

INTERNATIONAL BANKS IN THE BALTIC STATES: ASPECTS OF GROWTH SUSTAINABILITY

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Abstract. The internationalization practice of the financial institutions has been intensively studied since the 1960s. Due to the increase in international capital flows, foreign direct investments and international trade at that time active development of international or cross-border banking began. At the moment the world is undergoing a very complex process with a high uncertainty in the global banking and financial markets. This article focuses on the banking sector development and some aspects of management of commercial banks in Lithuania and other two Baltic countries. The main subject of the paper is to comparatively analyze the inwards and outwards development in the international banking. The main stress is oriented to aggregated credit enlargements in the Baltic States during the period of the first decade in the 21st century. Commercial banks during the last global economic crisis have been looking for a possible optimization of activities and consequent changes in their networks could be an option for its development assessment. However, the priority could be to identify the cross-border international credit expansion in the Baltic countries. On the other hand, these activities are relied to the countries' macroeconomic indicators and mainly to the accumulated money supply. There is a scientific self-determination described in this paper in line with the analysis identifying the particular Baltic countries in the dynamics of accumulated deposits and credits of international banks. Subsequently it increased the growth of money supply. Nowadays banks are required to make sensible strategic decisions in order to keep sustainable banking businesses in the future. However, influences of the financial institutions to the global economical recession affect international banks creating negative feedback to their previous problems.

Keywords: International Banking, Central Banks, Baltic States, Sustainable Credit Expansion, Money Supply.

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1. Introduction

In the post-communist transitional countries, international banks have been operating only since the beginning of the 1990s, after a significant liberalization of the financial market and elimination of entry barriers. Growing foreign ownership in the banking sector raises several interesting questions about the role of foreign banks in transitional economies. There is an extensive literature analysing the impact of foreign banks on the stability of less developed banking markets (Dages et al. 2000, Buch et al. 2003). The studies about the effects of foreign banks in the Baltic transitional region have been mainly descriptive.

Currently complicated processes with high uncertainty in the global banking and financial markets are

generally discussed in nowadays economic literature. The wave of this financial distress reached Lithuania and its Baltic neighbours as well. Moreover, the situation in financial markets of small open economy should be seen as one of the country's economic security and even national security factors. To that extent, the threat is real when commercial banks have liquidity problems or central banks open discussions about the monetary policy change and currency devaluation.

Generally a profit-seeking institution and a commercial bank, is always looking for a solution how to increase its profits and thus assumes a certain level of risk. Sustainable macro-economic point of view of such activities often does not assess risk in any of the money supply increase and in a disproportionate impact for emerging markets. This can be achieved

based on the principle of financial management - the risk must be compensated for the additional profitability. The more return per unit of risk, the more credit is efficient. In general, the risk is transferred to all the country's economic growth sustainable threats.

The onset of the global financial crisis often addresses the problems associated with the international banking infrastructure and its impact on the national macro-economic processes. Now, recognizing that real estate prices for a sharp growth, as the price index rising, high value commercial banks have created money supply growth, which was virtually out of control the central banks in Lithuania and Latvia in particular cases.

The problem is that internationalization of banks had several meanings in different periods. Foreign direct investment in credit institution is not only financial resources, new technologies, access to markets but also the greater potential for development, more reliable risk management and new added value. Moreover, so far many economies have been dependent on foreign direct investment flows in the field of commercial banking. However, besides the positive aspects negative effects occur. Especially when the Baltic countries do not have really independent central banks, such as their monetary policy that is restricted by currency board arrangements (CBA) (it was also the case in Estonia before 2011). Therefore, countries' dominant commercial banks take over the central bank role in regulating money supply and demand. In the absence of a serious interest in the country's macroeconomic stability, the following international banks maximize their profits and increase supply of money by widely giving cross-border credit from primary banks funds. Such a scenario has long been expected, but now it may be confirmed by realistic figures.

