FINANCIAL LIBERALISATION AND GLOBALISATION - IMPACT AND EFFECTS IN SOUTH-EAST EUROPEAN COUNTRIES

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1. Financial liberalisation - notion and importance

1.1. Notion of financial liberalisation

The process of financial liberalisation started in the late sixties and early seventies and it has become one of the most important processes in the world economy over the last two decades of the twentieth century. The essence of this process is removing the government's control over the interest rates, banks' credit policies, ownership structure and international capital mobility. The process of financial liberalisation directly influences the level of interest rates and indirectly, the structure of capital costs, marginal efficiency of investment and the levels of aggregate savings, investments and employment. When implemented in full, financial liberalisation implies the implementation of the following six measures:

- removing government's control over credit policy of banks;
- removing government's control over interest rates;
- free entry to the banking sector;
- autonomy of banks;
- private ownership of commercial banks and other financial institutions;
- removing government's control over international capital flows.[1]

The discussion on the effects of financial liberalisation in financial literature has intensified following the seminal works of Ronald McKinnon and Edward Shaw published in 1973.[2] The authors argue that government's impact on the process of supply and demand of financial resources has strong tendency to be harmful for an economy as a whole, as well as for the market participants. The basic thesis of the two authors is that an economy in which the government directly influences banks' credit policy and sets the ceilings on interest rates results in the fall in aggregate savings and investments and inefficient distribution of financial resources. Following from this, the authors conclude that the countries characterised by financial repression i.e. by the direct government's influence on the financial sector, end up having sub-optimal macroeconomic performance and less favourable development prospects.

Financial liberalisation creates a number of possibilities for the market participants. From the perspective of a borrower the global financial markets offer a number of choices and possibilities for borrowing accumulated financial resources in the countries with financial surpluses at a lower price (interest rates). In comparison with borrowing at the national markets, the borrowers have more options in the international financial markets or in the open national financial markets. They can also use a number of opportunities in the derivatives markets for hedging purposes.

Financial liberalisation can have a positive influence on the development of national financial markets due to the fact that local commercial banks and other local financial institutions are exposed to stronger competition from foreign banks. It can also lead to an increase in the levels of knowledge and technology, and consequently decrease costs of financial transactions and interest rates. From the point of view of financial investors (lenders), financial liberalisation offers many options in line with the portfolio theory argument of not putting all eggs into the same basket. It allows making more profit at a lower risk.

1.2.The importance of financial liberalisation for economic activity and growth

Financial liberalisation should have as a consequence an efficient distribution of financial resources, rising level of aggregate savings and more efficient use of financial resources as preconditions for creating a sustainable basis for the economic growth and development.

Interest rates, as a price of money, have a direct influence on the costs of financing the working capital needs, and an indirect influence on the companies capital structure. Deregulation of interest rates i.e. removing the ceilings on deposit interest rates set by the government, has resulted in increased competition in the commercial banking industry, but also in an increase in interest rates on deposits and loans.

The supporters of financial regulation argue that by imposing the ceilings on interest rates the government stimulates the economy through lower level of interest rates on loans. The arguments are the following:

- the government imposes the ceilings on deposits interest rates,
- the ceilings on deposit interest rates result in a lower level of interest rates on loans,
- a lower level of interest rates on loans allows higher aggregate investments,
- increase in aggregate investments stimulates GDP growth and employment,
- increase in employment contributes to the broader tax base, and increase in aggregate expenditure to the increase in private sector consumption which stimulates investment activity.

On the other side, the supporters of financial deregulation and liberalisation have the following arguments:

- by setting the ceilings on deposits interest rates the government supports an increase in moral hazard activities and adverse selection, causing a decrease in economic efficiency of the borrowers, reducing competition as well as the level of savings,
- a decrease in savings causes a decrease in investments, and
- decreased level of investments causes a decrease in employment, and economic stagnation.

Merton Miller, a Nobel prize laureate for 1990, has been one of the prominent proponents of financial deregulation. He states the following: "Regulation, in practice, affects an industry's competitiveness mainly by lowering it. Regulation, by its very nature, makes costs of production higher than they otherwise would be. ... To say that regulation raises costs of production is not to suggest, of course, that such cost increases are never justified. Externalities, such as pollution, do exist; and imposing compensating costs on those who cause it, and thereby reducing their combined output of product plus pollution, is often clearly in the public interest."[3]

Joel Bessis points out the problems arising from too many regulations, on one hand, and too much competition, on the other: "Too many regulations conflict with competition for two reasons. Those who are constrained by regulations are at a disadvantage compared to other players. Regulations have often limited the scope of operations of the various types of financial institutions, thereby interfering directly with free competition. This is the old dilemma that led to the deregulation of the banking industry. ... Too much competition, conversely, generates new risks during the transition between the old and the new rules. Lifting existing constraints stimulates new competition. Sometimes, this leads to increased risks and failures for those players that are not yet ready to new businesses. Deregulation implies that players can freely enter new markets without any barriers, thereby disrupting established behaviour. The brutal increase in competitive forces is a source of new risks."[4]

Financial liberalisation, however, implies an important role of the government and international regulatory institutions in setting the standards in financial industry, and in carrying out the process of supervision. The reason for the government regulation, and for the adoption and implementation of the international standards and rules lies in the fact that there are important asymmetries in available information between different market players. The most important source and reason for regulation are different goals of private financial institutions and economic policy makers. The goal of private financial groups is to make profit. In commercial banking industry, like in other industries, making higher profits involves undertaking the new risks and these are associated with the higher rates of return required. A specific feature of the banking industry in respect to other industries is that the banking industry creates a new purchasing power through the process of extending loans as a necessary precondition for new investments. The influence of this industry on the real sector is of an utmost importance, especially in the countries in transition and developing countries with the undeveloped capital markets.

1.3.Financial liberalisation and economic growth - recent evidence

The process of financial liberalisation on a global economic scale has been carried out from the very different starting positions of different countries over the last three decades. The possibilities and advantages of the liberalised financial markets, as previously discussed, could be primarily used by the global players who have substantial advantages in information, technologies and financial resources. As borrowers, companies can take the advantage of the liberalised capital markets if they are already world-class companies, or at least if they are well known companies in the global markets, but in order to become the world-class company it is necessary to create preconditions in the local financial markets supportive of local companies. The countries, which already have developed market structures and financial institutions, have substantial advantages in comparison with the countries lacking developed financial systems.

As a consequence of the very different starting positions of different countries, the process of financial liberalisation has partly contributed to a huge gap between rich and poor countries. The level of wealth of the five richest countries in the world, measured by the wealth coefficient [5], was 128 times higher than the level of wealth of the five poorest countries in 1980. The difference has been almost doubled over the 18-year period. In 1998, the wealth coefficient of the five richest countries in the world was 249 times higher than in the five poorest countries. Our analysis[6] shows that the fastest growing economies in 1980-1998 were Singapore, Hong Kong, South Korea, China, Taiwan-China, Ireland, Portugal, Mauritius, Japan, and Sri Lanka. Comparing the results of Causevic's analysis with the results of the analysis carried out by Williamson and Mahar[7] it is rather puzzling that four out of ten fastest growing economies over the 1980-1998 period were largely or partly financially repressed (South Korea, China, Taiwan-China, and Sri Lanka). Moreover, throughout 1990s and at the beginning of the 21st century, China has been the fastest growing economy in the world and it is still partly financially repressed economy.

Table 1 - Ten fastest growing economies in the world oer 1980 - 1998 period

Rank	Country/Economy	Wealth Coefficient in 1980	Wealth Coefficient in 1998	Coefficient Growth in %
1	Singapore	2.058	5.444	164.5
2	Hong Kong - China	2.301	5.079	120.7
3	South Korea	0.663	1.418	113.9
4	China	0.083	0.159	91.6
5	Taiwan-China	1.492	2.849	91.0
6	Ireland	2.377	4.524	90.3
7	Portugal	1.186	2.182	84.0
8	Mauritius	0.435	0.750	72.4
9	Japan	3.667	6.140	67.4
10	Sri Lanka	0.108	0.172	59.3
	Average world wealth coefficient	**1.528**	**1.380**	**- 9.7**

Source: Causevic, Fikret, Financial Deregulation, Globalization, and Efficiency of Economic Policy, Ph. D thesis, Sarajevo, September 2002

The following table shows that among the ten fastest growing economies in the world over the 1980-1998 period, South Korea, China, and Taiwan-China have been relatively closed economies with an above-average number of restrictions on capital flows (the total number of restrictions is 14).

