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Host's Dilemma in International Political Economy:

The Regulation of Cross-Border Banking in Emerging Europe, 2004-2010

Ivaylo Iaydjiev

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Ivaylo Iaydjiev[1]

Abstract

Cross-border banking and foreign affiliates came to dominate the financial systems of many countries in Eastern Europe, Latin America, and Sub-Saharan Africa in the 1990s. Yet, the regulatory reform agenda, set by countries with limited exposure to foreign banks at home, has largely neglected the needs of host jurisdictions. Thus, host regulators with foreign-dominated banking systems find themselves with a de facto lack of control over their financial systems while being at the same time largely shut out from key international decision-making forums. This presents host regulators with a dilemma between undertaking potentially costly national policies in a global financial system or relying on cooperative solutions by forums in which they have little voice.

This paper develops how this situation differs from the well-known "regulator's dilemma" in IPE and how it shapes the demand for cooperation by host states under conditions of asymmetric interdependence. It then illustrates the "host's dilemma" experienced by emerging European states between 2004 and 2007 before highlighting the surprisingly effective response of international institutions once the crisis hit the region in 2008. Based on this, it suggests three conditions under which international institutions might successfully mitigate the host's dilemma: low politicization, high ideational consensus, and high implementation capacity.

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[1] Blavatnik School of Government, University of Oxford. ivaylo.iaydjiev@bsg.ox.ac.uk

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1. Introduction

In the 1990s and the early 2000s the world saw a dramatic expansion of financial integration driven by ever increasing international capital flows. An important part of this trend was driven by a series of bank-sector openings to foreign investment in Emerging Europe, Latin America, and Sub-Saharan Africa. From virtually non-existent, foreign banks came to dominate the banking systems of most countries in these regions. Today foreign banks own more than 50% of all banking assets in 52 countries, and in 17 countries that level exceeds 90% (Claessens and van Horen 2014). Economists widely welcomed these developments as the efficiency benefits foreign banks brought were seen to largely exceed potential costs in terms of financial stability or access (Cull and Martinez Peria 2010).However, the global financial crisis of 2008-09 demonstrated that global banks, poorly supervised by their home authorities, could also be a significant source of financial contagion. Thus, the IMF has argued that a limited number of large complex financial institutions at the core of the global financial system could act as “super spreaders” of losses (IMF 2010:7).

Given the Janus-faced nature of banking integration, how can host countries on the receiving end of cross-border flows harness its benefits while minimizing the risks? Economic theory suggests that banking integration carries the promise of catch-up and convergence with advanced countries. This occurs most visibly through the transfer of capital from countries with already high savings to capital-poor host countries; thus the population in the home countries gets a higher return on its investments, while entrepreneurs in the host country get improved access to capital. In addition, it also brings collateral benefits such as improvements in technology and governance and serves as a sign of approval for local banking systems with little history (Kose, et al. 2009, Gros 2003).

However, as host countries have been relinquishing de facto control over their financial systems, they have had to accept a regulatory agenda set overwhelmingly by countries, which are home to cross-border banking groups. It is in forums such as the Basel Committee on Banking Supervision (BCBS), from which host countries are largely excluded, that the governance regime for cross-border banking has been developed, including the division of responsibility and the institutional mechanisms to ensure financial stability. Host countries are thus been asked to rely on cooperative solutions by forums in which they have little voice.

This situation in which a host country has effectively relinquished de facto control over its financial systems while relying on forums for cooperation from which they are excluded to ensure cooperation can be described, following Pistor, as “host’s dilemma” (Pistor 2010). This dilemma is particularly acute in emerging Europe[2] – in 2004, when most countries from the region joined the EU, foreign ownership of banking assets was under 50% for just one country, Slovenia. By 2008, only 3 countries had more than a quarter of all banking assets in the hands of local owners (Claessens and van Horen 2014). Yet, they have had to adopt an *acquis communautaire* largely shaped before their ascension to the EU, a hard law version of

[2] For the purpose of this paper, emerging Europe denotes the 10 countries that joined the EU in 2004 and 2007. While a priori applicable to non-EU member countries, this analysis does not explicitly address their situation as they have recourse for tools such as capital controls that are prohibited under the EU legal framework. Croatia for example made use of similar tools in the run-up to its accession to mitigate the credit cycle.

the soft law prescriptions of the BCBS in which none of the countries from the region are represented.

Emerging Europe, therefore, represents an interesting case to examine in more details the implications of the host's dilemma for receiving states between 2004 and 2008. During this period host regulators struggled to restrain a credit boom, which led to increasing vulnerabilities. Equally intriguing, however, is how the dilemma was overcome in 2008-09 through successful crisis management led by the international financial institutions and comprising multiple stakeholders, including home regulators, host authorities, and the private sector. This therefore presents the core empirical puzzle for this paper – why after years of benign neglect, leading to a credit boom, did we observe effective crisis management during the bust phase?

These questions build on existing international and comparative political economy research on the politics of foreign banking. A first set of studies analyzed the reasons for bank-sector openings in various regions and the respective influence of structural changes, financial crises, and international institutions (Pauly 1988, Martinez-Diaz 2009, Epstein 2008). While they focused on foreign bank presence as an outcome variable, the goal of this paper is to analyze the politics of cross-border banking *after* liberalization. A second and growing literature has examined who makes the rules in international standard setting bodies, thus focusing on great power regulatory politics (Drezner 2007, Singer 2007, Posner 2009, Büthe and Mattli 2011). As it seeks to explain interactions among regulators with significant power and high institutional access it often presents the exact opposite of the host's dilemma. Another set of literature focuses on explaining the politics of institutional change (or lack thereof) in global financial governance, again focusing by definition on countries with access to international forums (Moschella and Tsingou 2013, Helleiner 2014). Finally, some studies do indeed focus on developing countries with limited institutional access and their resistance to regulatory harmonization, but they tend to study countries with low levels of foreign bank ownership, mostly in East Asia (Walter 2008, Mosley 2010, Chey 2014).

This article aims to develop the notion of the "host's dilemma", to demonstrate empirically its existence, and to probe the role of international institutions in resolving it. To this end, it exploits the within-case variance in the case of emerging Europe between 2004 and 2010, in particular the differing response to the credit boom (2004-2007) and to crisis management (2008-2010). It first develops an analytical framework for the host's dilemma using a supply and demand framework (Keohane 1982). It differentiates the "host's dilemma" in opposition to the dominant view of the "regulator's dilemma" in the IPE literature (Kapstein 1989), traces its different functional demands and considers the problems that arise because of asymmetrical interdependence on the supply side. It then focuses more specifically on cross-border banking flows in emerging Europe and outlines their role and the response of host states and international institutions during the boom and then during the bust phase of the credit cycle. Finally, it examines why the management of the crisis has been relatively successful despite a previously weak response to the host's dilemma in the region during the boom phase.