The research object is an internationalization of credit institutions and development of money flows during the economic boom. In addition, the object is to analyse the empirical data from the Baltic countries concerning credit expansion that has been based not only on local monetary resources. Moreover, the last object is to evaluate the changes in the global cross-border flows of credit in the Baltic States.

Research target: to review foreign banks' structure and investment dynamics in the Baltics after the unification with the EU; to outline credit institution's infrastructure changes related to their expansion strategies; to overview central banks' policies in

global and local aspects; to assess the international banks responsibility to the sustainable growth in the new markets on the basis of deposit and loan ratios.

Research methods are systematic analysis of statistical data and scientific literature and general and comparative analysis. Moreover, the research methods analyzing more general context can be divided into three main groups. Quantitative methods focus mainly on the theories and assumptions of potential claim, qualitative methods focus on new theories and application of knowledge, hybrid methods use both approaches and are partly used in this investigation. Quantitative methods are based on the present case when larger amounts of banks' data are analyzed using statistical methods and mathematical adjustments (Spitzlinger 2006). Thus, a mixed mode between the two extreme cases of choice is mainly applied in this paper. A comparative analysis between the three Baltic countries is also used.

2. Contemporary Situation in the Banking System

Internationalization of banks had several meanings in different periods. Some authors (Edwards 1975) defined multinational banks as the ones operating in the Euro markets. Other economists (Aliber 1984) suggested that there are quite a few banks that are truly international and the majority of international banks are just domestic banks with branches abroad. Distinction has to be made between the internationalization of a single bank and the whole banking sector of the country (Uiboupin 2003). Depending on the research approach, either the internationalization of a single bank or the internationalization level of the entire banking sector can be of interest. When there is a definition such as internationalization of the banking sector, one can distinguish between inward and outward internationalization. The term *inward internationalization* is used when either foreign institution settles in a place, country or region or when activities in that country or region are mainly expressed in foreign currencies. *Outward internationalization* can be defined as the establishment of the banking institutions of a given country in other countries (Pintjens 1994). It is possible to calculate both sides of the internationalization of a given country proceeding from several criteria.

- The importance of the credit sector in the economy of a country could be measured as full amount. This

can be calculated by dividing the balance sheet total of the whole banking or credit sector by the gross national product of the country. This criterion is not a true indicator of internationalization, but it indicates the size of the financial sector in relation to the economy as a whole. If this rate is high, then there are comparatively few restrictions to banking on the part of the country. This measure, certainly, has its limitations, especially in small and open economies such as Lithuania, Latvia and Estonia. Therefore, it is easier to produce financial volume than goods and services.

- The volume of banking claims in foreign countries. This symbol determines market share in the world market. The inadequacy of this measure is that banking claims in foreign countries are not the only determinants of the size of international centres. Also non-intermediation that has been very important in recent years has developed at the cost of direct credit granting.
- The share of banking claims in foreign countries to the percentage of total banking claims. This ratio states the degree of openness of the banking sector in a given country.
- Structure of an institution's balance sheet. Here the proportion of international gross positions is taken into account.
- The quantity of foreign banking institutions. A high number of foreign banks and their branches reflect the importance and attractiveness of a banking market. In the current publication the number of banks and their branches is used as a measure of foreign banks' entry. Moreover, this measure is widely used in many empirical studies about the internationalization of banks (Hermes, 2003).
- The share of foreign banks' assets in the total banking market assets. This is a most frequently used measure of banking market internationalization reflecting the penetration of foreign banks in a country.

All the above criteria measure inward internationalization; however, outward internationalization can be measured additionally. The importance of the domestic banks in foreign and international financial markets reflects outward internationalization. One possible criterion of the outward internationalization is the number of foreign outlets of banks (Uiboupin 2003). There could be four levels of the internationalization of the financial services sector (Pintjens 1994). In the first position, banks act as in-

