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# Transfer of reputation: Multinational banks and perceived creditworthiness of transition countries

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## ABSTRACT

How do international investors evaluate sovereign borrowers whose histories and institutions are too new or weak to send strong signals about their creditworthiness? In this paper, I suggest that the perceived creditworthiness of many transition countries' governments rests on a 'transfer' of good reputation from prestigious multinational banks, as foreign direct investors. The entry of reputable foreign banks into a transition country signals to international financial markets about the financial strength of that host economy. It also involves the transfer of the status of lender of last resort to the foreign parent bank. Foreign bank penetration can thus create optimistic expectations about a host country's capacity to service its sovereign debt. Using panel data for 23 transition economies during the period of 1996–2009, my empirical results provide support for the argument stressing the exogenous role of foreign financiers as enhancers of the credibility of host country governments. The results are robust to instrumental variable analysis and the inclusion of number of controls for alternative determinants of investors' perceptions of country risk. This proposition is further backed by evidence from three transition countries: Hungary, Estonia and Ukraine.

## KEYWORDS

Multinational banks; foreign direct investment; credibility; lender of last resort; sovereign credit risk; transition countries.

How do international investors evaluate the creditworthiness of sovereign borrowers? In particular, how do they evaluate governments of those countries whose histories and institutions are too new or weak to provide adequate signals about their creditworthiness? What are the sources of government credibility in sovereign debt markets? The purpose of this paper is to examine the impact of foreign banks on 'perceived creditworthiness' of a host country.<sup>1</sup>

Much scholarship in political economy has inquired into the effects of the 'democratic advantage' on government credibility in sovereign bond markets. In their seminal paper, North and Weingast (1989) argue that political institutions in eighteenth-century England that limited executive discretion, such as constitutional checks and balances, enhanced the credibility of a country's promises to repay its debt. The literature exploiting historical as well as contemporary data has demonstrated that there is a democratic advantage in sovereign credit markets: democracies have greater ability to make credible commitments because they possess certain characteristics, such as constitutional checks on executive authority, respect for the rule of law, and protection of property rights (Schultz and Weingast, 2003; Butler and Fauver, 2006; Stasavage, 2007; Beaulieu, Cox and Saiegh, 2012; Biglaiser and Staats, 2012). Along these lines, Schultz and Weingast (2003) argue that democratic governments are able to more credibly commit to repaying their debts because the violation of international lending agreements can result in a loss of constitutional support and hinder their re-election prospects (Schultz and Weingast, 2003). As a result, democracies should be perceived as countries with a lower probability of defaulting, and thus can sell more sovereign bonds at better prices than otherwise comparable autocracies.

The democratic advantage thesis is not without its critics, however. Flandreau and Flores (2009) point out that historically, many successful sovereign borrowers in the nineteenth century were lacking constitutional checks and balances. Centralized authoritarian regimes in countries such as Russia, Austria and Prussia were able to borrow on favourable terms because it was the reputation of the underwriting bank that was the basis for the sovereign debt assessment. Using recent data, Archer, Biglaiser and DeRouen (2007) also show that democracies received no more favourable ratings than did autocracies. For instance, some autocracies, including China, Singapore and various Middle Eastern countries, often receive similar ratings to stable democracies, such as the Czech Republic, Slovenia, Chile or South Korea. In a study that controls for level of development, Saiegh (2005) shows that democratic governments were more likely to reschedule their debts, and paid similar interest rates to autocratic governments.

Scholars have noted that modern credit markets place a greater weight on economic and financial stability than on political regime type in their evaluation of sovereign borrowers (Adams, Mathieson and Schinasi, 1999). A large literature exists that highlights the importance of economic determinants of sovereign credit risk, such as level of economic development, economic growth, external debt and inflation (Cantor and Packer, 1996; Eichengreen and Moody, 1998; Afonso, 2003; Mora, 2006; Archer, Biglaiser and DeRouen, 2008; Afonso, Furceri and Gomes, 2011). Scholars have also examined the effect of sovereign defaults on bond ratings and

interest rate spreads (Reinhart, Rogoff and Savastano, 2003; Borensztein and Panizza, 2009).

Another line of research explores whether delegation of competences to international organizations increases the creditworthiness of member states (Dreher and Voigt, 2011). In particular, Hauner, Jonas and Kumar (2007) and Gray (2009) argue that European Union (EU) accession improves the credibility of new member states from Eastern Europe (EE) because it sends positive signals to financial markets about their domestic economic policies and reforms.

These structural and institutional approaches, while fruitful, are incomplete. They do not examine the impact of economic agents, such as foreign direct investors or lenders, on the creditworthiness of nation-state governments in sovereign debt markets. This paper starts with the assumption that international investors face a particular challenge in assessing the creditworthiness of countries that either have weak democratic institutions and failed economic policies, or are new in the market.<sup>2</sup> Governments of these countries find it difficult to signal the credibility of their policies. I argue that reputable multinational banks, as foreign direct investors, can signal the creditworthiness of such sovereign borrowers. The presence of reputable financiers in these countries decreases investors' uncertainty about institutions and policies, which affect governments' capacity to service their debts.

The argument put forward in this article draws on insights from the literature on the role of financial intermediaries, as underwriters of sovereign bonds, in sovereign debt markets (Riley, 1980; Fang, 2005; Flandreau and Flores, 2009, 2012). My story extends the existing research arguing that there is a 'transfer' of reputation from a foreign bank *investor* to a host government. I show that countries with a substantial foreign bank presence fare better in sovereign credit markets than otherwise comparable countries. Therefore, I suggest looking at multinational banks as enhancers of the perceived creditworthiness of sovereign borrowers. In developing and transition countries where information is scarce and unreliable, investors pay attention to the signals and events – such as foreign bank entry – that can be easily interpreted. Investors believe that foreign banks will decrease the likelihood that a host government will default on its debt, and in effect use a foreign bank entry as shorthand in their models. Thus the actual record of a foreign bank's effect on institutions and policies of host countries may be less important than the nominal entry of such foreign banks.

The transition countries of EE are particularly good test cases for examining the impact of foreign banks on governments' perceived creditworthiness in international credit markets. The banking systems in these countries transformed from being dominated by state-owned banks to exhibiting significant growth of foreign ownership. I draw on

several data sources to test my hypotheses. I present evidence on reputable bank investors in EE with the focus on Austrian and Swedish banks. I then quantitatively assess the impact of foreign bank penetration on perceived creditworthiness of host governments, controlling for alternative political and economic factors. I address the potential endogeneity problem using a two-stage least squares procedure, instrumenting for foreign bank entry using a measure of population size. Finally, I briefly review evidence from three country cases: Hungary, Estonia and Ukraine.

### THE ARGUMENT: FOREIGN BANKS AND SOVEREIGN CREDITWORTHINESS

Countries that are new in the market, lack credible domestic institutions, or have histories of failed economic policies and fiscal crises have little ability to signal credible commitments to international investors. In Flandreau and Flores' (2009: 647) account, the nineteenth century's leading creditor banks – Rothschilds, Barings and other large banks – 'owned a "brand" that could grant market access on favourable terms'. In their subsequent work, Flandreau and Flores (2012: 223) argued:

The world we consider is one in which investors use the signals from certain prestigious brands to make inference about countries' types. Investors cannot tell which countries' debt would be a good investment, but they know that credible delegated monitors that have knowledge and the capacity to enforce; hence investors react not to news about a country's behaviour but rather to the presence (or absence) or a prestigious underwriter.

Therefore, given the scarcity of information about sovereign borrowers, investors relied on the reputation of prestigious bank underwriters, with monopoly power and the capacity to implement conditional lending and punish defaulters, to guide their investments in the nineteenth-century market for sovereign debt (Flandreau and Flores, 2009, 2012). These prestigious financiers helped sovereign borrowers accumulate reputational capital. In contrast to Flandreau and Flores' work, my article highlights the role of reputable multinational banking groups, as foreign direct investors, in host countries lacking creditworthiness in sovereign bond markets. I argue that a foreign bank's good reputation is valuable for the host country because it generates expectations about the country's future debt servicing that facilitates the host government's access to international credit markets. Some argue (Mehl, Vespro and Winkler, 2006) that the very fact that the reputable and experienced foreign bank entered a

transition country was interpreted as an improvement in the country's financial strength. The entry of foreign banks serves as shorthand for a positive assessment of the financial strength of a host economy. Foreign banks can thus provide a solution to the information and credit risk problems of a sovereign borrower.

