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Financial systems of countries in transition

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November 2012.

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Introduction

European Union idea has started before more than half a century, precisely by the Treaty of Paris in 1951. It was consist with the example of integrated economic market in the United States. The pre-shape of European Union as we know now was the formation of the European Coal and Steel Community (ESCS). That project was proposed by French foreign minister Robert Schuman and after an approval of six countries (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany) was signed in Paris as a unique European market for pooling coal and steel resources of mentioned countries. During this half a century European Union continued with a growth of the Union by accepting the candidate countries which honor the fundamentals on which EU is living. After finishing the accepting the countries in Western and Central Europe, the governments of the EU Member States have agreed to extend the EU to countries in Western Balkans, South East Europe. At present, among these countries, there are only two candidates for EU membership – Croatia and FYR of Macedonia. Other countries of the region are considered as potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia).

The EU integration process implies legally binding, sweeping liberalization measures – not only capital account liberalization, but investment by EU firms in the domestic financial services and the maintenance of a competitive domestic environment, giving these financial liberalization process strong external and internal constraints. The way of becoming a member of EU is leaded through Stabilization and Association Process (SAP) which is helping these countries to fulfill the main conditions regarding the possible membership. However the centerpiece of the process is Stabilization and Association Agreement (SAA). SAA represents a unique contract between the EU and each potential candidate country, respecting mutual rights and obligations. Also one of the main bodies involved in the process for countries of the Western Balkans is the Commission of European Communities which has three aims: first, to encourage regional cooperation; second to promote economic stabilization and a swift transition to a market economy; and third to offer the prospect of EU accession. These Agreements are similar in principle to the Europe Agreements signed with the Central and Eastern European Countries (CEECs) in the 1990s.

While expanding the EU in the surroundings happened and still happen changes in the cultural, environmental, technological but especially in economic and financial way. The financial integration of EU countries progressed over the past 30 years in a way of financial globalization

and liberalization of capital control especially in countries and economies in transition. Most over the impact is on the benefits of cross-border flows which are bringing better global allocation of capital and improved international risk-sharing possibilities.

But as already mentioned, regardless the positive changes and effort to construct and maintain the European and global financial system and market, a big environmental affect in a nature of finance crises jeopardize the financial system of Europe, world and in the same way development and seeking certainty of future EU members, countries of Western Balkans.

It is at least to say the fact that newer financial crises caused the question of admitting new members among EU countries because of their possible negative affect on whole financial system of Europe and on the other hand forced us to analyze the potential benefits and cost of the financial integration which could face future EU members during their integration of their financial system into EU financial system as well as into the world financial market. This paper is going to focus on describing the financial system of countries of Western Balkans, negative and positive affect of domestic environment on the development of financial system and on changes in financial system required by EU through the process of potential membership in EU.

History and financial changes in the Western Balkans

When we are talking about financial system in general we can say that he is divided in three sub-sectors, such as: the banking sector (regrouping the commercial or deposits banks), the non-banking financial institutions (like savings-institutions, insurance companies, private pension funds, mutual funds societies, investment funds...) and capital (or financial) markets.

One of the roles of the bank in any financial system is to act as credit-supplier from the deposits they collect and fund they borrow from the Central Bank. These characteristics represent the main difference between banking and non-banking system. While speaking about this difference it is most important to say that non-banking institutions regarding the role in mobilization and allocation of financial resources, have unnoticed affect in the financial system of Western Balkan countries. Still the dominating affect on financial market is reserved for the banking sector which is growing and in some countries is managing over 90% of total financial assets, while, as mentioned above, capital markets and non-banking financial institutions play only marginal roles.

Even if we are talking about higher and significant difference between bank and non-banking sector the financial sector in Western Balkans improved through restructuring process, which can be observed in systematical, theoretical, political, governmental and legislation changes obtained from EU experience. Beside internal will, there is a support of international financial institutions like IMF, the World Bank and the ERBD.