termediaries for international payments. This is their traditional function. The second level is attracting liabilities in foreign currencies. This is the internationalization of the liabilities side of a bank's balance sheet leading to credit granting in foreign currencies. The internationalization of the assets side of a bank's balance sheet is the third level. The fourth level is the provision of certain international financial services, such as participation in international bond issues and intermediation of international investments. Moreover, globalization of banking can also be characterized as the process of expanding banking activity abroad and replacing domestic banking business content by international content (Taeho1993). In current paper the globalization and internationalization of banks is described as enlargement of banks' movements into foreign markets by setting up controlled units in foreign countries. Thus, the cross-border lending is not considered as a form of internalization but only foreign enlargement of a bank that is realized through foreign direct investments. Banks can be illustrated as four dimensional structures. If we refer to the international business activities of banks subsequently the national boundaries become a critical measure which defines the country of origin by which a bank is licensed; the host countries in which the credit institution's facilities are located; the countries in which the bank's clients live; and the national currencies in which the banking services are denominated. Therefore, the dimensions of a bank are:

- The parent organization O_i , licensed in country i , can be a bank holding company or a commercial bank. A bank holding company is a company which controls at least one bank by its share ownership or its power to elect a majority of members of the bank board;
- The banking facility B_j , located in country j , produces banking services. If the banking institution has facilities that produce banking services in two or more countries, it is a multinational bank.
- The customers of C_k banking services, residing in country k , may be classified into government units, financial institutions, non-banking business firms and individual households.
- The banking products P_m , denominated in national currency m , can be classified into three categories: asset-based products, liability-based products, and fee-based products.

Consequently international banking contains four

dimensions: $\{O_i, B_j, C_k, P_m\}$. If a minimum one subscript is different from the rest, it is an international banking service. As a result, it can be said that purely domestic banking is a special case of international banking – where all the subscripts are the same (Tae-ho 1993). However, international banking differs from domestic banking. Whereas a bank wants to become international, it has to estimate with international dimensions. Each dimension makes it more complicated to manage bank efficiently and adds some risks but in a number of positions is useful as well:

- Structure difference. A multinational bank has a more complicated structure. It affects personal management, product diversification and accounting problems. Nevertheless, its multinational structure may enable the bank to avoid very high-level domestic competition or some regulations, which may restrict domestic activity.
- Environment and marketing issues. Countries usually differ significantly from each other, including cultural, legal, well-being and other differences. Therefore, it is complicated for a multinational bank to apply the best marketing strategy in different countries.
- Market entry specifics. There are several questions about how a domestic bank can become multinational, for instance, how a bank can run the internationalization process. This topic is also closely related to market entry theories as well as merger and acquisition techniques. Even in perfect capital markets there still exist several regulations for monetary authorities who make it difficult to enter new banking markets.

Currently the financial and banking markets are turning global. On the one hand, it is not easy to tell the difference between the globalization and internationalization of banks. When the internationalization can be defined as the process of increasing banking activity abroad and replacing the domestic banking business content by the international one, then globalization can be seen as the next stage and defined as the process in which banking becomes worldwide in terms of geographical coverage and universal in terms of banking services provision. Geographical coverage implies that there is no longer a single directional meaning from home abroad. The universal provision of banking services presumes the harmonization of banking rules and the removal of barriers so that all banks can participate in all markets. Thus, interna-

