FACTA UNIVERSITATIS
Series: **Economics and Organization** Vol. 2, N° 3, 2005, pp. 229 - 236

FINANCIAL SECTOR REFORM IN THE BALKAN COUNTRIES IN TRANSITION *

UDC 336.7 (497)

Srdjan Golubović[1], Nataša Golubović[2]

[1]Faculty of Law, University of Niš, Trg kralja Aleksandra 11, 18000 Niš, Serbia and Montenegro
[2]Faculty of Economics, University of Niš, Trg kralja Aleksandra 11, 18000 Niš, Serbia and Montenegro

Abstract. *This paper deals with the financial sector reform in the Balkan transition countries. Unlike the transition economies of Central Europe, no radical changes took place in this sector in the Balkans. A delay in the realization of structural changes is partly a result of these countries historical legacy, and partly a result of the circumstances in which the transition process took place. Essential changes in the financial sector started at the end of 90s, with the adoption of appropriate laws and subsequent application of concrete measures directed towards the growth and increase of the financial sector efficiency. After discussing the former system legacy, this paper analyses the content of the financial sector reform in the Balkan transition economies. On this basis we shall try to point out to the changes which are necessary for the establishment of an efficient financial system.*

Key Words: *Financial Sector, Balkans, Transition, Restructuring, Banking Sector*

INTRODUCTION

The financial sector reform, i.e. its accommodation to the requirements of market economy is an important segment of economic transformation. The transition countries experience points out that the changes in the financial sector are necessary if the crisis in macroeconomic conditions is to be avoided, especially in the real sector of the economy.

Received February 20, 2005
* This paper is a part of the project "Cultural and Ethnic Relations at the Balkans – Possibilities of Regional and European Integration", No.1310, realized by the Institute for Sociology of the Faculty of Philosophy, University of Niš, with the support of the Ministry for Science, Technology and Development of the Republic of Serbia.

Three factors underline the importance of the financial sector reform and its contribution to the macroeconomomic stability and growth/catch-up of the transition economies. First, several studies on the factors of economic growth have identified positive relationship between the growth and the financial sector development measured by its depth and level of financial intermediation, showing that while the causality may run in both directions, the presence of a sound and deep financial sector stimulates output growth. Second, success in establishment and preservation of macroeconomic stability depends on the stability of this sector. Finally, growth and efficiency of financial sector intermediation is crucial for the outcome of other reform measures including privatization, growth of private sector, etc. After consideration of previous system heritage, the paper analyses content of the financial sector reform in the Balkan transition economies. In the last, third part, the paper deals with the state of the financial sector in Serbia.

FINANCIAL SECTOR BEFORE TRANSITION

In former socialist economies the financial sector was completely adjusted to the requirements of centrally-planned management of economy. Concentration of scarce financial resources and their allocation was carried out through a monobank system which, along with the central bank as a formal supreme monetary authority, comprised several specialized state banks (1). Such outlined financial sector had a mainly passive role. The resources necessary for the continued realization of economic transactions were provided by the plan, and the central bank had the role of "service of the economy" (2). In such a system specialized financial institutions had a significant role. They did not act independently and the allocation of credit resources was performed according to the rules established by the central banking authority.

The soft budget constraint, immanent to the socialist economies – either in centrally-planned (Romania, Bulgaria and Albania) or in self-management (former SFRY) managements – had continuously stimulated quasi-fiscal activities, so that the balance sheets of enterprises and bank portfolios were burdened with losses. The banks absorbed companies' losses in the following ways: by taking over the risks connected with foreign loans *ex ante* (in the moment of taking the foreign loan) and *ex post* (by taking over the loans of enterprises when they become unable to service their foreign obligations) or by granting the credit to enterprises with negative real interest rates. Since there was direct allocation of credit in the monobanking system, banks were not obliged to assess the credibility of enterprises; neither were they in the position to refuse the credit request or to force enterprises into bankruptcy (3). The banks were, first of all, a state service which took deposits from the citizens at low interest rates. At the same time, credits at negative real interest rates were granted to privileged enterprises. All losses in the financial sector were covered by the central bank monetary emission.

The socialist economy was characterized by strong state intervention in economy which manifested itself through all-encompassing price control, subvention of enterprises, etc. The price control was directed towards reduction of prices of basic commodities and services regardless of costs, which should enable rise of living standards. In such conditions prices did not reflect production costs. On the basis of such prices, the supply structure did not match consumer preferences. Since low prices stimulated consumption and de-stimulated production, the state had to subsidize producers in order to stimulate production. Elimination of subventions and liberalization of market and prices at the end of 80s and beginning of 90s, together with an inadequate production structure, caused accumulation of losses in state companies. In spite of their losses, yet, the companies continued to operate. Their preservation was motivated by the avoidance of huge social costs which might arise in the case of their closure. The survival of these companies was provided for by credits, as well as by printing money (or by foreign loans). In that way, the losses were absorbed by the banking system, i.e. one part of the deficit had been gradually shifted from the budget to the financial system.

