Transforming Markets

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Chapter 2
Markets in Crisis

Introduction

By 2007, the economies of the EBRD region were growing at a record pace. The region was basking in the success of a sustained period of economic improvement. Many countries had embraced democracy and the principles of the market economy. Eight of the countries where the EBRD was investing were now established EU member states and preparing to leave the ambit of the Bank. Two more had joined the EU at the start of the year. Naturally, many delegates at its annual meeting in Kazan in May congratulated the EBRD on a job that was progressing well.

In the previous four years, GDP growth in the region had accelerated to a rate of almost 7 per cent a year, up from an already high rate of around 5 per cent a year between 2000 and 2003. Even more striking was the breadth of improvement that had taken place. Each of the 30 EBRD countries of operations had seen increases in output for seven years in a row (other than a 0.2 per cent fall in Kyrgyz Republic in 2005). The region’s GDP was now more than 50 per cent above its level at the start of the millennium.

Income convergence with western economies was finally happening across the board, especially for those closest to or within the EU.

This rosy economic picture was no less true for some of the Soviet Union’s former republics. In the Baltic states, growth had accelerated to 10 per cent a year by 2007. Many resource-rich countries in the Caucasus and Central Asia had seen increases in GDP that were nothing less than spectacular, helped by the acceleration in commodity prices. In Armenia, Azerbaijan, Kazakhstan and Turkmenistan, GDP had more than doubled since 2000. Households were beginning to see the fruits of these developments.
For the Kazakh farmer, just as for his counterpart in the US Midwest, improvements were unmistakable. Wheat prices and incomes were rising, banks were keen to lend for business expansion and real estate values were booming. Working on opposite sides of the world, twelve time zones apart, the once ideological enemies were now an integral part of a continuous global production cycle and appeared to share a common future of growth and prosperity.

What they shared in fact was a common underlying and serious problem: a rampant financial sector with little respect for borrowers’ ability to repay. In a matter of months their dreams would be shattered, and with them those of many more, as a financial tornado tore through the USA and Kazakhstan before morphing into a global financial crisis.

1. Financial Problems in Kazakhstan

Kazakhstan was indeed an early outlier in the crisis that was to engulf the whole of the EBRD region and a harbinger of what was to come more widely.

An attractive investment opportunity

A plentiful supply of oil and gas, mineral resources and a vast, highly-fertile agricultural landscape—covering an area the size of western Europe—had allowed Kazakhstan to tap international capital markets as interest in emerging economies re-emerged in the 2000s. A period of economic reform after the Russian crisis—efforts which won praise from the IMF—resulted in a strong macroeconomic performance, despite currency appreciation pressures from financial inflows as growth rocketed. At the time, Kazakhstan even earned the epithet of ‘tiger of the steppe’ in a comparison—wholly misplaced in retrospect—to fast-growing Asian economies such as South Korea and Taiwan. Unlike Kazakhstan, these original Asian Tigers had built strong manufacturing sectors and had little by way of natural resources.

Rising production and a steep increase in global commodity prices propelled its economy and the net inflow of FDI, already running at almost US$ 3 billion a year in the first half of the decade, grew to around US$ 12 billion by 2007. Foreign exchange earnings grew similarly fast and provided
ready fuel to spur on the financial system to offer new loans to businesses and households who were more than eager to join the spending spree.

As the economy was booming, the country’s banks, primarily domestic, had expanded rapidly, competing fiercely for market share at home while also spreading their reach to foreign markets. Investor confidence was high and banks like Bank TuranAlem (later renamed BTA Bank) and Kazkomm'erzbank (KKB), the largest bank in Kazakhstan, both of which had been early EBRD clients, were easily able to raise funding on the international credit markets.

With a stable exchange rate, the ability to borrow abroad in hard currency at low interest rates and charge double-digit rates in tenge to customers at home became irresistible for Kazakh banks. Ignoring growing balance sheet mismatches and the risk of a sudden depreciation, the banks piled on their exposures as profits rose. Construction and property became the outlet for this growing pool of liquidity and real estate prices accelerated, most noticeably in major cities like Almaty and Astana. In short, Kazakhstan’s economy fell victim to a speculative construction and property boom as domestic credit expanded at over 60 per cent a year—even increasing by 80 per cent in 2006.2

Investing in the financial sector

André Küüsvek, an Estonian banker who moved to run the EBRD’s operations in Kazakhstan in 2004, recalled that around two-thirds of the EBRD’s portfolio in the country in those days was in the financial sector. There was little opportunity for involvement in municipal areas and the corporate sector was largely in the hands of oligarchs.

For the EBRD, the model of developing the domestic financial sector as a means of intermediating funds generated by resource sectors, thereby allowing them to be reallocated towards productive, job-creating sectors, especially to SMEs, or for industrial energy efficiency, underpinned this thinking.

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1 The EBRD had exposure to BTA through its trade finance and grain receipts’ programmes before it purchased convertible preference redeemable shares in BTA in 2001, alongside other IFIs. Following a loan in 1998, the EBRD purchased an equity stake in KKB in 2003. Preference shares in BTA were converted to ordinary shares in 2006.

2 The EBRD Transition Report, published in 2007, noted that almost one-half of all bank liabilities originated abroad and that the property sector accounted for more than 32 per cent of bank lending at the end of 2006.
In addition to the credit lines, the EBRD also held equity stakes in KKB and BTA. Both banks were competing for better market share. However, Küüsvek noted that while the largest banks were successfully raising money internationally via large syndications and foreign listings there was in fact little scope to reinvest the scale of these funds effectively back at home. Consequently, much of the financing was funnelled directly into the construction industry, fuelling a property bubble that would soon burst spectacularly.

Awkwardly, there were also clear examples of ‘connected banking’, where banks conduct their lending on the basis of (sometimes too cosy) relationships with business associates and related companies. The EBRD grew increasingly wary of the activities at BTA, especially after the return to the helm of the bank of its major shareholder, Mukhtar Ablyazov. Ablyazov, who had been freed from jail in 2003 and subsequently fled the country (in 2009), was to be accused and convicted of fraud—and, many years later even murder, following the death by shooting of the former co-owner of BTA, Yerzhan Tatishev.

Tatishev died in what was originally billed as a freak hunting accident in 2004, at a time when Ablyazov was no longer at the bank and out of favour with the administration of President Nursultan Nazarbayev. But in 2005, at a hastily called extraordinary shareholders meeting, Ablyazov was brought back into the fold and appointed chairman of BTA’s board of directors.

Ablyazov returned with big ideas for the bank. Küüsvek was not convinced. He and the Austrian head of financial institutions at the EBRD, Kurt Geiger, went to see the reinstated head of BTA. The EBRD decided there would be no further transactions with BTA but that it would nonetheless remain a shareholder.

Instead, as the largest foreign investor in Kazakhstan outside the oil and gas sector, the EBRD sought diversification opportunities and shifted its portfolio away from financial institutions towards the corporate and power sectors. It managed to maintain strong growth in its predominantly non-sovereign business volume.

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3 Ablyazov had been a Minister for Energy, Industry and Trade before helping to found the Democratic Choice of Kazakhstan (DCK) in 2001, a political party that posed a challenge to the Nazarbayev regime. He was jailed for six years for abuse of office and illegal financial dealing in 2002 but, after promising to stay out of politics, was released in 2003. See ‘Former managing director of BTA Bank extradited to Kazakhstan from UAE’, Fergana News Agency, 5 March 2020, https://en.fergana.news/news/115794/.

4 The EBRD’s eventual exit from BTA took place in 2011.

5 In 2007, the non-sovereign share was 88 per cent, with the portfolio increasing by more than one-third in that year alone.
It was against this backdrop of heady financial sector growth, a booming property market and a rapidly expanding economy that things began to turn in 2007.

The turn in 2007

Commercial bank lending had been accelerating over several years, heavily reliant on international wholesale funding and debt securities with bullet repayment structures. Credit risk indicators such as loan-to-deposit ratios (LDRs) had soared to over 150 per cent and in many banks more than one-third of exposure was to construction and real estate (with residential mortgages adding further to the concentration risk).

Concerned at the unsustainable pace of credit growth, the Kazakh regulatory agency, the FSA, imposed a number of measures in the second half of 2006, including limits on banks’ short-term external borrowing. Nonetheless, banking assets continued to expand fast, doubling that year, and private external debt jumped to over 90 per cent of GDP.

The FSA deployed a further round of prudential tightening the following April. But by then, bank margins were being squeezed and asset growth had started to slow, even though house prices continued their upward track for a few months more.