2. Host's dilemma and the need for international cooperation

Whose dilemma? Host's dilemma vs. regulator's dilemma

Host supervisors are on the receiving end of large international banking flows, which in the run-up to the crisis were the largest component of the capital inflows to emerging European countries[3]. Such flows are particularly problematic in comparison to FDI flows, which are much more stable because of a longer commitment, or equity flows, for which holders take automatic hits when the value of the liabilities declines. In contrast, banking flows represent debt which must be repaid in full and on time regardless of changes in the financial situation of the debtor. Moreover, bank-intermediated credit flows are particularly procyclical and volatile as they are often driven by the balance sheet management of global banks. When risks appear low during the boom phase this allows an expansion of the balance sheet, often through wholesale funding and the accumulation of non-core liabilities (Brunnermeier, et al. 2012:8-11). Conversely, when risk perception rises during the bust phase, such funding quickly becomes too expensive. Therefore, there is significant synchronization of cross-border bank flows that depends on global factors and risk perception – factors well beyond the control of host country authorities (Bruno and Shin 2011, Forbes and Warnock 2012).

Given its procyclical and volatile nature, host regulators have significant incentives to keep a close eye on cross-border banking. Their worries often directly reflect the procyclical features of such flows as during the boom phase they are concerned about excessive credit growth leading to bubbles, especially in real estate. During the bust phase, the main concern is that liquidity could just as easily reverse direction and flow out of local affiliates and towards parent banks, provoking a systemic crisis and leaving the host state to foot the bill. Given the large level of foreign ownership and the low internationalization of domestic banks, host regulators face a rather different dilemma than the one faced by home governments, which has been the subject of extensive scholarship for several decades (Kapstein 1989, Oatley and Nabors 1998, Singer 2007, Drezner 2007). According to the original regulator's dilemma, "with the globalization of capital markets, public officials have been forced to make tradeoffs between domestic regulation on the one hand and international competitiveness on the other" (Kapstein 1989:324). Perhaps it would be more accurate to rephrase this as the "home's dilemma" as this brings out more explicitly the assumption behind much of the existing scholarship that countries have banks which compete externally against other banks which might be benefiting from lower costs due to lighter regulation at home. In turn, this assumption crucially but again implicitly hangs on the notion of "banking nationalism", or that countries seek to indeed promote the interests of "their" banks (Veron 2013, Epstein and Rhodes 2014).

The "host's (regulator) dilemma", on the other hand, is fundamentally different. Host supervisors differ from home supervisors in two crucial respects. First, they have no own banks to promote abroad; hence they are not subject to the competitiveness constraint. Nevertheless, they are subject to another constraint – they need to keep their country

[3] The structure of capital flows differed importantly among countries. For example, in Bulgaria an overwhelming part of capital flows came in the form of FDI.

profitable for international banks. The performance of national banks at home, both in terms of financing the real economy and in terms of tax revenues, depends on their success abroad, but ultimately they would find it very hard to leave and relocate elsewhere. Yet, that is precisely the very real threat that host countries face, with potentially devastating consequences as demonstrated by the Argentinian and Asian financial crises. Therefore (risk-adjusted) profitability is the constraint host supervisors have to face when dealing with stability issues. The second key issue where host regulators differ is in their access to international standard-setting bodies and other financial institutions with responsibilities for maintaining global and national financial stability. Unlike many of their largest home counterparts, who negotiate directly key standards between themselves, host supervisors are largely rule-takers. Therefore they generally face a different choice than the dilemma whether to negotiate or to compete, namely whether to adopt rules to which they were not part or to risk incurring the costs of a national approach in a largely international capital market. In this way the host's dilemma interacts with and responds to the bargains struck by the home regulator's dilemma.

Demand for cooperation: Information, enforcement, burden-sharing

Given the different challenges host regulators face, the functional demands for cooperation they are likely to have differ from those of home regulators. In the standard home regulator's dilemma, international cooperation is a way to prevent a regulatory race to the bottom induced by global competition that might undercut domestic stability at home (Singer 2007); hence the stated objective is often to create a "level playing field". The demand for cooperation for host regulators is also connected to domestic financial stability, but given large foreign-bank ownership this goal is understood in a different way. Host regulators therefore require cooperation to address specific problems with the supervision, regulation and resolution of cross-border banks

The first issue host regulators face is related to acquiring the necessary information to make judgments on the potential risk exposure of their economies. Whereas home supervisors often have an overview of the situation of the parent bank group as a whole, host supervisors can largely only "see" the situation in the local part of the group. Thus, host regulators are reliant on whatever information the home country has gathered for its own microprudential purposes. Even if shared, it might still not provide host regulators with the necessary information to fulfill their macroprudential mandate. This informational asymmetry can lead to potentially serious incentive conflicts in information sharing between home and host supervisors. In normal times, home supervisors do not derive a significant benefit from engaging with counterparts in non-systemic (for the bank group) jurisdictions. More worryingly, they have a strong interest in limiting any information about deteriorating performance of the bank group as a whole as that is likely to provoke calls for intervention from host authorities. The latter, recognizing that negative information is likely to be restricted, have therefore an incentive themselves to quickly move to ring-fencing and other forceful measures at the slightest hint of trouble (D'Hulster 2012). Thus, information-sharing arrangements are likely to fall apart precisely when they are needed most.

A second issue often faced by host supervisors is that of potential regulatory arbitrage by systemic banks in their own jurisdiction, which undermines their ability to enforce regulations. Host countries that try to implement measures to reduce credit growth or other financial risks are creating incentives for banks to look for ways of minimizing the regulatory "burden". In cross-border banking, they can generally take two approaches: banks can move lending to other less regulated domains, such as leasing companies, and continue their activities while evading the legal requirements of banking; or they can switch to direct cross-border lending from the foreign bank abroad to the customer in the host country as local affiliates simply pass their loan books to their parent banks. Such challenges are not unique to host country regulators as home country regulators similarly worry about financial intermediation shifting to "shadow banks" in response to regulatory changes (Houston, et al. 2012, Reinhardt and Sowerbutts 2015). However, the cross-border aspect of banking introduces specific challenges, as host countries are dependent on cooperation and reciprocity from the home regulator. This might not be forthcoming as the home regulator might regard the foreign jurisdiction chiefly as a source of profit for "its" banks. As spill over effects from its decisions are not part of its (national) mandate, a home regulator might have little incentive to cooperate on measures that are designed to ensure domestic stability in the host's financial system.

The supervisory and regulatory challenges stem, to a certain extent, from the resolution challenges national authorities face. Given the lack of a global resolution framework for failing banks, regulators accountable to their national constituency are unlikely to take into account possible externalities and will instead seek to minimize the fiscal costs for their own country and citizens (Schoenmaker 2013). Thus, in a multi-country setting, ex-post negotiations after a crisis can lead to the underprovision of support as national authorities seek to limit the exposure of national taxpayers by dividing and "carving out" the existing capital. What is needed, therefore, is an ex-ante agreement on burden sharing which will enable the orderly resolution of cross-border banks (Goodhart and Schoenmaker 2009). In its absence, once a crisis strikes the protection of domestic stakeholders precedes that of international creditors. For host states, these resolution dynamics present an even more acute problem of burden sharing than for home states. If a banking group experiences significant problems, it could be forced to withdraw capital or liquidity, or ultimately even to sell healthy and systemic subsidiaries in the host state. This often can happen even without the host supervisor participating in the discussions. In the absence of adequate burden sharing arrangements, the burden of responding to the consequent banking problems falls on the host country and its regulators. In turn, this creates a divergence between who takes the decisions with systemic implications and who is responsible for the financial consequences of these actions (Pistor 2010).