tionalization can be seen as an early stage of globalization. Yet the source suggests that banking cannot become entirely global before the globalization of customers' needs and cultures. Moreover, some authors (Berger et al. 2003) concluded that banking industry may never become fully intercontinental. Even if all regulations are coordinated, there will remain special products like loans to small and medium sized enterprises and relationship lending that will never be global. Probably for retail customers the globalization process will take a long time as their demand for fully standardized service is quite low. So far banks must treat customers in various countries in a different way. This suggests that the expansion of specific banking activity abroad has thus far been more internationalization than globalization. Nevertheless, the globalization of wholesale banking tends to grow rapidly. Therefore, it could be useful to overview the ideas explaining reasons for banks' internationalization. At first, the internationalization of services sector in general could be discussed. Significant insights into the analyses of the specific aspects of the service sector internationalization were given in 1990s by Erramilli (1990, 1993), who classified internationally traded services into two groups: soft services and hard services, which serve as useful tools in analysing the pattern of internationalization of services. Hard services could be exported in the same way as manufactured goods. Soft services require close contact and physical proximity of producers and consumers (trade, financial services). Businesses producing soft services are typically not able to enter foreign markets by exporting first. The theory of multinational banking was first developed in the 1970s (Grubel 1977). This theory of international banking is based on the theory of foreign direct investments in manufacturing. Along with this theory multinational banks have some comparative advantages. Banks follow their customers abroad to better serve their domestic clients who have gone out of the country which is called the gravitational pull effect. The internationalization of banking grows equivalently with foreign direct investments as banks try to meet multinational companies' demand for banking services abroad. Such behaviour of moving abroad is seen as a defensive strategy that is necessary to assure continued business with the local primary branches of foreign subsidiaries so that the existing flow of information resulting from the institution-customer relationship will not be obstructed by a competing bank. Moreover, a

multinational bank can exploit market imperfections in the same methods as non-financial corporation. There are two main positive theories of multinational banking: the eclectic paradigm versus internationalization theory. The theory of internationalization emphasizes the importance of transaction costs in imperfect markets. Therefore, a market imperfection is a necessary condition for internationalization. Within the internationalization framework the knowledge advantage of a firm becomes a public good within the firm (Williams 1997). The application of internationalization theory to banking presupposes the defensive approach of banks. The bank-client relationships are unique and market knowledge about clients can be used at low marginal costs in internal markets. Therefore, the motivations for multinational banks to expand abroad are market failures, location particular factors and regulatory differences. As it has been noted, there are some other theories that could be subsets in internationalization theory (Williams 1997). Comparative advantage theory is the application of Heckscher-Ohlin theory to international banking. According to the theory, banks with comparative advantage dominate the world market. Banks internalize their advantage through activities of foreign branches and subsidiaries. Moreover, multinational wholesale banking theory focuses on the activities of multinational banks in the Euro markets. Multinational banks can offer narrower interest margins spread in the Euro markets due to lower transaction costs in the wholesale markets. Horizontal and vertical integration are also used to explain the multinational banking. Horizontal integration provides a possibility for allocation of business-specific knowledge at different markets at lower costs. Vertical integration is considered to be both internationalization and ownership advantage. However, the eclectic theory fails to explain vertical and horizontal integration (Williams 1997). Lately more attention has been paid to the network approach to internationalization since it was established that many companies' international activities are firmly interconnected (Mattsson 1985). Not least important is a more sociological approach which concentrates on the types of relationships within the network. Banking between banks around the world is shifting from a reciprocal exchange of services to becoming more of a system in which large money-centre banks wholesale products and services to regional banks, which in turn retails them to clients in their markets.

However, the internationalization cannot be carried out in service sector in the same ways as in industrial sector. On the other hand, in terms of internationalization options services do not deviate radically from goods. The potential modes tend to cluster in three types: (i) exporting, (ii) various contractual models of internationalization, and (iii) various investment type modes of internationalization (Hellman 1996). Furthermore, it has been argued that internationalization may be more risky for a service company than for a manufacturing company. Thus, the investment method of internationalization is very important for the banking sector. Outward internationalization follows the investment mode closely as they both are foreign branch offices, establishing new subsidiaries, joint ventures and companies' mergers. Nowadays the internationalization of banks has been significantly influenced by structural changes in the world trade, the growth of direct investments into foreign countries, the development of the European Union and other international institutions aid programs, etc. Historically the oil crisis of 1973 was one of such macroeconomic factors. Because of the crisis, monetary resources began to accumulate (without the intention of exploitation) in the oil exporting countries; while the oil importing countries suffered money shortage due to the deficit in their current account of the balance of payments. The disproportion between the location and demand of money resources gave a powerful boost to the internationalization of banks, which began to set up subsidiaries in the oil countries. Consequently an opportunity was given to drain money from oil producing countries back to the oil importing nations. The recent financial crisis essentially has similarities in money flows as it was in 1970's, i.e., from global importers to global exporters.