The deceleration of credit growth was compounded by the first ripples of the subprime mortgage crisis in the USA. As Bear Stearns, a New York global investment bank, reported mounting losses on subprime exposures in July 2007, international banks started to look more critically at riskier assets. Kazakhstan’s onerous external obligations were an obvious source of vulnerability, particularly when set against a domestic boom based on shaky foundations.

The country’s copious exposure to foreign finance suddenly turned what had looked like a positive sign of transition and integration with the world of international capital into a major liability, as access to funding dried up amid a widening global credit chill. No longer able to access foreign funding or refinance foreign obligations coming due, Kazakh banks sharply cut back on new lending and began to raise interest rates.

Prior to Bear Stearns, most commentators remained relatively sanguine at the unfolding picture—for example, Moody’s noted the low level of government debt, virtually none of which was external, and the build-up of foreign exchange reserves in the National Fund.
By October 2007, however, it was clear that the global rise in investor nervousness and increasing risk aversion on the part of lenders worldwide was now a major threat to the country’s economy. On 8 October, Standard & Poor’s (S&P) cut its rating for Kazakh debt, citing a significant tightening in credit conditions for borrowers. Announcing the step, S&P analyst Luc Marchand said:

The rating downgrades reflect funding problems in the Kazakh financial system. [...] Since July, falling domestic depositor confidence and difficulties in rolling over maturing international syndicated loans and cross-border interbank deposits have forced Kazakh banks to obtain short-term funding from the National Bank of Kazakhstan to support their liquidity.6

The downgrade was a trigger for furious activity to try to restore calm to the worried markets. Nazarbayev, the country’s powerful president, said the government would support the country’s commercial banks and instructed the authorities to free up US$ 4 billion to do so. He also criticised the ratings agencies and called the downgrade unfounded, while his Prime Minister Karim Massimov was quoted as complaining that the country was under attack from hedge funds and vowing “we shall fight back”.7

During a press conference in the northern city of Pavlodar in December, the Kazakh President told reporters:

I think ratings agencies should think more thoroughly and understand that Kazakhstan stands firmly on its feet and will not allow any Kazakh bank to collapse ... The economy is stable ... It’s not objective that the ratings are being cut.8

By February 2008, in his annual state of the nation address, Nazarbayev acknowledged that the problems emanating from the USA had indeed become a problem for Kazakhstan and he called on his government to take steps to curb the volatility on the domestic financial sector:

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We must learn lessons stemming from the US mortgage crisis which has had a serious impact on the global financial system as well as our banks. ... We have to intensify work to fight inflation. The government must temporarily ... cut state spending across the board apart from social spending ... This will help ease inflationary pressure.9

That same month, Küüsvek announced that the EBRD was planning to earmark up to half a billion dollars in funding for Kazakh banks to help them overcome their problems with borrowing on the international markets:

We plan to sign new projects worth about US$ 1 billion this year and maybe half of that will be with banks. In the second half (of this year) we might try to reopen the syndicated loan market for Kazakh banks.10

The Kazakh authorities responded decisively to the problems faced by the financial sector, pumping in central bank liquidity and creating a financing facility for lending to construction companies and small firms. But external forces became too strong for this medicine to have its desired effect.

Any optimism about an early recovery from the problems in the economy was short-lived once the full force of the global crisis became apparent in the wake of the collapse of US investment bank Lehman Brothers in September 2008. Kazakhstan was now confronting a ‘double whammy’ from its dependence on foreign borrowing and commodity exports, and its banks were in the front line.

By November, Finance Minister Bolat Zhamishev was saying that Kazakhstan once again faced “huge risks” following a precipitous fall in the oil price.11 He noted:

Now that a second wave of the crisis has engulfed us, we have to realise that a period of rapid economic growth due to high oil prices (has ended) ... we have to ensure the economy evolves ... with the smallest possible losses.12

11 Oil prices (WTI) fell from around US$ 140 per barrel at their peak in June 2008 to US$ 50 per barrel in November, reaching a low of US$ 45 per barrel at the turn of the year.
Bank debt was also a big concern with non-performing loans rising rapidly following the collapse in house prices which triggered insolvencies in the construction sector.\(^{13}\)

As the crisis unfolded into 2009, the Kazakh government pitched in to buy up shares in the biggest banks: BTA, in which it bought new shares representing three-quarters of the stock, KKB and Halyk.\(^{14}\) Already having seen a drop in GDP growth of 7 percentage points in 2008 against the average for the decade,\(^{15}\) Kazakhstan’s economy was now facing a highly uncertain future.

2. Contagion and Crisis

From Kazakhstan to Europe

Kazakhstan’s boom on the back of huge flows of foreign bank finance had been extreme. Primarily driven by emerging markets investors’ desire to exploit a growing economy with large supplies of natural resources, the financial flows had enabled domestic expansion. But as oil prices plunged, a significant devaluation of tenge followed in February 2009. The currency mismatches on the balance sheets of the Kazakh banks came back to haunt them. What had been an early casualty of imprudent financial behaviour became a full-blown crisis, and significant bank rescue efforts followed.

Further west it was not natural resources that had enticed foreign banks to follow a similar path into the EBRD region but skills, low wages and proximity to the large market of the European Union. The economic boom here had been more broadly based and, for most countries, more measured. But it exhibited the same dynamic of foreign finance leading the way and encouraging large-scale bank borrowing, mostly in foreign currencies.

Foreign banks dominated the region’s banking systems. In some cases, such as Estonia, it was virtually total—99 per cent of banking assets were foreign-owned—but even for central and south-eastern Europe, foreign

\(^{13}\) The house price index fell by around one-fifth between the summer 2007 peak and October and dropped by a further one-third by the end of 2008, meaning average prices had more or less halved in eighteen months. \textit{Source}: Trading Economics.


\(^{15}\) GDP growth fell to 3.3 per cent in 2008 from an average of 10.1 per cent since the turn of the decade, and dropped to 1.2 per cent in 2009. Growth in per capita GDP turned negative.
bank penetration was some 80 per cent in 2006 and rising. It is no surprise that when the financial crisis hit global banks with hurricane-like force in the autumn of 2008 it was these countries, like Kazakhstan, that were caught severely in its path.

**Misplaced optimism**

A year earlier it had all looked different. Buoyed by years of solid growth, the emerging economies of former communist eastern Europe appeared more or less impervious to the wave of dire financial news sweeping over the Atlantic. Even as the US sub-prime mortgage crisis metamorphosed into a credit crunch in western Europe, and clouds gathered over eastern Europe, the impact was still expected to be manageable.

That changed in one fell swoop with the bankruptcy of Lehman Brothers on 15 September 2008. Confident assertions about an imminent successful conclusion of the transition journey for many economies in eastern Europe melted away. Growth forecasts were wound back savagely and repeatedly. Eastern Europe ultimately turned out to be the emerging region of the world hardest hit by the crisis.

In retrospect, many saw the Lehman collapse not so much as the cause of the rapid descent of the eastern European economies, but as a catalyst that revealed underlying frailties. As the economic downturn deepened, it became clear that record levels of growth had been masking deep-seated residual challenges in the economies where the EBRD was active.

There was no doubt that the post-communist states had made remarkable progress in terms of wholesale economic transformation. However, the path to economic convergence with the more advanced economies beyond the EBRD region was going to be much longer and more arduous than originally anticipated.

Only four months before the Lehman shock, the EBRD had produced a set of relatively optimistic forecasts that reflected the prevailing view of the region. Growth would moderate slightly across the EBRD’s countries as a whole, in line with the global economic climate.

That was not entirely bad news. The previous growth rates were becoming unsustainable, based on inflows of foreign capital that might dry up. The region would still see respectable growth of some 6 per cent for 2008, only a little below the robust rate of 7 per cent recorded in 2007.
In their May 2008 Economic Forecast, the EBRD economists wrote, “The international credit crisis has so far only had a limited impact on the region as a whole. Banks in the region had little if any exposure to structured assets linked to US mortgage markets.”

The economists warned that any protracted stress on the western financial markets could lead to a sharper than expected downturn in capital flows to the region, exposing the substantial external financing requirements of some countries, especially in the Baltics and south-eastern Europe.

Downturn takes hold

By November, when the EBRD issued its 2008 Transition Report, the temperature was markedly different. The pace of growth across the EBRD regions was now expected to drop sharply to 3 per cent in 2009, according to new forecasts, almost half that predicted just six months earlier.

This Transition Report, entitled somewhat tenuously by the time of publication “Growth in Transition”, recognised the abnormality of the situation. The EBRD Chief Economist Erik Berglof, a Swedish economics professor previously in charge of the Centre for Economic and Financial Research at the New Economic School in Moscow, who had taken over from Willem Buiter in 2006, said:

There are now increasing signs that the wider economy is being affected, with industrial production slowing down and even contracting in many countries. These developments stem not only from more expensive credit and a rapid reduction of growth in key export markets, but also increasingly from the shutdown of traditional lending channels.