CONTENT OF THE FINANCIAL SECTOR REFORM

The common characteristic of the Balkan transition countries is that, in the first phase, they avoided any radical reform of their financial sector. Instead, these countries undertook partial changes like transformation of the monobank system into two-tired banking system (central bank performs its traditional functions while the commercial state and private banks take the responsibility for transactions with citizens and economic subjects i.e. savings and credit function). Along with the abandonment of the monobanking system, these countries liberalized foundation of new banks and decentralized decisions regarding the volume and prices of financial services.

Among the Balkan countries with the centrally-planned system Bulgaria was the first country that undertook changes in the traditional socialist banking system. It introduced two-tired banking system in 1987, and clearly divided competence of national bank and regional banks. The banks which had previously specialized in selected sectors were transformed into universal banks providing financial services to all sectors of the economy. At the same time, the 59 branches of the Bulgarian National Bank (BNB) were transformed into commercial banks (4). The foreign bank entry was restricted until the end of 1994 when Greek Xios Bank and Dutch ING bank opened their branches in Sofia. The legal system slowly adjusted itself to the new environment. The law on the Bulgarian National Bank was adopted in June 1991, and the Law on Banks and Credit Activity in 1992. The absence of structural changes in the financial sector, accompanied by inadequate laws, insufficient institutional capacity and limited (foreign) competition, resulted in an uncontrolled growth of the credit placement and in a huge growth of nonperforming loans in the banking balance sheets. For example, in 1995, almost 75% of banking loans was classified as nonperforming. The culmination was the emergence of a financial (i.e. currency and banking) crisis during 1996-97 and a considerable reduction of number of banks in Bulgaria to 30 in late 1996. Other Balkan countries had similar experience. The collapse of the monobank system accompanied by liberalization led to a rapid increase of the number of banks. During the 1995 the Croatian banking system comprehended 53 banks, out of which only one was in foreign ownership, The Slovenian banking system comprised 39, and the Romanian 24 banks (5). The mid-90s were marked by the endeavor of the state to carry out a bank rehabilitation program. With the exception of Slovenia, in all other transition countries, the rehabilitation process did not considerably change the banks' behavior since the state intervention (writing-off debts, nonperforming loans take over, banks equity financing, etc.) and the intertwined banks and big state enterprises (debtors) generated an increase of non-performing loans in the banking assets.

At the end of 90s essential changes started in the financial sector of the Balkan countries. They included application of a set of measures which influenced functioning and structure of the financial sector. The successful realization of structural changes in the financial sector means previous creation of appropriate legal conditions for their application. The solutions accepted by legislation, adopted at the beginning of 90s, manifested themselves as an obstacle to normal functioning of the financial sector. That is why these countries, by the end of 90s, enacted completely new laws, in agreement with the EU standards, especially concerning the independence of the central bank of executive authorities, regulation of the banking system, functioning of the financial market, etc. Bulgaria, Albania, Bosnia and Herzegovina in 1997, Croatia in 2001, Macedonia and Romania in 2004, adopted new laws on the central bank (6). The adopted laws are mainly in agreement with the European norms concerning the definition of the central bank's main task (price stability as a priority) as well as mechanisms for preservation of the central bank independence in relation to executive authorities. At the same time, appropriate changes were adopted which regulate position of banks, nonbanking financial institutions and functioning of financial market (7). In the area of banking and financial intermediation the European standards are not well defined as in the case of regulation of the central bank position. We should have in mind that the functioning of the financial system in accordance with the European regulation depends on the level of its development and on the ability to stand the competition on an open market. However, the analysis of the legislative shows that better standards were achieved concerning the license approval, definition of the minimal capital requirements necessary for the foundation of banks, determination of the sphere of banking activity, responsibility of the owner, etc. The same applies to the legislation regulating the financial market, its functioning, agents, determination of instruments, rights and obligations which emanate from those instruments.

