, Athens, Frankfurt)
  - Concentration of indegree connections forms bridgehead centres in CEE (Host hubs: Moscow, Warsaw, Budapest)
- Lack of control function in IFCs located in CEE capital cities
  - Only exception is Budapest: control functions of OTP Bank, the only regionally based MNC with regional subsidiaries network)

Parent (HQ)-subsidiary (CEE) relations

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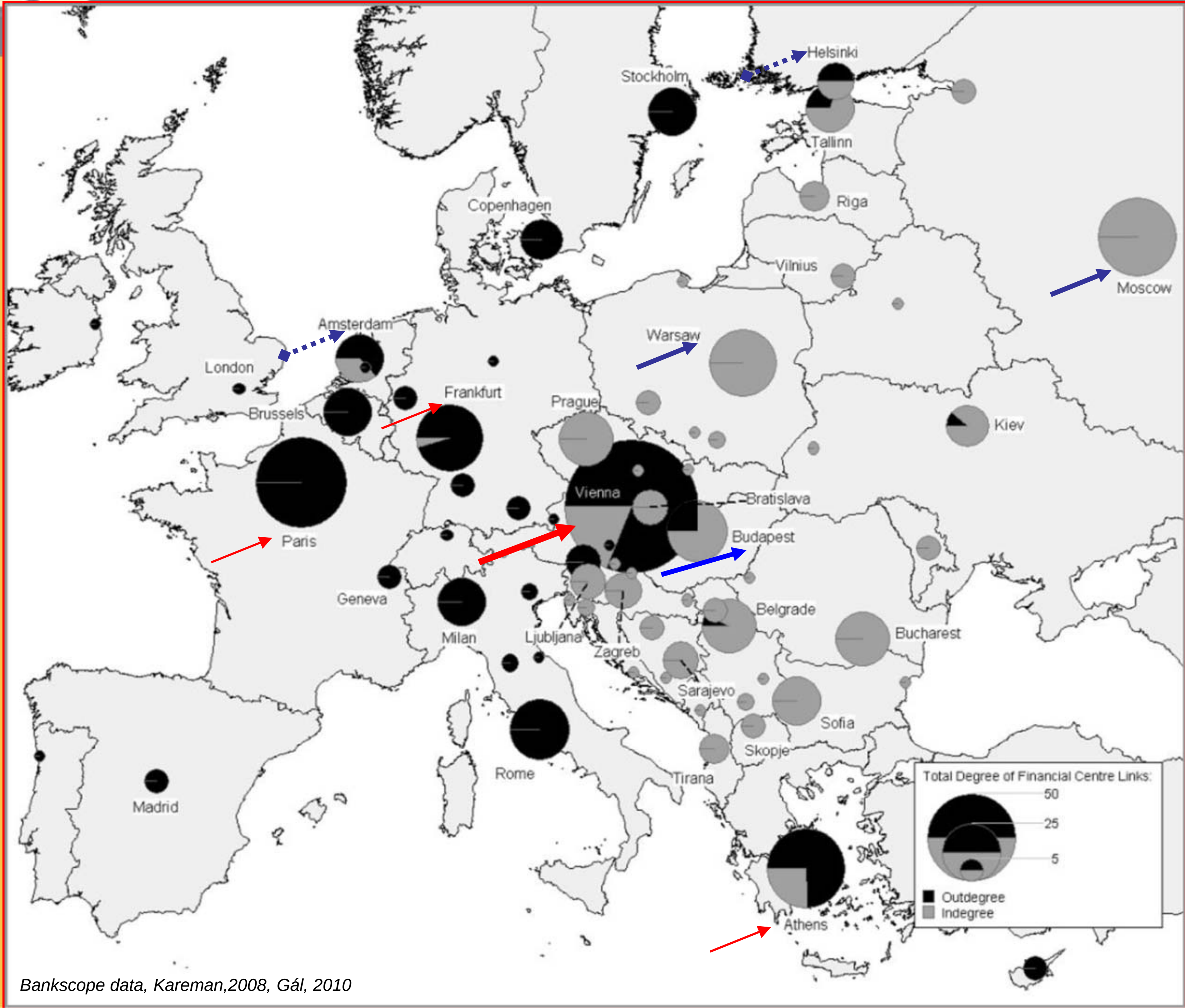
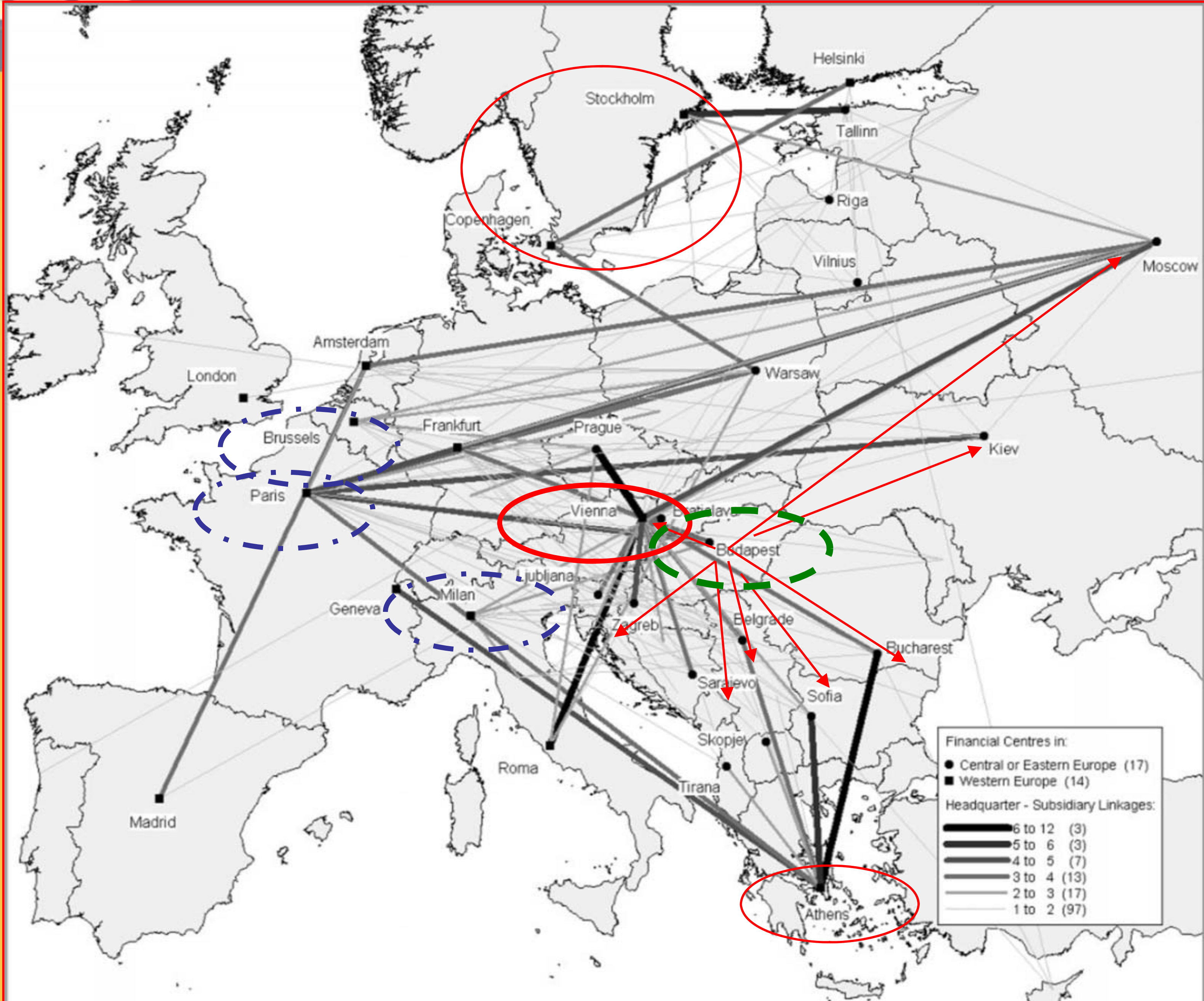


Bankscope data, Kareman,2008, Gál, 2010

Concentration of control functions of parent-subsidiary relations



Kareman,2008, Gál, 2010

Why does non of the NMS host real IFC function?