To sum up, host regulators depend on cross-border cooperation to underpin cross-border banking by mitigating information asymmetries, by limiting regulatory arbitrage, and by providing burden-sharing agreements. These challenges are magnified by other practical challenges such as generally more limited resources, which make host states particularly reliant on analysis conducted by home authorities, international institutions, or global banks themselves. If cooperation successfully responds to these demands, then host states can reap the benefits of banking integration. However, if such cooperation fails, they are then left with the financial consequences.

Supply of cooperation: Asymmetric interdependence and international institutions

How could these demands by host regulators be realized? How and when is cooperation in accordance with them supplied? Answering these questions emphasizes what can be termed the “supply side” of international cooperation. Given mutual interdependence, in theory both regulators would have incentives to cooperate. Thus, cooperation can be the outcome of self-enforced bargaining outcome and does not necessarily rely on formal institutional mechanisms (Oye 1986, Axelrod 1984). As long as both regulatory authorities have significant “skin in the game”, this would induce them to work together to reach a cooperative solution through Coasian bargaining provided transaction costs are low enough. Alternatively, even low transaction costs could prevent cooperation if the gains for both actors are small. However, if the two sides are in a situation of asymmetric interdependence, that creates a bargaining situation which empowers the less dependent side and suggests the final outcome is likely to be closer to its initial preferences (Keohane and Nye 1989). In other words, this introduces an element of power in the relationship, shifting the outcome closer to the preferences of one of the sides. Conversely, the more dependent side is likely to incur a disproportionate share of the costs. In these cases, formal institutional mechanisms would be required to mitigate the power asymmetry generated by the asymmetry of interdependence. Soft law and informal institutions would be unlikely to significantly affect the unfavorable bargaining situation of the dependent state.

In the case of cross-border banking, the key measure of interdependence is the extent to which a certain foreign affiliate is systemic to the home[4] and to the host country. Following Herring (2007), if the affiliate is systemic to both financial systems, then regulators are likely to reach a cooperative solution through Coasian bargaining. Alternatively, if the costs of the problems cross-border banks can cause are insignificant to both jurisdictions, it will likely not be a cause for major concern. The last point is also true if the bank is systemic to the home country, but its exposure to the host country is both small from the point of view of the parent group and non-systemic for the host’s financial stability. However, the situation can quickly turn into “nightmare scenarios” if there is an asymmetry of exposure to the consequences of a bank failure (Herring 2007:14-19). From the home regulator point of view, such a scenario involves a systemic bank in its jurisdiction with a significant exposure in a host’s country, which is however *not* systemic to the host itself. These countries are empirically rare and home authorities dispose of significant means accorded by global and European law to address such a situation. However, whenever a bank which is systemic to the host is either not systemic for the home market or its activities in the host countries represent an insignificant part of its global operations, the host authorities face a “nightmare scenario”. Yet, this is precisely the situation of many countries find in Emerging Europe, but also in Latin America and Sub-Saharan Africa.

The dilemma faced by host regulators comes from the fact that the very institutions that are supposed to mitigate the power asymmetry that arises from their exposure to foreign ownership are likely to be created and confined to home country regulators (as per the original insights of the regulator’s dilemma). Without the possibility of participating directly in these institutions, and thus making sure they respond to their demands for international cooperation, host regulators are exposed to the unfavorable bargaining outcomes that arise from their asymmetric interdependence. There are two ways out of this dilemma. First, states might seek to align their interdependence with that of home countries. It is unlikely they could achieve a more symmetrical exposure to each other’s markets given the large differences in the size of financial markets (which are themselves the source of the gains from banking

[4] More specifically, to be systemic for the home country, the affiliate needs to first be systemic to its parent group, which in turn should be systemic to the home state.

integration that host states are looking to harvest in the first place). Therefore, to achieve this host states could seek to reduce foreign ownership within their banking system to a situation in which it is no longer systemic. This means a conscious choice in favor of national approaches, which is eschewing the benefits of banking integration. The second way out of the host's dilemma would be to make sure that formal institutional arrangements respond to their demands for cooperation, which is most unambiguously achieved through their inclusion in decision-making forums and by granting them real voice.

To summarize, host regulators on the receiving end of cross-border banking flows face a distinctively different dilemma than the prevailing notion of the (home) regulators' dilemma centered around two particular issues. First, cross-border banking flows make ensuring financial stability in host jurisdictions very difficult without international cooperation. Second, such international cooperation is unlikely to be forthcoming without the involvement of international institutions, which however are the produce of the original home regulator's dilemma and hence unlikely to reflect hosts' needs. The remainder of this paper provides empirical support for these conclusions from emerging Europe.

3. The credit boom in emerging Europe

Cross-border banking and increasing vulnerabilities

Starting with the collapse of command economies in 1989, countries in Emerging Europe embarked on a path towards their transformation into market economies with corresponding modern banking sectors. For various reasons, but particularly under the pressure to find new capital to fuel their development, countries in the region dismantled their state-owned banking systems in the hope of improving efficiency and reducing political interference (Epstein 2008). Given the lack of capital domestically, this often meant bringing in foreigners, also in the hope of gaining credibility for their banking systems with short histories (Grittersová 2014). The result was a rapid increase in foreign ownership of banks and assets in the region, with only one country where the share of foreign bank ownership of its assets was below 50% in 2004 (Slovenia). On the eve of the crisis in 2008, all but three countries had less than a quarter of all banking assets under local ownership (Claessens and van Horen 2014).

After a decade and a half of transformation, the accession of eight countries from emerging Europe to the EU in 2004, and then Bulgaria and Romania in 2007, raised expectations that political and economic integration would enable local economies to partly catch up with the incomes and standards of living of Western Europe. One channel, which received a lot of public attention, was trade, with the hope that joining the Single Market would provide a boost to exports. The second channel involved financial integration. The expectation was that given better growth prospects, capital would flow from the west, where returns to savings were low, to capital-poor countries in the east, helping them to satisfy their large demand for investment. This would improve the economic potential, the legal framework, and, ultimately, the political institutions of the recipient states.

For a while it appeared that this "convergence machine" was working beautifully and even exceeding expectations. During the honeymoon between EU accession and the financial crisis of 2008-2009, countries in the region were growing at annual rates of 5-6% (trailing only China and India), with many in the Baltics even exceeding 10%. Income levels began to slowly but surely catch-up with the most prosperous half of the continent. Unlike the previous period when tradable exports and moderate levels of capital inflows provided the fuel for growth, after 2004 the growth model became more and more driven by increasing levels of domestic demand. Annual demand rates regularly exceeded GDP growth and reached double-digits in some countries, such as the Baltics, Bulgaria and Romania (Bakker and Klingen 2012:3).

What provided the fuel for this convergence was accelerating credit growth driven by banking capital inflows. Given very low initial levels of financial development, this was initially welcomed. However, while the absolute level remained moderate, the speed of credit growth began to cause worries. In particular, credit was largely directed towards the non-tradable sector and thus supporting consumption or real estate investment. This drove ever-widening current account deficits, largely correlated with the level of credit growth, which in turn had to be financed through external capital inflows. As some IMF economists have highlighted, in previous crises even lower current account deficits than the ones observed in emerging Europe in 2004-2008 have caused significant problems as they made countries vulnerable to a reversal of capital flows (Sorsa, et al. 2007).