All historical events in past 20-30 years have left consequences which are in fragmented way noticed in whole financial system on Western Balkan. Twenty years ago, financial markets in former Yugoslavia and in Albania were poorly developed by a lot of factors. The break-up of once big county Yugoslavia (Slovenia, Serbia, Croatia, Bosnia and Herzegovina, Montenegro and Macedonia) led to fragmentation of once whole unique financial system to pieces including financial services companies through establishment of new regulatory institutions and freezing of foreign currency deposits. During so called conflict age in 90's on Balkan we had: hyperinflation in Serbia and Montenegro; the wars in Bosnia and Kosovo; and banking crises in several countries of the region that weakened the financial sector. Besides this internal problems in the countries, macroeconomics disturbances in surrounding, inefficient legislation, a large stock of bad debt and low capitalization rates made financial system in Balkan uncertain and undefined. When we are speaking about the structure of financial system, it was characterized by domination of banking sector, while the role of non-banking sector in concentration and allocation of financial resources was almost non-existent.

General irresponsibility of banks as main participants in financial system can be explained with them unable to fulfill the requirements established by governmental laws and with a high-level of risky loans which resulted in general insolvent stage of banking sector.

During 10 year period after 90's governments started with the process of modernizing and strengthening bank sector by new regulatory frameworks, financial supervision which resulted in stabilizing the whole sector, reducing bad loans dramatically, and with a help of privatization government decreased ownership in banking to less than 20% and attracted foreign banks into the market.

Unfortunately, despite these positive developments cited above, financial markets in the Western Balkans remained small, fragmented, and at an early stage of their development in comparison with EU financial system. The general characteristics of this market are: activity on the equity market is considerably lower than activity of the banking sector; majority of the countries are characterized by low liquidity on the capital market (with exchange concentrated on small number of shares of listed companies).

If we want to talk about new period after year 2000, with a certainty is responsible to say that whole Western Balkan banking sector is drastically improving in a way of modernizing and

strictly implementing and honoring activities regulated by European financial laws. Because of that he has recently attracted considerable attention from foreign investors through a removal of national restrictions, the liberalization of market access, and the sale of state owned banks.

Beside entrance of potential investors, Western Balkans becomes popular market for more EU banks who wanted to expand their activities to countries of the region. Their first presence was noticed on the beginning of year 2000 when they started setting up small representative offices in order to serve their home clients who were entering the region. After development of the market and making a stronger connections with Europe through EU regulative, Western Balkan financial market become more familiar with local conditions so EU banks expanded their presence in the region.

Now some of them have established branch networks on the region with offering a broad range of financial services and acting as so called “universal banks”. Majority of foreign banks retain the highest share of total assets of banking system in the region. For example:

- In 2007, banks with majority of foreign capital controlled approximately 75% of banking market of Albania, Bosnia and Herzegovina, Montenegro and Serbia.
- In 2005-2007, the market share of foreign banks stood at around 90% in Albania. Banks with majority of foreign capital controlled 86.1% of Bosnia and Herzegovina banking market in 2005, 90.3% in 2006 and 91% in 2007.
- In Serbia, it increased from 37% in 2005 to 75.5% in 2007, due to privatization and organic growth of the subsidiaries of EU banks.
- Share of foreign capital, in Montenegrin banking sector, was around 78.8% by the end of 2006.

Owners include international banking groups coming primarily from EU countries (such as Austria, Italy, Greece, France, etc.). Austrian and Italian banks in particular operate across the Western Balkans. For instance, the Austrian investors are dominant in Bosnia and Herzegovina (59% of banking assets in 2007) and in Albania (55% of banking sector in 2005). Greek banks have also entered the region. By mid 2005, they had invested around EUR 750 million in the Western Balkans, half of which in Serbia alone.

All of this changes and investments in whole region by EU banks enabled numerous positive changes in the region such as: providing stable foreign source of financing domestic credit expansion and improving the performance of the domestic banking sector. The mode of action of EU banks was directly forced to strength the banking system in the region and to improve the low level of intermediation. That did that using foreign direct investments of EU banks into domestic banking sector.

Besides that, their enormous experience in modern way of running business through risk-management, marketing techniques and whole know-how enabled them to raise awareness of importance in implementation new governance standards and introducing new financial products.

Except the capital that EU banks brought in the region of Western Balkans, more importing was EU regulative as more significant in the way of building stable financial perspective of the region. As we could notice in every country banks with a foreign capital had a big influence in regional banking markets, which, as expected, during the new economic crises showed really risky especially if the bank wanting to reduce the global costs starts with detaching main part of the capital from Western Balkans.

Newer history

The world crisis from the beginning 2007 causes increasing bank credits by 30% in the area, and the rise continued the first months during next year. Banks in region of Western Balkans maintained safety position because of insulation. The interesting fact is that the Balkan banking recorded growth during the years of crises while other bigger financial markets such as European and overseas were trembling every day.