Table 2-The number of restrictions on international capital movements 1998 and country ranking according to openness for international trade and capital transactions

	Country	The Number of Restrictions on Capital Mobility in the Country	Country Ranking of Openness in GCR 2000
1	Singapore	5	2
2	Hong Kong - China	1	7
3	South Korea	11	41
4	China	12	54
5	Taiwan - China		
6	Ireland	2	4
7	Portugal	4	10
8	Mauritius	4	48
9	Japan	3	37
10	Sri Lanka	---	---

Source: World Economic Forum, Global Competitiveness Report 2000, Geneva, New York, Oxford, Oxford University Press, 2000; IMF, Annual Report on Exchange Arrangements and Exchange Restrictions 1999.;Sri Lanka was not included in Global Competitiveness Report

Robert Barro and Xavier Sala-i-Martin[8] analysed economic growth performace on a sample size of 122 countries over the 1965-1990 period. The authors show that 24 fastest growing economies (the upper quintile) in the world over the period were the following: Singapore, South Korea, Botswana, Malta, Taiwan, Hong Kong, China, Indonesia, Cape Verde, Japan, Malaysia, Congo, Lesotho, Cyprus, Seychelles, Tunisia, Rwanda, Thailand, Brazil, the former SFR Yugoslavia, Syria, Portugal, Norway and Greece. The conclusions of the authors about the most important causes and sources of economic growth are very interesting. Democracy, in the standard sense of the word, is not a key precondition for the economic success. The most important sources of economic growth are education, investments and health protection. Taking into account that 13 out of 24 fastest growing economies in Barro-Martin analysis were predominantly or partly financially repressed over the 1965-1990 period, the conclusion about the influence of quickly and fully adopted financial liberalisation on economic growth and macroeconomic stability does not support the Shaw-McKinnon thesis.

However, there is an evidence that already well established market economies in the late 1970s and at the beginning of the 1980s, benefited by adopting the measures of financial liberalisation. This is especially true in case of the United States, Germany, the United Kingdom, Ireland, Spain and Italy. In the case of the United States, the financial liberalisation had as a consequence substantial increase in interest rates both on deposits and on extended loans in the early 1980s, subsequent recession, and a budget deficit followed by a huge rise in public debt (newly issued treasury bills and bonds), from about USD 950 billion in 1980 to about USD 5,750 billion in 1999. ? Such a huge increase in newly issued treasury bills and bonds has allowed the Fed to apply more sophisticated techniques of implementing monetary policy, especially in the way of directly influencing the short-term structure of interest rates and indirectly, the long-term interest rates, including the structure of capital costs in business companies. Contrary to the thesis put forward by McKinnon and Shaw, financial liberalisation in the United States resulted in huge and historically highest level of the household debt (negative savings) during the 1990s.[9]

2. Financial liberalisation in South-East Europe

This part of the paper deals with the medium-term results of financial liberalisation in South-East European countries i.e. in Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FR Yugoslavia, FYR Macedonia and Romania. The process of financial liberalisation in the region began in 1990, but the most important steps were taken during the 1996-2002 period in almost all countries in the region.

According to the data of the European Bank for Reconstruction and Development all countries in the region implemented full current account liberalisation and full financial deregulation (deregulation of interest rates) by the end of 2001:

Table 3 - Financial liberalisation in South-East Europe

Country	Current Account Convertibility	Deregulation of Interest Rates	Exchange Rate Regime
Albania	full	full	Managed float
Bosnia and Herzegovinia	full	full	currency board - pegged to euro
Bulgaria	full	full	currency board
Croatia	full	full	Managed float
FR Yugoslavia	full	full	Serbia managed float / Montenegro pegged to euro
FYR Macedonia	full	full	fixed to euro
Romania	full	full	managed float

Source: The European Bank for Reconstruction and Development, Transition report 2002 - Agriculture and rural transition, London, October 2002, pp. 112, 128, 132, 136, 148, 152, 188.

An analysis of growth rates and the levels of wealth in the countries in transition carried out by Causevic[10] has shown that the best performer out of the 26 countries in transition has been Slovenia, followed by Czech Republic, Slovak Republic, Hungary, and Poland. A country with the highest level of wealth coefficient among the SEE countries has been Croatia, which ranked sixth, followed by Romania (rank ten), and Bulgaria (rank eleven).

Table 4- Wealth coefficients of the countries in transition accounted on the basis of USD PPP - 2000

Rank	Country	Wealth Coefficient
1	Slovenia	2.176
2	Czech Republic	1.733

3	Slovak Republic	1.261
4	Hungary	1.145
5	Poland	1.039
6	Croatia	0.849
7	Estonia	0.833
8	Belarus	0.791
9	Lithuania	0.754
10	Romania	0.630
11	Bulgaria	0.620
12	Russia	0.618
13	Latvia	0.610
14	Kazakhstan	0.484
15	Armenia	0.429
16	Uzbekistan	0.382
17	FR Yugoslavia	0.371
18	Moldova	0.347
19	Kyrgyz Republic	0.342
20	Ukraina	0.338
21	Turkmenistan	0.320
22	FYR Macedonia	0.294
23	Azerbaijan	0.262
24	Bosnia and Herzegovina	0.246
25	Albania	0.232
26	Tajikistan	0.154
	Average coefficient	**0.664**

Source: Causevic, Fikret, Financial Deregulation, Globalization, and Efficiency of Economic Policy, Ph. D thesis, Sarajevo, September 2002

2.2. Financial liberalisation and macroeconomic performance in Albania

Financial liberalisation in Albania started in 1992/1993 when the first steps were undertaken by establishing the two-tier banking system (1992) and by allowing the first foreign-owned bank to start operating (1993). The process of financial liberalisation has been intensified since 1997 by putting financial pyramids under the international administration (1997), amending the Banking law (1998), lifting credit ceilings for private banks (1999) and selling the National Commercial Bank to a foreign investor.[11] By the end of 2002, the full current account convertibility and interest rate deregulation were in place in Albania. Banking codes, supervisory practices and capital adequacy are based on the Bank for International Settlements codes and practices. Capital adequacy ratio was raised to 12 % in May 1999.

At the beginning of 2002, there were 13 commercial banks in Albania out of which 12 were owned by foreigners. The last state owned bank is the Savings Bank, the largest bank in Albania with 59.2% share in total assets, and 63.7% share in total deposits of commercial banks in Albania[12]. According to EBRD 2002 Transition report, privatisation of the Savings Bank failed in 2002 due to the lack of investors interest since the Bank is the most important financer of the government deficit.

The ratio of total banking assets in Albania to GDP increased from 45.8% in 1996, to 49.2% in 1999, and 53.9% in 2001. However, the most important asset-items have been the treasury and inter bank transactions, having approximately 82% share in the total assets over the last four years. The share of loans extended to private sector and individuals in the total assets was extremely low in comparison with the other SEE countries, ranging in Albania from 5.6% in 2000 to 10.2% in the mid 2002. The ratio of loans to private sector to GDP at the same period was 2.7% and 2.9% respectively.

Table 5 -Albania - Aggregate balance sheet of commercial banks - millions of LEK

Assets	30/09/2000	30/06/2001	30/06/2002
1. Treasury and inter-bank transactions	215,716.3	253,614.2	257,447.4
- transactions with Central Bank (CB)	28,575.2	30,390.3	26,802.2
- treasury bills and other bills eligible for ref. With CB	120,932.3	156,475.3	165,700.5
- transactions with banks, credit inst. and other financial institutions	51,493.0	51,680.5	50,679.4
2. Operations with customers	31,121.5	19,201.8	33,328.1
- loans to private sector and individuals	14,512.5	17,199.3	32,086.6
- loans to public administration	15,556.3	241.1	0.0
3. Securities transactions (net)	4,650.6	9,214.5	14,482.0
Provisions	- 16,044.4	- 11,012.0	- 1,337.8
4. Other assets	1,843.2	2,038.5	0.0
5. Fixed assets	7,035.0	5,506.3	13.1
Accrued interest	206.1	- 273.0	858.7
T O T A L	**260,572.8**	**289,302.2**	**314,538.3**

Liabilities and Capital	30/09/2000	30/06/2001	30/06/2002
1. Treasury and inter-bank transactions	6,879.1	6,267.4	17,762.8
2. Operations with customers	220,827.9	247,412.5	261,795.6
- of which with private sector	215,442.3	241,101.5	257,397.3

3. Other liabilities	13,618.7	11,821.5	11,123.0
4. Permanent resources	15,716.1	20,607.7	20,550.6
Accrued interest	3,531.0	3,193.1	3,306.1
T O T A L	**260,572.8**	**289,302.2**	**314,538.3**

Source: the National Bank of Albania / web page: www.bankofalbania.org

Macroeconomic stabilisation in Albania was achieved in 1999, when the problem of high inflation rates in preceding years was eliminated. The inflation rates measured by the annual average of consumer prices were relatively high in 1994 (22.6%), in 1997 (33.2%), and in 1998 (20.6%). Since 1999, inflation rates have been very low, between 0.4% and 3.1%. At the same time, GDP growth rates were 9.9% in 1999, 6.5% in 2000, and 9.5% in 2001. The growth rates have been primarily driven by foreign direct investments, with a minor role of the commercial banks' loans for businesses and new jobs.