Let me begin with exploring the two main channels through which foreign banks can signal the creditworthiness of host governments. First, foreign banks supply what I call a fiduciary reputational capital.<sup>3</sup> Foreign banks' branches and subsidiaries are managed and supervised to the standards of the parent bank (Adrianova, Demetriades and Shortland, 2008: 233).<sup>4</sup> Therefore, the host country 'imports' regulation and supervision from the foreign bank's home country's regulatory authorities who provide credible restrictions on the host country government's ability to behave irresponsibly.<sup>5</sup> The home supervisors of parent banks provide an additional layer of prudential supervision to the foreign-owned banking group branches and subsidiaries and cooperate with host supervisory authorities (e.g. through supervisory colleges) (Boss *et al.*, 2007: 121).<sup>6</sup>

A reputable parent bank with a large market share needs to protect its brand name and reputation, and is unlikely to behave opportunistically since a risky decision would affect its market share, and thus its profits (Fang, 2005). For instance, Gorton (1996) shows that the concern with retaining their reputation may have deterred American banks from behaving as 'wildcats' (i.e. issuing banknotes and subsequently disappearing) in the nineteenth-century free banking era. Large investment stakes thus incentivize good behaviour on the part of multinational bank investors, because the return on investment depends critically on the host countries' stability and growth. By conducting their operations in a safe and sound manner, foreign banks in turn decrease the probability of banking crisis in a host country (Demirguc-Kunt *et al.*, 1998).

Second, foreign banks branches and subsidiaries tend to increase the host country's 'resilience to withstand shocks' (Cárdenas, Graf and O'Dogherty, 2003). The market perception is that the subsidiary will benefit from the support of the parent bank, which would assure the solvency of the subsidiary and cover its losses (Tschoegl, 2003). Although the parent bank does not have the legal obligation to stand behind its subsidiary, the expectation is that concerns about a loss of reputation will lead the parent bank to support its subsidiaries (Cerutti, Dell'Araccia and Soledad Martinez Peria, 2007: 1671). A government's ability to service its external debt also depends on the extent of bailouts it has to provide to stabilize the domestic banking and financial system.<sup>7</sup> Thus, the financial ability and willingness of multinational banks to provide support to their subsidiaries increases the odds of debt repayment by a host government.

In sum, the main insight of my theoretical approach is that foreign banks can decrease a host country's credit risk, because investors

envision lower financial vulnerability and fewer bank rescues financed by host country governments during times of financial crises, thus a minimal impact on the host country's public spending and external debt. Therefore, I expect countries in which reputable foreign banks have high market share to outperform others with comparative characteristics in terms of their perceived creditworthiness in sovereign credit markets.

## REPUTATION OF MULTINATIONAL BANKS

The most frequent empirical measure of the reputation of bank underwriters used in previous studies is their relative market share (DeLong, 1991; Megginson and Weiss, 1991; Fang, 2005; Flandreau and Flores, 2009). From the economic point of view, market share means profits at stake, and bigger banks have more to lose from a tarnished reputation (Fang, 2005: 2734). When discussing the reputation of an investment bank underwriter, DeLong (1991: 209–10) noted:

If reputations as honest brokers are sufficiently fragile, a firm with a large market share will find it most profitable in the long run to strive to be above suspicion in every short run: it will not imperil its reputation for the sake of higher short-run profits on any one deal. . . With a small market share, the future returns expected from a reputation as an honest broker may be also small, and might be less than the benefits from exploiting to the fullest one unsound deal in the present.

Following the same logic, as a proxy for the reputation of a foreign bank, I suggest the parent bank's market share in a host country (measured by total assets). I also use the parent bank's rating by credit rating agencies as an additional measure of reputation. I recognize that these are only imperfect measures of reputation.

Table 1 provides the information on the market shares of the top ten foreign bank investors in the EE region in 2011.<sup>8</sup> Except for the non-rated Hypo Group Alpe Adria, these multinational bank investors are included among the top 100 banks in the world (as measured by the total value of their assets); ranked by size of Tier 1 capital; rated globally by credit rating agencies; and headquartered in countries of Western Europe.<sup>9</sup>

It is thus reasonable to assume that these large bank investors should have strong incentives not to tarnish their reputation for the sake of higher short-term profit opportunities via their subsidiaries in various host countries. As Bonin (2010: 467) puts it, the long-term business models of these multinational banking groups involved 'making a commitment to a transition economy host country, so as to build up the requisite reputational

**Table 1** Top 10 multinational banks in transition countries

Bank	Total assets in Central and Eastern Europe (2011) (consolidated, billions of euros) <sup>1</sup>	Total assets in East Central and South-Eastern Europe <sup>3</sup> (2010)	Share of assets of EE subsidiaries as % of group assets (2011)	Standard & Poor's Ratings (2012)
UniCredit Group (Italy)	116.3	20.4	12.5	A- (UniCredit Bank Austria)
Raiffeisen (Austria)	84.8	14.7	57.7	A
Erste Group (Austria)	84.0	18.3	40.0	A
Société Générale (France)	73.7	12.4	6.5	A
KBC Group (Belgium)	55.0	7.0	17.1	A-
Intesa Sanpaolo (Italy)	40.6	9.6	6.4	A
Commerzbank (Germany)	26.4	3.1	4.0	A
Santander (Spain)	24.4	1.8	1.9	A+
Swedbank (Sweden)	17.1	2.0	8.2	A+
Hypo Group Alpe Adria (Austria)	12.6	3.5	35.9	unrated

Source: Raiffeisen (2012) and Author's calculations.

Notes: (1) This list excludes OTP with a total of 35.9 billion euros, mostly in Hungary. It also excludes the Slovenian Nova Ljubljanska Banka with a total of 17.3 billion euros, in which the government owns 45%. (2) Spain's Santander has for the first time entered the Top-10 of foreign banking groups in EE after acquiring a majority stake in Polish Kredyt Bank in 2011. (3) Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Latvia, Lithuania, Estonia, Romania, Bulgaria, Croatia, Serbia, Macedonia, Bosnia & Hercegovina, Albania, and Kosovo. (4) Standard & Poor's downgraded the credit ratings of Italy by two notches to triple B plus from single A in June 2012. As a result, the ratings of Italian banks were also downgraded since they could not exceed sovereign ratings.

capital necessary for further expansion in the region.' This focus on reputation puts constraints on the parent bank, in that it is unable to withdraw its support for its subsidiaries without damaging the parent's reputation and long-term investment opportunities in the EE region.

As Table 1 shows, there are three market leaders in terms of assets – Erste Group, Raiffeisen Bank International and UniCredit Bank Austria – the three largest Austrian banks that together have a cumulative share of over 53 per cent of the total banking assets in EE (excluding the ex-Soviet republics). UniCredit is the largest bank by asset share in Croatia and

Bulgaria, and the second largest in Poland. Erste is the largest bank in Slovakia, the Czech Republic and Romania and the second largest in Hungary. Raiffeisen has a top five market position in the Czech Republic, Slovakia, Croatia, Romania and Bulgaria. Column 3 of [Table 1](#) provides an additional criterion to gauge the importance of the size of EE operations for the major Austrian banks: Raiffeisen's and Erste's assets in EE countries represent almost 58 per cent and 40 per cent of the banking group overall assets, respectively.<sup>10</sup>

The Austrian banks had already started to enter the EE markets in the mid-1980s mainly to provide services to the Austrian firms operating in the region, but from the early 1990s they began to establish subsidiaries, initially as greenfield operations. Then in the mid-1990s they accelerated their expansion through privatization of state-owned banks in EE. The three market leaders have a long history of operations. The UniCredit Group origins date back over five centuries to the establishment of Rolo Banca in 1473, when Monte di Pietá, a public institute providing secured loans, was created in Bologna, Italy. Currently, the UniCredit Group includes two formerly independent Austrian banks, Bank Austria and Creditanstalt, as well as a former German bank, HypoVereinsbank. Erste Group was founded in 1819 as the first Austrian savings bank and grew through 'acquisitive growth'.<sup>11</sup> The first Austrian Raiffeisen banking cooperative, owned and administered by its members, was founded in 1886 and grew organically without a single bankruptcy.<sup>12</sup>

These three largest Austrian banks send a quality signal to the international financial community. First, they enjoy high credit ratings, no worse than A- by Standard & Poor's at the peak of the European debt crisis in 2012. The recent Moody's (MIS, 2012) report states that given their significant domestic market shares and heavy involvement in EE, as well as the proven track record of the Austrian government to support its major banks, these large Austrian banks benefited from three notches of parental support. Second, these banks, regulated and supervised to the standards of the Austrian supervisors, the Austrian National Bank and the Financial Markets Authority, comply with international regulatory requirements, including the capital requirements of Basel 3. The direct exposure of the large Austrian banks to structured credit products, the main source of banking instability during the recent credit crisis, was limited. But as a reaction to the crisis, the Austrian authorities further tightened the regulations to improve the banks' balances in foreign markets.<sup>13</sup> These new regulations apply to all subsidiaries in EE and will be monitored jointly by home and host country regulators.<sup>14</sup> As a consequence, the Austrian regulatory authorities also upgraded the regulatory and supervisory framework in host countries.