He pointed out that stabilisation of banking systems would need to be the priority for governments across the whole region. Hinting at the intense and productive cross-border cooperation in which he personally would later play a key role, Berglof added,

Stabilisation measures will need to be coordinated with other countries—both in western Europe and in other transition countries—taking account of the inter-linking ownership structures in the region’s financial system.¹⁹

The EBRD’s new President, Thomas Mirow, who arrived in office just as the conflict between Russia and Georgia erupted (Chapter 5) was now facing a major economic crisis in the region the EBRD, and he as its President, was charged to support. It was a true baptism of fire.

Mirow was in no doubt about the sort of impact the financial crisis would have on the institution he was leading. He began by telling shareholders that the Bank’s profitability was under threat for the first time since the 1998 Russian crisis. The damage included a US$ 135 million exposure to the now bankrupt Lehman itself, which would have to be marked down as an impairment. In October, The Financial Times quoted Mirow as saying, “the EBRD will be hit ... To what degree is not yet completely clear ... But we will see write-downs on our listed equities and on the unlisted.”²⁰

It was too soon to gauge the full extent of the impact that would be wrought across the region by the global financial meltdown, but the direction was clear. As each day passed the outlook appeared increasingly bleak as the “sudden stop” of finance took more and more banks and companies to the brink of collapse.

The EBRD’s downgraded economic forecasts turned out to be far too optimistic, like others at the time. The about-turn in the region’s output was on an unparalleled scale. Predicted growth went from plus 6 per cent in 2008 to minus 6 per cent a year later, although the final outturn transpired to be not quite as dramatically bad.

The effect on the EBRD’s finances was also pronounced. When they came, the EBRD’s losses dwarfed the €61 million shortfall experienced in 1998. After earning profits just shy of €2 billion in 2007, the Bank’s account was to swing into losses of €602 million in 2008 and €746 million in 2009.

For Mirow, there was no question that the EBRD had to respond. But how? And what would shareholders be prepared to do to help? These were the questions that needed to be addressed as he prepared the ground for action.

3. Preparing a First Response

On 17 and 18 November, Mirow and his team decamped to a hotel in the Hertfordshire countryside with the Board of Directors for a retreat to discuss the EBRD’s next steps. It was early days and there was a certain amount of caution among the assembled company.

Management was at pains to make it clear right from the word go what the EBRD could do and—just as importantly—what it could not do. The Bank provided project finance and projects needed preparation, which could take some time. Projects also needed to meet sound banking criteria. The EBRD was not the International Monetary Fund (IMF). It did not have a mandate to manage macroeconomic crises: it did not finance fiscal or balance of payments gaps. Nor was it a lender of last resort.

Nonetheless, it had a duty to support its clients where feasible and a solid track record of helping the authorities to find policy solutions in difficult situations, working alongside other international financial institutions.

Not the IMF but an active market participant

An internal debate about the EBRD’s role in response to the crisis had been underway before the retreat. According to Jeromin Zettelmeyer, a former IMF economist then at the EBRD, it was the strict definition of the mandate that engendered the Bank’s initial caution as the crisis started to engulf the EBRD’s regions. As he later recalled, “the EBRD was not set up to be a crisis fighting institution. Crisis management was for the IMF. The EBRD was about long-term development and transition.”

It was not immediately obvious what role the EBRD could play, Zettelmeyer said.21

This was certainly correct from a strict macroeconomic perspective. The IMF had long years of experience in dealing with economic crises all around the globe, while the EU had a leading role in policy formulation for many of the EBRD’s countries. The EBRD was far smaller than the European Investment Bank (EIB), whose reach by now extended well beyond the boundaries of the EU. The EBRD could not respond alone with the vast amounts of finance that was clearly needed.

21 Interview, 2020.
Although the EBRD lacked the financial firepower to stem the macro effects of the crisis the economists foresaw the outlines of a coordination role in which the EBRD might play a significant part, especially as it was acknowledged to be a major, and often the major, investor in the countries of its region.

At a micro level, the Banking Department too could see a way of playing a role and had some experience of dealing with crises, albeit on a much smaller scale than what they were now confronting. After all, the EBRD was a nimble private-sector focused and demand-led institution. Its ear was close to the ground where the crisis was happening, in the periphery of the EU and further afield. Intimate local knowledge distilled from more than fifteen years of working with clients in its countries of operations, and with offices in every country, large and small, was a unique asset.

For their part, the bankers knew that the EBRD’s balance sheet had at least some capacity to help well-run companies and banks survive the intense pressures they were under and make it to the other side of the economic cycle. They were already at work with clients on restructurings and devising rescue packages and ready to provide advice to companies, banks and policymakers.

IFI coordination

Berglof was acutely aware of the imbalance between eurozone-led banks and central, eastern, and south-eastern European (CESEE) banking systems and the risks this imposed on the region. Coordination failures were a common feature of international crises and he could see the problems that lay ahead. Fortunately, the OCE team he had built was well-suited to the task of finding a solution.

Zettelmeyer had cut his teeth at the IMF researching debt defaults and complex resolution mechanisms, while his colleague, Piroska Nagy-Mohácsi, a Hungarian economist and another recent IMF recruit, was corralling international institutions to help with the crisis in Georgia that had erupted earlier in 2008, and one of the present authors had experience as a former head of delegation to the Paris Club, an official debt resolution agency. The team quickly reached a view on the strong need for coordination, notably between the public and private sectors.

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22 Andrew Kilpatrick.
What had started as a private sector banking problem was rapidly escalating into a public sector one, as cries for help grew and unemployment rose. The EBRD’s niche role was its focus on the private sector, whereas the IMF and World Bank dealt with the public sector. “We were uniquely positioned to play a private-public coordination role for which the EBRD was created,” said Zettelmeyer. The economists ran with this idea, leading the way with an action plan that just a few months later would become known as the Vienna Initiative.

The group also strongly believed that all of the multilateral development banks (MDBs) together could play a key counter-cyclical role, with each bringing something special to the table. This was seen as especially important for the many countries in the region which lacked the fiscal capacity to offset the recessionary forces now at work.

The prominent role assumed by the economists in those early days of crisis response was something of a novelty, which in some Bank circles was viewed with a certain suspicion. Zettelmeyer recalls: “The EBRD position was complicated by the fact that the initial formulation of the crisis response—the initial thinking about it—was an OCE-led exercise. The Bank was not used to being led by the OCE.”

Typically, economists’ advice was to warn when to put the brakes on and sound notes of caution about whether projects put forward by bankers really conformed with the mandate and had meaningful impact on the transition process. But, Zettelmeyer said: “The bankers welcomed the OCE initiative, because by leading a coordinated response the EBRD was protecting its investments.”

Mirow contemplates what’s needed

Although ahead of the game, the economists were aware they had to persuade the new President of the wisdom of pushing a more prominent role for the EBRD, including in terms of increased investment, when the financial world appeared to be in retreat. At that time, the inclination of every commercial bank was to turn inwards and protect assets, reduce risk exposures and withdraw from markets and new business.

As a former State Secretary at the Federal German Finance Ministry—famed for its strict budgetary policy—at first sight Mirow might have appeared an unlikely candidate for such a radical strategy. Significant expansion could also lead to pressure on the EBRD’s balance sheet and potentially
to a capital increase, which did not appear to be on the cards, since he had only recently ruled it out during the debate over Turkey.

This was a time of difficult choices. Mirow, whose habit of collecting his thoughts in silence behind closed doors contrasted with his predecessors, nonetheless rapidly concluded there was only one logical route forward. The EBRD needed to be cautious, yes, prudentially as a bank, but it also needed to be bold, demonstrably above the fray as a supranational institution.

The pressures were unprecedented but Mirow saw virtue in leading the charge to redress the financial failures hitting the EBRD region so dramatically hard, and that to do so effectively would require joining with other international actors to strengthen the position. He also surmised that shareholder support would be crucial to the endeavour and this formed part of his thinking ahead of the Hertfordshire retreat.

It was doubly fortunate that Mirow had recently appointed a very able member of staff to head his office, Hans Peter Lankes, an economist who had served as Berglof’s previous deputy. Lankes, a fellow German national, was not only familiar with the region but also knew the EBRD inside-out having played a major role in its development (Volume 1, Chapter 10).

Mirow, as a former G7 deputy, was also well-connected to the international financial coordination mechanisms that were getting under way. This followed US action to support its financial institutions and the recapitalisations of British banks, led by a call from UK Prime Minister Gordon Brown for a global rescue effort to prevent a total collapse of the financial system and a recession comparable to the Great Depression of the 1930s.