Moreover, the end of the Cold War and the breakdown of the communist system became especially important factors for the internationalization of banks. The Western banks hurry to dominate these emerging markets. Evidently the Baltic States are influenced by this wave as well. The latest wave of internationalization of financial institutions is characterized not only by following their existing consumers. The "follow-the-client" rule for banking internationalization is only relevant for small banks. Meanwhile the behaviour of larger banks is influenced by more complex diversification policies. One of the most common explanations for a new pattern of expansion is related to the effects of the increase in banking

competition caused by financial deregulation (Berger et al. 2000). As margins and fees are tightened in domestic financial markets, banks seek to expand across border to generate higher returns. Thus, with banks' net interest margins under downward pressure due to the intensification of banking competition some financial institutions seek to diversify geographically onto markets with a potential to expand in addition to greater net interest margins.

3. Central Bank Policy Changes

From the macroeconomic opinion, the decade preceding the first signs of the financial crisis in 2007 and its massive spread in 2008 seemed an extremely favourable period in the modern history of the world economy (Hrnčir 2009). Constant and comparatively dynamic economic growth coexisted with low and non-volatile inflation. The outbreak of the financial crisis brought that "golden decade" to an end. With the benefit of hindsight, it is clear, however, that the primary causes of the crisis were already built into the "golden" period. More specifically, the long-running successful macroeconomic situation promoted undue satisfaction with the existing trends and led to underestimation of the arising imbalances and implied risks. A situation to bubbles was thus created. This period was simultaneously one of consolidation of changes in the monetary policy orientation and in the concept of central banking in general. In that respect, deep changes had been taking place since the late 1970s and early 1980s. The key feature of those changes was an orientation towards price stability as the principal goal of monetary policy. The assurance gained position that price level stability is the most important way in which central banks and monetary policy can contribute to economic development and sustainable growth.

In this period, both central bankers and academic economists seemed to reach a consensus regarding the concept of modern monetary policy – the goal: price stability; the instrument: short-term interest rates. Although short-term interest rates alone have only a modest impact on economic activity, there is a standard assumption that their transmission affects medium- and long-term interest rates, which do have a substantial impact on the economy. When trying to achieve price level stability, central banks follow a specific monetary policy strategy. Up to the 1990s, the monetary policy strategies applied led to price stability only indirectly through the use of interme-

mediate targets, such as the targeted value of a monetary aggregate or exchange rate. In the last decade, however, an increasing number of central banks have switched to achieving price stability directly, i.e. without intermediate targets, under a monetary policy strategy of inflation targeting. This direct orientation of monetary policy on its final goal, price stability, can be considered a culmination of the growing role that price stability has been playing in the monetary policy of contemporary central banks.

A comparison of central banking and monetary policy during the recent "golden" decade with the 1960s and 1970s reveals that the changes that have taken place are profound indeed. The shift towards price stability as the dominant goal of monetary policy has been accompanied by substantial changes in the role, activities and monetary policy of central banks.

Therefore, in order to ensure financial market stability, an important role is allocated to the supervisory authorities. This key role is given to the national central bank of the country. The central bank is in charge of capital markets, monetary policy consistency, public financial control in commercial banks' activities, while at the currency board model commercial banks are often partly taken over by the central bank's task (Bennett 1993, Hanke 1992). An uncontrolled and unsustainable practice of commercial banks' credit expansion took place in all the Baltic States in the period of 2003-2008. The loans to businesses and residential portfolio grew from 11 billion Litas in 2003 to 66 billion Litas in 2008. Therefore, deposits grew faster than real gross domestic product (GDP). Above and beyond it is a very significant disproportion. It was a case of the central bank's inactivity. On the other hand, central bank should not affect credit institutions, especially those carrying out current requirements. Only if such institution violates the regulations of the central bank, it may be a subject to sanctions (Wihlborg 2009, Fleming 1996).