However, not everyone agreed that indicators in emerging Europe suggested that the region was poised for a crisis. In particular, other economists at the IMF, especially at the European department, argued that such developments reflected rather the successful transformation of the countries and an equilibrium phenomenon related to the process of catch-up and convergence (Abiad, et al. 2007). Financial markets appeared to validate the bright prospects of these countries by providing financing for their current account deficits at declining risk premia, reflecting globally high liquidity and low risk aversion (Bakker and Gulde 2010). Thus, the region experienced a threefold increase in net capital inflows between 2004 and 2008, rising from around $100 billion to more than $300 billion, or around 10% of GDP. This was not only high by historical standards, but also in comparison to other emerging markets – indeed, in terms of net capital inflows in the four years preceding the crisis "the unweighted average in the EU-9 (107% of 2003 GDP) was almost three times as large as in precrisis Indonesia, the Philippines, and Thailand (38% of 1992 GDP)" (Bakker and Klingen 2012:7).

The crucial component driving this surge of capital flows were bank loans from Western Europe. By one official estimate, 80% of Western bank exposure translated into additional credit growth, thus raising annual domestic demand growth in the region by 2% (IMF 2011:94). Facing constraints at home and looking for a source of profits, Western banks, eagerly embraced a "second home market" strategy focused on Eastern Europe (Epstein 2014). Their aggressive competition for market share in this newly emerging corner of Europe with its bright growth prospects shaped their approach to lending to the region which relied on intra-capital markets. Thus, they funded the new loans with capital raised cheaply on (calm) international capital markets using the brand name of the Western parent bank rather than local deposits. This was crucial as it allowed credit growth to continue even as deposit growth in emerging Europe countries slowed (Feyen, et al. 2014, Cull and Martinez Peria 2012).

A failing global and European banking governance framework

This rapid growth of credit and its association with cross-border banking did not go unnoticed by local regulators and international financial institutions. Differing interpretations of the cause of rising current account deficits, benign financial conditions, and strong GDP growth all restricted the appetite for decisive actions. However, countries also had to rely on an institutional framework to address such issues that was ill suited to their interests. In order to join the EU host countries had renounced a number of policy tools such as capital controls in order to promote financial integration and convergence. Meanwhile, a number of countries had also introduced formal or informal currency pegs to the euro (the three Baltic states and Bulgaria), which further restricted their policy space.

The pre-crisis framework however gave the home (also known as consolidated) regulator the lead without considering potential conflicts of interests (Pistor 2010). The standards on home-host division of responsibilities were developed at the BCBS, which was set up in 1974 as an informal forum for discussions among G10 members in response to the globalization of financial activities (Goodhart 2011). The resulting Basel Core Principles (BCP), successively updated in 1975, 1983, 1997 and 2006, were concerned primarily with addressing problems arising from the international activities of large domestic banks in home markets as demonstrated by the collapse of the German Herstatt bank in 1974, the problems of US and

European banks in the Latin American debt crisis, and the collapse of BCCI in 1991. The drafters of these accords saw the quality of home country regulation as higher, and hence the general direction was to eliminate supervisory gaps by increasing the power of the consolidated supervisor to oversee the activities of “its” banks outside its jurisdictional borders. Therefore, the BCP are mainly aimed at mitigating problems related to inadequate regulation in emerging markets, not the other way around, which is reflected in the way they empower home supervisors at the expense of host ones (Persaud 2010).

This is perhaps not surprising considering that until 2009 the BCBS consisted only of home country authorities. Originally, it represented a response to G10 countries own regulatory dilemma as countries with international banks competing globally. In the years before the crisis only three BCBS countries had levels of foreign ownership of local bank assets higher than 10% (Belgium, Germany, US) and none were higher than 20% - in sharp contrast with levels of 70-80% not uncommon for host countries (Claessens and van Horen 2014). The situation has not changed much since the crisis despite the much-advertised increase in BCBS membership – only one out of the 27 members is predominantly a host country (Mexico). The other countries with foreign ownership of bank assets exceeding even the low bar of 25% are either offshore centers (Luxembourg, Hong Kong) or saw a one-off spike due to events during the financial crisis (Belgium).

At the EU level this regime was embraced and the role of the home supervisor was even strengthened with the explicit goal to promote regional financial integration. European law made several of the soft law recommendations of Basel II legally binding for all banks in the EU, regardless of the level of financial development in the country in which they operated. First, the European single passport system allows banks registered in one EU country to set up branches (although not subsidiaries) in other countries without seeking the explicit approval of the local regulator. These branches remain under the direct supervisory authority of the home regulator despite that their activities might be systemic for the host financial system. Second, the Directive of Credit Institutions, revised in 2006, and the third Capital Requirements Directive (CRD III) from 2006 implementing Basel II both stress the role of the home country authorities as lead supervisors. For example, they are in charge in coordinating the approval of applications to use more sophisticated capital calculation rules and, in the case of absence of agreement within six months, can make a decision not to impose extra burdens on companies dealing with multiple supervisors (Quaglia 2010:57). Again, these outcomes are hardly surprising, considering that the new member states exercised very little influence over the negotiation process, which was often completed or very advanced by the time they joined the EU (Quaglia 2010).

The insistence on home supervision in the EU is also reflected in the institutional framework put in place to support regulatory cooperation. As part of the so-called “Lamfalussy Process”, the Committee of European Banking Supervisors was set up in 2004 to bring together national regulators to provide advice for the consistent implementation of directives in the sphere of financial services (Quaglia 2008). Yet, this consultative body largely lacks any enforcement power and consensus is sought in taking decisions. Given this and a membership comprising 51 regulators from 27 countries, it is hard to see how it could have served as mediator between home and host supervisors. In the development of its 2005 guidelines on home-host cooperation for example not a single institution from a new member state provided a response to the consultation. Hence, it is hardly surprising that the guidelines ended up advising host regulators to seek information only from the home authorities and not from the subsidiary or the parent group (Pistor 2010:20, 37-38). This did little to mitigate the asymmetric interdependence between home and host authorities in Europe, leaving them to interact and bargain based on their unequal mutual exposure, which strongly favored home states. The supply of international cooperation reflected the bargains struck at the level of the home's regulatory dilemma, without significantly addressing the needs of the host.

This issue was also reflected in practice in the two main tools on which CEBS relied to promote and sustain regulatory cooperation. The first one was so-called college of supervisors, which should facilitate the supervision of systemically important cross-border financial institutions by encouraging the exchange of information and cooperation between different national regulators. However, before the crisis such colleges were relatively rare, largely limited to considerations of capital requirements (given their basis in the CRD directive), and with restricted participation by host authorities as consolidated home supervisors took the lead[5]. Crucially, they operated by consensus decision-making and without a mediation mechanism to resolve potential conflicts other than bargaining among the parties involved (Alford 2010). The second instrument to address cross-border banking challenges was a memorandum of understanding between regulators (MoUs). The EU put in place a multilateral MoU on high-level principles among central banks and supervisors in 2003, increasing it in scope to include finance ministers in 2005 (Quaglia 2013:69-70). However, as the cases of Fortis and the Icelandic banks operating in the UK illustrated, such principles were quickly swept aside once the crisis struck. The IMF (2014:6) assessment is particularly damning: "As MoUs were nonbinding and supervisory colleges were not empowered to make decisions, many MoU commitments—such as timely sharing of information—were quickly abandoned as domestic financial stability concerns became paramount. Supervisory colleges could not restrain unilateral action."