Armed with the arguments that management had prepared, Mirow presented the case for action at the November retreat of the EBRD Board.

4. Gearing Up

Despite the initial caution of many shareholder representatives present at the retreat, the effect of discussing the issues collectively helped to amplify the view that this was no ordinary downturn and that the situation was particularly perilous for the EBRD region and the fate of its transition. Capitals would need to be carefully briefed on the central and eastern European situation with the hope that they would pay close attention to it, notwithstanding the enormous domestic pressures they were under.
Fresh from the rural retreat, and eager to consolidate the gains made at the meeting, Mirow wrote to shareholders right away outlining the consensus for an EBRD response that had been forged during the discussions in Hertfordshire. There was, said Mirow, clear agreement on the need for a determined EBRD response that would send a clear signal of the Bank’s preparedness to support its countries of operations:

Given the limited resources of the Bank relative to the magnitude of the challenge, the Bank’s response must be based on its country and project expertise and not in the first instance on lending volume ... [and] be guided ... by its core operating principles of transition impact, sound banking and additionality.23

Significantly, the EBRD would respond to the needs of all countries, including the more advanced economies in central Europe and the Baltics, “without questioning graduation”. A crucial element in the response would be a significant reinforcement of coordination with other IFIs “in order to leverage on each other’s particular strengths”.

Mirow was careful to leave room for higher business volume and proposed to shareholders that investments would rise to €7 billion in 2009—a 20 per cent increase on the upper bound that had been set for 2008.

The €7 billion reflected a mid-scenario that assumed a resolution of the global financial crisis and a resumption of growth by 2010. Given the uncertainties and a “significant likelihood” of a more pessimistic economic scenario, the projections also considered the possibility that the Bank’s business volume would be constrained even with a resolute crisis response effort.

The President’s proposals, based around the mid-scenario and plans for scaled-up financing, were adopted by the Board on 10 December.

5. EBRD’s Early Operational Efforts

The EBRD’s initial response was designed to focus especially on supporting the region’s banks and making sure finance kept flowing, in particular to small- and medium-sized firms. The broader corporate sector was expected

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to benefit from extending working capital lines and short-term debt refinancing, while the EBRD’s Trade Facilitation Programme (TFP), which was a well-established product valued highly by clients, was expanded, keeping trade flowing to and from the region at a time of severely restricted access to finance.

Appropriate emphasis was given to policy dialogue too, especially related to the financial sector and in close cooperation with the IMF, central banks and regulatory authorities. The crisis had shown that a number of key areas such as bank insolvency rules, corporate governance and domestic capital markets had been found wanting.

An operational delivery Task Force involving the heads of all banking teams, as well as representatives from the credit, economics and planning departments, was swiftly set up under Varel Freeman, the First Vice President, to ensure that the Bank made good on its commitments. The Task Force met weekly throughout the crisis, reporting regularly to the Board on progress in the Bank’s crisis response.

Graduation postponed

A stand-out element in the crisis response package was additional financing of €500 million the Bank had set aside for central Europe and the Baltics, precisely those countries from which the EBRD was supposedly stepping back ahead of their envisaged ‘graduation’ from the EBRD in 2010.

This chimed with demands from the more advanced countries themselves for which it was clear that this was not the time for the EBRD to start winding down its business. On 13 November, the Prime Minister of Hungary, Ferenc Gyurcsány, had written to the Bank’s shareholders, saying,

At this difficult juncture, we urge the EBRD ... to strengthen its presence and, rather than investing less, to substantially step up its financing for Central Europe for as long as is necessary to help overcome the current crisis, preserve and consolidate the achievements of transition, and set our economies back on a path of recovery.  

Of the eight EU countries likely to graduate from the EBRD by the end of 2010, only the Czech Republic had done so—in 2007 before the full force of the crisis hit the region. Although the EBRD stuck to the principle of graduation, the lasting effects of the crisis postponed the remaining countries’ graduation. Even now, over a decade later, these countries are still recipients of EBRD finance.

Financial institutions first

The Bank put an immediate focus on the worst hit areas. At the start of December 2008, Mirow made his first trip as EBRD President to Kazakhstan.

The EBRD also threw its weight behind Latvia, one of the worst hit countries whose GDP would drop by more than 20 per cent, saying it was looking to support systemically important banks that had no foreign strategic investors—banks like Parex Banka, in whose subsequent successful rescue and restructuring it would play a significant role (see Box 1).25

Another prominent locally-owned bank to benefit was Banca Transilvania in Romania, in which the EBRD had held a 15 per cent stake since 2001. The EBRD provided a €100 million loan. Nick Tesseyman, who had taken up the position of group Director for Financial Institutions in August, said, “In these exceptional global circumstances, the EBRD is using all available means to help shore up economic confidence in the region.”26

Georgia’s two largest banks, TBC and Bank of Georgia, were also a priority for the EBRD, since Georgia was now feeling the double impact of the crisis and the effects of the August 2008 conflict with Russia on its banking sector.27

Even as the EBRD was preparing for unprecedented levels of investments, management appeared confident that the Bank had adequate capital.

“No capital increase or any other additional contributions from the Bank’s shareholders have been requested or are needed,” a statement issued after the last Board meeting of the year said.28

But at this stage the EBRD was still expecting positive growth ahead. The severe downturn in train would demand a far greater response than first anticipated.

Financing continued apace in 2009, in line with the promised crisis response. In the first three months of the year, new investments rose to €1.1 billion, up 64 per cent from the same period a year earlier and a record for any first quarter of the year since the Bank’s inception.29

It would not be long before the Bank’s corporate planners, and the President himself, realised an effective response to the mounting pressures on businesses in the region would require enhancements to the EBRD’s capital base.

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29 EBRD Press Release, 7 April 2009. ‘EBRD investments hit record €1.1 billion in Q1.’

### Parex Bank, Latvia

On the same day in April 2009 as it announced the rise in first quarter investments, the EBRD also unveiled its plans to contribute to the rescue of Parex Banka. This decision was not uncontroversial. The investment was deemed risky and fraught with potential political complications.

An earlier suggestion that the EBRD work with Parex had been rejected on integrity grounds. However, given its systemic importance as the second largest bank in Latvia (and largest Latvian-owned bank) with several subsidiaries in the Baltics and the Commonwealth of Independent States (CIS), and given the impact of the crisis, the EBRD decided to go ahead this time but only on the basis of a very tough stance on corruption and stringent governance guidance.

The EBRD team worked hand-in-hand with the IMF on the rescue of Parex. The fact that both institutions were taking part made it easier for each of the individual institutions to proceed.

The Latvian authorities had effectively nationalised Parex in November 2008, after a run on the bank linked to concerns about losses on its securities portfolio and its ability to repay two syndicated loans. The troubles in Latvia’s banking system began earlier with some deposit outflows from Swedbank’s Latvian subsidiary which were reversed when the Swedish government announced support. However, Parex did not have
a strong foreign parent company and its deposits were quickly haemorrhaging, with daily outflows peaking at €100 million a day, depleting deposits by more than one-quarter in the space of a few months.\textsuperscript{30} The bank sought government assistance in late October and the state decided to take an initial 51 per cent controlling stake in November.

That was not enough to stem the run on deposits and the government then stepped in to buy up the remaining shares owned by the founders, Valerijs Kargins and Viktors Krasovickis, who received a symbolic one lat each.

For the EBRD, the investment in Parex Banka was critical to increasing confidence not just in the individual bank but also in the wider Latvian financial sector. It was supporting the recapitalisation of Parex and bringing its own expertise and reputation to strengthen the Latvian bank’s corporate governance. The hope was that after a period of restructuring Parex might be privatised to a strategic investor. One of the key contributions of the EBRD participation in the Parex rescue was its intense lobbying to persuade the EU authorities to change their position and allow state aid to a bank.

The Board approved the EBRD’s acquisition of a stake of a 25 per cent plus one share on 7 April 2009. The capital injection would give the EBRD representation on the supervisory board of Parex and a direct say in future developments, including in meeting anti-money laundering international best practices.

EBRD First Vice President Varel Freeman said the EBRD investment would “see Parex Bank through the most difficult time in its history”. The Bank’s involvement would help restore confidence in the bank and the whole Latvian financial sector. As a shareholder, the EBRD would be able to participate in the development and implementation of a strategic plan for Parex’s restructuring.\textsuperscript{31}

The purchase of the Parex stake became effective in September 2009. But much like other consequences of the crisis it was not the end of the story.