While the core markets of the Austrian banks are in Central and South-Eastern Europe, Swedish banks dominate the banking sectors of the

Baltic countries. The history of Swedbank, the largest retail bank in Sweden, can be traced back as far as 1820 when the first Swedish savings bank was founded in Göteborg. Swedbank expanded in the Baltic region through the acquisition of shares in Hansabank. Foreign ownership of the major banks in the Baltic countries by reputable Nordic banking groups has often been referred to as ‘an implicit guarantee of capital supply to the Baltic banks, and... as a substitute for a lender of last resort’ (Adahl 2002: 112). The close financial integration with the Scandinavian countries through the foreign bank ownership contributed to the financial stability in the Baltics because the parent banks were willing and able to absorb losses, instead of leaving in the aftermath of financial turbulence (Purfield and Rosenberg, 2010).

In addition to these prestigious international banks, there were other banks with a smaller market share active as foreign investors in the transition region. These smaller rivals have less reputational capital at stake and are less able to signal quality. These banks also tend to be assigned lower ratings by credit rating agencies. The largest Greek banks, such as EFG Eurobank, National Bank of Greece and Alpha Bank, established their subsidiaries in Albania, Bulgaria and Romania, where their market shares represent 4.1 per cent, 3.6 per cent and 2.6 per cent of total assets, respectively (Raiffeisen Research, 2012). The Greek banking groups accumulated massive sovereign debt problems and have been recently losing their market share in EE. The leading state-owned Russian banks investing primarily in the Commonwealth of Independent States (CIS) are Sberbank, with a market share of 21.8 per cent; VTB, with 13.7 per cent; and Gazprombank, with 5 per cent (Raiffeisen Research, 2012). Banks in Russia and other CIS states tend to receive low bank ratings due to high credit risks from related-party or insider lending, considered as an indication of weak corporate governance and weak financial regulation and supervision (MIS, 2011). As a result, the probability of bank and debt defaults is higher in countries with low foreign bank presence, or where Russian banks or non-western banks have a large market share and perpetuate unsound banking practices. For instance, there were 23 bank defaults in the CIS during the 2008 global credit crisis, but no bank default in the core EE markets of reputable western banking groups (Barisitz *et al.*, 2010).

## EMPIRICAL ANALYSIS

I test the hypothesis of a positive impact of foreign bank ownership on the perceived creditworthiness of host governments on data for 23 transition countries of EE for the period from 1996–2009. In this article, I study the creditors’ *perception* of sovereign credit risk. Following Brewer and Rivoli (1990) and Dreher and Voigt (2011), I measure country

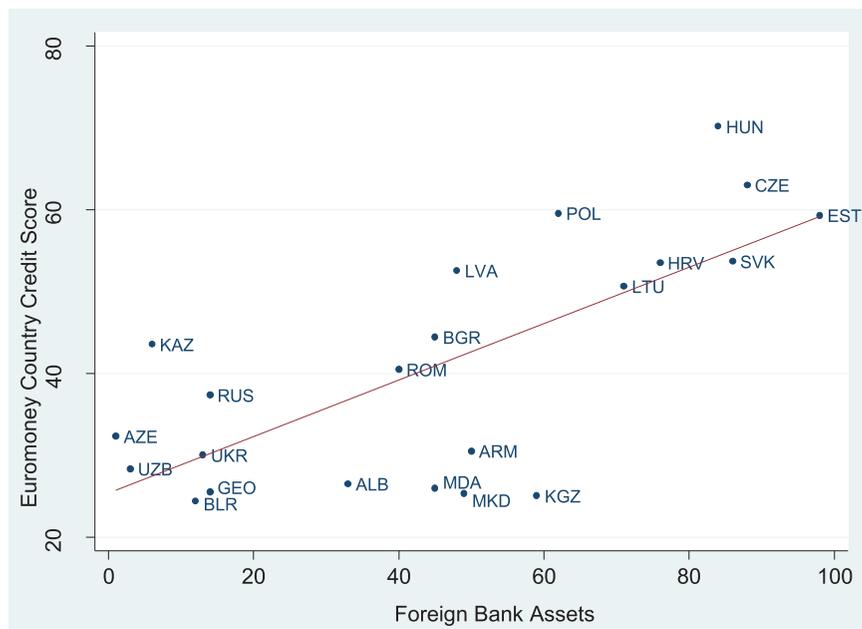
creditworthiness by employing Euromoney credit ratings.<sup>15</sup> The Euromoney country scores reflect 'actual financial market conditions' and thus allow us to examine more broadly the perceptions of financial markets (Brewer and Rivoli, 1990: 362).<sup>16</sup> Every March and September, Euromoney publishes a comprehensive measure of country risk ratings for a large number of countries. The overall country risk measure is a weighted linear additive of nine categories: political risk, economic performance, debt indicators, debt rescheduled or in default, credit ratings, access to bank finance, access to short-term finance, access to capital markets, and discount on forfeiting. The individual scores for each of these components are obtained by polling experts, whose opinions are based on data observed from financial and credit markets. These measures are widely used by banks, mutual funds and other financial institutions. They are considered an authoritative source of 'consensus opinion' on a country's risk levels and creditworthiness. The scores range from 0 to 100, with higher scores denoting lower risk. High scores mean that a government's announcement to repay loans as agreed upon is perceived as credible. Following Dreher and Voigt (2011), I use the September credit scores.

I also use two alternative dependent variables to verify that the findings are not specific to the Euromoney country risk rating system. I employ the Emerging Market Bond Index (EMBI) global spreads, the most commonly used measure of investors' credit risk perceptions and risk appetite. For local currency yields, I use 10-year government bond yields. Interest rate spreads tend to be inversely related to Euromoney creditworthiness ratings.

The ratings provided by the major credit rating agencies do not appear to be the appropriate variable of interest. While the Euromoney credit scores are based on assessments of independent experts on individual countries, rating agencies rely on their own analysts' assessments for their credit ratings. The latter type of assessment is thus more easily influenced by subjective biases of the individual risk assessors. For instance, Boley, von Dewell and Hoekerd (2000) argue that rating agencies are often reluctant to downgrade their country risk ratings for fear of damaging business relationships and for fear of regional contagion effects. The Euromoney risk ratings encompass a full range of indicators, including ratings from Moody's, Standard & Poor's and Fitch IBCA, that represent ten per cent of the overall score. The Euromoney scores are also available for a larger group of EE countries and over a longer period than alternative indicators. Finally, rating agencies often react to movements in bond spreads (De Grauwe and Ji, 2012: 870), and thus lag (instead of lead) behind the market in adjusting their credit ratings, which provide information already known by the market participants (Eijffinger, 2012: 916).

My primary measure of the relative market power of foreign banks in host countries is their share of assets of total bank assets (by country). I also use the percentage of assets of 'south-south' banks among foreign banks (by country) as a proxy for less reputable banks with a smaller market share in the EE banking sectors. South-south banks are those banks whose major shareholders come from another less developed country (e.g. Russian banks in the CIS countries). The data on foreign and south-south banks comes from Claessens and van Horen (2008, 2011). Using a definition standard in the empirical literature, the authors of the database designate a bank as foreign owned if 50 per cent or more of its shares are owned by foreign investors. Figure 1 shows that foreign bank market share (in terms of assets) and country creditworthiness are strongly positively correlated (0.46); this indicates that countries with a higher presence of reputable foreign banks enjoy higher credibility in international financial markets.

In choosing my control macroeconomic variables, I follow prior studies (Brewer and Rivoli, 1990; Butler and Fauver, 2006; Dreher and Voigt, 2011). Per capita income (logged) and gross domestic product (GDP)



**Figure 1** Correlation between foreign bank market share and creditworthiness of EE governments in 2001.

growth rates are likely to exert a positive influence on government credibility. Conversely, high inflation and high external debt over exports can be considered to be outcomes of bad economic policies, thus they likely increase country risk.<sup>17</sup> These economic indicators are taken from the World Bank's World Development Indicators and the European Bank for Reconstruction and Development (EBRD) databases.