The pressure of the world financial crisis has brought about considerable changes in the competences of central banks and in the nature and instruments of monetary policy. The quantitative reduction policy, dramatic growth in central banks' balance sheets and growth in their credit exposures, including to the non-banking sector, to previously unimaginable proportions represents a departure from standard central banking and monetary policy (Hrnčir 2009). However, the Baltic States' central banks have less

monetary policy instruments because of the currency boards' arrangements, but despite it they showed very little effort to curb skyrocketing money supply by international banks using cross-border loans.

4. Empirical Evidence from the International Banks in the Baltics

The internationalization of banking in the Baltic States using comparative analysis and effort to classify the over-lending problems that arise in commercial credit institutions in the global financial crisis are the priority subject of this paper. The scientific problem is to determine how international banking institutions are managing local deposits then cumulating loans with additional foreign credit that have a real effect on the domestic money supply. Qualified aggregate deposits to loans ratio could be a suitable indicator for evaluation of the credit institutions responsibility. In addition, such an overflow of credits could be an indicator of central bank supervision activities as well as its main function to control the stability of domestic prices. Therefore, international banks are working like central banks concerning the money supply activities. On the other hand, real central banks have practically only one monetary policy instrument, the commercial banks' required reserves rate setting. However, the key factor could be and should be a restriction on the activities of commercial banks to issue loans only in the domestic currency. Reviewing the largest operating international banks in the Baltic countries, it is obvious that the major banks in the region are controlled by foreign banks mainly from Sweden and Denmark.

As it was mentioned, the main feature of the internationalization of banks is a sustainable development in the 1990s. Furthermore, the global international banks could be intended those banks which operate in more than a few countries where the primary bank has branches or departments (Angkinand 2010). This requires not only having a harmonized legal regulation but a unified terminology and standards in the settled services that could be closely coordinated in terms of the monetary policy keeping sustainable banking sector. Certainly, these strategic objectives and implementation of the guidelines require methodical and prolonged effort (McCauley 2002).

In the first case, the large decline in real activity in many countries would be explained by a decline in the supply of credit, while in the second case the de-

cline in real activity would explain a declining demand for credit. Disagreements among economists about the appropriate response to the crisis reflect differences in opinion about the main source of current problems and the need for adjustment (Østrup et al. 2009).

The transition from administrative to market economy methods of regulation is a challenge for the central bank and for other credit institutions in the Baltic States. The central bank has no right to interfere in the activities of credit institutions; therefore, a directive must be carried out in accordance with laws and maintain credibility. The procedures of central bank could not affect the decisions of credit institutions provided; especially which carries out the prudential requirements. Consequently adopted banking law amendments had strengthened the supervision of banks. The primary supervisory objective is to develop banking controllers to license an inspection system and ensure the security of funds. Harmonization of banking regulations for the risk control and regulatory domains to common international standards is a critical matter for competitiveness (Cerasi, Chizzolini 2001).

However, each party should take extra measures to ensure the success of banking and financial stability. For instance, it is known that since 1997 the Baltic countries were strengthening existing banks by foreign bank admission in Lithuanian, Latvian and Estonian markets mainly fulfilled by privatization of banks (Dubauskas, 2004, 2005). Significant growth of foreign capital in the banking sector (Lithuania, Latvia and Estonia) accelerated the integration of the Baltic banks into the global financial system.

Another such a radical change in behaviour of commercial banks in effect after the crisis began in 2008, it is down or "bad" loans. This loan, which payments are delayed for more than 60 days or collateral is significantly impaired. Such loans in 2009 increased from 4.6 to 19.3 percent of year-end. Banks forced to make huge provisions for such loans. Throughout the banking system reserves were nearly 4 billion Litas. In 2006 *Danske Bank* analysts wrote that it is very risky, (Valgreen 2006). His warnings came true to those countries, which were mentioned in his statement. Further the progress of the banking networks and a deposit/loan ratio are evaluated in the three Baltic States. The first country overviewed is Estonia followed by Latvia and Lithuania (Tables 1, 2).

