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One of the most remarkable aspects of the transition of central and eastern Europe was the engagement of West European banks in the region. The main driver was the search for profitable business by banks whose scope for expansion in their home markets was limited. In most of the region, the arrival of west European banks was welcome, since they rapidly provided modern banking services to poorly served populations and were relatively well run. While locally-owned banks were often involved in connected lending and other scandals, the foreign banking groups brought with them better reputations, partly the result of the more effective supervision to which they were subject.

Bypassing the thin domestic deposit base, parent banks, then abundantly liquid, financed their subsidiaries in central, eastern and southeastern Europe (CESEE), allowing them to expand lending rapidly in the early 2000s. This allowed financial resources raised in western Europe to flow to the relatively capital-scarce region of central and eastern Europe and raise growth rates in the latter. This process of capital flows contributing to convergence in an emerging market region was seen as a great triumph for Europe. It contrasted with the situation of emerging markets elsewhere, which were largely supplying capital to the developed parts of the world, a phenomenon known as the 'Lucas paradox'.

While the unprecedented financial integration of CESEE with western Europe through cross-border banking provided a powerful vehicle for convergence, it also created serious vulnerabilities which were to threaten this process when the global financial crisis struck. Banks in the region had plenty of money to lend, but bankable investment projects were in relatively short supply. Entrepreneurs tended to lack the needed credit histories and title to collateral and so relied more on informal finance and retained earnings. Financing large corporate investment was mainly left to foreign parent companies. The abundant bank funding thus went into the property market and to support consumption, rather than to build the productive base of the economy. Furthermore, with high local currency interest rates and poorly developed derivative markets, banks had an incentive to lend in foreign currencies – euros or Swiss francs or even Japanese yen – and the lower interest rates and longer maturities available on such loans also made them attractive to borrowers. Integration of the CESEE banking systems with that of the EU15 thus led to large current account deficits, a bubble in housing markets, and vulnerability to a depreciation of the domestic currency.

While vulnerability of households to exchange rate movements (and the subsequent credit problems for the banks) looks obvious in retrospect, it was of course less obvious at the time. The convergence narrative held that as productivity and incomes in the CESEE region rose, the real exchange rates of local currencies would appreciate as a by-product of the Balassa-Samuelson effect. With the candidate countries also striving to meet the convergence tests for euro adoption – including keeping inflation low and nominal interest rates stable – the risks of a sudden depreciation of the local currencies and of distress to borrowers in foreign exchange were thought by many to be minimal.

When the global financial crisis broke in 2008, the funding markets for the parent banks dried up, making it much harder for them to continue the onward funding of subsidiaries in CESEE. The inflows that had financed large current account deficits came to a sudden stop, and there was a danger that both funding and capital would be withdrawn from the region, exacerbating the squeeze on these countries. The IMF was called upon to support adjustment programs in a series of countries, including Latvia, Hungary, Romania, Serbia, and Bosnia and Herzegovina, support which was sometimes supplemented by the EU. Maintenance of the exposure of parent banks to their subsidiaries was vital to averting worse balance of payments problems and ensuring that domestic banks could continue to support economic activity. There was a danger that the bank regulators of the home and host countries would pull the banks in opposite directions as each prioritised the survival of entities under their

own jurisdiction, and that banks would make matters worse, as each tried to steal a march on the other by exiting from markets before restrictions were applied.

This was a coordination challenge. In response, the Vienna Initiative was established as a forum involving the main public and private players. The banking groups were asked to make monitorable commitments to maintaining the health of their subsidiaries in each country and the level of their financing. These commitments formed part of the national adjustment programs supported by the IMF and the EU. In parallel, the European Bank for Reconstruction and Development, the European Investment Bank Group, and the World Bank Group surveyed the financing needs of the individual banking groups and made a commitment to provide at least €24.5 billion of financing to them over the period 2009-2010, an amount that was significantly exceeded in the event. Home and host supervisors were engaged to ensure that these measures were not thwarted by supervisory action. The Vienna Initiative stabilized the situation and gave the countries the space in which adjustment could take place.

As the global financial crisis transformed into the Eurozone crisis in 2011, cross-border banking turned from being a driver of convergence into a potential brake on it. The parent banks in western Europe (and Greece) came under renewed funding pressures, with both markets and regulators calling for the deleveraging of their balance sheets. Support from home governments became problematic, not only in being subject to EU state aid rules, but because of the dangers of the mutual entanglement of financially threatened states and financially stressed banks, the 'doom loop.' While deleveraging of banks was essential, there was a danger that it would be disorderly and that it would put the CESEE region under particular pressure. As the European Union rushed to create a banking union and to centralise supervision and resolution matters in the Eurozone, the Austrian regulators introduced measures to force their banks to reduce their vulnerability, measures which had a direct impact on their subsidiaries throughout much of the CESEE region.

In these circumstances, the Vienna Initiative was transformed into a platform concentrating on home-host supervisory cooperation in the CESEE region (Vienna Initiative 2.0). The original initiative had shown itself to be a useful forum for bringing banking groups together with home and host supervisors, and also the expertise and financial muscle of the IFIs and the European Commission. Following the unilateral Austrian measures, it produced a set of agreed principles governing cross-border supervisory cooperation and which stressed the importance of supervisors taking into account the spillover of their measures on other countries.

The CESEE region has proved fairly resilient to the new pressures. In response to the steady withdrawal of parent funding, banks managed to mobilise more domestic deposits than expected. Nevertheless, credit growth has been very slow throughout the region since the crisis, much lower than in the previous decade. This is partly the product of rising levels of NPLs and more subdued economic conditions, and partly due to the reduced dynamism of the banks responding to regulatory and market pressures on their parents. That the convergence process has continued (although at slower rates), it largely reflects the fact that growth in western Europe has been so hesitant since the crisis.

The Vienna Initiative has tried to ensure that cross-border banking, once the driver of growth, does not become a major drag. In addition to the supervisory cooperation mentioned above, there has been close monitoring of developments, allowing such problems as the fate of Greek bank subsidiaries in the Balkans to be identified in time. The creation of the European Banking Union and the establishment of single supervisor and resolution authorities at the ECB for Eurozone banks has affected the ability of host regulators to influence the activities of subsidiaries in the CESEE region. Bank subsidiaries, which are a very minor part of the whole group, are often systemically important in the small financial markets of the west Balkan countries. The Vienna Initiative has thus sought to ensure that the voices of host supervisors are heard in supervisory colleges and at the ECB, the new home supervisor.

A major Vienna Initiative programme to remove obstacles to the reduction of NPLs in the region has had considerable success. It has also promoted the use of IFI credit guarantees to facilitate lending to SMEs as a way to provide funding that is efficient given new capital and liquidity rules. In both cases, the Vienna Initiative's work has fed into broader EU-wide initiatives. The proposal to create a Capital Market Union recognizes that Europe as a whole is too dependent on banking and insufficiently on capital markets. The Vienna Initiative has also sought to make sure that such a union also provides a vehicle for smaller countries in the region to obtain the financing that they need.

If cross-border banking is to continue to be a factor for convergence, there will need to be much more cooperation between supervisors and an awareness of the spillovers from supervisory action. When once banks were clamouring to enter the region, now banking group strategies have become much more discriminating, with more groups trying to leave the region than to enter it. Unless action is taken to keep banking healthy in the smaller countries of the region, the banking system there may atrophy and hold back the process of convergence.