I also test the 'democratic advantage' thesis that contends that democratic institutions enhance the credibility of governments. I control for regime type using the polity2 variable in the Polity IV database, which is a continuous measure of democracy on a 21-point scale from -10 to 10 (with 10 representing the most 'democratic' score). I further test the argument that investors consider membership in the EU as an implicit guarantee for the bonds of member and candidate countries from EE. Following Afonso, Gomes and Rother (2011), I test two leads of the EU dummy considering that international investors anticipated the EU accession. I also use the contemporaneous EU variable.

Finally, I include bond default history as an indicator of a country's probability to default in the future. Default history (by country) is obtained from Standard & Poor's, which defines sovereign default as the failure of a sovereign to meet a principal or interest payment on the due date as stated in the original terms of the debt issue. I measure default history using a dummy variable, defined as 1 beginning in the year of default and thereafter, and 0 otherwise.<sup>18</sup>

I estimate fixed-effects models on panel data to control for unobserved heterogeneity across countries<sup>19</sup> as well as year time effects.<sup>20</sup> To reduce concerns about reverse causality or simultaneity, I use one-period lagged regressors in all estimations.

### Interpretation of results

Table 2 shows the baseline models. The models explain between 0.60 and 0.70 per cent of the variation in perceived creditworthiness. Consistent with my theoretical framework, the results in models 1–2 indicate a strong, positive influence of high foreign bank penetration (measured as the percentage of foreign bank assets of total banking assets) on investors' perceptions of a country's credit risk at least at the 1 per cent level of significance. In models 3–4, I test how south-south banks influence credibility of EE governments. The negative and statistically significant coefficients, again at least at the 1 per cent level, suggest that these less reputable banks may generate uncertainty and increase country risk.

In terms of economic control variables, the results show that most of them are significant predictors of creditworthiness. As expected, country

**Table 2** Foreign and south-south banks and sovereign creditworthiness

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
FOREIGN BANK ASSETS	0.050*** (0.013)	0.041** (0.014)	-0.124** (0.040)	-0.125** (0.040)	0.028* (0.013)	-0.115** (0.035)
SOUTH-SOUTH BANK ASSETS	11.747*** (2.576)	12.152*** (2.587)	13.659*** (3.423)	14.430*** (3.396)	4.989 (2.682)	5.499 (3.726)
PER CAPITA INCOME (log)	0.279*** (0.070)	0.294*** (0.071)	0.098 (0.070)	0.136 (0.071)	0.164* (0.068)	0.033 (0.069)
GDP GROWTH	-5.683* (2.603)	-6.427* (2.643)	-7.316** (2.508)	-7.999** (2.493)	-1.384 (2.812)	-2.445 (2.642)
INFLATION	-0.022** (0.008)	-0.023** (0.008)	0.004 (0.009)	0.001 (0.009)	-0.034*** (0.007)	-0.013 (0.008)
EXTERNAL DEBT	-4.052* (1.722)	-4.195* (1.723)	-2.176 (1.577)	-2.289 (1.567)	-1.163 (1.602)	-0.626 (1.418)
BOND DEFAULT		0.263 (0.150)		0.352* (0.140)	0.110 (0.143)	0.215 (0.131)
DEMOCRACY		1.702 (1.006)		1.054 (0.985)	1.144 (0.910)	0.480 (0.888)
EU (t + 2)					0.465*** (0.066)	0.308*** (0.066)
FOREIGN BANK ASSETS (t-1)						
R-squared	0.638	0.641	0.601	0.615	0.698	0.666
Observations	293	291	230	230	271	210
Method	FE	FE	FE	FE	FE	FE

Standard errors in parentheses; \* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.001.

credit risk declines with higher per capita income. Economic growth is significant at conventional levels, with the expected positive coefficient, but only in specifications involving reputable western banks. As expected, high inflation and high external indebtedness are consistently related to higher country credit risk. The results show that bond default tends to increase the country risk but only in regressions with reputable foreign banks as the variable of interest. The perceptions of country creditworthiness do not appear to be responsive to regime type, except for one case at the 5 per cent level. Surprisingly, I find no anticipation of EU accession, tested as the second lead of the dummy variable for EU. A casual inspection of the Euromoney indices does not show a jump around the time of the EU accession, either. Models 5–6 include the lagged value of the dependent variable on the right-hand side of the equation to control for the inertia in Euromoney country risk ratings. Not surprisingly, the lagged dependent variable is highly significant, reflecting the sluggishness of creditworthiness indices. It did not alter the statistical significance of foreign and south-south banks.

### Robustness checks

In Table 3, I test for the robustness of these results. In order to increase the confidence of results, I employ the yearly average of (log) EMBI global bond spreads (included in the JPMorgan EMBI global index) as an alternative dependent variable (available for seven EE countries). I estimate random-effects models.<sup>21</sup> EMBI indices are the most widely used emerging markets sovereign debt benchmark that measures borrowing costs of governments in credit markets.<sup>22</sup> In the estimation with bond spreads (model 7), foreign banks retain a strong effect on perceived creditworthiness (in a sample more than three times smaller). A high foreign bank market share is associated with lower bond spreads. Other results appear to be consistent with my previous estimates, except for inflation which is no longer significant.<sup>23</sup> The use of the yearly average of (log) 10-year government bond rates (yields in percentage per annum) as the second alternative dependent variable (available for 12 EE countries) did not alter the statistical significance of foreign banks (model 8).<sup>24</sup>

I further investigate the causal claim that foreign bank entry changes risk perception of bond investors. Following Rose (2004), I include two leads and two lags of the principal explanatory variable rather than one year lag (models 9–10). It might be argued that countries have to reform their policies prior to foreign bank entry. These reform policies, rather than foreign bank penetration, might then cause the observed effect of foreign banks on perceived creditworthiness. For instance, if policy reforms are implemented two years prior to foreign bank entry and these

Table 3 Robustness Checks

	Model 7	Model 8	Model 9	Model 10	Model 11
FOREIGN BANK ASSETS	-0.012*** (0.003)	-0.004** (0.001)			0.051*** (0.014)
FOREIGN BANK ASSETS (t + 2)			0.021 (0.013)	0.014 (0.013)	
FOREIGN BANK ASSETS (t - 2)					
PER CAPITA INCOME (log)	-1.245*** (0.157)	0.273 (0.548)	10.087*** (2.526)	13.242*** (2.774)	12.395*** (2.648)
GDP GROWTH	-0.063*** (0.019)	-0.029** (0.009)	0.249*** (0.068)	0.222** (0.072)	0.272*** (0.071)
INFLATION	-0.854 (0.530)	-0.412 (0.539)	-6.983** (2.555)	-6.906* (2.851)	-6.399* (2.719)
EXTERNAL DEBT	0.004* (0.002)	0.001 (0.001)	-0.015 (0.007)	-0.021* (0.008)	-0.022** (0.008)
BOND DEFAULT	0.848*** (0.257)	0.553* (0.242)	-2.693 (1.680)	-3.592* (1.772)	-3.981* (1.730)
DEMOCRACY	-0.025 (0.022)	-0.062 (0.037)	0.430** (0.147)	0.198 (0.156)	0.201 (0.152)
EU REFORMS (t - 2)	-0.031 (0.204)	-0.064 (0.100)	-0.316 (1.075)	0.075 (1.114)	-0.457 (1.080)
R-squared	0.907	0.569	0.644	0.615	0.644
Observations	66	114	287	289	291
Method	RE	FE	FE	FE	FE

Standard errors in parentheses; \* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.001.

reforms improve country creditworthiness, the coefficient on the second lead of foreign bank variable should be significant. However, neither the coefficient on two leads nor the coefficient on two lags is significant at conventional levels, implying that the effect of foreign banks on country creditworthiness materializes *after* rather than prior to their entry. Furthermore, I explore more explicitly whether transition reforms affect the influence of foreign bank penetration on country risk by employing the EBRD transition indicators. These indicators have been used to track reform developments in EE countries in six areas: large and small scale privatization, governance and enterprise restructuring, price liberalization, trade and foreign exchange system, and competition policy.<sup>25</sup> Arguably, if the influence of foreign banks is through their impact on economic and institutional reforms at the onset of their entry, the effect should no longer be possible once I directly control for reforms in regressions. As model 11 shows, the coefficient on the EBRD reform index (two lags) is not significant at conventional levels, while the coefficient on foreign banks retains its strong statistical significance.