The main constraints of IFC formation in CEE

CEE cities: rather gateways than regional financial centres (RFCs)

1) Lack of critical mass of host economies and financial markets
2) EU IFIs control financial sectors in CEE (Subordinated power relations)
    a) Global financial players built up their activities parallel rather than promote regional focus
    b) Little evidence on internal connectivity within CEE (except OTP)
    c) Budapest is the only capital that host regional control & surveillance function in finance (OTP, MKB)
3) Little evidence in regional HQ functions
    a) Low level of of institutional concentration: e.g. low presence of global investment banks, institutional investors and assets managers
    b) Low level of specialisation; lack of sufficient advisory, equity&debt support
    c) <u>EU-wide consolidation</u> of IFC network and the <u>dependency</u> on relations networks of western IFIs overcompensate the organisational and geographical proximity can be provided by a RFC
    d) Negative impacts of stock exchange consolidation on CEE capital cities

Possible role of offshoring in IFC formation: the difference between BPO/SSC and IFC

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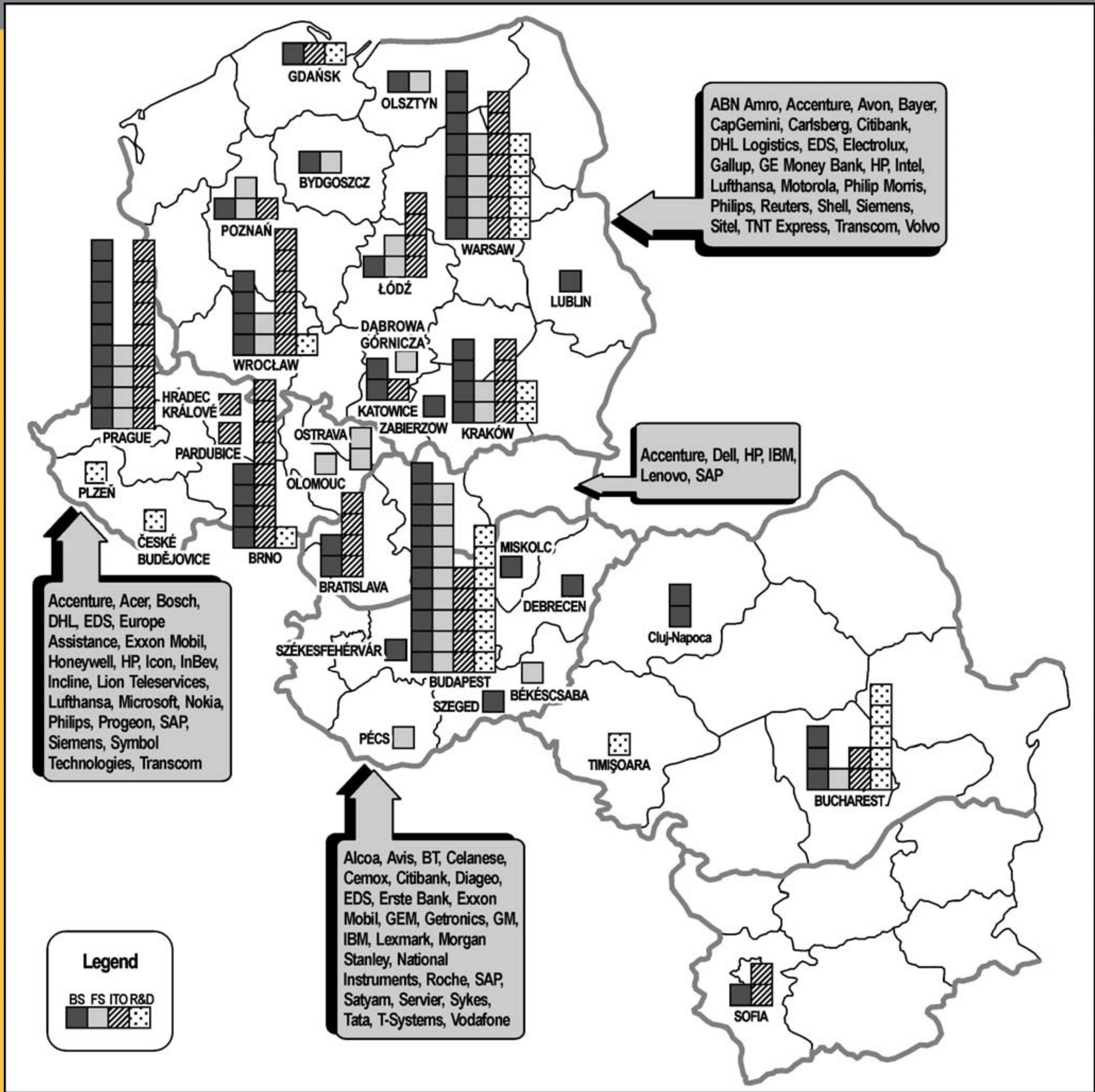
- IFCs are more embeded to their national and regional hinterland
- BPO/SSC are more footloose
- BPO/SSC involve low and medium value skill tasks, highly codified
- Service exporting hubs will not result in natural evolution to IFC.
  - BPO/SSC centres are not IFCs (Mumbai’s plan to shift)
  - No strong indigenous institutional base, no control/command functions
  - Impact on host location (<u>Multiplicator effects are limited)</u>
  - Low level of territorial (regional, local) embeddedness