The key step in restructuring the banking sector is strengthening the competition and privatization of the banks. The competition represents the foundation of market economy. Inside the financial sector the competition reduces transaction costs, allocates risk on actors which are able to take this risk and gives right incentives for investments. Closely intertwined with the strengthening of the competition is privatization of state banks. At the end of 90s this process started to accelerate. In Bulgaria, for example, at the end of 2003, the share of state ownership in the banking assets was only 2%, and in 1996 this share increased to 82% (8). Privatization had been realized mainly through foreign strategic investors, which lead to a noticeable increase of foreign ownership in the domestic banks. According to EBRD, only in Slovenia the share of foreign banks in the overall banking assets does not exceed the level of 50%; in other Balkan countries that share is considerably larger. In 2003 that share was 91% in Croatia, 86% in Bulgaria, 68,3% in Bosnia and Herzegovina and 58% in Romania (*Transition Report*, 2004). In the nineties, the banks in these countries suffered enormous losses while the governments were not able to realize equity financing. This is the reason why these countries decided to sell the biggest banks to foreign strategic investors.

One of the characteristics of the financial sector in the Balkan countries is the banking sector domination. The financial resources are mostly of medium and short-term nature which means that the banks have limited possibilities to change the so-called term structure of deposits in order to secure long-term placement. The banks cannot change real investors, which place money into capital and not into debt, and thus take much bigger risks and at the same time ensure long-term assets for investment and operation of enterprises. In addition, the developed financial market ensures transparency of equity capital and its optimal allocation (Šonje, 2002, p. 72). The experience of these countries points out that the financial market can not develop spontaneously; rather it requires state intervention which should create necessary conditions for its normal functioning. Despite considerable efforts during 90s, the depth of the financial market in the Balkan countries is insufficient. The general characteristics of this market are:

- activity on the equity market is considerably lower than activity of the banking sector,
- majority of the given countries are characterized by low liquidity on the capital market, with exchange concentrated on small number of shares of listed enterprises, and,
- an increased sensitivity of the financial markets to the movements of speculative capital and emergence of misuse caused by the absence of adequate financial infrastructure (appropriate regulatory framework, accounting informational systems, etc.).

EXPERIENCE OF SERBIA

The financial sector transformation in Serbia started in early nineties with the adoption of Law on banks and other financial organizations in 1992, Law on the Central Bank of FRY in 1993 and other laws that started to modify the institutional framework in accordance with the market demands. Institutional changes, however, were not consistent; neither did they interrupt the soft budget constraint. The low financial discipline continuously stimulated quasi-fiscal activity and its deficit. The primary emission through negative balance is the most obvious example of the soft budget constraint. Illiquidity was not sanctioned in an adequate way, which enhanced deterioration of financial discipline and jeopardized efficient allocation of available resources. The soft budget constraint was conditioned by unsolved property relations, by the fact that the bank owners were at the same time their biggest debtors, by shortcomings of legislature, as well as by inconsistent economic policy.

The inefficiency in the financial sector was also influenced by its undeveloped structure. It was characterized by domination of the banking sector, while the role of non-banking institutions in mobilization, concentration and allocation of financial resources was negligible. Such institutional infrastructure, with ill-defined property rights, did not provide an ambiance for rational and efficient banking. The majority of the banks were insolvent and unable to fulfill the requirements established by prudential norms while the banking balances were burdened by a high level of risky, non-performing loans. Unprofitable and nonperforming foreign currency subbalances became prevalent in balance sheets. In the second half of the 1990s, even according to the banks own reports, the Yugoslav banking sector as a whole was saddled with substantial negative capital (Labus, 1998, p. 32-48). This situation encouraged moral hazard behavior and adverse selection of debtors. Potential losses in 2000 resulting from risky assets and corresponding off-balance items exceeded 100% of banking assets in 12 banks which accounted for 56,5% of the aggregated balance sheet amount; such losses surpassed 50% of capital in 20 credit institutions comprising 82,6% of the balance sheet sum. According to NBY report, the banking sector which was burdened by a high share of bad loans in the banking assets was not able to meet the demands of citizens and companies for credit services and mobilization of funds; neither was it able to ensure the fulfillment of prudential standards.