### Endogeneity

One obvious problem in my analysis is endogeneity: foreign bank presence may be determined by a host country's perceived creditworthiness, or both are driven by the same, omitted variables. To address endogeneity, I estimate an instrumental variable regression, using the commonly employed instrument in the literature on foreign banks to explain the motives behind their investments in developing countries. Following Detragiache, Tressel and Gupta (2008), I use population size as the measure of potential market size. The assumption behind using the population is that multinational banks can establish a dominant position in small countries by making a relatively small initial investment. I have no reason to assume that population size will have a direct effect on country creditworthiness. Following Beaulieu, Cox and Saiegh (2012), I include GDP in my estimations (instead of GDP per capita) since economic development and democracy are not exogenous to each other. Data come from the World Bank's World Development Indicators.

Table 4 reports the results of the two-stage least squares estimations. In the first-stage regressions, I regress the foreign bank market share on the instrument, and all the other control variables from the second stage. In the first stage, the instrument is highly significant, confirming the strength of the instrument chosen. The *F*-test is considerably larger than the rule of thumb value of 10, allowing the firm rejection of the null hypothesis of weak instruments. The two-stage least squares analysis isolates the exogenous portion of the effect that foreign bank penetration has

**Table 4** Two-stage least squares analysis

	First Stage	Second Stage
POPULATION	-0.000*** (0.000)	
FOREIGN BANK ASSETS (instrumented)		0.647*** (0.112)
GDP (log)	3.230* (1.568)	5.985*** (0.750)
GDP GROWTH	0.029 (0.292)	0.152 (0.190)
INFLATION (log)	-4.010** (1.500)	1.783 (1.046)
EXTERNAL DEBT	0.072* (0.030)	-0.040* (0.021)
BOND DEFAULT	-0.237 (7.608)	-8.349* (3.956)
DEMOCRACY	2.288*** (0.269)	-0.856** (0.301)
EU	12.266** (4.506)	0.680 (3.972)
F-statistic (excluded instruments)	115.836	
p-value of F-test	0.000	
Observations	283	283

Standard errors in parentheses; \*p < 0.05, \*\*p < 0.01, \*\*\*p < 0.001.

on creditworthiness. The results indicate that even adjusting for endogeneity, large market share of foreign banks has a strong, positive influence on the perceptions of creditworthiness of host government by sovereign bond investors.

### EVIDENCE FROM COUNTRY CASES

This section illustrates *how* reputable foreign banks make host country governments credible in international credit markets through the two main channels: by contributing to better regulatory oversight and by providing commitment and external funding. In the selection of case studies I applied the 'diverse-case' method (Gerring, 2006), trying to ensure that the cases represent the full range of variation in the independent and dependent variables. I examine three specific cases involving the elevated presence of foreign banks from Austria (Hungary), Nordic countries (Estonia) and Russia (Ukraine). These cases illuminate the variation between reputable and non-reputable banks. The cases also illustrate temporal elements of variation: the dynamics of foreign bank penetration over time. Hungary was the first to open and benefitted from an early and radical jump in creditworthiness, but has recently experienced quite a substantial decline in foreign bank ownership. Estonia has gradually attained a very high foreign ownership of its banking system that has helped to build its credibility. In Ukraine, foreign bank presence has increased in recent years but the case seems to confirm the hypothesis that foreign banks have a favourable impact on banking sector

development and perceived creditworthiness only after they have attained sufficient market share.

### Hungary

Hungary is a prototypical case of a country that, although it started the transition with large external debts, was able to establish credibility for long-term government borrowing and servicing of public debt in the early years of transition. The presence of major Austrian banks helped the Hungarian government build creditworthiness in sovereign debt markets. The government allowed foreign banks to operate as early as 1985, applying a very liberal licensing policy. But the critical juncture for the development of the banking sector in Hungary were the reforms introduced by the government led by Gyula Horn between 1994 and 1995, when, seeking to build its credibility, it privatized the newly recapitalized banks to foreign investors through 'strategic partnership' (Abel and Siklos, 2004). The newly created State Privatization Agency was mandated to find strategic foreign investors who would take ownership and management control in domestic banks. Because of weak domestic banks and a series of costly but unsuccessful loan consolidation schemes, the government had little choice but to open its banking sector to foreign financiers in spite of domestic opposition (Abel and Siklos, 2004; Majnoni, Shankar and Varhegyi, 2003).<sup>26</sup>

This helped the government reduce the fiscal and quasi-fiscal costs of bank restructuring, which were relatively low: about 12.9 per cent in comparison with 30 per cent for the Czech Republic by the end of 1990s (Tang, Zoli and Klytchnikova, 2000). By 2000, foreign banks owned 85 per cent of all banking assets (Table 5). As McDermott (2007: 238) argued, the new foreign bank owners brought financial stability to the Hungarian banking sector, and new risk management to the newly acquired banks. Furthermore, these international banks, as new owners, put pressure on the Hungarian government to improve the quality of banking supervision and regulation (McDermott, 2007: 238). This resulted in a new banking law in 1996 that fostered a better regulatory framework, as well as consolidation and coordination among different supervisory authorities (McDermott, 2007: 229). So, while the Hungarian approach to banking reforms in the early years of transition was less successful, and led to several bank bailouts, banking stability, supervisory capabilities and prudential regulation improved after the entry of foreign bank investors. The institutional framework of the Hungarian banking sector appears to be on strong footing, according to the EBRD index on banking sector reforms reported in Table 5. Table 5 also shows that banking sector performance indicators improved; for instance, non-performing loans dropped substantially.

**Table 5** Foreign banks and banking development in Hungary, Estonia, and Ukraine

	1995	2000	2005	2010
Foreign banks assets (as% of total assets) <sup>1</sup>				
Hungary	29	85	63	64 (2009)
Estonia	24	98	99	99 (2009)
Ukraine	4	14	28	50.8 (2009)
EBRD index of banking sector reform <sup>2</sup>				
Hungary	3.0	3.7	4.0	3.7
Estonia	3.0	3.7	4.0	4.0
Ukraine	2.0	2.0	2.7	3.0
Nonperforming loans (% of total gross loans) <sup>3</sup>				
Hungary	6.6 (1997)	3.0	2.3	9.8
Estonia	2.4	1.0	0.2	5.4
Ukraine	34.6 (1998)	29.06	19.6	15.3

Notes: (1) Source: Claessens and Van Horen (2011), data for Ukraine for 2009 from EBRD.

(2) The index measures reform progress in the following areas: the liberalization of interest rates and the credit allocation process, the volume of lending to the private sector, private ownership in the banking sector, the degree of bank competition, bank solvency, and the establishment of a framework for regulation and prudential supervision. The indicator can take values between 1 and 4.33, with 1 representing little or no progress, and 4.33 corresponding to the full convergence of banking laws and regulations with BIS standards.

Source: EBRD Transition Reports, various issues. (3) Source: World Bank's World Development Indicators; data for 1995 from the EBRD Transition Reports. The EBRD reports notably different data on non-performing loans for Ukraine: 12.5% for 2000, 2.2% for 2005, and 27.9% for 2009.

In the same time period, the market rate charged to the government fell. For instance, in March 2002, 10-year bonds were yielding 9.62 per cent for Slovenia,<sup>27</sup> compared to 6.94 per cent for Hungary and 5.5 per cent for the Czech Republic (otherwise comparable countries in terms of being leaders in economic and democratic reforms).<sup>28</sup> Foreign bank penetration provided a clear and credible signal that the Hungarian government would be able to honour its commitments to repay its debt. Even though the government has been close to fiscally unsustainable for years (its public debt reached 75 per cent by early 2009), it had no difficulty obtaining external financing through the sales of government bonds to investors (Aslund 2011).<sup>29</sup> It was able to raise more than US\$1 billion annually in the 1990s. The Hungarian government was the biggest sovereign borrower in EE (Bonin and Wachtel, 2003) but it never defaulted on its bank or currency debt.