Extension of the crisis to the other sectors of the money market and the economy world its long duration, marked the development of the banking environment during first half of the year 2008, the dynamics of growth in the area of Balkans remained vigorous.

The rather low level of exposure to the international financial institutions, weak integration at the international markets and the strong capitalization of the international banks operating in the Balkan area are some of the factors explaining the isolation position.

If we are talking about newer and further tendencies of EU membership Slovenia joined the UE in 2004, Romania and Bulgaria in 2007. Croatia is the next one for enrolling because she started from 2006 to negotiate as potential member, and after Croatia the next country which is really close to membership is Macedonia but contrary to Croatia they just signed the Agreement of stabilization and association (the first step towards adhesion) in 2001 and didn't start the official preparing for the membership. Albania, Serbia, Montenegro and Bosnia-Herzegovina are the last countries of Western Balkan applying for the membership but their position is

undefined yet because these States only signed the Agreement of stabilization and association, without obtaining any statute of applicant country.

The reorganization of the financial sector, the banking environment and privatizations took big steps in Balkan countries these last years and are almost finished. But unfortunately while we are talking about reorganization of financial system or privatizations in every country in transition from time to time we can hear about the corruption, organizing crime or even indirectly presence of any actual political party.

Despite that, new legal and institutional, obligatory reforms under the terms of the process of European integration, should also have durable positive effects on the regional economies and the banking structure. Economists are expecting continuous growth of GDP. Especially economists from the IMF, but by watching the budget deficits of these countries and the actual economist crises, financial markets in this region have the irregular behavior which automatically reflects on the size and possible pulling international capital from country.

While financial crises on big markets are lowering available credit on the international markets, the companies of the area turn more and more to the local banks to secure a loan. Besides that, the mortgage loans became one of the most dynamic products in the sector. The financial institutions became able to support the strong growth of the deposits of the last years, as confidence increased in the banking environment. To that are added the completion of the privatization of the banks, various institutional reforms in financial systems and the rise of the levels of incomes.

Slovenia enjoys the strongest base of saving of all Balkan countries, with approximately 108% of the GDP in 2007. As, increasingly solid confidence in the banking environment of Balkan countries (and their financial system), stimulated by privatizations and the arrival of foreign banks during last years, was confirmed by a continuous increase in the saving expressed as a percentage of the GDP.

Conclusion

Countries of Western Balkan in the beginning of transition period avoided any radical reform of their financial system and focused only on partial changes which didn't have any major affect on future position on financial market. But after obtaining a position in the Europe where they become a few unsettled economies they noticed that restructuring is necessary in a case of urge avoiding the macroeconomic crises. As mean that development of financial sector is an important segment of economic transformation.

While speaking about reforming the financial sector, the main idea in the Western Balkan countries was changing the role of it in a way of higher mobilization, concentration and allocation of financial resources. That reform established continuing process of financial integration on internal and external (European) perspective.

The dynamic and focus of changes were realized only in banking system through very strong entry and presence of foreign banks. With their entrance on the market of Western Balkan countries, they received a significant safety in liquidity way and rises the believing of citizens in banks.

In a case of speaking about other sectors of financial system as non-banking sector or direct financial market, it's needed to state underdevelopment. There are many reasons, of which lack of EU regulative, higher presence of political structures inside the decision circle are one of the stronger. Until now, the most important changes in financial system in these countries were realized only in banking sector, while the changes were almost insignificant in the other segments of the financial sector. Speaking about process of privatization of state capital, is mentioned as highly important part of maintaining structured and defined capital which is expected to be leading fund of countries in transition. Unfortunately, corruption and political covers determined bad outcome of this process and in that way determined high loss.

However, it would be necessary to determine the optimal level of foreign banks participation in order to leave enough space for the domestic banks which would risk becoming entirely dependent from these foreign banks. In fact, the local banks play a very important role in these countries by financing the numerous small and medium size enterprises which are not financial attractive for banks from abroad.

One of the main conclusions which must be spotted by countries in transition is development of two other financial sectors but with strict liberalization, because the current world wide crisis

showed that too large financial liberalization could lead to serious financial and banking risk. In a way of being more confident during a process of financial development, countries should have governmental rules which would lead system to obtained liberalization and possibility to improving.

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