Table 6 - Albania - basic macroeconomic data

	1998	**1999**	**2000**	**2000**
1.Fiscal data (% of GDP)				
- General government balance	- 10.4	- 11.4	- 9.1	- 8.5
-Government expenditures	30.7	32.7	31.4	31.5
- General government debt	60.1	62.2	71.5	72.6
2. Gross domestic product (in millions of LEK)	460,631	506,205	539,210	590,237
- Gross domestic product per head -in USD	903	1,078	1,094	1,330
3. Foreign direct investments (in millions of USD)	45	51	141	204
4. Gross foreign reserves (in millions of USD)	384	485	608	680
5. External debt - millions of USD	970	1,068	1,130	1,157
6. Current account deficit (in % of GDP)	- 8.2	- 7.2	- 7.0	- 6.3
7. CPI INFLATION (annual average - in %)	20.6	0.4	0.1	3.1
8. UNEMPLOYMENT RATE (in %)	19.6	18.0	16.9	14.6

Source: the National Bank of Albania, Annual Report 2000; Statistics; EBRD, Transition report 2002, London, October 2002, p. 113

2.3. Financial liberalisation and macroeconomic performance in Bosnia and Herzegovina

Central Bank of Bosnia and Herzegovina (CBBH), established in August 1997, is the only institution on the state level which has the responsibility for conducting single monetary regime under the currency board rules. BH had no single currency until June 1998 when the convertible mark (BAM) was introduced as a single currency under the hard currency peg regime (1 BAM = 1 DEM). Entity agencies in Federation of BiH and Republika Srpska have been established after the establishment of CBBH. According to the Banking Law of FBH, adopted at the end of 1998, required core share capital was increased from BAM 2.5 million to BAM 5 million. The amendments to FBH Banking Law adopted at the end of 2000, required the commercial banks to have met the core share capital of BAM 7.5 million by March 2001, then BAM 10 million by June 2001. The banks were also required to increase their core share capital to BAM 15 million by 1 January 2003.

At present, BH has one of the most liberal financial systems in Central and South-Eastern Europe. Banking laws and the entity banking agencies' rules allow for an independent credit policy of commercial banks. The banks have to meet the criteria for managing risks in the banking industry and the criteria for the classification of assets as set by the banking agencies. Almost all the rules are based on the Basle standards and rules in the banking industry. Having in mind that 26 out of 33 banks in FBH, and 8 out of 14 banks in RS were privately owned at the end of 2001 and that at the same time 75% of the total amount of core capital of BH banks was also privately owned, the indirect influence of the entity governments on credit policy through state-owned banks plays a minor role.

Interest rates are freely determined in the market according to the commercial banks' internal management goals and strategies. Free entry into the banking sector has been allowed since 1997. Both residents and foreigners have been allowed to establish commercial banks with no limit regarding foreigners' share in the required core capital. The banks have to meet the criteria of required core capital, as well as technical and personnel requirements. At the end of 2001, over 60% of the total core capital of banks in BH was owned by foreigners. The autonomy of banks is also allowed. According to the banking laws, banks in BH have the autonomy to run their own affairs and businesses, with an exception of state-owned banks. However, having in mind that state-owned banks have been playing a minor role in the banking sector, the autonomy of banks is the rule, not an exception in BH.

Changes in the entity banking laws (1998-2000) had as a consequence substantial decrease in the number of licensed banks. According to the data of CBBH and the entity banking agencies the number of banks in BH decreased from 66 at the end of 1998, to 56 at the beginning of 2000 and to 48 by the end of 2001. ? Political stabilisation in BH, led by the presence of international community, has resulted in the rising interest of foreign investors for direct investment in the banking sector. In spite of a decrease in the number of licensed banks in BH, the total value of assets increased by 73.4% from 1997 through 2001. Non-performing loans have been written off from the balance sheets of state-owned banks, and some of these banks have been privatised. The structure of consolidated balance sheet of commercial banks in BH can be seen in the following table:

Table 7 - Consolidated balance sheet of commercial banks in Bosnia and Herzegovina
- BAM millions

		31.12.'98	**31.12.'99**	**31.12.'00**	**31.12.'01**
1.	**ASSETS**	**3,589**	**3,883**	**4,244**	**5,337**
1.1	Reserves with the CBBH	207	276	287	870
1.2	Foreign assets	543	832	945	1,346
1.3	Loans extended to enterprises	2,547	2,468	2,586	2,385
1.4	Loans extended to Citizens	260	276	398	703
1.5	Receivables from the governments	32	31	28	33
2	**LIABILITIES AND CAPITAL**	**3,589**	**3,883**	**4,244**	**5,337**
2.1	Governments' deposits	153	136	110	243
2.2	Demand deposits	777	1,051	1,304	1,942
2.3	Time and savings deposits	475	600	506	1,048
2.4	Foreign liabilities	1,555	1,515	1,572	1,308
2.5	Net capital	629	581	752	796

Source: Central Bank of Bosnia and Herzegovina, Bulletin 4/2001, pp. 91-95
Important note: There are some inconsistencies in the data on balance sheet items published by the CBBH and by the entity banking agencies (in cases of some items the differences are even about 15%). Fikret Caušević, the author of this paper, is not responsible for the differences.

The share of reserves and foreign assets of commercial banks in BH has increased from 24.3% at the end of 1997 to 41.5% at the end of 2001. On average, 60% of the total foreign assets has been held in foreign banks and non-bank financial institutions.

However, the share of loans extended to enterprises decreased from 70.5% at the end of 1997 to 44.7% at the end of 2001. The largest share of loans has been extended to enterprises in trade and services industries (about 60% of the total loans). In the same period, loans extended to citizens increased by 5.2 times. On the liabilities and capital side of balance sheet the value of demand deposits increased by 3.4 times from 1997 to 2001, and their share increased from 18.4% to 36.4%. Time and savings deposits increased by 2.8 times, and their share from 12.1% to 19.6% from 1997 through 2001. Net capital increased by 38.4%, but its share decreased from 18.7% to 14.9% over the analysed period.

Having in mind that commercial banks in BH have been in fact the only financial institutions responsible for business sector financing (insurance companies had almost no role in business sector financing), the conclusion on the impact of financial deregulation in BH on economic growth and development can be derived from the data shown in the tables 7 and 8:

Table 8 - Economic indicators in Bosnia and Herzegovina - 1998 - 2001- values in BAM millions

	1998	**1999**	**2000**	**2001**
Gross domestic product (GDP)	7,439	8,604	9,433	10,375*
CPI inflation - in %	5.8	2.8	7.0	0.8
Trade deficit	- 4,077	- 4,673	- 4,317	- 4,692
Trade deficit as % of GDP	54.81	54.31	45.76	45.22
Official employment	651,314	654,371	639,053	598,416
Official unemployment	398,639	409,290	415,037	416,753
Estimated informal employment*	215,000	220,000	240,000	265,000
Value of the total assets of the banking sector	3,589	3,883	4,244	5,337
Assets of the banking sector as a % of GDP	48.25	45.13	44.99	51.44
Foreign currency Reserves of BH (CBBH)	283	866	1,021	2,697
Foreign debt	n.a.	n.a.	4,200	4,100

Sources: Central Bank of Bosnia and Herzegovina, Bulletin 4/2001, pp. 26, 47, 55, 59, 65, 89-95; source of data on foreign debt is the Council of Ministers of BH; * - author's estimation of GDP for

2001 and of the number of informally employed - the equivalent number of full working engagement (1,600 working hours per year); inflation rate is constructed by the author, and it represents weighted average of the rate of inflation on the entity level using 0.75 weight for FBH and 0.25 weight for RS.

The data presented in tables 7 and 8 suggest the following trends. GDP has increased by 58.1% over the 1997 - 2001 period. At the same time, the assets of banks have increased by 73.4%. Taking into account that GDP growth has been primarily led by foreign donations on multilateral and bilateral basis (approximately about 70% of GDP growth), substantial increase in the banking assets has not played most important role in GDP growth. Trade deficit of BH has been extremely high - on average 50% of GDP over the past four years. The commercial banks have channelled the highest share of credits extended to enterprises to the commercial enterprises. Having in mind that the commercial enterprises have been primarily orientated to imports of final consumer goods, it was hardly surprising to see such a high trade deficit.

2.4. Financial liberalisation and economic growth in Bulgaria

Process of financial liberalisation in Bulgaria began in 1991 by liberalising interest rates in February, and by establishing the First Bulgarian Stock Exchange in November. In the following year, new Banking Law was adopted, which was followed by the introduction of the loan classification and provisioning. BIS capital adequacy standards were enacted in March of 1993, and the Bankruptcy Law was adopted in July of 1994. The first phase of financial system reforms from 1991 through 1997 was marked by the financial instability, reflected in the fact that Bulgarian currency devalued roughly by 7.4 times against USD from 1994 to 1996. Financial crisis reached its peak in February of 1997, and it was followed by the introduction of new lev pegged to deutsch mark and later on to euro.

The second phase of financial liberalisation started after the introduction of new Bulgarian Lev in 1997. In July 1997, the Bulgarian National Bank started to implement monetary policy on the currency board rules. The process of financial liberalisation in Bulgaria has been fostered by the privatisation of the first state-owned bank, and by adoption of the New Banking Law. Full current account convertibility in Bulgaria was introduced in September 1998. The accession of international capital markets was marked by the first corporate Eurobond issue in August 1999 and by the first government Eurobond issue in November 2001.