Within this governance framework, host states in emerging Europe struggled to address increasing vulnerabilities in the run-up to the crisis. Various conventional measures related to loan classifications, reserve requirements, fiscal stance, and monetary policy, wherever possible, made little difference in reducing credit growth (Hilbers, et al. 2007). Some countries, such as Bulgaria and Romania, sought to introduce de facto credit ceilings through high reserve requirements and/or capital weights on foreign liabilities to little avail as financial intermediation quickly circumvented them through direct cross-border loans or loans by leasing companies (Bennett, et al. 2015, Lim, et al. 2011). An IMF assessment of the credit cycle in emerging Europe argued that to a large extent the boom-and-bust cycle was the result of "bad luck" and that "even perfect policies might not have been able to prevent all of the rapid credit growth and build-up of imbalances" due to global factors (Bakker and Gulde 2010:26). In the words of the former head of the European department at the IMF, the countries in the region were "innocent bystanders" (Interview with Marek Belka, 5 Feb 2016, Warsaw).

Overall, host states in emerging Europe experienced credit booms driven by capital inflows intermediated by Western European banks. These flows led to significant overheating and buildup of vulnerabilities in a number of countries by transmitting financial conditions from well beyond their borders into the local banking market. This reflects the first part of the

[5] Furthermore, so-called Level 3 committees such as CEBS were not part of supervisory colleges, leaving the interactions within them only to national regulators without a common EU input.

host’s dilemma and creates the demand for cooperation to achieve financial stability. The second aspect of the host’s dilemma addresses the supply of such cooperation through existing governance arrangements. In the case of emerging Europe, they reflected the bargains struck by home regulators in solving their own regulatory dilemma between competitiveness and stability, and hence did little to satisfy the demand for cooperation from 2004 to 2008. In short, “the existing governance structure gives [host regulators] neither powers nor responsibilities to participate in the allegedly coordinative governance structure” (Pistor 2010:38).

4. Crisis management in emerging Europe

The financial crisis and bank flows in emerging Europe

By leaving the countries exposed to the movements of international capital flows, the host's dilemma led to the buildup of significant vulnerabilities in emerging European financial systems. Current account deficits in 2008, fueled by cross-border banking flows, were at very high levels, reaching a staggering 25% of GDP in Bulgaria and 22% of GDP in Latvia. Estonia, Lithuania, and Romania were also running current account deficits well into double digits, while the remaining countries also had deficits in between 3% and 6% of GDP. Private debt was at historically unprecedented levels at above 100% of GDP in Bulgaria (where it increased eight-fold in just 5 years), Latvia, Estonia and Slovenia, and at around 65-70% elsewhere, vastly outstripping GDP growth. Meanwhile, public debt was reduced to very low levels across the region, with the notable exception of Hungary (67% of GDP in 2007) and Poland (45% of GDP in 2007). The remaining eight countries were all among the 11 countries in the EU with the lowest public debt in 2007, with the Baltics, Bulgaria and Romania with levels well under 20% of GDP.

Some problems were becoming visible in the region in early 2008, especially in the Baltics and Hungary, but they escalated into a full-blown regional crisis after the collapse of Lehman Brothers. At first, the region appeared little exposed to the "toxic" products in the subprime mortgage sector in the US. However, as CDS spreads shot up, interbank lending dried up, and cross-border banking slowed to virtually zero, it soon became clear emerging Europe stood on the brink of a classic emerging market crisis triggered by the sudden stop of capital (Calvo 1998). With no new private financing large current account deficits and private debts were impossible to sustain, leading to a sharp adjustment. In 2009, GDP collapsed, with the Baltics suffering falls between 14% and 18% of GDP, with Bulgaria, Romania, Hungary and Slovenia falling by between 5% and 7%. The Czech Republic and Slovakia contained the fall to around 4%, while Poland even managed to grow at a rate of 1.7% for 2009. Current account deficits contracted sharply, improving between 14% and 20% of GDP in a single year between 2007 and 2008 in Bulgaria and the Baltics, and between 5% and 7% in Romania, Hungary, and Slovenia.

The crucial transmission mechanism for the crisis was cross-border lending flows. During the pre-crisis period, emerging Europe had experienced significantly higher net capital inflows compared to other emerging markets at around 5% of regional GDP, accelerating to 10% of GDP in 2007 (Berglof, et al. 2009:3-4). Once the crisis hit, Western European banks, facing capital and liquidity pressures at home, reversed their strategy of funding local lending through internal capital markets and instructed affiliates to fund lending only through local deposits. This resulted in a sharp slowdown in bank lending across all countries in emerging Europe. The swing was largest in Bulgaria, Latvia, and Slovakia, with a 20% of GDP decline year-on-year, while banking flows elsewhere collapsed between 9% and 16% of GDP. Given the large role of bank lending for the region, its collapse was reflected almost one-to-one in the collapse of overall capital inflows, although FDI and remittances flows remained relatively stable. In turn, this put local currencies under pressure, falling in countries in floating regimes or requiring significant use of reserves in countries with fixed exchange rates. It also led to the bursting of the real estate bubble in many countries and a sharp slowdown in investment.

The crisis experience confirms both the relevance and the consequences of the host's dilemma. Prior to the crisis, research showed that foreign banking can enhance efficiency and competition in the host country, but also be stabilizing for lending during local downturns (Cull and Martinez Peria 2010, De Haas and van Lelyveld 2008). The concerns of host authorities about possible contagion effects from cross-border banking during a crisis, and hence the basis for their demand for cooperation, were however now validated (Kudrna and Gabor 2013). It was indeed multinational bank subsidiaries that cut lending more than domestic banks, suggesting that the risks of "cut and run" are real for host financial systems (de Haas and van Lelyveld 2014). Moreover, the crisis reflected problems of parent banking groups in funding themselves in the wholesale markets, spurred by problems in third countries, rather than any particular problems in host countries (Popov and Udell 2012). In turn, this leaves their financial system exposed to the choice of strategy by large multinational banks (Brunnermeier, et al. 2012).

The host's dilemma is also evident in the cross-country impact of the crisis. It is countries that managed to tame the cross-border banking-led credit boom that experienced the lowest bust. Before the crisis their policy choices would have been singled out as standing in the way of financial development and economic growth in comparison to other less-worried peers. However, it is precisely the countries with the largest vulnerabilities that suffered the most severe crisis: "pre-crisis current account gaps and pre-crisis net external positions help explain an important part of subsequent cross-country differences in demand growth" (Milesi-Ferretti and Lane 2014:18). More importantly, even beyond the costs of output volatility among countries with larger booms and busts, GDP growth for 2003-2010 as a whole was *higher* for the countries with the *lower* credit growth (Bakker and Gulde 2010:25). Hence, it would appear that there is no tradeoff between higher growth and more vulnerability in terms of credit growth – indeed, it is the countries with low vulnerability that had the highest growth.

Resolving the host's dilemma through international institutions

Given the vulnerabilities generated by the host's dilemma, it is hardly surprising that the financial press in late 2008 and early 2009 was replete with reference to a future collapse in emerging Europe. Seasoned observers saw "the classic makings of a capital account crisis à la Asia" (Roubini 2009b) and warned about the "Eastern crisis that can wreck the Eurozone" (Munchau 2009) and "the bill that could break up Europe" (Economist 2009a). The World Bank president Robert Zoellick was concerned enough to declare that "I would consider it an immense tragedy if Europe were to break into two parts again" (Wagstyl 2009b). Observers were drawing parallels with previous crises, especially in Asia and warning of similarly devastating currency and banking crisis (Krugman 2008). Given that on the eve of the crisis emerging European countries were often running larger currency account deficits, had larger levels of foreign currency loans, and less international reserves than in previous emerging market crises such as Thailand, Indonesia, Turkey, and Argentina, these worries seemed largely justified (Bakker and Klingen 2012:75-76). In early 2009, attention was drawn to BIS research, showing the region needs to rollover loans worth $400 billion, or one-third of the region's GDP (Aslund 2010:70).