Table 1. *Danske Bank, Nordea, SEB and Swedbank*
Loans in Euro Millions

Year	2004	2005	2006	2007	2008	2009	2010
ESTONIA							
Total Sum	5641	7724	11639	15033	16366	9893	9737
Index (year 2004=1)	1	1,37	2,06	2,66	2,9	1,75	1,73
LATVIA							
Total Sum	3679	6450	10653	13696	15262	10378	9387
Index (year 2004=1)	1	1,75	2,9	3,72	4,15	2,82	2,55
LITHUANIA							
Total Sum	4055	6587	9928	14787	17440	13140	11856
Index (year 2004=1)	1	1,62	2,45	3,65	4,3	3,24	2,92

Source: Calculated by the authors from commercial banks' annual reports.

According to the size of the loan portfolio, *Swedbank* leads in Estonia with the total amount of 8 billion Euros.

Moreover, the volume of loans from 2004 to the end of 2008 almost tripled. The following in the sequence is *SEB* loan portfolio that goes up significantly every year but only by one percent in 2008. *Nordea* and *Danske Bank* loan portfolios had similar sizes from year to year with the only contraction in 2008 when *Nordea Bank* was able to overtake its rival. These loan volumes of two banks have increased more than four-fold from 2004 to the end of 2008. It is necessary to mention that due to the start-up situation data was not available for the *DnB Nord* in Estonia during the overviewed period. Besides, this bank has quite a little share in the total international banking in Estonia.

In general, an index of the loan portfolio has increased from 1 to 2.9 from the year 2004 to 2008 and decreased to 1.73 in 2010. On the other hand, the index of the deposit portfolio has enlarged from 1 to 2.25 from the year 2004 to 2008 respectively with an obvious decrease trend in 2009 and 2010 (see Table 2). It means that a part of the total loan portfolio growth during the economic growth was financed from the outsourced capital inflows.

Table 2. *Danske Bank, Nordea, SEB and Swedbank*
Deposits in Euro Millions

Year	2004	2005	2006	2007	2008	2009	2010
ESTONIA							
Total Sum	3950	5735	7487	8748	8900	5170	5565
Index (year 2004=1)	1	1,45	1,9	2,21	2,25	1,31	1,41
LATVIA							
Total Sum	2460	3450	4308	5547	5393	9085	8159
Index (year 2004=1)	1	1,4	1,75	2,25	2,19	3,69	3,32
LITHUANIA							
Total Sum	4188	5630	6741	8777	8253	8371	8988
Index (year 2004=1)	1	1,34	1,61	2,1	1,97	2	2,15

Source: Calculated by the authors from commercial banks' annual reports.

The analysis of the banks in Latvia shows that all evaluated banking networks are also operating in other Baltic and Nordic countries. From the overview of the international banks' subdivisions variation on the yearly basis can be seen that *Swedbank* network has the negative change with the branches number decreased by 5 units. However, this change was observed in 2008. A number of branches shrunk in the *DnB NORD* bank network the same year. Other banks showed a growing number of branches in the reviewed years. *DnB NORD*, *Danske Bank* and *Nordea* have been showing annually increasing statistics of their banking network since 2004.

Nevertheless, *Swedbank* had a prime position in the size of the loan portfolio in Latvia since 2004. Its loan volume has more than quadrupled and at the end of 2008 amounted to 6 billion Euros. However, the loan portfolio decreased in 2009 and 2010. *SEB* loan portfolio was narrowly ahead of the *Nordea* bank portfolio in 2008. Besides, none of the analyzed loan portfolios decreased in the year 2008; the obvious drop-off was only in 2009 and 2010.

In the analysis of banks' deposit and lending relationship it was observed that *Nordea*, *DnB NORD* and *Danske Bank* had the lowest ratio of these indexes. This situation could be easily explained by the fact

that these banks received additional funding for its activities from the primary (mother) banks operating in other countries. However, respective ratios of *SEB* and *Swedbank* ranged between 45 to 65 percent because these banks were able to operate without additional funding.