Essential changes in the Serbian financial sector started at 2000. The essence of the restructuring strategy was to undertake bank rehabilitation and recapitalization only if it is expected to produce viable institutions with good prospects for privatization through the sale to a strategic investor at a reasonable price and only if it can be implemented with identifiable fiscal resources. By the middle of May 2001, the NBY adopted the Strategy for the restructuring of the banking sector which forecasted classification of banks according to solvency criteria, liquidity, equity financing. It also stated their importance for the functioning of the whole economy regarding four categories: A – healthy banks, B – solvent banks, but in need for equity financing, C – insolvent banks but with potential viability and/or systemic importance and D – insolvent banks whose license for banking operations should be taken away from them. Out of 71 banks, 29 were ranked in group A (with the share of 13% in overall banking assets), and 16 banks (with the 19% of the overall banking assets) into group B. By adoption of the Bank Bankruptcy Law on October 2002, bankruptcy proceeding against four banks (Beobanka, Beogradska banka, Investbanka and Jugobanka) had started. Those banks accounted for almost 60% of the book value of the sectors assets and for about two-thirds of the outstanding commercial credit to the nonfinancial sector. At the same time, actions oriented towards bringing into agreement the legislation with the market demands were undertaken. During 2002 Amendments to the Law on banks and other financial organizations were adopted. Those Amendments strengthened the regulatory and control role of the central bank and accepted the international standards. Likewise, the new law on the central bank was enacted, which strengthened the position of the supreme monetary authorities and created the conditions for its functional, financial and personal independence (9). As part of the banking sector restructuring Bureau for Clearing and Payment had been replaced by a contemporary bank-based settlement system as of the beginning of 2003. In order to increase competition, the entry of foreign banks was liberalized. Between 2000 and 2002 the central bank gave seven licenses to newly established banks in foreign ownership. The banking sector reform led to considerable changes in the banking structure. The number of banks was reduced to 43 in 2004; among them, 11 were in majority ownership of foreign shareholders, 18 banks were in majority ownership of domestic subjects, and 14 banks in majority ownership of the Republic of Serbia (10). Since privatization of banks is yet to be done, it is clear that foreign bank participation in the overall banking assets is considerably lower than in Croatia, Bulgaria and Romania. On the basis of this experience, it is necessary to carefully create a strategy of foreign bank entrance to the domestic market, to determine the optimal level of foreign bank participation and leave enough space for the domestic banks in order to avoid the position of complete dependence of the domestic banks or their sudden withdrawal from the market (Jeremić, 2004, p.256).

The most important changes were realized in the banking sector. In other segments of the financial sector, the changes were almost insignificant. The banking sector dominates the financial sector structure, which suggests that shareholding is still underdeveloped, i.e. that the participation of equity securities is not sufficient in the market. Majority of trade on the financial market constitute short-term financial assets; among them short-term government and corporate bond and bank deposits dominate. An important indicator is also the level of development of the secondary market. In the case of Serbia, financial activities are reduced to those which represent primary transfers of financial savings. If activities on the secondary market are almost absent, then we cannot speak about a developed financial market. From the point of view of participants, the domestic financial market cannot be considered as developed. Contrary to OECD countries, which are characterized by the substantial presence of institutional investors (insurance companies, private pension funds, investment funds) on the Serbian financial market their role is negligible. The key challenge in further development of the financial market is to find the way to mobilize domestic savings, which is out of the financial flows. It means completion of legislature, privatization of enterprises and establishment of regulatory institutions of financial markets.

CONCLUSIONS

The main goal of the financial sector reform in the Balkan countries in transition is the change of the financial sector role, i.e. its adjustment to the role it otherwise has in market economies. It means that the financial sector must have an active role in mobilization, concentration and allocation of scarce financial resources. The Balkan countries accepted a gradualist approach to the financial sector reform with an emphasis on some other aspects of transformation. These countries' experiences in the nineties points out that partial institutional changes do not create a favorable environment for structural changes. Partial changes oriented towards the banking sector restructuring through different concepts of domestic banks rehabilitation did not bring expected results. Instead, the financial sector reform has to include integral and harmonized changes in all its segments: banking, insurance, equity market, position of institutional investors and supply of financial instruments. Only with successfully synchronized (and not partial) changes in all these segments, can an efficient financial system be established.

ENDNOTES

1) Exception from such arrangement of the financial sector was former SFRY, which had developed banking system with its basis constituted of commercial banks (basic and associated banks, which represented associations of basic banks), regionally bound and under state control. This, however, did not mean that Yugoslav financial sector was more productive. On the contrary, the fact that founders of the banks were publicly-owned companies created the possibility for credit-acquisition without any constraints and at a negative real interest rate.
2) The basis for the functioning of two clearly separated financial spheres (one for citizens and the other one for enterprises) was a "cash plan" for determining the quantity of money and a "credit plan" which determined distribution of credits inside the well defined goals of the monetary-credit policy. See: Sundararajan, V., *Central Banking Reforms in Formerly Planned Economies*, Finance and Development, Vol. 29, No. 1, March 1992, p.11.
3) State guarantees for credits to privileged enterprises or industries completely "eliminated risk consideration in decision-making about giving bank credits". See: Kovačević, R, *Svetska iskustva u sanaciji i reorganizaciji banaka,* Jugoslovensko bankarstvo, No. 9-10, 1995, s.10.
4) Since majority of newly founded banks proved inefficient, Bank Consolidation Company was created in Bulgaria with the aim to stimulate formation of stronger banks through mergers. As a result, overall number of banks was reduced from 81 in 1992 to 42 at 1995. See: Walko, Z., *The Bulgarian Financial Sector*, Financial Stability Report, No. 8, 2004, pp. 95-98.
5) More about banking sector transformation in the Balkan countries see: Bonin, J., *Banking in the Balkans: The Structure of Banking Sectors in Southeast Europe*, Economic Systems, No. 28, 2004, pp. 145-147.