Contrary to such doomsday scenarios, however, a full-blown crisis in emerging Europe was successfully averted. There was sharp adjustment and significant GDP declines across the board, especially in the Baltic countries. However, as the dust settled, observers expressed their surprise that "the crisis is missing some of the defining attributes of emerging market crises in the past" (Berglof, et al. 2009:2). First, currency crashes were avoided, with fixed exchange rates holding through the crisis in the Baltics and Bulgaria, and floating currencies recovering quickly after sharp falls in Poland, the Czech Republic, Hungary, and Romania. By far the most controversial case was that of Latvia, where both the IMF and external observers argued that the lat needed to be devalued, but ultimately the Fund went along with the wishes of the European Commission and Latvian authorities, who argued strongly for preserving the peg to the euro (Roubini 2009a, Hugh 2008, Blustein 2015). Second, unlike many previous crises, which led to systemic banking collapses, this outcome was largely averted in the region (Laeven and Valencia 2010). The exception was the crisis in Parex, Latvia's second largest bank, which needed to be restructured, and Hungary's OTP, both of which were domestically owned banks. The bigger worry was that foreign banks which dominated the region would "cut and run" as they have in previous crises (Roubini and Setser 2004, Epstein 2014). However, foreign bank presence appears to have, if anything, mitigated bank lending outflows once the crisis did hit (Berglof, et al. 2009). Overall, net exposure of Western banks fell by 1.3% of GDP between 2008Q3 and 2010Q2 – considerably less than the average of 9% of GDP net declines witnessed within the same timeframe in previous crises (Bakker and Klingen 2012:86).

What largely accounts for the "great escape" of emerging Europe from the host's dilemma are the actions of international institutions. Countries vigorously responded to the shock in credit markets by relaxing reserve requirements, increasing deposit insurance, advocating a no-dividend policy, and, whenever possible, cutting interest rates (Czech Republic, Poland), or providing some fiscal support (Bulgaria, Poland). Yet, by October 2008 a sell-off in government securities and the plunge of the florint has pushed Hungary to seek external support from the IMF, followed soon by Latvia in December 2008 due to worries about its banking sector, and Romania in early 2009 following problems with the maturity structure of its debt. Worries were also mounting in the rest of the Baltics and Bulgaria, and there were some concerns about the currency depreciation in other countries, especially Poland. It was clear external support would be required.

Such support came from three main sources. First, the EU revived a largely forgotten balance-of-payments facility to support non-euro countries, quadrupling its resources to 50 billion euros by mid-2009. It disbursed a total of 14.6 billion euros to Hungary, Latvia, and Romania, or around 30% of the overall financing package. The EU also made use of its structural and cohesion funds, which were frontloaded and their flexibility relaxed, and stepped up the lending activities of the EIB and the EBRD (Jacoby 2014, Darvas 2009). The second source was support from the IMF, which after a period of downsizing, saw its resources tripled by the G20 in response to the crisis. It quickly put these to work, with a total of 27.2 billion euros lent to just 3 EU countries by 2009. Finally, the Vienna Initiative provided a coordination platform to prevent a run to the exit by foreign banking groups in the region. This was underpinned by a 24.5 billion euros joint action plan for bank lending by the EBRD, EIB, and the World Bank.

The role of the IMF, the EU, and the Vienna Initiative in emerging Europe are discussed extensively in other studies (Lütz and Kranke 2014, Hodson 2015, Gabor 2015, Haas, et al. 2015, Independent Evaluation Office 2014, Jacoby 2014, Epstein 2014, Pisani-Ferry, et al. 2013, Blustein 2015, Pistor 2012, Bakker and Klingen 2012, Aslund 2010, Darvas 2009). In the context of this paper, however, the focus is on how these institutions helped to address the three interlinked challenges of the host's dilemma experienced by countries in the region in the run-up and during the crisis: information, enforcement, and burden-sharing asymmetries. The first problem highlighted above is acquiring timely and accurate information on the state of the parent banking group, which was addressed by the Vienna Initiative. As part of it, the EBRD, alongside other institutions such as the BIS, provided extensive information about the network of mutual exposures, which also raised public awareness of the problem faced by emerging European countries. The problem of uncoordinated bank withdrawal was recognized from the outset and the EBRD was active in drawing the attention of policy makers. Of more operational importance, however, the Vienna Initiative provided a forum, which gathered foreign banks, home and host regulators, and international institutions. This made possible a set of commitments which softened the obstacles to information sharing by alleviating at least partly the worries of both home and host regulators. Thus, home regulators committed to not constrain how parent banks use bailout money, while their host counterparts committed to not ring-fence assets (Pistor 2012). These commitments were complemented by an agreement of banks to maintain their exposure to the region and the financial health of their subsidiaries and to make such commitments public.

Such "soft" promises might not by themselves necessarily alleviate the concerns of host concerns unless there are some enforcement mechanisms in place, which directs attention to the second aspect of the host's dilemma. To be sure, banks themselves had significant incentives not to disengage from the region, not the least reputational concerns and the desire to maintain relationship with countries, which were the source of significant profits, (Interview with senior World Bank official, Washington, 2015). It would also have been operationally difficult to pull out given the large brick-and-mortar lending operations (Interview with Bas Bakker, Warsaw, 2016). Nevertheless, there was a very real prisoner's dilemma: no single bank would prefer to leave, but should there be a run to the exit, it would be rational for each bank to be the first one out so that it can preserve the value of its investment. In order to prevent this, the international financial institutions used a mixture of moral suasion and financial incentives to ensure enforcement of these non-legally binding commitments. On the "stick" side, as early as Hungary the IMF sought commitment letters from banks as a precondition to supporting the countries in which they were doing business, with the practice becoming formalized within the context of the formal Vienna Initiative later (Interviews with senior IMF official, Washington, 2015 and Bas Bakker, Warsaw, 2016). On the "carrot" side, the EBRD, EIB, and World Bank prepared a financing package aimed at the private sector, ultimately providing 33 billion euros of debt funding, equity, trade finance, support for SMEs, small infrastructure projects, multilateral guarantees, syndicated loans, and others (EBRD, et al. 2011).