Due to the fact that currency reform was carried out in 1997, Bulgarian national currency has maintained the stability ever since. The consumer price fell from an annual average of 123% in 1996, and extremely high inflation of 1,082% in 1997, to 22.2% in 1998, and 0.7% in 1999. Inflation rate increased during 2000 and 2001 to 9.9% and 7.4% respectively, but it was at a moderate level. Financial stabilisation in 1997 and adoption of the new package of laws in the banking industry laid the ground for the commercial banking sector restructuring and rising interest of foreigners in the sector. The number of banks decreased from 42 in 1996 to 35 in 2001. At the same time, the number of foreign owned banks increased from 3 in 1996 to 26 in 2001. The share of state owned banks in the total assets of commercial banks decreased from 82.2% in 1996 to 19.9% in 2001. In July 2002, the Bank Consolidation Company selected Bank Austria - Hypo Vereinsbank as the exclusive buyer of Biochim Bank (fourth largest bank). The last remaining state owned bank, State Savings Bank (DSK), is under the process of privatisation.[13]

Since 1997, financial liberalisation and monetary stabilisation in Bulgaria have allowed the commercial banks to be autonomous in structuring their balance sheets and portfolios on a more stable footing, at a lower systemic risk.

Table 9 - Bulgaria - aggregate balance sheet of commercial banks - in thousands of BGN

ASSETS	31/12/1999	31/12/2000	31/12/2001	30/06/2002
1. Vault cash and current accounts with BNB	917,513	736,961	1,287,012	989,325
2. Claims on banks and other financial institutions	2,667,253	3,895,202	4,049,424	3,270,656
3. Securities in trading portfolio	1,041,749	1,061,816	1,521,307	1,766,729
4. Securities in investment portfolio	623,958	436,999	520,636	827,652
5. Credits	2,399,428	3,022,254	4,145,865	4,769,243
- credits to the budget	3,518	3,445	5,772	6,871
- credits to public enterprises	291,973	117,034	148,273	193,604
- credits to private enterprises	1,608,693	2,332,882	3,159,490	3,601,207
- credits to individuals and households	495,244	568,893	832,330	967,561
Total earning assets (1-5)	6,732,388	8,416,271	11,524,244	11,623,605
6. Assets for resale	15,108	8,483	14,509	14,214
7. Claims on interest and other assets	205,561	205,058	220,758	273,208
8. Fixed assets	352,858	406,747	461,018	483,771
T O T A L	**8,233,428**	**9,773,520**	**12,220,529**	**12,394,798**

LIABILITIES AND EQUITY	31/12/1999	31/12/2000	31/12/2001	30/06/2002
1. Deposits - total	6,106,386	7,116,201	9,555,693	9,632,734
- deposits by banks	468,555	583,591	698,569	661,117
- deposits by other institutions	167,849	142,921	208,782	219,724
- deposits by non-financial institutions and other clients	5,649,982	6,389,689	8,648,342	8,751,893
2. Short-term attracted resources	110,133	199,735	169,454	199,536
3. Interest payments and other liabilities	557,536	684,622	530,516	557,466
4. Long-term attracted resources	170,658	272,800	308,989	291,769
5. Subordinated term-debt	0	0	1,171	1,097
TOTAL LIABILITIES	6,944,713	8,273,358	10,565,823	10,682,602
6. Capital	889,850	1,105,289	1,206,408	1,242,051
7. Reserves	388,865	394,873	448,298	470,145
T O T A L	**8,223,428**	**9,773,520**	**12,220,529**	**12,394,798**

Source: the National Bank of Bulgaria

According to the data of the National Bank of Bulgaria, total assets of commercial banking sector in Bulgaria increased by 18.7% in 2000, and 25% in 2001 on a yearly level. The ratio of total assets to GDP was 34.6% in 1999, 36.5% in 2000, and 41.3% in 2001. The structure of assets was characterised by increasing share of the loans from 29.1% in 1999 to 33.9% in 2001. However, the share of vault cash and current accounts with the National Bank of Bulgaria, claims on banks and other financial institutions and securities in trading portfolio, taken together, have been the most important part of the total assets. The share of these balance sheet items since 1998 has been about 57% of the total assets. Roughly one third of the total commercial banking assets since 1998 has been held in the banks and other financial institutions in developed countries. It was the amount of approximately USD 2 billion at the end of 2001. This amount was about 90% of the total value of foreign direct investments in Bulgarian economy over the 1999 - 2001 period.

Despite the fact that the total value of loans extended to private and public enterprises was two times higher in 2001 in comparison with 1999, these loans were not the most important source of GDP growth. The ratio of loans extended to enterprises to GDP was 8% in 1999, 9.2% in 2000 and 11.1% in 2001. Furthermore, looking at the data from the following table, it is evident that the number of unemployed people has been rising over the last three years.

Table 10 - Bulgaria - basic macroeconomic data
- in millions of BGN

	1999	2000	2001
1. Current account	- 1,147.8	- 1,484.5	- 1,819.0
2. Trade balance	- 1,970.8	- 2,503.2	- 3,478.1
3.Capital and finance account	1,268.4	1,644.3	1,406.1
4. Net direct investment	1,483.7	2,161.4	1,487.3
5.Gross external debt (millions of USD)	9,989.3	10,364.3	9,903.5
6. Unemployment (in %)	16.3	18.0	19.5
7. Inflation CPI (annual average in %)	0.7	9.9	7.4
8. Gross domestic product (millions of BGN)	23,790	26,753	29,618

Source: the National Bank of Bulgaria, Balance Sheets of Commercial Banks; Data on inflation are from: EBRD, Transition report 2002, October 2002, p. 133

GDP growth was not impressive in real terms, ranging from 5.4% in 1999, to 2.6% in 2000, and 3.3% in 2001. Foreign direct investments have been the most important source of GDP growth. These investments have increased since 1997, with the total amount of USD 507 million in 1997, USD 789 million in 1999, and USD 1,003 million in 2000. The impact of introduction of a stable currency in Bulgaria, as well as other reforms which have been carried out in financial and fiscal sectors, have had a very positive influence on the inflow of foreign direct investments.

The banking sector reform and implementation of the Basle Capital standards have been associated with the dominance of foreign owners in the sector, and with the restructuring of the banking assets towards lower- risk balance sheet items. The best illustration of the trend is the structure of balance sheet of the largest bank in Bulgaria - Bulbank, which is owned by UniCredito Italiano. Bulbank had 20.5% share in the total banking sector assets in Bulgaria in 2001. The structure of Bulbank assets was dominated by claims on banks and other financial institutions (54.7% share in the Bulbank assets) at the end of 2001. On the other hand, the share of loans extended to private sector was only 12.3% in the Bulbank assets.[14]

2.5. Financial liberalisation and macroeconomic performance in Croatia

The first steps of financial liberalisation in Croatia were taken from 1991 through 1994, after the declaration of independence from the former Yugoslavia (June 1991). The first step was the introduction of new currency - Croatian Dinar, replaced by the new currency - Croatian Kuna in May 1994.

The introduction of the new currency has marked the beginning of a new phase of financial liberalisation and reform. Full current account convertibility was introduced in May 1995, followed by the bank rehabilitation programme in November and the introduction of capital adequacy standards in December of the same year. The Bankruptcy Law was adopted in January 1997 and two years later this law was replaced by the new one. The Banking Law adopted in December 1998 was also changed by the adoption of new Banking Law in July 2002.

The process of financial liberalisation in Croatia has had as a consequence a proliferation in new banks. There were 43 banks in 1993, 54 banks in 1995, and 61 banks in 1997. The number of banks has been falling since 1997 to 43 at the end of 2001. The share of state-owned banks in the total banking sector assets declined substantially from 51.9% in 1995 to 39.8% in 1999 and to only 5.0% at the end of 2001. At the same time, the number of foreign owned banks was rising - from 7 banks in 1997 to 24 banks at the end of 2001. The process of privatisation and internationalisation of Croatian banking system was almost completed during 2002. According to the European Bank for Reconstruction and Development, during 2002 Croatian Government sold its stake in Dubrovacka Banka, Unicredito/Allianz Group completed the takeover bid for Zagrebacka Banka, as the largest bank in Croatia in terms of assets, and the Government sold its 25% stake in Splitska Banka. As a consequence of the privatisation deals, mergers and acquisitions in Croatian banking sector during 2002, eight foreign banking groups control over 90% of total banking assets.[15]

Aggregate balance sheet of commercial banks has been characterised by the dominance of loans extended to enterprises and citizens. However, the share of these loans was declining - from 49.1% in 1999 and 44.8% in 2000, to 43.4% in 2001. An additional problem was a divergent trend in loans extended to citizens and loans extended to enterprises. Loans extended to citizens have been substantially rising, both in absolute and in relative terms. On the other hand, loans extended to enterprises have been stagnating despite the fact that total banking assets have been substantially rising. During 2001, loans extended to enterprises increased by only 2.2%, and the total assets by 32.7%. The ratio of loans to enterprises and citizens to GDP was 32.4% in 1999, 32.9% in 2000, and 39.5% in 2001. A substantial increase in deposits and assets in 2001 was primarily caused by the conversion of former western European currencies to euro. As a difference from a decreasing share of the loans, the share of low-risk balance sheet items has been rising. The share of money assets and deposits with the Croatian National Bank increased from 10.4% in 1999 to 15% in 2001. At the same time, the share of deposits with banking institutions increased from 11% to 16.1%.