6) Law No. 312 on the Statute of the National Bank of Romania, June 28, 2004; Law No. 8269 on the Bank of Albania, December 23, 1997; Law on Bulgarian National Bank, June 10, 1997; Law on the Central Bank of Bosnia and Herzegovina, June 28, 1997; Law on the Croatian National Bank, April 5, 2001; Law on the National Bank of the Republic of Macedonia, 2002.
7) With new legislature, the banking regulative adjusts itself to the international supervisory standards and European banking directives concerning foundation and realization of banking transactions, curing and liquidation of banks, capital adequacy and deposit insurance.
8) Quoted according to: *The Bulgarian Financial Sector*, Financial Stability Report, No. 8, ONB, 2004, pp. 96-97.
9) See: *Zakon o Narodnoj banci Srbije*, "Službeni glasnik RS", No. 72/2003.
10) See: *Bankarski sektor u Srbiji*, Izveštaj za četvrti kvartal 2004.godine, Narodna banka Srbije, Februar 2005, p. 5.

REFERENCES

1. *Bankarski sektor u Srbiji*, Izveštaj za četvrti kvartal 2004.godine, Narodna banka Srbije, Februar 2005.
2. Bonin, J.(2004), Banking in the Balkans: The Structure of Banking Sectors in Southeast Europe, Economic Systems, No.28, pp.145-47.
3. Jeremić, Z.(2004), Finansijski sektor u Srbiji – komparativni prikaz, Ekonomski anali, str. 256.
4. Kovačević, R.(1995), *Svetska iskustva u sanaciji i reorganizaciji banaka*, Jugoslovensko bankarstvo, br.9-10, p.10.
5. Labus, M.(1998), *Financial Sector in Yugoslavia*, in: Pitić,G.(ed.), Challenges and Opportunities for the Economic Transition in Yugoslavia, International Conference Proceedings, 5-6 November, 1997, Belgrade, Economic Institute, pp.32-48.
6. Sundararajan, V.(1992)., *Central Banking Reforms in Formerly Planned Economies*, Finance and Development, Vol.29, No.1, March 1992, p.11.
7. Šonje, V.(2002), *Banovna i financijska pitanja na putu Hrvatske prema Europskoj uniji*, u K.Ott (ed.), Pridruživanje Hrvatske Evropskoj uniji, Institut za javne financije, Zagreb, p.72.
8. *The Bulgarian Financial Sector*, Financial Stability Report, No.8, ONB, 2004, pp. 96-97.
9. Transition Report, 2004, EBRD.
10. *Zakon o Narodnoj banci Srbije*, "Službeni glasnik RS", br. 72/2003.
11. Walko, Z., *The Bulgarian Financial Sector*, Financial Stability Report, No.8, 2004.

REFORMA FINANSIJSKOG SEKTORA U BALKANSKIM ZEMLJAMA U TRANZICIJI

Srdjan Golubović, Nataša Golubović

U radu se sagledava reforma finansijskog sektora u balkanskim zemljama u tranziciji. Za razliku od centralnoevropskih zemalja, u balkanskim zemljama nema korenitih promena u ovom sektoru. Ovo kašnjenje u sprovodjenju strukturnih promena delom je rezultat nasledja ovih zemalja, a delom okolnosti u kojima se ukupan proces tranzicije odvijao. Suštinske promene u finansijskom sektoru u ovim zemljama započinju krajem devedesetih godina, kada najpre dolazi do usvajanja odgovarajućih zakonodavnih promena, a zatim i primene konkretnih mera usmerenih na rast i povećanje efikasnosti finansijskog sektora. Nakon razmatranja stanja u finansijskom sektoru pre tranzicije, u radu se analizira sadržaj reforme finansijskog sektora u balkanskim tranzicionim privredama. Na osnovu te analize, pokušaćemo da ukažemo na promene koje su neophodne za uspostavljanje efikasnog finansijskog sistema.

Ključne reči: *finansijski sektor, Balkan, tranzicija, restrukturiranje, bankarski sektor*