Perhaps the most visible way international institutions addressed the host dilemma was through providing significant help to ensure burden sharing once the crisis hit. As with any balance of payments crisis, this was a function of the level of capital outflows, and the mix between external financing and domestic adjustments that compensates it. Given the potentially significant financing gap estimated by the World Bank, the EBRD, and the IMF of around $250-300 billion overall (Wagstyl 2009b, Wagstyl 2009a), the Vienna Initiative played an important role in limiting banking outflows (Haas, et al. 2015). Countries also significantly cut their expenditures and, when possible, raised taxes, nowhere as much as in Latvia, which implemented a fiscal adjustment worth 10% of GDP in 2009 in its quest to protect the peg. However, countries also received large packages to support their adjustments, limiting somewhat the fallout from the financial turmoil imported from abroad. Total IMF/EU support for Hungary, Latvia, and Romania reached $62.2 billion between 2008 and 2010, alongside a precautionary $20.5 billion credit line agreed with Poland. Total packages amounted to 32% of GDP for Latvia, 19% of GDP for Hungary, and 15% of GDP for Romania (Darvas 2009). IMF funding exceeded 1000% of each country's quota and programs were three to five times as large as previous SBAs approved for Thailand, Indonesia, and Korea in terms of GDP. Applications were processed very quickly, with the Hungarian and Latvian program taking as little as 4 weeks from initial request to approval by the Executive Board. Funding was significantly frontloaded, committed upfront, and disbursed fast in order to respond to a rapidly worsening financial situation. Finally, conditionality was more streamlined and limited, with a gradual fiscal adjustment path, and budgetary support, reflecting an attempt to account for the social costs of the programs (Takagi, et al. 2014).

In all of the above cases, the direct impact of international institutions in partially softening the problems, which host countries had experienced prior to the crisis, is evident. Prior to their involvement, for example, there was a danger that nationally oriented reactions in Western Europe would lead to ring-fencing in emerging Europe, undermining banking integration. For example, Austria restricted its bailout facilities to institutions regulated under its banking legislation, that is, banks in Austria and their branches, but *not* their subsidiaries abroad (Pistor 2012:11, Pisani-Ferry and Sapir 2010). French banks receiving state support promised to increase domestic credit by 3-4% annually, while the Dutch ING announced further $32 billion worth of loans to Dutch borrowers in exchange for government support (Economist 2009b). As a response, host regulators sought to restrict the re-allocation of funds from subsidiaries with excess capital or liquidity to their parents through the non-distribution of dividends or the capitalization of profits, a mild form of ring-fencing (Cerutti, et al. 2010). This dynamic was contained thanks to the commitments made at an informal European Council meeting in March 2009, where participants agreed that "support for parent banks should not imply any restrictions on the activities of subsidiaries in EU host countries" (Council of the European Union 2009). It is important however to highlight that the positive impact of international institutions does not mean that the response was necessarily optimal. Thus, ideas such as a regional rescue fund, promoted by Austria and Hungary, a fast-track euroization proposal by the IMF, and direct help from the ECB to non-euro countries were rejected, often by core euro area countries like Germany. Of these, perhaps the general neglect of the region by the ECB is the clearest demonstration that host states cannot readily count on the supply of cooperation by institutions which have large impact on their financial fortunes but in which they have no direct voice (Darvas 2009, Aslund 2010, Jacoby 2014).

5. Explaining success in emerging Europe: Politics, interpretation, mechanisms

The boom and bust credit cycle in emerging Europe, intermediated through cross-border banking flows, demonstrates both the practical relevance and consequences of the host's dilemma, and the fact that it can indeed be mitigated by international institutions. That raises the question about what explains this relative success given the general neglect of the region during the buildup of vulnerabilities. To put it in another way, under what conditions would the supply of cooperation would be forthcoming in response to the needs of host regulators? Regardless whether institutions are created or modified to address more efficiently joint problems (Keohane 1984), to provide public goods (Barrett 2007), or to serve as instruments for "redistributive cooperation" (Oatley and Nabors 1998), they reflect the interests of their members. This has also been the argument of many studies of international regulatory politics (Kapstein 1994, Simmons 2001, Singer 2007, Drezner 2007, Helleiner and Pagliari 2011).

Yet, countries in emerging Europe are hardly represented directly in the key forums that should address issues of financial instability. No country from the region is present at the table for discussions at the BCBS even after its expansion. Prior to 2007, no country from the region was a member of the eurozone, and hence the region was not represented at the executive board of the ECB (Slovenia joined in 2007). All emerging European countries are members of the IMF given its nearly universal membership, but they have a total of 3.41% of voting shares. Even this significantly overestimates their influence as the 10 countries are split in 4 different groups, none of which is led by an Executive Director from the region: they are represented by the Netherlands (Bulgaria, Romania), Sweden (the Baltics), Switzerland (Poland), and Turkey (Czech Republic, Slovakia, Hungary, Slovenia). Even at the EBRD, with its specific regional mandate, the 10 emerging European countries are divided among 7 different representatives at the 24-member Board of Directors; only two have direct representation through a director on the Board (Czech Republic and Bulgaria). As for the EU, the new member states "either had not yet joined or had only recently joined when the vast majority of financial services rules were negotiated and agreed upon during the first five years of the twenty-first century" (Quaglia 2010:8).

In such circumstances, host countries have no other feasible option than to rely on the competent international institutions to carry out their mandate to the best of its abilities. The case of emerging Europe suggests the necessary confluence of three conditions for this outcome: first, that powerful states do not use the institutions to shift adjustment costs (low politicization); second, that the institution and its staff have a clear analysis of the problem that can act as an "instruction sheet" (high consensus); and third, that the institution has the necessary mechanisms and resources to follow up on its prescriptions (high implementation capacity).

The first condition, low politicization, was evident in emerging Europe. In the words of the director of the European department at the IMF, Marek Belka, "it was relatively politics free. The Fund acted according to its best or even better than to its best practices and did what was seen to be correct […] The problem of politicization appeared later, in the first case of Greece for example" (Interview with Marek Belka, Warsaw, 2016). The one exception to this was Latvia, where the Fund was particularly skeptical of the prospects for success, but where both the Latvians, and, crucially, the ECB and the EC, insisted on protecting the peg (Blustein 2015:9-11). This demonstrated that in cases where powerful shareholders were able to amplify the position of determined country officials, the IMF could be forced into a subordinate position: ultimately, the IMF provided just $2.3 billion out of a total package of $10.5 billion, although it did insist on appropriate measures to make the program internally consistent. In all other cases, including in joint lending to non-EU countries, the Fund was responsible for at least two-thirds of the overall financing package.

This relatively low level of politicization, apart from Latvia, where worries of contagion took the upper hand, could be explained by the pattern of exposure of Western European banks to the region. Their overall exposure in 2008 was significant at around $1.4-1.6 trillion, or above 10% of euro area GDP. By far Austrian banks were the most exposed, with lending to the region at around 70% of its GDP, although Swedish, Greek, and Belgian banks had also lent sums higher than 20% of their country's GDP (BNP Parisbas 2008, cited in Connolly 2009). One analysis showed that losses could be as high as 11% of GDP for Austria, 6% of GDP for Sweden, 3.6% of GDP for Belgium, 2.3% of GDP for the Netherlands, and 1.5% of GDP for Italy (Evans-Pritchard 2009). Notably, the exposure of French and German banks was only several percentage points of their own GDP, making any losses relatively small.