\textsuperscript{31} EBRD Press Release, 7 April 2009, ‘EBRD Board approves finance package for Parex Bank’.
Following discussions between the interested parties (Parex management and other stakeholders, the Prime Minister of Latvia and the EU Directorate-General for Competition), EBRD’s investment was disbursed on condition that Parex would be split into a ‘good’ bank and ‘bad’ bank. The good assets and liabilities were to be spun off into a newly created bank, Citadele, owned by the Latvian Privatisation Agency, while impaired assets, syndicated loans and state funding remained in a bad bank branded Reverta. The split took place in August 2010 and the value of EBRD’s investment was transferred to Citadele for a 25 per cent plus one share stake. Some further changes were made but delayed until the EC concluded the measures were in line with state-aid rules.32

The presence of the EBRD, alongside the significant restructuring, helped to make Citadele a privatisation candidate. As had been hoped for, a consortium of investors came forward in 2014, led by Ripplewood Advisors, a US investment company, and purchased the new bank. The EBRD remained a shareholder (with a stake of 25 per cent less one share), with its good knowledge of the bank and the Latvian market giving comfort to the new shareholder and its clients.

“The EBRD’s investment in Parex and the policy advice we provided played a crucial role in Latvia’s post-crisis macroeconomic adjustment,” said Sabina Dziurman, the EBRD banker who led the work on the Parex investment. She added: “There is no doubt in my mind that we took a very large risk with an investment in a bank that was badly managed and poorly governed. But we persevered because this was a systematically important bank that was critical to Latvia’s economic future. It was a risk worth taking.”33

Citadele is today the fourth largest bank in Latvia with a successful track record and stands as a testament to the major effort by the EBRD, Latvian authorities and others in responding decisively to the crisis situation in 2008.

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32 The matter was not resolved finally until July 2014.
33 Interview, January 2021.
6. **High-level Coordination: The Vienna Initiative**

The collapse of Parex during the autumn of 2008, and Latvia’s negotiations with the IMF for support, came when there was a flurry of activity aimed at addressing the crisis but little by way of joined up thinking, a situation that Chief Economist Berglof saw as a major cause for concern. He warned repeatedly of the dangers of uncoordinated national responses to the crisis and the threat of regional systemic risks in emerging Europe.

Berglof and his colleagues were pioneers in a drive to plug a policy void that had undermined the coherence of many of the responses to the crisis. Together, they made sure that the EBRD played a significant role in the inception, roll out and management of a platform that would address problems in emerging Europe’s financial sector.

According to one observer reflecting on this time:

> Piroska Nagy-Mohácsi and Erik Berglof of the European Bank for Reconstruction and Development (EBRD) ran around Europe trying to get something done. They proposed a public-private partnership to deal with the situation where no one cared about their neighbour and ... everyone was focused on preserving their own country.34

There was no lack of activity at the time, with individual programmes of support from the IMF, the European Commission and others for the benefit of a number of countries hit hard by the crisis. Ukraine, Hungary and Latvia all benefitted from international sovereign support over the last three months of 2008.

In late November, the western European private sector piped up, with the heads of the six large EU-based banks most heavily engaged in central and eastern Europe35 writing to European Commission President José Manuel Barroso and French Finance Minister Christine Lagarde (at the time Chair of the Economic and Financial Affairs Council of the EU). The bankers sounded an alarm bell about the state of financial stability in emerging Europe and pressed for liquidity injections, strengthened

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deposit insurance, more IFI funding and for appropriate regulatory steps to be taken.\textsuperscript{36}

The challenge, however, was to bring all these different initiatives together, to coordinate activities and to make sure there was a fair outcome for all concerned. The fear was that if the international banks with prominent subsidiaries in the region quickly withdrew to their home markets in western Europe, bank deleveraging would devastate central and eastern Europe’s banking systems.\textsuperscript{37}

At a conference at the EBRD’s London headquarters in early December, the EBRD economists raised the possibility of a broader meeting that would address this issue of coordination and burden sharing, discussing the idea with Thomas Wieser, Director General of the Ministry of Finance of Austria. The aim of the meeting was to bring together the home and host supervisory and fiscal authorities of the large EU-based bank groups operating in emerging Europe and to forge agreement on the basic principles of information exchange, coordinated management of exposures and crisis burden-sharing.

On 23 January 2009, Wieser hosted a meeting at the Austrian Ministry of Finance in Vienna, with participants from the central banks and ministries of finance from seven central and eastern European ‘host’ countries and six advanced EU ‘home’ countries, and from the IFIs—the IMF, the EBRD, the EIB and the World Bank Group (including the IFC and the Multilateral International Guarantee Agency), as well as the European Commission.

Berglof initially labelled this platform for collective action between the public and private sectors the ‘Vienna Club’ (after the Paris Club). The formal title given to the platform was the European Bank Coordination Initiative, but it very quickly became known as the Vienna Initiative.\textsuperscript{38}

\textsuperscript{36} ‘Stability for the Financial Sector in EU Member States and Candidate Countries’, Letter from Andreas Treichl, Corrado Passera, André Bergen, Frédéric Oudéa, Alessandro Profumo and Herbert Stepic to Christine Lagarde, Manuel Barroso, Joaquin Almunia, and Charlie McCreevy, 1 December 2008.

\textsuperscript{37} Mark Allen in a comprehensive review of the chronology of the Vienna Initiative, on which this and the later commentary draws, notes: “From the time of the Latin American debt crisis of the 1980s, if not before, action to encourage creditors to maintain exposure and not to succumb to the temptation of withdrawing financing precipitately from a debtor country in distress had been a feature of the international handling of debt crises.” Mark Allen, ‘Ten years of the Vienna Initiative: a chronology’, in EIB, Ten years of the Vienna Initiative, p. 16.

\textsuperscript{38} One close observer suggested the change of name to Vienna Initiative from Vienna Club to avoid any cynical connotation that the effort might be portrayed as a talking shop over tea and biscuits! The analogy with the Paris Club was apt however as the meetings required collective action between the interested parties (in this case non-binding agreements between public and private creditors) and regular meetings to forge consensus and actions. The London Club of private creditors (although moribund) was another angle.
As described by former IMF official Mark Allen:

This was intended as a way to deal with the collective action problem among the banks, to send a signal to the markets and to allow the IFIs to complement each other’s work. It was agreed that the IMF would draw up a proposal for burden-sharing rules between home and host authorities. Such a proposal was presented and broadly approved at a follow-up meeting of the group at the Joint Vienna Institute on 17 March 2009.39

At the heart of the matter was a tension between the international banks, who were under financial pressure and needed to meet constraints imposed by home supervisors, and thus wanting to protect their balance sheets as quickly as possible by cutting exposures, and host authorities who wished to ringfence and protect their domestic banking systems and stem capital outflows.

What the Vienna Initiative sought to solve was a classic coordination failure. Individually, an international bank may find it optimal to cut losses and withdraw from a crisis-hit economy, hoping that firms who borrowed from its subsidiary can repay by borrowing elsewhere. If all banks follow this strategy, however, firms may well be unable to roll over their debts. Defaulting en masse, they deepen the economic crisis, amplifying losses for the international banks. Much like banks in, say, Latvia had to be protected from a bank run by depositors in those depositors’ best interest, whole economies needed to be protected from a bank run by international lenders.

The importance of the Initiative lay in:

Arrangements with individual banks to maintain exposures as part of an international support package with the approval of their home authorities and to recapitalize subsidiaries should stress tests performed by the host authorities require it. These agreements to maintain exposure and capitalization were the central feature of the original Vienna Initiative.40-41

41 The Vienna Initiative website, http://vienna-initiative.com/about/vienna-initiative-1-0/overview/, cites the main initial objectives as: to prevent a large-scale and uncoordinated withdrawal of cross-border bank groups from the region, which could have triggered systemic bank crises not only in individual countries but in the region as a whole; and ensure parent bank groups maintained their exposures and recapitalise their subsidiaries in emerging Europe and that national support packages of cross-border bank groups benefitted their subsidiaries in emerging Europe and thus avoided a ‘home bias’.
The EBRD took a group approach to lending to the banking sector, helping to shore up exposures of key western banking groups in the region by targeting their subsidiaries in a number of EBRD countries of operations. On 7 May 2009, for example, the Bank announced a series of transactions with UniCredit, an Italian bank and the largest banking group active in central and eastern Europe. It invested a total of €432 million in UniCredit subsidiaries across eight eastern European countries. Similar support was provided for the subsidiaries in the EBRD regions of Paris-based Société Générale and Austria’s Raiffeisen Bank International. Later, as south-eastern Europe fell prey to the unfolding Greek and eurozone crisis, the EBRD was to provide almost €1 billion of support for the banking operations of Greek banks which played a particularly significant role in the Balkans. (The EBRD’s role in helping to ameliorate the Greek crisis is examined in Chapter 4.)