- IFCs criteria:
  - Geographical concentration of indigenous and internationally well-known financial firms
  - Generating comlex range of financial services
  - Concentration of control & command HQ functions

Geographical landscape of services offshoring in CEE



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IMPACT OF THE CRISIS ON CEE CAPITALS

Earlier banking crisis and privatization resulted in unprecedented shares of foreign ownership in CEE banking

- First banking crisis in the early 1990s: collapse of local economy, incresed bad debts, low equity base
- Bank and credit consolidation on the expenses of the states (11% of GDP in Hungary, 1990s)
- FDI flew into the banking sectors: customer-seeking
- One of the fastest growing regions of the world in terms of banking ROE, ROA after the Millenium (high rate of profitability, cushions of parent bank liqudity)

High level of financial dependency on global (EU) financial markets

"Great capitalist transformation" of Eastern Europe has been expressed over the last decade by a high level of debt and financial dependence on Western European banks, which is without precedent since decolonization… Samary, 2009
(Towards a Western/Eastern Europe Banking and Social Tsunami)

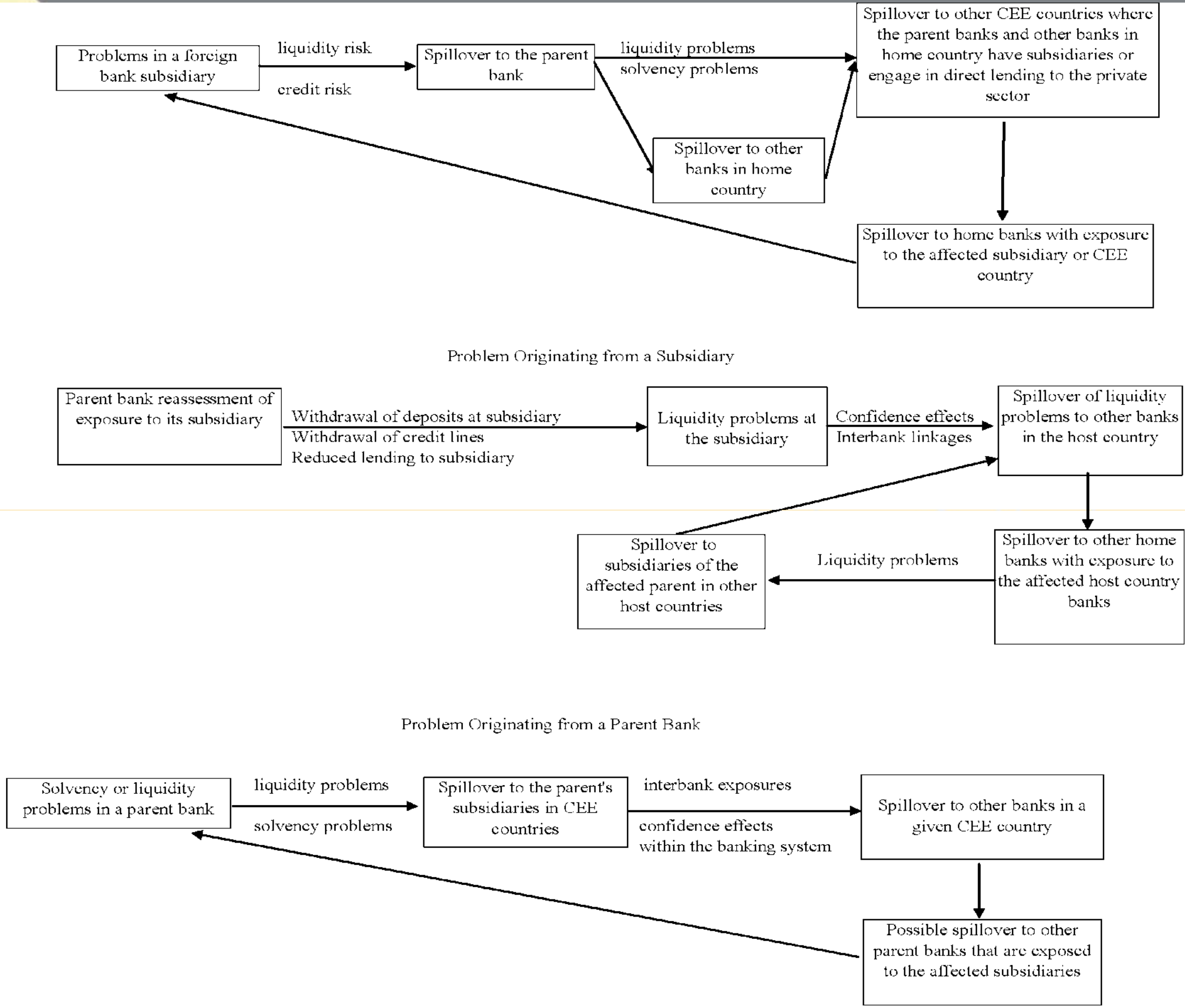
TRANSITION & POST-TRANSITION

- Heavy reliance on FDI (in export-led industries & financial services)
- Deterioration of „endogenous" capital, rapid privatization
- Dual-economy/finance): core-periphery/dependent power relations
- Debt and credit dependence on subsidiaries of foreign banks (foreign debt fuelled growth and consumption)
- Loss on national control functions in finance is more pronounced

IRREGULAR SPREAD OF THE CRISIS

- Era of crises: transnational networks are channels of financial shocks (Current account imbalances, currency crisis, profit repatriation)
- Shortage in liqudity in the developed coutries spread to East Central Europe
- Divided Europe? two-tier EU?, (Vienna initiative)