The overall index of the loan portfolio has increased from 1 to 4.44 in Latvia in the period of 2004–2008. On the other hand, the index of the deposit portfolio enlarged from 1 to 1.95 in the period of 2004–2008. It means that a larger part of the total loan portfolio growth was financed from the outsourced capital inflows.

The analysis of the banks dealing with international banking activities in Lithuania is quite analogous to the Latvia's situation. However, the largest bank in Lithuania is *Swedbank*. It is the major bank in terms of banking network which increased its number of branches from 2004 to 2007. Even so, *Swedbank* closed 8 of its branches in the year 2008 while other banks were still expanding their branch networks. Lithuanian division of *DnB NOR* nearly doubled its branch network and was ahead of *SEB* in the year 2005. *SEB* network increased by 20 units, *Nordea Bank* by 14 local subdivisions and *Danske Bank* by 11 subdivisions from 2004 to the end of 2008.

The analysis showed that under the economical growth credit volume got *SEB* to the first place during the years from 2004 to 2008. Moreover, the loan portfolio volume increased fourfold within five years. *Swedbank* held the second position with an average annual loan portfolio growth of 44 percent. In general, all the analyzed Lithuanian banks' loan portfolios grew very rapidly.

The study of the banking ratio, the deposits and loans relationship showed that *Danske Bank* and *Nordea* had the lowest ratios in Lithuania during the years from 2004 to 2010. It means these banks required additional funding from their primary (mother) banks. In general that could be one of the main reasons of the overheating of financial markets in Lithuania as well as in other Baltic countries. For instance, the accumulated loan portfolio for these five biggest banks was 17.4 billion Euros, while the aggregated deposits amount for the same banks was just 8.2 billion Euros only in the year 2008. It means that additional funding from foreign primary banks was 9.2 billion Euros. On the other hand, *Swedbank* and *SEB* had the highest deposit and loan relationships. On the whole, the loan portfolio index increased from 1 to

4.06 in Lithuania from the year 2004 to 2008 but decreased in the value of index to 2.9 in the end of 2010. Alternatively the deposit portfolio index increased from 1 to 2.07 from the year 2004 to 2008. With some decline in 2009, it continued to increase to 2.1 in 2010. Nevertheless, it means that about the half of the total loan portfolio growth was financed from the outsourced capital inflows.

5. Conclusions

The changes in central banking in reaction to the world financial crisis and the related move away from technical monetary policy towards a more radical policy represent a major defining moment and departure from the conditions and tendencies of the past decade, although with varying intensities across central banks. These changes occurred under the pressure of the crisis in the environment where standard monetary policy approaches and instruments had failed or were far less effective. Nevertheless, not many changes occurred in the central banks of the Baltic States with exception of the Estonian central bank.

The review of the international banking business performance exposed that banks are the largest foreign financial intermediaries that support the availability of liquidity for global sustainable development in the Baltics. The international banking business is quite novel in the Baltics and it acts as a replacement for a local bank which could be characterized by universality.

The analysis of development in the international banking expansion problems revealed that skyrocketing credit growth was financed not only from the local savings but also from the cross-border international banks' resources even in the bigger amounts. Summarizing the overviewed Baltic countries' banking indicators the lowest credit deposit ratio was in Estonia during the analysed period of 2004–2010. Nevertheless, the decline of banking network reflecting possible financial crisis started in Estonia also in 2008. The analysis of network and credit expansion activities in the Baltic countries revealed that of all the banks involved in key financial data in the period from 2004 to 2010 in all three countries the leading role was taken by *Swedbank*.

It seems the main reason for the overheating of the Baltic economies could be explained as the uncontrolled additional cross-border money supply for dominating international banks' branches in this region. Moreover, in this case controlling institutions

(mainly the central banks) did not act as it is proposed by many monetary expansion theories.

However, the influence of the banks credit expansion to the global financial recession affects the banks themselves and recent decline in activities generate new consequences to the future. As a result the credit growth could be related to the available local deposit resources.

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