The Vienna Initiative sought to prevent a mass exodus from emerging Europe of precisely those banking groups that had such a dominant position in the financial sector of the region.

The foreign banks had a double-edged role in the run up to the crisis. Their investment had underpinned rapid economic growth, but this growth had turned into a liability once it developed into a surge and pushed loan-to-deposit ratios to exceptional heights—in most cases reaching well over 100 per cent and in Latvia touching 300 per cent. As Croatian central bank governor and a later Vienna Initiative chair Boris Vujčić noted: “Part of the blame for the unsustainable expansion of CESEE countries rests with Western European banks.”

The quid pro quo from the western European private sector to the pledges of liquidity and support from the public sector was that they should maintain their exposure in the region. In late March 2009, the CEOs of the parent banks began signing commitment letters pledging their support, initially for Romania and Serbia, and saying their banks would maintain their exposure and recapitalise their subsidiaries.

This was an agreement from which there could only be winners. As Vujčić pointed out 10 years later, the commercial banks were not acting out of pure altruism.

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42 EBRD Press Release, 7 May 2009. ‘EBRD and UniCredit join forces to support businesses across eastern Europe’.

43 See Figure 1 in World Bank and IFC staff, ‘A perspective from the World Bank Group’, in Ten years of the Vienna Initiative, p. 73.
Due to the size of cross-border operations, for some banking groups large credit losses in the region could have jeopardized the solvency of the parent institution. In such a context, it was in foreign banks’ best interest to keep supporting these economies. There was a case for coordination.\textsuperscript{44}

Everyone involved recognised at the time that there would subsequently be a further restructuring and deleveraging within the region. Vienna, however, had made certain there was no uncoordinated stampede for the exit.

**The Joint IFI Action Plan**

A second key element within the Vienna Initiative was the Joint IFI Action Plan (JIAP) launched on 27 February 2009 by the EBRD, the EIB and the World Bank Group to channel €24.5 billion into the region over the following two years. Introduced just a month after the first Vienna meeting, the finance aimed to support the banking sectors in the region and to fund lending to businesses hit by the crisis.\textsuperscript{45} The EBRD President explained how he saw the joint effort:

> The institutions are working together to find practical, efficient and timely solutions to the crisis in eastern Europe. We are acting because we have a special responsibility for the region and because it makes economic sense. For many years the growing integration of Europe has been a source of prosperity and mutual benefit and we must not allow this process to be reversed.

The EBRD hosted the secretariat of the Vienna Initiative from the outset and through its initial years. Given the number of actors involved—some 90 participants, including 15 systemically-important European banking groups active in the region, met at the first Full Forum—and the complexities of supervisory arrangements across multiple jurisdictions against a rapidly changing economic and financial backdrop, the Vienna Initiative was remarkably successful.

\textsuperscript{44} Boris Vujčić, ‘Managing a supra-national public-private platform still based on sovereign interests’, in *Ten years of the Vienna Initiative*, p. 5.

\textsuperscript{45} EBRD Press release, 27 February 2009, ‘EBRD, EIB and World Bank Group join forces to support Central and Eastern Europe’.
A review in September 2009 concluded that reductions in cross-border exposures had been contained and financial conditions in CESEE stabilised. By the end of that month, the three IFIs had disbursed over €16 billion of support in the form of senior loans, tier 1 and 2 capital, trade finance, facilities for small business loans and syndicated loans. The adjustment programmes, banking exposure agreements and JIAP financing succeeded in avoiding systemic collapse and restored confidence in CESEE financial systems. After severe recessions in 2009 most of the region’s economies began to grow again in 2010.

In total more than €33 billion was delivered to the region by the end of 2010, well in excess of the original target. A report on the JIAP published in 2011 recorded that the EBRD’s delivery too had exceeded its initial objective of a contribution to the JIAP of €6.0 billion, to reach a total of €8.1 billion.

7. International Response and the EBRD

The 2009 Annual Meeting

As the months passed from the start of 2009 the true scope of the macro-economic impact on the region was becoming clearer with every new assessment from the EBRD’s economists. In January, they were no longer predicting growth of three per cent for 2009 but just 0.1 per cent. By May, they were expecting a contraction for the year of five per cent and, by the end of the year, they estimated that output would shrink by 6.3 per cent.

The priority for Mirow and his team now was to ensure that the EBRD was in a position to do whatever it could to make sure that the progress the region had made over the previous 20 years was not sacrificed to a crisis whose origin was not even of its own making.

With timing that could not have been more convenient, the Bank was about to embark on its regular five-year capital resources review (CRR), the fourth such review (CRR4), which was due to be discussed by Governors

in a year’s time and cover the period from 2011 to 2015. There was no need for an immediate decision on resources as available capital was adequate in the near-term. But in a letter to Governors on 17 April 2009 previewing the upcoming EBRD Annual Meeting, Mirow warned that: “the Bank’s capital and prudential ratios could impose constraints on the level of activity during the CRR4 period”, and that the trade-offs between a higher crisis response, the effects of more impaired assets and capital requirements “will need to be evaluated”.

Management prepared a paper entitled: “Fighting the Crisis, Promoting Recovery and Deepening Transition”, which formed the basis for a Governors’ discussion at the 2009 Annual Meeting in London. In keeping with the straitened economic backdrop to the event the meeting was held at the Bank’s headquarters rather than in a central London hotel, as was traditionally the case when the EBRD staged its conferences in the UK and not in a country of operations.

The paper concluded that the EBRD’s contribution to economic recovery had to draw on the lessons from the crisis. One such lesson was that building markets and promoting the private sector was not enough on its own. It was also important to improve the quality of those public and private institutions which supported markets and ensure that they worked well together.

Mirow wrote to the shareholders ahead of the meeting enclosing the paper, saying:

These are not new insights, but the abundant liquidity of the past years allowed them at times to be sidelined. I propose to derive operational implications from these lessons for the Bank over the coming months, with a focus on the most effective ways to combine project finance, technical cooperation and policy dialogue.

The question of more intense support for policy development, the creation and strengthening of public institutions needed to introduce conditions more conducive to the promotion of the private sector and efforts to reinforce economic resilience featured prominently during the May discussions. In his summing up, Mirow told Governors in the closing session:

I should like to mention the wish many of you expressed to see the EBRD engage more strongly in policy dialogue, for instance in relation to
banking regulation and banking supervision. We take this very seriously. It will have an impact on the Bank’s activities and probably also on how we finance this.48

Later, as staff ground through different business projections for the CRR4 period, and as demand for EBRD finance and help grew, it became obvious that shareholders would need to be primed for a change of heart on capital needs. Mirow and his team began to do just that.

The G7 and G20 meetings

As the EBRD worked on its own response to the crisis, individually and with partners in the context of the Vienna Initiative and the Joint IFI Action Plan, the G20 leaders were also developing their global response, which had direct implications for the multilateral development banks including the EBRD.

The G7 Finance Ministers under the chairmanship of US Treasury Secretary Henry Paulson had agreed a five-point plan of “exceptional action” to stabilise financial markets, restore the flow of credit and support systemically important banks back in October 2008,49 following a week of dramatic stock market falls (of around 20 per cent) amid concerns that financial systems in the USA, and, especially, the UK, were on the point of collapse. This helped avert an immediate disaster.50

Nonetheless, it took a little while before international leaders fully understood the important role the IFIs could play—collectively as coordinators with convening power and financiers of last resort—in the face of a global, as opposed to domestic, crisis. UK Prime Minister Brown, Nicolas Sarkozy, the French President and Robert Zoellick, the World Bank President each called for an effort to create a new international financial architecture.

At the behest of the outgoing US President George W Bush, the first G20 Leaders’ Summit was convened in Washington in November to consider the

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48 President Mirow’s closing speech to the Annual Meeting.
issues facing the international community. Encouragement was given to the MDBs to use their full capacity and ensure “[they] have sufficient resources to continue playing their role in overcoming the crisis”.51

Spurred on by the gravity of the situation, Prime Minister Brown took the initiative to ensure that the proposed actions under the five principles agreed by the G20 were followed up by the relevant financial actors.52 With the UK leading the G20 in 2009, he summoned the world’s financial authorities to develop a fully-fledged international response—which in due course resulted in a global stimulus worth over US$ 5 trillion53—and one in which the IFIs, including the EBRD, were given a prominent role.