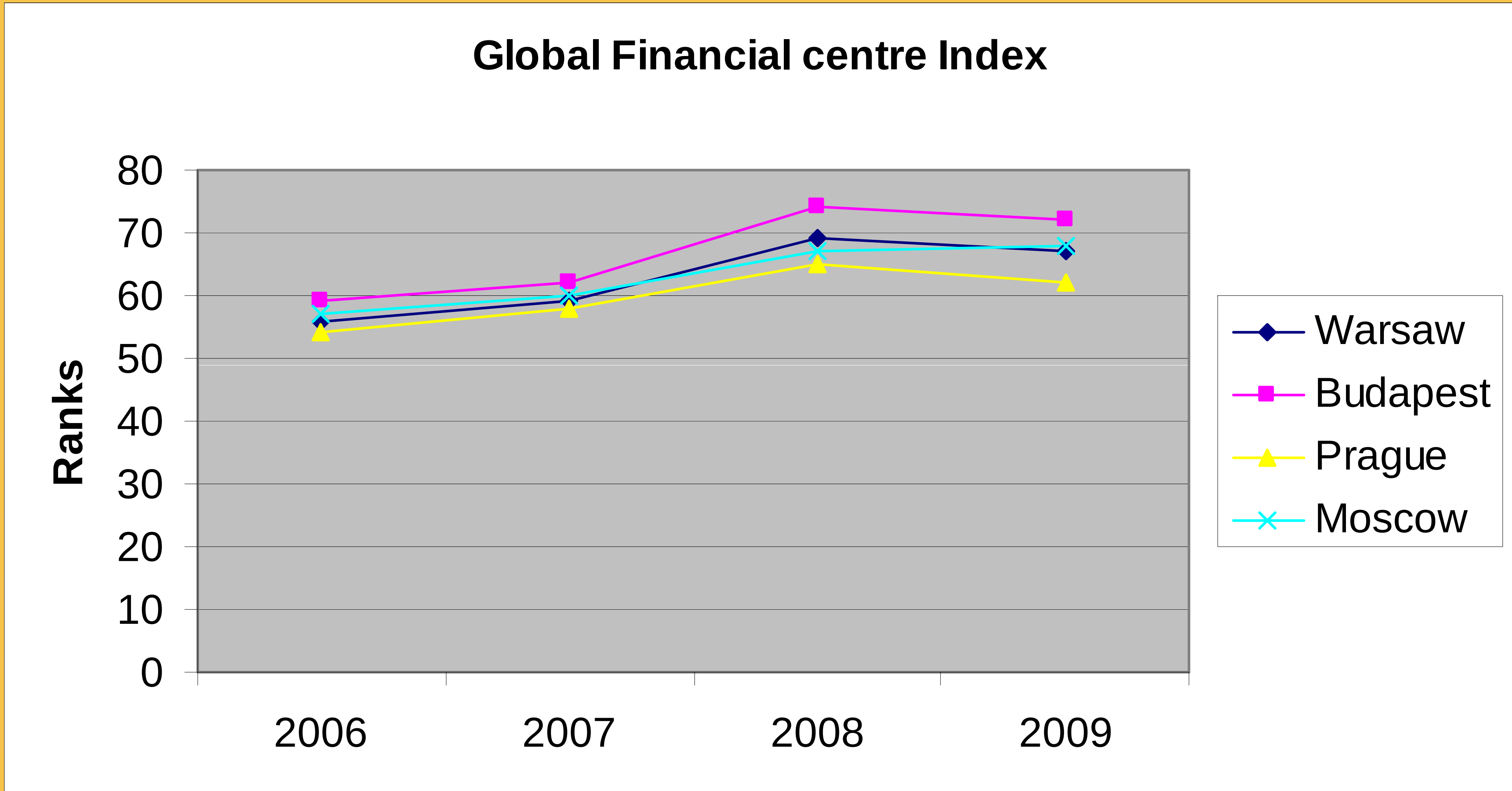
Problem Originating from a Parent banks and Subsidiaries during the Crisis