Table 11 - Croatia - aggregate balance sheet of commercial banks- millions of HRK

ASSETS	31/12/1999	31/12/2000	31/12/2001
1. Money assets and deposits with CNB	9,733.5	11,489.3	22,196.3
2. Deposits with banking institutions	10,312.5	17,695.3	23,900.1
3. Treasury bills and CNB bills	3,139.5	6,059.0	9,687.2

4. Trading portfolio of securities	1,067.8	2,462.4	4,795.6
5. Loans to financial institutions	1,246.2	1,085.6	1,479.6
6. Loans to other clients	45,931.5	50,130.7	64,402.5
7. Investment portfolio of securities	15,477.1	14,167.5	12,741.3
8. Investments in subsidiaries and associates	1,768.6	2,411.0	2,199.8
9. Foreclosed and repossessed assets	447.2	614.5	446.8
10. Tangible assets and software (net of depreciation)	3,164.6	3,252.5	3,501.2
11. Interest, fees and other assets	2,518.1	3,169.2	4,273.5
12. Net of specific reserves for unidentified losses	743.6	699.4	1,195.7
T O T A L	**93,522.9**	**111,837.7**	**148,428.3**

LIABILITIES AND CAPITAL	**31/12/1999**	**31/12/2000**	**31/12/2001**
1. Loans from financial institutions	5,282.3	3,510.9	3,629.1
2. Deposits	56,997.0	72,683.4	104,697.2
- of which time deposits	34,102.1	42,375.1	61,774.6
3. Other loans	15,007.5	16,329.0	15,947.7
- of which long term loans	13,354.7	15,825.7	15,353.7
4. Supplementary capital	343.1	520.3	2,655.8
5. Interest fees and other liabilities	4,849.2	5,475.5	7,783.0
6. Profit / loss for the current year	466.4	1,123.2	570.0
7. Capital (excluding profit/loss for the current year)	10,577.3	12,195.5	13,126.3
T O T A L	**93,522.9**	**111,837.7**	**148,428.3**

Source: the Croatian National Bank

The analysis of macroeconomic performance in Croatia over the last four years, based on the data published by the Croatian National Bank and the European Bank for Reconstruction and Development, shows that real GDP growth rates have been very low. Real GDP growth rate of 5.4% in 1998 was followed by the negative real growth rate of 1.3% in 1999, and with positive growth rates of 1.5% and 1.9% in 2000 and 2001 respectively.

Table 12 - Croatia - basic macroeconomic data

	1998	1999	2000	2001
1. Gross domestic product (in millions of kuna)	137,604	141,579	152,519	162,909
2. GDP nominal growth rates	11.1	2.9	7.7	6.8
3. Retail price inflation (annual average)	5.7	4.2	6.2	4.9
4. Foreign direct investment (in millions of USD)	835	1,445	1,086	1,325
5. Foreign currency reserves (in millions of USD)	2,816	3,025	3,525	4,697
6. Foreign debt (in millions of USD)	9,586	9,872	11,002	11,189
7. Trade balance (in millions of USD)	- 4,147	- 3,299	- 3,204	- 4,012
8. Current account balance (in millions of USD)	- 1,530	- 1,391	- 433	- 642
9. Unemployment (in % of labor force)	11.4	13.6	16.1	15.8

Source: EBRD, Transition report 2002, London, October 2002, p. 137

The negative real growth rate in 1999 was associated with increasing unemployment (from 11.4% in 1998 to 13.6% in 1999), which was not the case in 2000. Despite the fact that unemployment climbed to 16.1%, Croatian economy had positive real growth rate of 1.5% in 2001, as a result of the rise in productivity. Financial stabilisation in Croatian banking sector and growth of the total banking assets have not been followed by the significant growth rates in the real economy. This problem can be seen as a temporary phenomenon and a consequence of transitionary effects, but the absence of financial resources for the development projects remains a very important issue.

2.6. Financial liberalisation and economic growth in FR Yugoslavia

Process of financial liberalisation in FR Yugoslavia has been very slow over the 1991-2000 period. This was a consequence of anti-reform orientated governments and conflicts between the constituent parts of FR Yugoslavia. Kosovo, the province of Serbia, was placed under the United Nations control in June 1999 and deutschmark was adopted as a sole currency in Montenegro in November 2000. New government in Serbia substantially improved the position of FR Yugoslavia by accepting the reforms-orientated measures in Serbian economy after coming into power in October 2000. In January 2001, partial current account convertibility was introduced and it was followed by the adoption of full current account convertibility in May 2002. Montenegro established its independent Central Bank in December 2000. Currently, there are three separate financial systems in FR Yugoslavia: Serbian, Montenegrin and Kosovar.

Opening up the Serbian financial system for foreign direct investors was reflected in the fact that the first foreign bank was granted licence in March 2001. According to EBRD Transition report 2002 the process of financial liberalisation has been accelerated during 2002, by allowing the entry of selected foreign banks. Despite this, the foreigners still cannot obtain the licence for establishing a new bank but only for entering the market through the acquisition of an existing local bank. According to the National Bank of Yugoslavia there were 43 banks classified in categories A and B, one bank was under administration, three banks were under the Federal Agency for Deposit Insurance and Bank Rehabilitation (category C), and 23 banks were under the process of liquidation (category D).[16] In January 2002, the National Bank of Yugoslavia closed the four largest state-owned and insolvent banks.

Taking into account that the exchange rate has been unified and managed under the floating rate regime and that inflation has been under control in Serbia since January 2001, the data from the balance sheet items should be taken into consideration very carefully.

Table 13 - Serbia - FR Yugoslavia
Aggregate balance sheet of commercial banks
- millions of YUD

ASSETS	31/12/2000	31/12/2001
1. Cash and equivalents	45,225.6	39,489.4
2. Deposits with NBY and short-term securities	28,876.7	20,045.3
3. Short term loans and placements	70,363.6	66,562.3
4. Short dated securities and other placements	28,299.0	6,637.8
5. Securities and other placements	2,395.6	2,238.1
6. Other assets and non-operating funds	25,752.1	13,829.8
7. Claims from FRY arising from foreign savings	188,114.2	66,786.8
8. Long term loans and placements	277,415.4	49,022.6

9. Long dated securities	8,437.5	8,106.4
10. Shares in capital	12,150.9	5,181.7
11. Fixed assets	17,319.1	13,559.9
T O T A L	**704,349.7**	**291,460.1**

LIABILITIES AND CAPITAL	**31/12/2000**	**31/12/2001**
1. Demand deposits	64,830.1	72,607.7
2. Short term liabilities of NBY	777.5	264.2
3. Short term deposits	26,092.6	20,677.3
4. Short term loans	12,419.8	3,728.3
5. Short dated securities	15,825.8	2,795.6
6. Other liabilities, subordinated liabilities and non-operating fund resources	25,689.9	7,855.3
7. Long term liabilities to NBY	984.4	389.0
8. Long term deposits	5,908.6	844.6
9. Long term loans	287,729.5	40,847.1
10. Long dated securities	2,943.4	1,166.0
11. Liabilities for frozen foreign currency savings	179,857.3	69,907.9
12. Long term provisions	57,547.2	24,191.4
13. Capital	23,743.4	46,185.7
T O T A L	**704,349.7**	**291,460.1**

Source: the National Bank of Yugoslavia, Balance Sheets of Commercial Banks

Real deposit rates of commercial banks in Serbia have been negative. The measured average of deposit rates was -11.57% in December 1998, -30.65% in December 2000, - 19.29% in December 2001, and -3.05% in June 2002. On the other hand , the real interest rates on extended loans were as follows: 32.60% in December 1998, 40.94% in December 2000, 9.15% in December 2001 and 15.77% in June 2002.[17] Clearly, the average real interest rate spread has been very high and discouraging for development-orientated projects.

Due to the fact that the real interest rate spread was very high, the share of loans extended to enterprises and citizens, out of which 39.6% in the total assets, was not surprising for 2001. However, this share could be lower for 2002, because of the non-performing loans writing off and closing down the four largest state-owned banks during 2002.