Following a round of visits to key capitals to win support for his plan, Brown chaired a G20 meeting in London on 2 April which reflected the spirit of cooperation and collaboration that had also been a hallmark of the Vienna Initiative. In their statement, the G20 leaders declared “a global crisis requires a global solution” and called for “systematic cooperation between countries” over regulatory systems.54,55

They made clear the MDBs were a key element in the global response: “We support a substantial increase in lending of at least [US$] 100 billion by the Multilateral Development Banks (MDBs), including to low income countries, and ensure that all ... have the appropriate capital.”56 They agreed to “reviews of the need for capital increases” among MDBs, including for the EBRD.57

52 The common principles for reform of the international financial architecture were: strengthening transparency and accountability; enhancing sound regulation; promoting integrity in financial markets; reinforcing international cooperation; reforming international financial institutions. See G20 Leaders’ Declaration, 15 November 2008, Office of the Press Secretary, The White House, Washington DC, https://georgewbush-whitehouse.archives.gov/news/releases/2008/11/20081115-1.html
53 The headline at the time was a US$ 1.1 trillion boost to the IMF, trade and MDB finance. But allowing for the full effects of fiscal action the total was calculated at closer to US$ 5 trillion. See “The April 2009 London G-20 Summit in Retrospect”, Colin I. Bradford and Johannes F. Linn, Brookings, 5 April 2010 https://www.brookings.edu/opinions/the-april-2009-london-g-20-summit-in-retrospect/
55 Not all were fully satisfied with the G20 response (including Austria and Sweden who were not members of the G20). “Yet the G20 process left a gaping void. To be efficient it focused on the ‘globally systemically important’ economies, but abstracted from possible spill-overs and developments in countries of regional systemic importance.” See Erik Berglof, Anne-Marie Gulde-Wolf, Piroska Nagy-Mohácsi and Thomas Wisser, ‘Reflections on multi-country and multi-player issues’ in Ten years of the Vienna Initiative, p. 53.
Only four months earlier, in December 2008, the EBRD had been confident that it could respond to the demands of the region without resorting to requests for further capital from its shareholders. But with the sizeable expansion of business volume and in a riskier environment, the question of adequate capital became much more pressing. By end-July 2009 commitments had exceeded €5 billion, the same as for the whole of 2008 and almost twice the amount achieved over the same period a year earlier, with some two-thirds deemed crisis-response investments. The rate of increase far exceeded the original estimate made by the Bank in its response to the earlier G20 call for a substantial increase in lending.

Meeting in London on 5 September, the G20 finance ministers and central bank governors acknowledged that the MDBs were fulfilling their side of the bargain and were “fully on track to deliver [US]$ 100 billion of additional lending”.58 Three days later, on 8 September, the EBRD announced a further increase in its planned investments for 2009. The Bank would now target €8 billion, a rise of another €1 billion and an increase of just over 50 per cent on the level of financing for 2008.

At a meeting in Pittsburgh on 25 September 2009, G20 leaders confirmed their position:

We welcome and encourage the MDBs to continue making full use of their balance sheets ... [and] ... we will help ensure ... the regional development banks have sufficient resources ... including through a review of their general capital increase needs to be completed by the first half of 2010.59

8. A Contingent Callable Capital Increase

In a statement that September, the EBRD said it was acting in response to an appeal from the G20 for MDBs to make full use of their current capacity. However, while the rise in envisaged spending for 2009 would come out of reserves, the Bank indicated that it was indeed now looking at its capital base: “Additionally, and consistent with the appeal from the G20, the

shareholders of the Bank are reviewing the long-term capital requirements of the EBRD to ensure that it has adequate funding for the years to come.”

Mirow spoke more bluntly in two interviews that he conducted on the sidelines of a financial conference in the Plöner Schloss, a castle in the northern German state of Schleswig-Holstein. He told both Reuters and Dow Jones newswires separately that the EBRD could stretch to another €8 billion in 2010 on existing capital resources. But in the Reuters interview he said that the Bank “would probably go beyond the 8 (billion euros),” should there be a clear signal of support for a capital increase from contributing institutions and the international community. “In terms of a capital increase this would be a mix of callable capital and a very much smaller amount of paid-in capital. We cannot yet speak about concrete figures.”

Mirow declined to say whether its shareholders would provide the EBRD with more funds. “I would not speculate on that,” he told Dow Jones. “We have to tell our shareholders what we can do with the existing capital and what is the potential. I think we have some good arguments to make.”

Towards the end of the month, Mirow outlined his proposals for a capital increase in a letter to shareholders that was quickly in the public domain. In the letter, Mirow warned that while the region’s economies “had begun to stabilise” they had “not done so uniformly and it would be premature to say that a general turnaround has begun. The crisis will have lasting repercussions.”

Writing 20 years after the fall of the Berlin Wall, Mirow said the region deserved broad support in continuing “its mutually beneficial integration into the European and world economies”. A €10 billion capital increase to €30 billion would allow the Bank to commit €9 billion to €10 billion annually, or €20 billion in total extra funding during the next five years, 2011-2015. Allowing for the mobilisation of additional capital from private investors, Mirow pointed out that the extra funds could reach €60 billion.

In his letter, Mirow also raised the prospect of a change in the development model of the region, in which there would be less dependence on foreign capital and a greater reliance on its own resources.

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60 EBRD Press release, 8 September 2009. ‘EBRD ups investments to €8 billion in 2009’.
The region will need to change its growth model—away from a reliance on easy finance and commodities, and towards the development of domestic financial markets, strong institutions and a diversified production base.

Commenting on the proposals, the Financial Times said:

Mr Mirow’s proposals highlight how the global recession has transformed the EBRD. Before the crisis, the US, the biggest shareholder, was keen to reduce the bank’s activities on the grounds that its role in supporting post-communist transition would end as the market economy took root in region. But following the crisis, and Barack Obama’s election as president, Washington has developed a more positive view of international financial institutions, including the EBRD. However, Mr Mirow remains sensitive to possible complaints from shareholders that bank executives may be taking advantage of the crisis to reinforce it as an institution.63

Shareholders formally approved the €10 billion capital increase at the EBRD Annual Meeting in Zagreb, Croatia, on 14 May 2010.

French Finance Minister Christine Lagarde, Chair of the EBRD Governors for that year, praised the structure of the transaction as “innovative in at least two ways”:

Firstly, it combines a rise in callable capital of €9 billion with a transfer of €1 billion of reserves to capital and secondly, it includes provisions to review the use of this capital after five years. I am very happy that the EBRD is demonstrating an exemplary sense of responsibility in the utilisation of its resources.64

The EBRD was able to scale up its activities but without putting any immediate strain on government coffers as the additional finance was primarily in the form of callable capital, with the rest taken from reserves that had been built up in good times (and, fortuitously, not depleted through a payment of dividends).

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63 Stefan Wagstyl, ‘EBRD seeks 50% increase in capital’, Financial Times, 28 September 2009. https://www.ft.com/content/a0dffec0-ac51-11de-a754-00144feabdc0

64 EBRD Press release, 14 May 2010. ‘EBRD shareholders boost capital, pave way for increase in investments’. 
After record lending commitments of €8 billion in 2009, annual business volume increased further to €9 billion in both 2010 and 2011.

9. A Focus on Local Financial Markets

Ahead of the Zagreb meeting, the EBRD President used a speech at the London School of Economics (LSE) to raise the prospect of a ‘New Growth Agenda’ for emerging Europe that would help deal with the imbalances and weaknesses in the region’s economies that had been laid bare by the crisis.

In his speech, Mirow again focused on the mismatch between external and domestic sources of financing and the need to promote further diversification of economies. Excessive reliance on foreign credit and borrowing in foreign currencies had emerged as one of the largest weaknesses in the region. Mortgages and loans for cars and other goods had appeared cheap at the low borrowing rates in the Swiss franc or Japanese yen. But they very quickly became unaffordable liabilities once local currencies came under pressure.

In Zagreb, the EBRD delivered its response to the challenge of foreign currency dependence when it unveiled a Local Currency and Local Capital Markets Initiative that sought to promote the use of local currency within a wider macroeconomic and regulatory framework that ensured sustainable and liquid markets for long-term funding in local currency.

Launching the new programme, Berglof said:

The crisis laid bare the region’s twin vulnerabilities of excessive reliance on foreign capital and excessive use of foreign exchange borrowing. As the recovery takes hold in the region, it is important to urgently address these vulnerabilities, with a fresh eye and approach that fuses the knowledge and expertise of key stakeholders: governments, IFIs, the banks and other private sector stakeholders.65

The new programme put local currency lending and local capital market development firmly on the EBRD’s agenda. The Bank had already borrowed and lent in local currency—as early as 1994 when it conducted transactions

65 EBRD Press release, 14 May 2010. ‘EBRD shareholders boost capital, pave way for increase in investments’.
in Hungarian forint. But the initiative took these activities to a completely new level. (The initiative is considered further in Chapter 8.)