However, foreign ownership has declined from 85 per cent to 63 per cent between 2000 and 2005 (Table 5). The largest domestic bank, OTP with 26 per cent of market share, has experienced a large deterioration of asset quality and high non-performing loans reaching 19 per cent at the end of 2012, which resulted in a lowering of the bank's credit assessment

by Moody's (MIS, 2013). OTP was privatized in 1995 but its privatization was designed, because of its size and prominence, to avoid foreign domination (Abel and Bonin 2000). Furthermore, the hostile policies of the current government led by Prime Minister Victor Orban negatively affected foreign bankers and tarnished Hungary's reputation as an investor-friendly heaven in EE. These policies included a scheme to force banks to allow early foreign-currency mortgage repayments at government-decreed discounts and a tax levy on banks (at 5 per cent of assets annually). Hungary, therefore, is a case demonstrating that host government's economic policy decisions, when disliked by foreign bankers, can tarnish the country's reputation and result in less favourable treatment in sovereign credit markets.<sup>30</sup>

In sum, the economically destabilizing policies of the current populist government alienated international lenders, worsened the country's fiscal and external financing environment, and thus prompted rating agencies to downgrade the government bonds to junk status, which led to currency depreciation (Ewing and Karasz, 2012). As a Moody's analyst pointed out, recent downgrades of Hungary's sovereign debt to investment threshold were 'primarily driven by the Hungarian government's gradual but significant loss of financial strength... As a consequence, the country's structural budget deficit is set to deteriorate'.<sup>31</sup> The major uncertainty appears to be centred on OTP and other banks without a western parent bank, because their potential bailout would seriously overstretch government finances, given the already high public debt (Walker, 2008). Furthermore, the 2008 global credit crisis has increased the risk aversion of investors, so that the sovereign debts of countries that prior to the crisis investors considered to be hardly risky at all were suddenly charged large 'panic risk premiums' (Marer, 2010: 21).

Nonetheless, in spite of these negative developments, foreign bank presence has again proven to be valuable to Hungary. Moody's identified foreign bank penetration as 'a major stabilizing factor' for the Hungarian banking system that could help to restore the government's creditworthiness.<sup>32</sup> The major Austrian banks still control the largest Hungarian banks, and hold 21 per cent of total assets (Table 6). To maintain their reputation, foreign parent banks have repeatedly assured the solvency of their Hungarian subsidiaries. For instance, when the Hungarian brokerage subsidiaries of foreign banks experienced substantial losses due to the contagion from the 1998 Russian financial crisis, parent banks quickly injected capital. Similarly, during the 2008 crisis, parent banks pledged to ensure a 'prudent capitalization of their subsidiaries' and to maintain at least 95 per cent of their exposure (De Haas *et al.*, 2012: 8).

**Table 6** Market shares (per cent of total assets) of top multinational banks in EE in 2011

Country	Bank Name	Market Share (%)	Rank	Parent Bank/Country
Hungary	OTP	19.3	1	Hungary
	Erste	9.3	2	Erste/Austria
	K&H	8.3		KBC/Belgium
	MKB	7.7	3	Bayerische Landesbanken/ Germany
	CIB	7.2		Intesa/Italy
	Raiffeisen	6.7		Raiffeisen/Austria
	UniCredit Bank Hungary	5.0		UniCredit Bank Austria/ Austria
	Estonia	Swedbank	49	1
SEB Pank		21.1	2	Sweden
Sampo Pank		11.9		Sampo Pank(Danske Bank)/Denmark
Nordea Bank Finland		11.2		Nordea Bank /Sweden, Finland, Denmark, Norway
Ukraine	PrivatBank	13.7		Ukraine
	Ukreximbank	7.1		Ukraine
	Oshadbank	7.0		Ukraine
	Raiffeisen Bank Aval	4.9	3	Raiffeisen/ Austria
	Ukrsotsbank	3.8		UniCredit Bank Austria/ Austria
	Prominvestbank	3.6		Ukraine

Source: Raiffeisen (2012), OECD (2011).

### Estonia

Estonia could be used as the paradigmatic case of a newly established country in which the transformation of the financial system from state owned to foreign owned (99 per cent in 2009 as Table 5 shows) resulted in greatly improved creditworthiness and access to sovereign credit markets. In contrast to Hungary, Estonia was a fully developed communist state along the standard Soviet lines. It was among the first Soviet republics to break away from the former Soviet Union, but given its historical legacy, it started the transition with no reputation in international markets. In the chaotic institutional and hyperinflationary environment prior to regaining monetary independence from the rouble zone in 1992, banking became a lucrative business in Estonia. Most state-owned banks earned most of their profits from foreign currency speculations and short-term foreign trade arbitrage transactions between the USSR and the West (Barisitz, 2002: 85). With lax or non-existent banking supervision, few restrictions were placed

on such speculations. As a result, big state-owned enterprises, enriched by speculations in a weakly regulated environment, were able with relatively little money to create their own banks, or grab the branches of all-USSR banks and exploit their resources to finance their own activities (Hanson, 1995; Sorg, 1998: 170–2). Resulting bad loan portfolios and mismatches on balance sheets caused liquidity problems in several banks, leading to the first banking crisis in 1992–93.

The Mart Laar government (1992–94) was determined to cut ties with incumbent interests from the socialist era, and so it committed to rapid privatization of banks and enterprises early in the transition.<sup>33</sup> A legal framework for foreign direct investments was adopted a few months after the country regained its independence in 1991, which turned Estonia into the ‘Hong Kong of Europe’. The liberal foreign investment and trade regimes as well as the privatization of banks and enterprises to foreign investors enabled the government to break decisively with the communist legacy. Although the government allowed foreign strategic investments in the banking sector right from the beginning, with the intention to privatize state-owned banks to foreigners, there was a lack of foreign interest initially. The government, in turn, did not have the financial resources to recapitalize domestic banks to make them more attractive (Sorg, 1994). In the end, a few foreign players bought shares in Estonian banks, holding about 24 per cent of total assets in the early 1990s (Table 5).<sup>34</sup>

Nonetheless, by the end of the 1990s, the privatization of Estonian government-owned banks to foreign banks was complete. Foreign, mainly Swedish and Finish, banks acquired nearly 98 per cent of the market share (Tables 5 and 6). Swedbank with 49 per cent market share is the most important player. While during the first banking crisis the domestic monetary authorities had to resolve bank problems, during the second banking crisis in 1998–99 (caused mainly by the financial contagion from Russia), foreign banks assisted in putting the Estonian banking system in order (Sorg and Uiboupin, 2004). The Estonian authorities used this crisis to reinforce supervisory institutions further. Following the German model, the government created a unified financial supervision (banking, insurance and securities markets), which was taken over by the Estonian Financial Supervision Authority in 2002.<sup>35</sup> The takeover of Estonian banks by Nordic banking groups was accompanied by substantial capital and liquidity injections, as well as by improvements in banking regulation and supervision. It has also led to intensified competition in the banking sector, improved transparency, and risk management, as the continuous improvement of the EBRD banking reform index demonstrates (Table 5). According to the International Monetary Fund’s (IMF) Report on the Observance of Standards and Codes, the quality of supervision in Estonia was considered to be comparable to that of the

most developed countries already in 2001 (Adahl, 2002). As a result, non-performing loans decreased to one per cent by 2000 (Table 5). The substantial foreign bank penetration enhanced the credibility of Estonian government whose 10-year bonds were yielding 8.4 per cent in 2002, only slightly more than Hungarian bonds yielding 7.8 per cent. Euro-money's risk rating for Estonia was also similar to that of Hungary.

Just as Estonia is dependent on the health and strategy of Swedish banks, the reputation of the parent banks also depends on the performance of their Baltic subsidiaries. During the 2008 global credit crisis, Estonia relied on the direct support of parent banks, and obtained a direct precautionary swap line with the Swedish Riksbank in March 2009 to meet any liquidity needs and insure against a depositors' run on its banks (Ingves, 2010). The Swedish government was also aware that the situation in the Baltic countries was important to the stability of the Swedish financial system; therefore it contributed large sums to international efforts to help these countries, not only Swedish banks (Dougherty, 2009). This prevented the deterioration of creditworthiness of the Estonian government, whose credit rating by Standard & Poor's was raised to A (from A-) in June 2010.

### Ukraine

Ukraine is an example of a country whose government has lacked credibility as a borrower due to its history of failed institutions and policies, resulting in hyperinflation, banking crises and debt defaults throughout most of the transition. As a result of bad economic policies, in 1993–94 Ukraine had the worst inflationary experience in the ex-Soviet Union: inflation peaked at more than 10,000 per cent and led to the biggest economic downturn in the history of the country, with a 23 per cent decrease in real output (Petryk, 2006). Throughout most of the 1990s, Ukraine's financial sector remained strongly dominated by the so-called 'pocket banks' or 'agent banks', which were the extended financial departments of owner firms, frequently engaged in connected lending (Barisitz, 2006).