Table 14 - FR Yugoslavia - Basic macroeconomic data (excluding Kosovo) - millions of YUD

	31/12/2000	**31/12/2001**

1. Gross domestic product (millions of YUD)	348,887.0	696,908.0
2. Gross revenue collected (millions of YUD)	138,749.1	320,474.9
3. Inflation - CPI (in %)	113.3	38.7
4. Foreign exchange (December)		
- YUD / EUR	58.67	59.71
- YUD / USD	63.17	67.67
5.Foreign exchange reserves (millions of USD)	524.2	1,169.1
6. Trade balance (millions of USD)	- 1,788.0	- 2,834.0
7. Current account balance (millions of USD)	- 339.0	- 624.0
8.Foreign direct investments (millions of USD)	50.0	165.0
9. External debt (millions of USD	10,056.0	10,529.0

Source: the National Bank of Yugoslavia

From the current perspective, it is not possible to draw a clear conclusion on the medium-term results of financial liberalisation and its impact on economic growth in FR Yugoslavia, because of the fact that the process started at the beginning of 2001 and its medium-term results can be seen in the next two or three years. According to the preliminary data for 2002, a significant macroeconomic improvement was achieved in collecting public revenues, foreign exchange of dinar was stable and retail prices were under control. Despite this fact, FR Yugoslavia together with FYR Macedonia, and Bosnia and Herzegovina are the three countries in SEE region with the highest unemployment rates (27.5%, 30.5% and 22.5% respectively [18]).

2.7. Financial liberalisation and economic growth in FYR Macedonia

After declaring the independence from the former Yugoslavia in September 1991, the process of financial reform and liberalisation in FYR Macedonia started by introducing the new currency in April 1992 and by establishing the two-tier banking system in the same month. The Bank for International Settlements standards of capital adequacy were adopted in May 1993 and the National Bank of the Republic of Macedonia carried out its first credit auction in November 1993. During the first four years of the independency, Macedonian banking system was burdened with inherited problems of non-performing loans from the former Yugoslavia. This was the reason for the adoption of the Banking Rehabilitation Law in March 1995.

Since devaluation of the national currency (denar) in July 1997, the exchange rate has been stable and nearly fixed to deutsche mark and consequently, to euro. During 1998 Macedonian authorities adopted new Bankruptcy Law and introduced full current account convertibility. The package of financial laws was amended again during 2000 by adopting the Law on Banks and the Law on Securities, and by amending the Bankruptcy Law.

The number of banks increased from 6 at the end of 1995 to 22 at the end of the next year, as a consequence of the Banking Law adopted in May 1996. After that, the number of banks increased to 24 in 1998. According to the Annual Report 2001 of the NBRM there were 21 commercial banks operating at the end of 2001. In addition, there were 17 saving houses but their financial strength has not been significant and these institutions have not played important role in the country's financial system. The banking system has been dominated by the two largest banks, which held the market share of 55.8% in the total assets and 29.6% in the total capital at the end of 2001.

The process of privatisation of Macedonian banking sector was almost completed by the end of 2001. At that time, out of the total number of 21 banks there were 20 private banks, of which 8 were owned by foreigners. As of 31 December 2001, the share of foreigners in the total banking capital was 40.1% and in the total banking assets 53.2%.

Table 15 - FYR Macedonia - aggregate balance sheet of commercial banks - millions of denars

ASSETS	31/12/1999	31/12/2000	31/12/2001	31/03/2002
1. Liquid assets (cash in vault and giro accounts)	330	2,490	2,285	3,232
2. Deposits with NBRM	3,025	3,656	3,739	3,948
3. Foreign assets	24,390	28,571	49,801	33,016
- of which accounts abroad	17,222	23,663	19,650	27,179
- foreign currency in vault and checks	3,833	2,911	27,729	3,811
4. Claims on Government	8,546	7,159	7,649	7,681
5. Claims on non-bank non-financial sector	31,975	37,947	37,790	38,391
- of which credits	22,978	25,602	25,806	25,463
6. Inter-bank claims	23,243	30,574	7,561	8,174
7. Other assets	20,503	20,821	19,510	22,493
8. Claims on banks from the former SFRY	116	119	121	122
T O T A L	**112,127**	**131,335**	**128,456**	**117,057**

LIABILITIES AND CAPITAL	31/12/1999	31/12/2000	31/12/2001	31/03/2002
1. Deposits	29,992	37,269	63,082	51,241
- demand deposits	10,459	11,894	11,170	11,008
- time deposits to	12,478	17,409	41,964	30,669

one year				
- time deposits over one year	3,481	3,300	4,233	4,222
2. Credits to non-bank institutions	1,061	1,049	1,506	1,459
3. Liabilities to the Government	2,409	4,505	3,144	3,082
4. Liabilities to the foreigners	15,825	15,460	13,508	12,074
5. Borrowings from NBRM	1,287	805	426	427
6. Inter-bank liabilities	22,929	31,290	30,253	6,383
7. Capital accounts	27,603	31,290	30,253	30,911
8. Other liabilities	11,842	13,227	11,481	12,721
9. Liabilities to banks from the former SFRY	239	493	185	217
T O T A L	**112,127**	**131,335**	**128,456**	**117,057**

Source: the National Bank of the Republic of Macedonia, www.nbrm.gov.mk

The most important characteristic of the aggregate balance sheet of commercial banks in Macedonia has been a decline in the value of total assets. This downward trend was the consequence of Kosovo crisis which began in the first half of 1999 and was extended over the next two years by war threats in Macedonia. These problems are pointed out in the NBRM Annual Report on Banking Supervision for 2001: "*The political and security crisis and the war upheavals in the Republic of Macedonia severely affected the total economic movements in the country, evident through the lower economic activity of the economic agents, declined industrial output, lower foreign trade and reduced foreign exchange inflows. The deteriorated security and the more restrictive measures of the monetary policy in the first half of 2001 inevitably affected the volume and the structure of the total activity of the banks in the Republic of Macedonia.*"
As a consequence, the aggregate balance sheet of commercial banks declined by 2.2% at the end of 2001 on a yearly basis and further by 8.9% during the first three months of 2002. However, the ratio of the total banking assets to GDP remained stable over the period, ranging from 53.6% at the end of 1999 to 53.8% at the end of 2001. The ratio of loans extended to private sector to GDP has also been stable but relatively low in comparison to Croatia and even to Bosnia and Herzegovina. It ranged from 11% at the end of 1999, to 10.8% at the end of 2001. The share of loans extended to enterprises and citizens in the total assets was 20.5% at the end of 1999 and 20.1% at the end of 2001. At the same time, the foreign assets was an assets-item with the highest share in the total assets: from 21.8% at the end of 1999, to 38.8% at the end of 2001 and 28.2% in the first three months of 2002. As far as the liabilities are concerned, the share of deposits increased from 26.7% at the end of 1999, to 43.8% at the end of March 2002. The total amount of foreign assets of Macedonian banking sector held on the accounts abroad was EUR 389 million at the end of 1999 and EUR

445 million at the end of March 2002. This amount was almost equal to the total foreign direct investments in Macedonia from 1994-2000 (USD 443 million).[19]

Table 16 - FYR Macedonia - Basic macroeconomic data - millions of USD

	1999	2000	2001
1. Current account balance	- 32.46	- 75.28	- 235.43
2. Trade balance	- 453.97	- 643.36	- 539.02
3. Foreign direct investment	31.80	176.23	442.32
4. Foreign debt	1,438.48	1,437.74	1,418.62
5. Inflation CPI (in %)	- 1.1	5.8	5.5
6. Net foreign assets of NBRM (millions of DEN)	--	42,245	50,334
7. Gross domestic product (millions of DEN)	209,010	236,389	238,570
8. Exchange rate (DEN/USD)	60.3	65.3	69.1
9. Exchange rate (DEN/EUR)	60.6	60.8	61.0

Source: the National Bank of Republic of Macedonia

Real growth rates in Macedonia have been declining over the 1998-2001 period. The high real growth rate of 8.5% in 1999, declined to 6.5% in 2000, and it was negative in 2001 (-3.5%). The recession has been caused by political and security crisis in the region, as it has already been mentioned. Taking this political turmoil in the region into account, it is difficult to assess the medium term impact of the financial reform on the economic growth in Macedonia. Having in mind a very difficult position of Macedonian authorities it can be said that the authorities have managed to maintain acceptable macroeconomic stability regarding current account deficit (6% of GDP in 2001), inflation and fiscal balances. On the other hand, EBRD data on unemployment reaching 30.5% in 2001, even over-estimated to some extent in comparison to ILO criteria, are not encouraging. With the outflow of foreign currencies higher than the inflow, it is necessary to seriously reconsider the financial possibilities for the development orientated projects.

2.8. Financial liberalisation and economic growth in Romania

Financial reform in Romania started by establishing the two-tier banking system in December 1990 and by adopting a new banking legislation in April 1991. Bank for International Settlements standards were enacted in January 1994 and Stock Exchange trading began in November 1995. Further development of the capital market in Romania was supported by the introduction of the over-the-counter market in October 1996.