10. ‘Vienna Plus’ and the Vienna Initiative 2.0

The Vienna Initiative had been an unqualified success and questions turned naturally towards next steps as the second Full Forum approached in the spring of 2010. There was no doubt that it had filled a hole in the European financial architecture. It was clear too that no other body or institutional setting was in place ready to take on its mantle. The Forum thus agreed to maintain the arrangements in view of the continuing vulnerabilities facing the region.

The focus now turned from crisis resolution and towards crisis prevention and led to what became known as “Vienna Plus”. Two working groups were set up to deliver improvements in new areas, again involving public and private sector participants. One group, chaired by the EBRD, looked at problems in local currency and capital markets; while the other group, led by the EC, concentrated on the role of commercial banks in the absorption of EU structural funds.

The crisis had revealed many weaknesses in the transition economies and led to major reflections on the implications for the emerging markets’ growth model.66 One important conclusion from this work concerned the vulnerabilities created by foreign currency lending in the EBRD’s countries of operations and the need to boost domestic savings. The Bank had begun work on strengthening local currency and capital markets to draw attention internally to the problems that would need to be tackled in Bank operations in future.67 The opportunity to work with banks, regulators and finance authorities across Europe under the Vienna Initiative umbrella fitted well with these objectives.

The working group reported in November 2010. It recognised the need for greater reliance on domestic savings, especially in domestic currencies, and made a number of recommendations, including tighter prudential requirements on foreign currency lending, greater local currency sovereign issuance and macroeconomic policies designed to support local

66 See Chapter 6.
67 See Chapter 8.
currency market development. The other working group suggested ways in which commercial banks could facilitate the use of EU structural funds. This was especially relevant to countries like Bulgaria and Romania where low absorption of these funds was particularly acute.

The third Full Forum in March 2011 introduced two further working groups, one on the implications of implementing Basel III regulations in emerging Europe (these were seen as a tightening of the regime), and the other on non-performing loans (NPLs) in CESEE.

During this time, the crisis in Greece was deepening and spreading to other highly indebted European countries, notably Ireland, Portugal and Spain. Most large European banks held significant amounts of sovereign debt of these countries, and this engendered a so-called ‘doom-loop’ as banks’ assets fell in value while increasing precariousness of banks’ balance sheets gave rise to concerns about forthcoming bank rescues. Those concerns, in turn, drove up yields on sovereign debt further depressing the value of bank holdings of sovereign paper.

Funding conditions worsened and national regulators pushed the parent banks to strengthen their balance sheets and raise capital. Banks operating in CESEE once again faced difficulties raising finance. The home bias of regulators—their tendency to favour banks’ lending within their jurisdictions over lending abroad—threatened to undo progress made under the Vienna Initiative.68

Towards the end of November, Berglof pressed the case for a renewed effort, a Vienna Initiative 2.0, in order to address the external risks and deleveraging once again facing the CESEE region.

The same players from the private and the public sectors met in Vienna in early January 2012 to consider the situation. At the meeting, they agreed a set of principles for coordination between supervisory authorities of home and host countries, including on the free allocation of liquidity and capital and consideration of spill-overs from national actions,69 and launched the Vienna Initiative 2.0 at the fourth Full Forum meeting in March.70

68 Among the concerns was a decision on 21 November 2011 by the Austrian authorities to increase capital requirements and introduce tighter lending criteria on cross-border activities by their banks.
70 The meeting also adopted reports from the working groups on Basel III and non-performing loans, embrac-
This second iteration of the Vienna Initiative was more structured with a Steering Committee headed initially for a five-year term by Marek Belka, who at the time was Governor of the National Bank of Poland. He was well-qualified for the role. Belka had been the Director of the IMF’s European Department and a key ally of the EBRD in the early stages of the crisis, and played a key role as chair of the Vienna Initiative in driving forward international coordination.

With the eurozone crisis intensifying and affecting the economies of CESEE negatively—eight out of 17 countries in CESEE experienced falls in GDP in 2012—and with cross-border deleveraging once again threatening these countries’ financial systems, the World Bank Group, EIB and EBRD announced a new Joint IFI Action Plan for Growth for the region, pledging to provide over €30 billion of new resources for infrastructure and the corporate and financial sectors in 2013 and 2014.

The final tally of €42.7 billion far exceeded the original estimate, with the EIB providing the largest amount at €28.3 billion and the EBRD at €7.0 billion the biggest proportional increase (up from an originally estimated €4.0 billion). According to the final report on the Joint IFI Action Plan for Growth, “assistance from the IFIs was in the order of 1½ per cent of the region’s GDP each year, and supported around 6 per cent of the region’s investment.”

By 2014, growth had returned to nearly all countries in the region. As had been the case previously, the rapid and substantial countercyclical financial support from the IFIs proved to be a timely input in a difficult situation.

The pioneering Vienna Initiative had fended off the potential for dual financial and currency crises across the region on more than one occasion.

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71 The 17 countries comprise EU member states, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia and EU candidate and potential candidate countries in the West Balkans such as Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro, and Serbia. Those with negative growth in 2012 were: Croatia, Czech Republic, Hungary, Slovenia, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia.


74 Of the 17 countries only Croatia and Serbia registered negative growth in 2014, of -0.3 and -1.6 per cent, respectively.

75 Subsequent work under the Vienna Initiative umbrella paid increasing attention to the concerns of southeastern Europe (SEE), whose countries were candidates or potential candidates for EU membership, and included the appointment of a representative from the region to the Steering Committee (initially the Gover-
Transforming Markets

It had been a major success for the EBRD and, in particular, for its Chief Economist. The CEO of Erste Group, Andreas Treichl, put it this way:

The Vienna Initiative was more than a success. No country in the [CESEE] region required any support to its banking system—the whole region was kept clean of government support, a huge success. It is a wonderful story to tell regulators in Brussels. A case of professional people getting together to solve a problem and having the guts to do it.76

11. The Crisis and the Transition Development Model

Within months of the beginning of the crisis, Berglof and his team of economists embarked on a long, hard look both at its impact on the region’s economies and the entire paradigm upon which the operationalisation of the EBRD’s mandate was based.

One outcome of this work was a detailed report77 published a year after the onset of the crisis. It raised questions about the development model for transition, especially the financial integration that had fuelled rapid expansion, and how to deal with countries, particularly further to the east, whose growth depended on income from natural resources. According to Zettelmeyer, the main editor of the report, the crisis challenged everything the EBRD had worked for up until then:

It challenged the very paradigm of financial integration. The paradigm that integration was a good thing was something we had written on our flag. That was the core ideology of EBRD—right below the idea of transition itself.

A close look at financial integration made clear that the model was a double-edged sword. On the positive side, the report declared “financial integration has significantly benefitted the transition region by contributing to high economic growth over at least a decade”, and attributed the relative success of CESEE transition countries to their deeper integration with advanced countries and the role of foreign-owned banks.

On the other hand: “Financial integration may also have had significant costs, in terms of encouraging credit booms and overborrowing, and possibly in biasing the denomination of borrowing towards foreign currency.”

Some of this inevitably reflected the process of integration, the authors noted, and by helping deepen financial systems the foreign banks may have had a longer-term stabilising influence. The report concluded that it would be wrong to try to end or reverse financial integration, even if it was possible, as this would “deprive [the region] of a source of growth”. Berglof was nonetheless in no doubt that the transition region was in deep crisis. In a foreword to the Transition Report 2009, he asked whether transition itself was in trouble:

How have the institutions and policy frameworks that were the outcome of the transition process coped? Are the ideas that drove transition, which in addition to market reforms and trade integration also encompassed financial liberalisation and integration, still attractive? Lastly, is the future of transition in doubt? Will the crisis lead to a backlash against market-oriented reforms?

Berglof responded to his own question—answering that posed by the title of the report, “Transition in Crisis?”—with what he said was a “qualified no”. The global recession had “demonstrated the resilience of reforms and economic integration” achieved over the previous two decades. But it had highlighted “some pitfalls of the development models that countries in the transition region have pursued.” Berglof concluded: “... it is clear that the way to address these pitfalls is to extend the transition agenda, not to replace it.”

78 ‘Transition in Crisis?’, EBRD Transition Report 2009, p. 73.
From this point on, the EBRD continued to pursue market-oriented solutions but paid closer attention to the distinct role of the institutions underpinning markets—especially to the need for effective state, legal and regulatory processes—and to market-enabling qualities successful transition needed to encompass.

The thinking behind a deeper interpretation of transition and operational procedures was as yet in its infancy and it would take some time before the transition concept was fully updated. Views on how the EBRD should implement its mandate and its newfound enhanced role were however about to receive a significant impetus from another crisis emerging on its southern borders. One in which the EBRD would again be called upon to play its part: the “Arab Spring”.

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81 See Chapter 6.