The population had little trust in domestic banks because of the losses it had to endure during the hyperinflation period, and because of the general fragility of the financial sector (Barisitz, 2006: 66). Suffering from increased credit risk shortly after the Ukrainian government defaulted on its foreign debt in 1998–2000, financial markets lost confidence and investors started to sell the Ukrainian Treasury bills. This precipitated a fiscal crisis. The average EMBI global spreads for 2000 peaked at 1,784 basis points. The government tried to prevent an immediate default on its debt by entering into restructuring negotiations with Treasury bill holders (Barisitz, 2006: 67). In 2000, a more reform-oriented government

came to power and adopted the new Law on Banks and Banking Activity, which aimed to strengthen the regulatory activity of the central bank and improve the regulatory standards for commercial banks. Nonetheless, insider practices continued and non-performing loans remained high (Table 5).

Ukraine's case demonstrates, as Tschoegl (2003: 222) argued, that the positive effects of foreign bank presence can be constrained only by their relatively small market share. Austrian banks were among the earliest to enter the Ukrainian market. By the end of 2004, of the western banking groups, only Raiffeisen was among the relatively important players; while ING Bank, Citibank Ukraine and HVB Bank Ukraine ranked among the top 20 (Barisitz, 2006).<sup>36</sup> Although foreign bank ownership attained 50 per cent in 2010, it decreased to 37 per cent by the end of 2011 (Raiffeisen Research, 2012). The lack of creditworthiness of Ukraine's government can be linked not only to the relatively low overall presence of foreign banks (the average market share of foreign banks was about 22 per cent) but also to the fact that the top foreign bank investors are less reputable banks. The major Russian banks – Sberbank, Alfa Bank and VTB – are among the leading banks in Ukraine.

Consequently, the banking system of Ukraine is on a much weaker footing than that of Hungary or Estonia: related-party practices remain widespread; creditor rights and banking supervision are weak; bank risk management and loan practices are underdeveloped; and the enterprise sector is opaque, impeding banks' risk assessment. All of this indicates that the banking system may not be resilient to systemic banking crisis (Duenwald, Georguiev and Schaechter, 2005). Some benefits of foreign bank ownership have been transferred to Ukraine, however. As Table 5 shows, the EBRD index of banking sector reform has slightly improved in recent years, also under the influence of foreign bank investors that started to move in particularly in the mid-2000s. Similarly, the country credit risk has decreased as evidenced by an eightfold decrease in the average EMBI global spreads between 2000 and 2007.

Nevertheless, due to limited improvements in financial sector quality and solvency, the two top Ukrainian banks missed payments on their debt obligations, which resulted in rating downgrades at the height of the global financial crisis (Olearchyk, 2009). In February 2009, Standard & Poor's downgraded Ukraine's long-term sovereign foreign currency rating to non-investment grade, suggesting that the country was 'vulnerable to non-repayment' of its external debt. Some smaller banks that defaulted on inter-bank credit markets were closed and the government saved or nationalized most medium-sized banks that were experiencing financial difficulties. By mid-2009, the costs of bank restructuring were estimated at about 5 per cent of GDP, but the total costs may have reached twice that level (IMF, 2009: 22). Repeated bailouts of

domestic banks resulted in deteriorated fiscal accounts: in 2009, the central government deficit reached 11 per cent and external debt peaked at 174 per cent of GDP.<sup>37</sup>

The increased, albeit limited, presence of reputable western banks has proven to be a source of strength for the Ukrainian banking markets. Since late 2008, the Ukrainian government has been unable to borrow on international capital markets, but foreign parent banks injected the necessary capital to their subsidiaries, and direct credit lines from foreign banks were rolled over. Thus sustained support and commitment by foreign, mainly Austrian, parent banks has been seen as one of the most important stabilizing factors in the 2008 crisis (Barisitz and Lahnsteiner, 2009).<sup>38</sup> Foreign banks remained committed to the Ukrainian market in order to retain their reputation in the region, in spite of its riskiness due to the country's bad economic policies, politically unstable environment and regulation protecting domestic banks.<sup>39</sup>

#### **The financial crisis of 2008: reputation amidst uncertainty<sup>40</sup>**

As Bonin (2010) noted, the 2008 global credit crisis became 'a stress test' for commitments of foreign banks in EE, since tighter funding constraints raised concerns about their large, uncoordinated withdrawal.<sup>41</sup> But these fears did not materialize. Western European parent banks continue to pursue a long-term commitment strategy in their EE hosts (Bonin, 2010), perceiving them as an extension of their home markets or as 'second home markets' (Winkler, 2009; Epstein, in this volume). Mindful of the reputational risk and the damage to their long-term business plans, the western parent banks supplied their subsidiaries in EE with liquidity and attenuated bank-lending outflows (Berglof *et al.*, 2009). As part of the 2009 Vienna Initiative, 17 major multinational banks entered into non-legally binding agreements made on a voluntary basis to support their subsidiaries in EE during the global credit crisis. This solved the prisoner's dilemma problem among foreign bank investors in EE.<sup>42</sup> As Epstein in this volume argues, the Vienna Initiative was in fact derivative of the investment strategies of multinational banks, who tried to use it to constrain host regulators from further raising capital and liquidity requirements, and to signal credibility to international creditors that the EE region was not vulnerable to bank failures and economic collapse.

As a result, the countries with high foreign bank penetration experienced a relatively stable pattern of cross-border lending during the global crisis, although the stabilizing impact tended to depend on the relative strength and soundness of the parent banks (Vogel and Winkler, 2010; De Haas *et al.*, 2012). However, an intensification of the euro area crisis put additional pressures on parent banks for higher capitalization.

Funding from parent banks has been moderately declining since the end of 2011, also due to deleveraging driven by less reputable parents, such as Greek banks in Romania (IMF, 2012).<sup>43</sup> Therefore, a new coordination agreement between government officials and multinational banks – ‘Vienna 2.0’ – has been concluded, seeking to avoid disorderly deleveraging in EE and achieve better coordination among bank regulators to minimize cross-border systemic risk.

## CONCLUSION

What are the sources of the credibility of nation states in sovereign debt markets? Investors’ perception of credit risk in sovereign lending is important because these perceptions affect both the supply and costs of sovereign credit (Brewer and Rivoli, 1990). In this study, I suggest that the perceived creditworthiness of many transition countries’ governments rests on a transfer of reputational capital from the prestigious multinational banks as foreign direct investors. The entry of reputable foreign banks serves as shorthand for understanding the strength of financial regulation and supervision in a host economy. It also involves the transfer of the lender of last resort to the foreign parent bank. Foreign bank penetration thus creates expectations about a host country’s capacity to repay its sovereign debt.

Using data for 23 transition economies and the period 1996–2009, my empirical results provide support for the argument stressing the exogenous effect of foreign financiers on perceived creditworthiness of sovereign governments by international investors, here proxied by country risk ratings. The results are robust to instrumental variable analysis and the inclusion of a number of controls for alternative determinants of investors’ country risk perceptions. The evidence on three country cases – Hungary, Estonia and Ukraine – provides additional support for this proposition. This study also shows that the international conditions matter, too. The 2008 global credit crisis and the euro area crisis increased the risks of unforeseen shocks and sudden shifts in investor confidence in the credibility of sovereign borrowers, thus an increase in sovereign bond yield spreads even in the absence of observable changes in banking sector characteristics or fundamentals.

My analysis has implications for future research. This article contributes to theoretical debates on the sources of credible commitment in international economy. Its findings extend the scholarship on reputation and credibility in international lending and borrowing. In Tomz’s (2007) dynamic theory of reputation, investors continually update their beliefs about foreign governments’ preferences, abilities, and their debtors’ record of repayment. These evolving impressions of investors constitute the borrower’s reputation in the eyes of international investors. While Tomz’s

reputational theory allows for reputational ‘destructions’ as well as ‘recovery’, by allowing for political change, the analysis presented here leads us to recognize that reputable foreign bank investors can infuse credibility to host countries, helping prospective or new sovereign borrowers to raise capital on international markets. Further research may identify alternative exogenous sources of credible commitment in international financial markets for countries suffering from reputational problems.

Second, it should be noted that investors and financial markets tend to be more responsive to the mere presence of foreign banks in transition and developing countries, rather than to their actual behaviour, and the impact of these banks on the likelihood that a host government will comply with sovereign debt obligations. Investors’ behaviour reflects the thinking that foreign banks encourage better policies and institutions. But the global financial crisis may have put some clouds over this assumption. Future research could explore the limits of credibility transfer from foreign banks to their hosts.