Implications for the capital cities

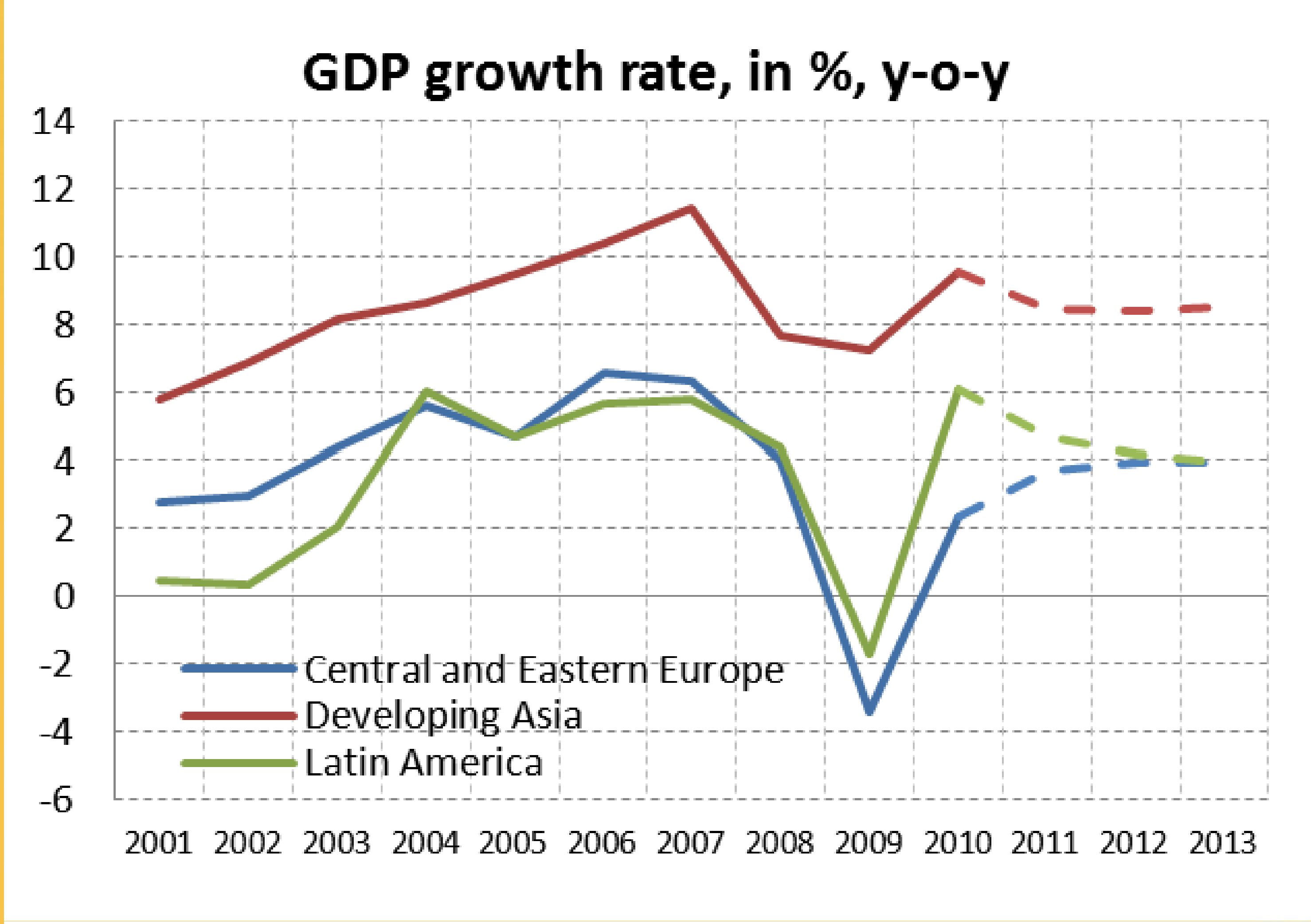
- There are signs of national financial centre development with certain international functions (weak institutional base) but no RFC.
- CEE cities: rather gateways than regional financial centres (RFCs)
- Alternatives to RFC? to attract new vawes of financial sector jobs through offhoring (relocation) & outsourcing services
  - BPO/KPO centres are not IFCs (Mumbai's plan to shift)
- Crisis environment (de-valuation of CEE shift to Asia)
  - Future of banking subsidiaries (relocation, consolidation)
  - Declining Warsaw, Prague, Budapest in terms of GFC index (local diversified/evolving centres)
  - Could Moscow become IFC (global contender (2009, GFCI)