Given the low salience of political concerns during most of the crisis in emerging Europe, staff could exercise their best judgment. This suggests a crucial feature of crisis response, namely the need for a consensual interpretative framework and economic ideas, which could serve as an "instruction sheet" for actions (Woods 1995, Blyth 2003, Chwieroth 2013). Prior to the crisis, IMF staff was extremely divided on whether developments in emerging Europe represented a natural process of catch-up or rather indicated increasing vulnerabilities (Abiad, et al. 2007, Sorsa, et al. 2007). Vulnerability exercises pointed to the latter, although much of the staff believed that European integration has changed the institutional characteristics of new member states, which should no longer be judged by emerging market standards (Interview with Bas Bakker, Warsaw, 2016). They seemed to be backed in their benign interpretation by positive market conditions and inability to identify a clear crisis trigger. However, as strains appeared in the Baltics in 2007, the vulnerabilities view became more prominent, while the collapse of Lehman Brothers and the ensuing financial turmoil provided the trigger for the crisis. At that point, the IMF also brought in a prominent figure from the region – former Polish prime minister and financial minister Marek Belka, to head its European Department. This helped identify the crisis clearly as a capital account crisis in which countries in the region were, in Belka's words, "innocent bystanders" and "basically powerless" (Interview with Marek Belka, Warsaw, 2016). This paved the way for large financial packages that corresponded to the very high financial vulnerabilities and current deficits in the region. Furthermore, it instilled urgency to the staff to provide very large but one-off financial packages to stop outflows in their tracks, which was the lesson of previous crises such as the one in Argentina. Hence, the programs were negotiated very quickly, were largely frontloaded and contained very streamlined conditionality as the countries were not seen as "guilty" for policy errors, bur rather as subjects of "bad luck" and problems originating elsewhere.

Two other elements were crucial in both enabling and supporting the IMF interpretation and policy response to the crisis. First, at that point the EU, and especially the EC, disposed of very little if any expertise in addressing balance of payments crises among member states.

Therefore, the IMF staff had the upper hand operationally, and in many times the EU staff found itself learning on the job. Initial IMF-EU cooperation was thus surprisingly successful and conflict free at the staff level (with, again, the notable exception of Latvia). This concept of learning under crisis constraint can explain why the initial programs bore such a large IMF imprint and why later on the EC became more assertive as it developed its expertise and/or became more constrained by its legal mandate (Schwarzer 2015, Lütz and Kranke 2014). Second, the crisis was perceived as a regional challenge rather than a set of different country cases: “everybody at the IMF looked at the whole region as a package” (Interview with Marek Belka, Warsaw, 2016). This orientation was strengthened by the EBRD, and especially by its chief economist, Erik Berglof, who argued from the outset of the crisis for a concerted regional response. The perception of the crisis as regional was perhaps clearest in the proposal for a regional rescue fund in early March 2009. However, the reluctance of German and other policymakers to enact such a fund and the ultimately failure of the idea underlines once again how staff interpretations work in the shadow of political constraints.

Finally, the response to the host’s dilemma in emerging Europe once the crisis hit highlights the importance of existing mechanisms and implementation capacity. The IMF translated the (politically permitted) staff consensus and prescription into action mostly through its standard SBA lending arrangements (although it also established a new precautionary instrument, the FCL, which was used by Poland and two other countries from outside the region). Furthermore, since the major financial crises of the early 2000s the Fund has actually struggled to find clients; hence, it had the capacity and the financial incentive to quickly provide and disburse loans to the countries in emerging Europe, as it needed revenues from interest on loans to cover its own potential funding shortfall. Its resources were further bolstered by the G20, which delegated to the IMF a leading role in fighting the crisis globally and tripled its resources to $750 billion. Overall, 79% of the financing for the 25 loans it made between November 2008 and June 2009 was directed towards European countries through standard SBA programs (Woods 2010:58).

Financing from the EU came chiefly through an obscure medium-term financial assistance facility, whose existence was rediscovered to the surprise of many, including Hungarian policymakers facing the crisis in October 2008. Previous to the crisis, it has been used only on two occasions, the last one being to lend to Italy in 1993; in 2002 it was redesigned specifically to provide for balance of payments assistance to non-euro EU members. What is crucial about this facility was that it was already existing in 2008 and assistance could be provided “off the shelf” without first going through negotiations among member states with clear distributional consequences. Even though the ultimate decision for assistance is taken by the Council on recommendation by the Commission, what is interesting is that the funds are raised directly by the EC on behalf of the EU on international capital markets, which then passes on the rates on its ‘AAA’ loans to members in difficulties without a surcharge. This instrument therefore is based on the EU budget and constrained only by its capacity to credibly absorb losses should they occur, rather than directly drawing on the financial resources of member states (Interview with John Berrigan, Brussels, 2016).

Finally, the EBRD provided much of the crucial resources that underpinned the success of the Vienna Initiative. In particular, the EBRD was instrumental in complementing official sector assistance by the IMF/EU through its direct relations and channels for discussion with commercial banks, thus providing the “convening power” for the coordination aspects of the Vienna Initiative (Pistor 2012). Furthermore, unlike the other IFIs, it works directly with and through the private sector, and especially banks; hence it was able to provide various direct debt, equity, and trade finance support to banks operating in the region[6]. This avoided the pitfalls and difficulties of working through governments in supporting banks, while also providing financing that corresponded better to the overall regional exposure of the banks rather than the country-by-country exposure of their subsidiaries.

[6] Unicredit (430 million euros), Societe Generale (400 million euros), Hungarian-owned OTP (220 million euros), Raiffeisen (150 million euros), Erste (100 million euros), Intesa Sanpaolo (100 million euros).

6. Conclusion

Overall, this paper sought to demonstrate that countries on the recipient end of large cross-border banking flows face a host's dilemma, which differs significantly from the well-studied regulator's dilemma between international competitiveness and domestic stability. Instead, such host countries with largely foreign-owned domestic banking systems are caught between their special needs for supervision, regulation, and resolution, and international institutions designed to meet such needs from which they are largely excluded. It then demonstrated that countries in emerging Europe largely found themselves facing the host's dilemma between 2004 and 2007, leading to a significant credit boom and increasing vulnerabilities due to accelerating cross-border banking inflows and a largely unresponsive governance framework. However, once the crisis hit the region between 2008 and 2010, international institutions responded and successfully mitigated a potentially significant collapse. Therefore, it was suggested that institutions could be responsive to the needs of host states if they are not politicized, if their staff has a clear consensus about the problem, and if they have pre-existing institutional resources they can deploy to this end.

The implications for host states are twofold. If they are to reap the benefits of banking integration, they need to make sure they are represented in international institutions, or, at the very least, that the institutions tasked with financial stability have the independence, expertise, and resources to address their problems. This draws explicit attention to the institutional underpinnings required for sustainable banking integration and holds lessons for both the ongoing development of the European banking union, and for future projects of banking integration in South-East Asia and elsewhere. However, this analysis also suggests that in the absence of appropriate institutional safeguards and resources, host states should be ready to forgo the alluring benefits of foreign banks. In particular, they need to be wary from the impact of foreign banks on credit growth and be ready to implement measures, which might be seen by others as preventing the full freedom of movement of banking flows.

There are clear areas for both theoretical and empirical further research on the host's dilemma given its relative neglect in international political economy studies. On the theoretical side, one area for fruitful inquiries is identifying the crucial components of international institutions that could make them responsive to non-members or marginal members, given that such institutions reflect by design the preoccupations of their members and founders. Another issue for scholars is how institutions interact –both between themselves and with private sector actors, and under what conditions such interaction can allow them to respond to the needs of host states (Abbott, et al. 2015). On the empirical side, it would be clearly beneficial to confirm the generalizability of the host's dilemma in other regions with significant foreign-bank ownership and presence, such as sub-Saharan Africa or Latin America. Furthermore, the successful response in emerging Europe calls for an examination of the much more controversial response to the crisis in the euro area given the central role of cross-border banking flows in it.

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