In the attempt to stabilise the monetary system, the exchange rate of national currency (lei) was unified in March 1997. The next step in the process of financial liberalisation was the introduction of full current account convertibility in March 1998. At the same time, the new banking legislation was adopted allowing the banks

to freely determine interest rates and credit policy. The process of privatisation of the state-owned banks began in March 1999, when the first state-owned bank was privatised. According to the data in EBRD Transition report 2002 the number of banks in Romania increased from 14 in 1993 to 36 in 1998, and after that decreased to 33 at the end of 2001. At the same time, the number of foreign owned banks increased from 1 in 1993 to 24 by the end of 2001.[20] However, the asset-share of state-owned banks has been high over the 1991-1998 period (approximately 80%), and from then on it has been decreasing to the level of 45.4% by the end of 2001. The privatisation of Banca Comerciala Romana, the bank with 35% share in the total assets of the banking sector, which began in March 2002, will substantially decrease the share of state-owned banks in the banking sector assets. According to the government agreement with the IMF officials, the process of privatisation in the banking sector is expected to be completed by the end of 2003.
The structure of the banking sector aggregate assets in Romania has been dominated by the loans extended to the non-government sector and by the inter-bank assets. The share of loans extended to the non-government sector increased over the last four years, from 31.7% at the end of 1999 to 36.3% in June 2002. Over the same period, the share of inter-bank assets increased from 22.9% to 29.6%. The total amount of foreign assets the banks held deposited in foreign banks was USD 1.45 billion at the end of 2001. The total banking assets increased in nominal terms by 27.7% in 2000, and by 51.3% in 2001. The ratio of the total banking assets to GDP was 33.8% in 1999, 29.2% in 2000 and 31.2% in 2001. Loans extended to the non-government sector were 10.7% of GDP in 1999, 9.4% in 2000, and 10.5% in 2001.

Table 17 - Romania - Aggregate balance sheet of commercial banks - millions of ROL

ASSETS	31/12/1999	31/12/2000	31/12/2001	30/06/2002
1. Foreign assets	22,842,698	40,130,891	50,966,334	44,738,283
- of which deposits with foreign banks	19,207,107	34,246,394	42,202,401	35,625,118
- of which equity interest in foreign banks	1,654,318	2,442,530	2,923,213	3,254,419
2. Domestic assets	159,334,927	192,542,729	301,180,108	360,504,147
2.1. Vault cash	1,273,958	2,322,949	4,320,045	3,080,055
2.2. Domestic credit	88,405,741	106,725,267	156,248,570	187,415,968
2.2.1.Non-government credit	57,719,485	75,007,107	118,254,451	187,415,968
2.2.2.Government credit	30,686,256	31,718,159	37,994,118	40,149,244
2.3. Float	131,303	188,019	541,549	67,191
2.4. Inter-bank assets	41,699,326	57,302,566	95,896,080	120,151,790
2.5. Other assets	27,824,599	26,003,929	44,173,866	49,789,143

TOTAL ASSETS	**182,177,625**	**232,673,620**	**352,146,442**	**405,242,429**

LIABILITIES AND CAPITAL	31/12/1999	31/12/2000	31/12/2001	30/06/2002
1. Foreign liabilities	11,178,578	13,181,292	20,896,304	29,740,177
1.1. Short term	4,084,424	5,911,101	11,952,071	17,355,988
1.2. Medium and long term	7,094,154	7,270,191	8,944,233	12,384,189
2. Domestic liabilities	170,999,047	219,492,328	331,250,139	375,502,252
2.1.Non-bank client deposits	116,750,882	159,318,296	234,876,529	261,297,162
2.1.1. Demand deposits	12,297,315	20,589,419	28,673,276	24,751,748
2.1.2. Households savings	39,238,116	44,548,689	63,706,466	75,446,703
2.2. Float	232,449	493,947	879,881	4,270,795
2.3. Inter-bank liabilities	9,626,508	11,042,157	13,121,250	13,490,654
2.4. Public deposits	5,630,419	7,024,413	13,030,044	13,556,482
3. Capital accounts	18,102,109	25,106,462	50,581,095	57,236,649
4. Other liabilities	20,656,680	16,570,053	18,761,340	25,650,510
TOTAL LIABILITIES AND CAPITAL	182,177,625	232,673,620	352,146,442	405,242,429

Source: the National Bank of Romania

One of the most important features of Romanian economy over the last five years has been the highest level of inflation in the SEE region. The inflation was gradually declining, from 54.8% in 1999 to an estimated 21% in 2002, which is a relatively high inflation rate. It is very interesting to compare the conclusion of Barro's analysis on the relation between inflation and economic performance with the real growth rates in Romania. Barro finds the inflation to be generally damaging for the economic growth, but this conclusion was not statistically significant for the countries with the inflation rates below 20%.[22] Romanian GDP expressed in real terms increased by 2.0% in 2000, and by 7.1% in 2001. On the basis of the data, it is clear that Romania had the highest rates of inflation and, at the same time, the highest real growth rate in the SEE region in 2001.

Table 18 - Romania - basic macroeconomic data

	1999	2000	2001
1. Gross domestic product (billions of ROL)	539,357	796,354	1,127,729
2. Current account balance (millions of USD)	- 1,469	- 1,363	- 2,317

3. Trade balance (millions of USD)	- 1,257	- 1,684	- 2,969
4. Gross international reserves (millions of USD)	3,653.6	4,842.2	6,380.6
5. Exchange rate (average ROL/USD)	15,333	21,693	29,061
6. Exchange rate (average ROL/EUR)	16,296	19,956	26,027
7. Foreign assets of NBR (billions of ROL)	45,491	87,877	153,600
8. State budget revenues (ROL billion)	93,239.8	120,342.2	148,203.1
9. State budget expenditures (ROL billion)	106,886.7	149,167.8	184,012.2
10. Budget deficit (ROL billion)	- 13,646.9	- 28,825.6	- 35,809.1
11. Inflation CPI (annual average in %)	45.8	45.7	34.5
12. Average interest rate spread (in % p.a.)	20.5	20.8	18.7

Source: the National Bank of Romania; EBRD, Transition report 2002, London, October 2002, p. 189

The economic growth in Romania has been primarily driven by foreign direct investments. Romania has attracted the highest amount of foreign direct investments in the region over the last ten years. At a first glance, it is rather surprising that Romania has attracted the highest amount of FDI, because of the uncertainties caused by the high inflation rates. However, having in mind that Romania is the only country in the region classified as moderate in natural resource endowment [23], it is possible to explain the readiness of foreign direct investors to invest in the country. The other factor is the number of population. Romania has the population which is nearly equal to the population of Croatia, Bosnia and Herzegovina, Albania, and FR Yugoslavia taken together.

3. Concluding remarks

In the last chapter of Global Political Economy, Robert Gilpin discusses the possible ways of governing the global economy. Gilpin starts by referring to Richard Cooper's insight in Economics of Interdependence, a book published in 1968. Cooper wrote about the intensifying clash between the economic and technological forces unifying the globe, on one hand, and the world's political fragmentation, on the other. He saw this problem as the most serious one in the global economic and political order.[24] Gilpin himself points out the following: "Three decades after publication of Cooper's book setting forth the great need for international governance, the rapid globalisation of the world economy has elevated the governance issue to the top of the international economic agenda. Neither domestic economies nor the increasingly integrated world economy can rely on markets alone to police themselves."

Gilpin also points out that there are three approaches to the global governance: neoliberal institutionalism, new medievalism, and transgovernmentalism. The author explains the position of neoliberal institutionalism, which is based on accepting the international rules and institutions such as the IMF, the World Bank, and GATT/WTO. Although these institutions have significantly improved the ways of governing the world economy, Gilpin stresses the central problem of the world economic order: "Efforts to create an international regime for multinational corporations, such as the Multilateral Investment Agreement, have reached a stalemate because of strong opposition from many countries and powerful interest groups. There is no regime for economic development, one of the most pressing issues in the world."[25]

Transgovernmentalism is another approach to the global governance, which is relevant to the countries in transition and the countries of the SEE region. This approach is also rule based like liberal internationalism, but this position accepts an important role of the nation-states. The elements of this approach are already in place in many areas such as banking and antitrust regulation and judicial matters. The process of integration of SEE countries into the global economy, or the process of globalisation of the region, has been underway since 1990. This process has been especially intense in financial systems through the process of financial liberalisation. Since 1997, financial liberalisation has been intensified in almost all the countries in the region, except in FR Yugoslavia, coordinated by the global institutions: the IMF, the World Bank, the Bank for International Settlements, on the basis of neoliberal institutionalism and transgovernmentalism.

At the beginning of 2002, all countries in the SEE region had fully deregulated financial markets, in terms of eliminating interest rates control by the governments, removal of full current account convertibility, the government control over credit policy of commercial banks and the autonomy of banks. In the context of transgovernmentalism, the instruments of global governance, banking supervision and prudent control have been enhanced in SEE countries by adopting the Bank for International Settlements and Basle Adequacy Capital Accord rules.