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### NOTES

1. I have borrowed the term ‘perceived creditworthiness’ from Brewer and Rivoli (1990).
2. Tomz (2007: 42) shows that investors charged 25 per cent more to new borrowers than to seasoned borrowers in the eighteenth-century Amsterdam market.
3. I thank Matthew Mahutga for the suggestion of this term.
4. A branch is an integral part of the foreign group and not a stand-alone entity, and is subject to the home country’s supervisory authorities. A subsidiary is a separate entity from its parent bank. According to the Basel Concordat of 1975, host and parent country supervisory authorities are jointly responsible for supervision and solvency of subsidiaries. Although in theory branches and subsidiaries involve a different parent bank responsibility and liquidity assistance, in practice the difference between them is often blurred. For a discussion of branches versus subsidiaries, see Tschoegl (2003) and Cerutti, Dell’Ariccia and Soledad Martinez Peria (2007).
5. Home country regulations applicable to a bank holding company affect the operations of its subsidiaries located in foreign countries (Cárdenas, Graf

and O'Dogherty, 2003). Furthermore, given that foreign subsidiaries operate in riskier economic environments, they tend to have higher capital and reserve requirements than branches (Cerutti, Dell'Araccia and Soledad Martinez Peria, 2007: 1675).

6. Over time, as host country's regulatory and supervisory framework strengthens, host authorities may occasionally tighten formal regulatory measures for foreign subsidiaries. For instance, during the first phase of the 2008 financial crisis, the Polish and Czech authorities increased capital and liquidity ratios for all banks under their jurisdiction, including foreign subsidiaries.
7. Gerlach, Schulz and Wolf (2010) find that countries with large banking sectors and low equity ratios exhibit higher yield spreads because investors expect bank rescues to be financed by government deficit spending.
8. Foreign banks rarely entered the EE markets through branches, despite the fact that local regulatory authorities did not impose any specific regulatory restrictions. One plausible explanation may be that branches are sensitive to the location-specific risk, and they thus tend to prevail in developed countries, while a parent bank tends to establish a subsidiary in more risky economic environments (Tschögl, 2003). This seems to correspond to the strategy adopted by Raiffeisen and other Austrian banks, which established branches and investment banking in Western Europe and subsidiaries in EE. Author's interview with a banker at Raiffeisen, 24 July 2012, Vienna.
9. While the investment strategies pursued by the largest Austrian banks focused on the acquisition of low-risk customers and large-volume transactions (Majnoni, Shankar and Varhegyi, 2003: 10), Hypo Group Alpe Adria, which was majority owned by BayernLB, a state-controlled German bank, engaged in more risky behaviour. The bank has pursued an aggressive growth strategy aimed at taking advantage of the rapidly growing markets in South-Eastern Europe without proper risk management. It experienced the sharp increase in non-performing loans (38 per cent) as a result of excessive credit exposures to EE (MIS, 2012). The Austrian government nationalized the bank in 2009 to prevent its collapse and destabilization of host countries. I am thankful to an anonymous reviewer for pointing this out.
10. Data come from Raiffeisen Research (2012).
11. Author's interview with a banker from Erste, 24 July 2012, Vienna.
12. The historical information on these banks was taken from their official websites.
13. The new supervisory guidelines – the so-called 'Austrian Finish' – of March 2012 recommend limiting new lending in EE to 110 per cent of local deposits, plus funding in local capital markets.
14. Author's interview with a banker from Raiffeisen, 24 July 2012, Vienna.
15. Perceived country creditworthiness in financial markets has been measured by country risk ratings, secondary market debt prices and risk premiums charged on sovereign loans (Brewer and Rivoli, 1990: 358).
16. The Euromoney ratings are highly correlated with another frequently used measure of country creditworthiness, the Institutional Investor's credit ratings (Gordon and Palmer, 1989; Brewer and Rivoli, 1990). The Institutional Investor country credit scores represent personalized assessments of sovereign risk analysts at major international banks.
17. Following Dreher and Voigt (2011), I transformed inflation by using the formula  $(\pi/100)/(1 + (\pi/100))$  to ensure that a few high-inflation observations do not drive the regression results.
18. Default, Transition, and Recovery: Sovereign Defaults and Rating Transition Data, 2010 Update, Standard & Poor's Global Credit Portal (February 23,

- 2011) and Sovereign Defaults at 26-Year Low, to Show Little Change in 2007, Standard and Poor's Global Credit Portal (September 8, 2006)
19. The Hausman tests suggest that the country-specific error is correlated with the regressors, indicating the need for fixed effects.
  20. The test for time-fixed effects rejects that all year coefficients are jointly equal to 0, therefore confirming that time effects are needed.
  21. The model passes the Hausman test, which suggests that random effects are appropriate. The model does not include year effects.
  22. The EMBI includes US dollar-denominated Brady bonds, Eurobonds and traded loans issued by sovereign governments. I thank Ugo Panizza and Jiri Jonas for generously sharing the data on EMBI global bond spreads.
  23. Beyond the set of core explanatory variables, I have also included the central government balance to GDP and current account, and obtained similar results. The results are also robust to alternative estimation techniques. Results on these robustness checks are available from the author.
  24. An independent year effect was taken by adding time trend instead of year dummies to the regression. Data come from the Global Financial Database.
  25. These indicators range from 1 to 4.33, where 1 represents little or no change from a centrally planned economy and 4.33 represents the standards of a market economy.
  26. Some argue that the Hungarian enterprise privatization strategy, which had already started under the first post-communist government of Antal in 1990, was determined by the need to obtain revenues to repay the country's large external debt to private banks (Drahokoupil, 2008). It should be noted, however, that Hungary has suffered from large external debt throughout the transition. Although the ratio of external debt to exports decreased from 162 per cent to 86 per cent between 1995 and 2000, it has subsequently increased to 179 per cent in 2009, according to the World Bank.
  27. As Aslund (2013) argues, Slovenia's post-communist transition has been an 'anomaly'. It had undertaken most market reforms during communism, and less after communism's collapse. The Slovenian banking sector remained mostly domestically owned. The small foreign bank penetration did not protect the country from the crisis, however. On the contrary, the problems in poorly managed state banks led to a recent systemic banking crisis.
  28. Data come from the European Central Bank.
  29. It is plausible that in part this was because of the IMF assistance in 2008–09 that reassured investors. I thank Rachel Epstein for this comment.
  30. This example illustrates the role of 'biased learning' in reputation, as theorized by Mercer (quoted in Tomz, 2007: 28–31), underlying that investors update their beliefs about a foreign government only when the government acts against investors' interests.
  31. 'Moody's Lowers Hungary to Investment Threshold', *M2 EquityBites*, London, 7 December 2010.
  32. *Intellinews-Hungary Today*, Beverly, USA, 2011.
  33. Author's interview with Mart Laar, former prime minister of Estonia, 19 July 2007, Tallinn.
  34. American Bank of the Baltics, with a US owner received a licence, in 1992 and INKO Baltic Bank, a subsidiary bank of the Ukrainian bank, in 1994 (Sorg and Uiboupin, 2004: 266).
  35. Author's interview with Raul Malmstein, chairman of the Estonian Financial Supervision Authority, 17 July 2007, Tallinn.

36. Raiffeisen, which was the pioneer among foreign bank investors, took over 90 per cent of the Ukraine's second largest bank, Bank Aval, in 2005. By 2011, Raiffeisen had nearly 5 per cent market share (Table 5).
37. Data come from the World Bank's World Development Indicators.
38. Ukraine has also benefited from the IMF Stand-By Arrangement to help the stabilization of the banking sector.
39. Author's interview with a banker from Erste, 24 July 2012, Vienna.
40. I have borrowed the title from Bonin (2010).
41. Foreign banks have been important channels of loans in foreign currency, which contributed to the rapid expansion of credit in some EE countries (e.g. Hungary, Romania and the Baltic countries). But Åslund (2011: 378) noted that in most EE countries the overall credit volume remained relatively small as a share of GDP, given their initial levels of financial development. None of these countries had high leverage, subprime mortgages or other types of toxic assets. Interestingly, foreign-currency denominated debt remained low in the Czech Republic and Slovakia with high foreign bank penetration, while it was high in Slovenia with low foreign bank presence.
42. Author's interview with a banker at Raiffeisen, 24 July 2012, Vienna.
43. Ukraine, Latvia and Hungary experienced higher declines in foreign bank deleveraging than the EE average between 2008 and 2012: 53 per cent, 38 per cent, and 38 per cent, respectively (IMF, 2012). But the foreign bank ownership in these countries was also lower (50 per cent, 66 per cent and 64 per cent in 2009, respectively) and the market share of less reputable banks higher. I am thankful to an anonymous reviewer for pointing to the trends in foreign bank deleveraging.

## NOTES ON CONTRIBUTOR

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