1 Introduction

This chapter traces the evolution of the financial system in the former socialist countries of Central and Eastern Europe (CEE) as they prepared themselves for entry into the European Union (EU). While it has often been asserted that EU accession has provided these countries with an important outside anchor (Berglöf and Bolton 2002), the analysis presented here suggests that the integration process also put these countries at great financial risk—one that materialized during the global financial crisis. Using the crisis as a starting point this chapter reflects on twenty years of transition in CEE and the governance void in matters of finance that it has created.

A functioning market-based economy depends on a well-working financial system—that is, on organizations that intermediate between savings and investments and allocate resources, as well as on institutional arrangements that mitigate the risk of collapse associated with complex financial systems. The former socialist countries of CEE possessed certain elements of a financial system, such as savings banks and organizations used by the government to store and to channel money; however, intermediation and allocation functions were centrally controlled and not left to autonomous actors. This arrangement was consistent with the organizational features of a centrally planned economy, but it was unsuitable for decentralized economies that relied increasingly on market mechanisms. For such economies to work, a new set of arrangements had to be found that allowed for greater dispersion of financial services combined with effective checks and balances to guard against the risk of systemic failure.

The story of the transformation of the financial sector in CEE from plan to market has often been told (Rostowski 1995; Buch 1996; Tihanyi and Hegarty 2007) so will not be recounted here. Nonetheless, recalling how finances were organized under socialist regimes serves to illustrate that the operation of financial systems is closely intertwined with the organization of the economies and the prevailing governance regime. The organization of
finance takes one form under one regime and quite a different form under another. Market economies are commonly distinguished by the organization of their financial systems, whether they are predominantly market- or bank-based (Mayer 1998; Allen and Gale 2001). Both systems have their distinct institutional arrangements designed to address the specific vulnerabilities inherent in them. Market-based systems are vulnerable to the existence of stock market bubbles, which may result in a crash. Bank-based systems have a high probability of suffering from bank failures and from the cyclical nature of credit booms and busts. Most economies have both stock markets and banks (Levine 2003) and thus are, albeit to varying degrees, vulnerable to either shock.

The history of financial markets is a history of crises (Kindelberger 2005; Minsky 1986), but it is equally a history of attempts to mend the institutional arrangements that prevent them. Often overlooked is that crisis management itself is a critical part of the governance regime for financial markets—arguably the most important one. Once one recognizes that financial markets are inherently instable,\(^1\) crisis management becomes an integral part of the governance of finance; it shapes the future behaviour of market participants—a fact that is widely acknowledged in concerns about the moral hazard associated with government bailouts. More importantly, it reveals who is the ultimate guardian of the financial system: whoever has the resources to rescue a financial system and as such is capable of setting the terms of the rescue deal. This role is typically denoted as ‘lender of last resort’. In the context of the global crisis, the role has morphed into ‘investor of last resort’ and even into the all-encompassing ‘whatever it takes’ (Andrews 2009)—a commitment that is more appropriately labelled as ‘ultimate guardian’. Using the guardian metaphor also emphasizes that crisis management is not about the bailing-out of individual banks or other intermediaries but is an attempt to prevent a collapse of the financial system.

This chapter argues that the designation of the ultimate guardian is the result of policy choices about the governance of finance. These include decisions about liberalizing capital accounts or not; building or not building reserves for ‘rainy days’; pegging, floating, or managing the domestic currency; allowing foreign bank ownership/dominance, or restricting it; and accepting or rejecting the principle of home country regulation for foreign banks operating on one’s territory. These decisions are not necessarily made for the purpose of outsourcing the function of the ultimate guardian. In fact, most made by countries in CEE were predetermined by the regional or global governance regimes they joined. The combined effect of these policies, however, has disabled governments in most CEE countries from protecting their economies against a looming crisis, as evidenced by their ultimately unsuccessful attempts to control the credit boom in the years leading up to the crisis; once the crisis erupted, causing the drying-up of external finance, they