Financial systems of the SEE countries measured on the basis of financial depth (the ratio of banking assets to GDP), ratio of loans extended to enterprises and citizens to GDP, and on the basis of intermediation (the ratio of loans to deposits) are not developed in comparison with the fastest growing economies. The ratio of total banking assets to GDP in twenty fastest growing economies in the world over the last two decades has been ranging from 85% to 175%, and the ratio of loans to GDP has been ranging from 65% to 145%. If we compare the data from the tables 19 and 20 we can draw conclusion that the best performers regarding the financial depth and intermediation in the SEE region were Croatia and Bosnia and Herzegovina.[26]

At the end of 2001, the ratio of assets to GDP in Croatia was 91.1%, the ratio of loans to GDP was 39.5% and the ratio of loans to deposits was 61.5%. At the same period, these ratios for Bosnia and Herzegovina were 51.4%, 29.8%, and 71.8% respectively. Taking into account that Bosnia and Herzegovina was the first country among all transition countries to successfully complete the reform of internal payment system, the success of this country is respectable. The process of privatisation was almost completed in the two countries by the end of 2001.

FYR Macedonia had also the above-the region-average ratio of assets to GDP (53.8%) at the of 2001, but at the same time relatively low loans to GDP ratio (10.8%). FYR Macedonia has been the best performer in privatisation process. The share of state-owned banks in the total assets in FYR Macedonia was only 1.3% at the end of 2001. However, Bulgaria was the country in the SEE region which has seen the substantial improvement in financial intermediation and financial depth. Bulgaria has succeeded to increase the assets to GDP ratio from 34.6% in 1999 to 41.3% in 2001, the loans to GDP ratio from 10.1% in 1999 to 14% in 2001, and the loans to deposits ratio from 39.3% to 43.4% in the same period.

The highest average rates of real economic growth from 1999 through 2001 had Albania (7.3%) and Bosnia and Herzegovina (6.4%), but the real GDP growth rates in these two countries were decreasing in 2000 in comparison to 1999, and stagnating in 2001 comparing to 2000. The best performer in terms of real GDP growth in 2001 was Romania. After the negative real growth rate in 1999, Romania saw 2% real growth rate in 2000 and the highest real growth rate of 7.1% in the region in 2001. On the other hand, financial liberalisation in Romania under conditions of highest inflation rate in the region except FR Yugoslavia, has had as a consequence the negative average real deposit interest rate and also the average interest rate spread has been significantly lower than the average growth rate in consumer goods prices. In the context of financial liberalisation, we should take into account that one of the most important goals of this process is to have the average interest rate which is sufficiently high to maintain real value of depositors' money holdings, and to support the economic growth on a sustainable basis by investing the money into the sectors with acceptable marginal efficiency of capital.

In contrast to Romania, the average real interest rate on loans from 1999 through 2001 was very high in Bosnia and Herzegovina (24%), relatively high in Albania (17%) and Macedonia (14.5%) and moderate in Bulgaria (6%) and Croatia (5.5%). The rising interest of foreign direct investors can be seen from the data in the Table 21.[27]

The total amount of FDI in the region increased from USD 5.54 billion over the 1994-1997 period to USD 15.11 billion over the 1998-2001 period, or by 2.7 times. On FDI per head basis, Croatia received the highest amount of FDI, with USD 1,277 per head from the 1994 - 2001 period. However, the real average growth rate in Croatia declined from 6.5% in the1994-1997 period, to only 2.0% in the 1998-2001 period.

The financial systems of the countries in the region have been substantially improved over the period. The governments of the countries have removed their control over the interest rates and credit policies, allowing the foreign capital to come to the countries' financial and other business sectors, but the real growth rates were not sufficient to solve the problems of the very high share of the population living in poverty, except in Croatia. The process of globalisation carried out in the region over the analysed period has been faced with the same dilemma which is pointed out by Robert Gilpin: "There is no regime for economic development, one of the most pressing issues in the world."

Appendix:

Table 19 - SEE countries - financial intermediation and economic growth

	Ratio of assets to GDP in %	Ratio of loans to enterprises and citizens to GDP in %	Ratio of loans to deposits as the measure of intermediation	Real GDP growth
A l b a n i a				
1999	49.8	2.6	6.6	9.4

2000	50.2	2.7	6.7	6.4
2001	50.7	2.9	7.1	6.3
Bosnia and Herzegovina				
1999	45.1	31.9	86.7	9.9
2000	45.0	31.6	88.2	4.5
2001	51.4	29.8	71.8	4.8
B u l g a r i a				
1999	34.6	10.1	39.3	5.4
2000	36.5	11.3	42.4	2.5
2001	41.3	14.0	43.4	3.3
C r o a t i a				
1999	66.1	32.4	80.6	-1.3
2000	73.3	32.9	69.0	1.5
2001	91.1	39.5	61.5	1.9
FR Yugoslavia				
2000	201.9	99.7	359.2	1.5
2001	41.8	16.6	122.8	5.5
FYR M a c e d o n i a				
1999	53.6	11.0	76.6	8.5
2000	55.6	10.8	68.7	6.5
2001	53.8	10.8	40.9	-4.6
R o m a n i a				
1999	33.8	10.7	49.4	-0.3
2000	29.2	9.4	47.1	2.0
2001	31.2	10.5	50.3	7.1

Sources: web pages and annual reports of the national banks of the countries in SEE region; EBRD, Transition report 2002, London, October 2002, pp. 113, 129, 133, 137, 149, 153, 189; real GDP growth is a difference of GDP nominal growth rate and annual average of CP inflation in %; the real growth rates in this table are not the same as GDP real growth rates published in EBRD Transition report 2002

Table 20 - SEE countries - privatisation indicators
Asset share of state owned banks

	1997	1999	2001
Albania	89.9	81.1	59.2
Bosnia and Herzegovina	82.5	75.9	8.9
Bulgaria	66.0	50.5	19.9
Croatia	32.6	39.8	5.0
FR Yugoslavia	89.8	89.0	68.0
FYR Macedonia	0.0	2.5	1.3
Romania	80.0	50.3	45.4

Source: EBRD, Transition report 2002, London, October 2002, pp. 112, 128, 132, 136, 148, 152, 188

Table 21 - SEE countries - Foreign direct investments 1994-2001- millions of USD
Asset share of state-owned banks

	1994 - 1997	1998 - 2001
Albania	293	441
Bosnia and Herzegovina	115	470
Bulgaria	848	2970
Croatia	1052	4691
FR Yugoslavia	740	415
FYR Macedonia	66	822
Romania	2440	5309

Source: EBRD, Transition report 2002, London, October 2002, pp. 112, 128, 132, 136, 148, 152, 188

Notes:
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2. Shaw, Edward S., Financial Deepening in Economic Development, New York, Oxford University Press, 1973; McKinnon, Ronald, Money and Capital in Economic Development, Washington, D.C., Brookings Institution, 1973
3. Miller, Merton H., Financial Innovations and Market Volatility, Basic Blackwell, 1991, pp. 213-214
4. Bessis, Joel, Risk Management in Banking, John Wiley & Sons, 1998, pp. 40-41
5. The wealth coefficient is defined as the ratio of the country's share in the world GDP to its share in the world population; this coefficient has been used in: Fikret Causevic, Financial Deregulation, Globalisation and Efficiency of Economic Policy, Ph.D. thesis, University of Sarajevo, September 2002
6. Op. cit.
7. Williamson, John, and Molly Mahar, Op. cit., November 1998
8. Barro, Robert J. and Xavier Sala-i-Martin, Economic Growth, The MIT Press, Cambridge, Massachusetts, 2001, pp.414-420
9. According to the data published in IMF, World Economic Outlook 2000, the total debt of household sector in the US was 4.1% of GDP in 1999, comparing with the net savings of 4% of GDP in 1990
10. Causevic, F, Financial Deregulation, Globalisation, and Efficiency of Economic Policy, Ph.D. thesis, Sarajevo University, September 2002; the analysis of rankings is based on the wealth coefficients derived as the ratio between the share of a country in the world GDP expressed in USD PPP to the share of the country in the world population.
11. See: EBRD, Transition report 2002, October 2002, p.111
12. The data from: National Bank of Albania, Banking Supervision Annual Report 2001
13. See: EBRD, Transition report 2002, London, October 2002, p. 131
14. Source: Bulgarian National Bank web page, Annual Report 2001
15. See: EBRD, Transition report 2002, London, October 2002, p. 135
16. See: the National Bank of Yugoslavia, Annual Report 2001
17. Source: the National Bank of Yugoslavia
18. Official data of statistics' offices in Bosnia and Herzegovina expressing 40%

unemployment are seriously flawed and inaccurate comparing to the data obtained from the Living Standard Measurement Survey in Bosnia and Herzegovina, sponsored by the World Bank and UNDP.
19. See: EBRD, Transition report 2002, London, October 2002, p. 153
20. The data from EBRD Transition report 2002
21. See the web page of the National Bank of Romania
22. Barro, Robert J., Determinants of Economic Growth - A Cross-Country Empirical Study, MIT Press edition, 1999, pp. 89-118
23. The other countries in the SEE region are classified as poor in natural resource endowment. See: IMF, World Economic Outlook - Focus on Transition Economies, October 2000, p. 115
24. Gilpin, Robert, Global Political Economy - Understanding the International Economic Order, Princeton University Press, 2001, p. 377
25. Gilpin, Robert, Global Political Economy - Understanding the International Economic Order, Princeton University Press, 2001, p. 380
26. See Appendix.
27. See Appendix.

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