Stagnatiing IFCs



Conclusions

- Future role of CEE in the global financial landscape
- The chance for gaining stronger position in the global division of labour without control and command functions is impossible
- Implications for transformation of the crisis-prone European financial landscape
  - EMU in crisis
  - Slowest recovery of CEE among the emerging regions
  - CEE suffers from its heavy reliance on western Europe
  - Past dependence on foreign investment (narrow ranges of export platforms)
  - Increasing role of the nation state (in IFC formation too)
  - Weakening states in CEE (no ability to support IFC formation vs. Asian counterparts and handling heavy dependencies on TNCs)
  - EBRD president's recipe


GDP growth rate, in %, y-o-y
14
12
10
8
6
4
2
0
-2
-4
-6
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Central and Eastern Europe
Developing Asia
Latin America

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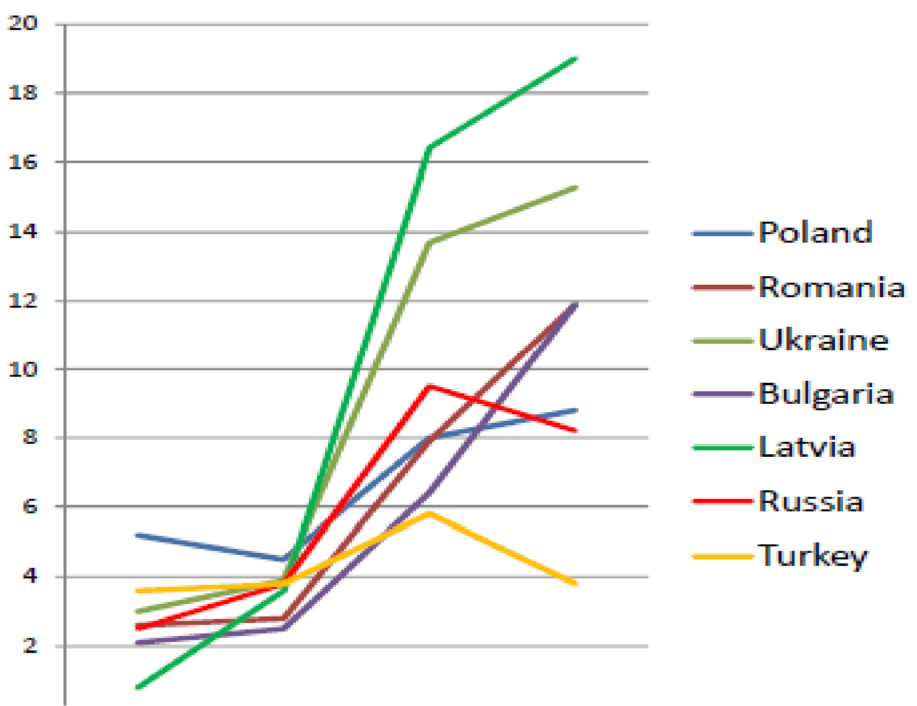
But still high foreign indebtedness of CESEE countries (1)

(external debt in % of GDP)

	2009	2010	2011f	2012f
Baltics	118,2	117,4	109,6	103,0
Latvia	156,3	165,2	152,0	141,2
Lithuania	91,4	85,7	82,2	78,5
Central Europe	85,3	83,5	83,7	81,5
Hungary	153,3	143,9	140,6	131,5
Poland	64,9	66,8	68,4	68,5
Southeastern Europe				
Bulgaria	113,6	102,3	94,7	88,2
Romania	71,8	74,2	78,7	75,6
Croatia	101,9	99,3	93,4	91,4

Vulnerabililities in the banking sector

Nonperforming loans on total loans (%)



Domestic FX-loans (% total loans)