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THE DEVELOPMENT OF THE BANKING SECTOR AND  
ITS MACROECONOMIC ENVIRONMENT IN  
SOUTHEAST EUROPE

DEPARTMENT OF WORLD ECONOMY

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INTERNATIONAL RELATIONS

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SOUTHEAST EUROPE

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## **List of abbreviations**

BH – Bosnia and Herzegovina  
CAGR – Compound annual growth rate  
CEE – Central-eastern Europe  
CIS – Commonwealth of Independent States  
CMEA – Council for Mutual Economic Assistance  
EA – Euro area  
EBRD – European Bank for Reconstruction and Development  
EC – European Commission  
EIB – European Investment Bank  
EU – European Union  
EULEX – European Union Rule of Law Mission in Kosovo  
FDI – Foreign direct investment  
FBH – Federation of Bosnia and Herzegovina  
FRY – Federal Republic of Yugoslavia  
FX – Foreign exchange  
FYRM – Former Yugoslav Republic of Macedonia  
GDP – Gross domestic product  
GMP – Gross Material Product  
IFIs – International financial institutions  
IMF – International Monetary Fund  
IPO – Initial Public Offering  
KPI – Key performance indicator  
NIM – Net interest margin  
NMS – New Member States  
NPL – Non-performing loans  
ROA – Return on assets  
ROE – Return on equity  
RS – Republika Srpska  
SEE – Southeast Europe  
SFRY – Socialist Federal Republic of Yugoslavia  
UNMIK – United Nations Interim Administration Mission in Kosovo

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*“It is much better to export stability to the Balkans than import instability from there.”<sup>1</sup>*

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<sup>1</sup> Olli Rehn EU Commissioner for Enlargement EU Enlargement 2009: A Balance Sheet and Way Forward. Foreign Affairs Committee of the European Parliament Brussels, 2 September 2009. (<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/358&format=HTML&aged=0&language=EN&guiLanguage=en>, downloaded: 05/02/2010)

## 1. Introduction

The region of Southeast Europe<sup>2</sup> (SEE) has growing importance from various aspects. The reviewed countries can serve as a rich case study for other emerging regions. During the specific time periods, the various challenges and applied policies provide useful lessons. From the international organisations' point of view, the interest is to stabilise and develop the region both in a political and economic sense. The aim is to avoid any security hazard in the area, and gain economic advantages in a region which is on its path to catch up with the more advanced European regions. SEE remains in the focus particularly from the aspect of EU policies, not only because of its geographical closeness, but also due to the strong economic linkages that have been built in the previous years. Furthermore, all countries in SEE participate in the EU accession process, which also means that economic integration becomes a core element. This consists of supporting the economies' real convergence, opening up the markets and harmonising the institutional framework. The dissertation analyses a pillar of this economic process, namely the banking sector's development in SEE.

In every well-functioning market economy, the financial sector has a primary role. In an environment of various market frictions, it supports the efficient allocation of resources, thus bolsters economic growth. Nevertheless, this link is rather bidirectional, as financial development and economic growth influence and reinforce each other. The financial sector is able to cause or contribute to economic downturns, but can also act as stabilising and growth enhancing factor within a well-functioning system. In case of SEE, where the banking system became dominated by large European banking groups, further vital impacts can also be stressed. During the transition process, foreign banks channelled various benefits and resources to the

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<sup>2</sup> Throughout the thesis, SEE refers to the region of Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia and Kosovo. This covers the successor states of the socialist Yugoslavia, but excludes Slovenia and includes Albania. It is important to underline, that although Kosovo's status is disputed by various international actors, here it is treated as a separate country case. When reviewing the socialist time period, SEE covers two countries; Albania and SFRY. The SEE term is used in the jargon of the EU and refers to the region of the candidate and potential candidate countries. Noteworthy, that based on this logic Turkey is occasionally included to this category for simplicity reasons. SEE is often used as a synonym for the "western Balkans" even in the EU jargon. The latter stems from the term of "Balkans", which has various political, historical and geographical interpretations, see for instance, Todorova (1997) or Mazower (2000).

region, they increased the system's capitalisation, enhanced competition, contributed to financial deepening and product innovation, and last but not, they had an important role in restoring public confidence in the banking sector. On the other hand, foreign banks had a specific impact on various systemic risk factors that became particularly relevant during the global crisis.

When referring to the financial development, the dissertation covers the features of the commercial banking sector, due to the fact that other segments merely have supplementary or minor role. So for instance, the capital market, microfinance institutions, the insurance segment, pension funds and various financial auxiliaries are omitted from the analyses, despite the fact that in certain country cases they have a notable role. Still, it is undisputable that in SEE the financial sector is dominated by the banking sector and can be characterised by a bank-based model, and this feature can be considered persistent. Nonetheless, besides focusing on the banking sector, the most relevant macroeconomic developments are also reviewed for better understanding. The development of the broader economic framework and macroeconomic environment go hand in hand with the development of the banking sector. However, within the thesis special attention is not given to other important related topics, such as the regulatory and supervisory framework or the corporate sector's restructuring and development.

The dissertation covers the time period starting from the end of the Second World War and ending with 2010, a year of the latest global crisis. Within this timeframe, four blocks can be well separated, providing the ground for the four main chapters of the thesis. The first discusses the socialist time period from the end of the Second World War until the fall of the socialist regimes, covering two peculiar country cases; Albania and SFRY. The goal of this chapter is to demonstrate, that despite the completely different socialist models, both systems have left behind similar legacies and challenges for the transition period. Both countries could be considered unique prototypes within the European socialist bloc, which is revealed during the analysis with the help of Kornai's model of the main line of causality. This model helps to overview the complete framework of the economies, including also the political background and motivations. Albania implemented a classical socialist model, and remained loyal to it throughout the socialist time period. From the late 1970s,

Albania chose complete isolation from the rest of the world and remained the poorest country in Europe. SFRY could be considered the other extreme, as it step by step developed its unique model of workers' self-management, and implemented various market economic elements to its system. Nevertheless, the impacts of these elements were always restrained by related regulations. This can be considered as the primary reason for the fact, that despite the two extremely different models, the broader economy and the banking system in both countries inherited similar legacies from the socialist times, and had to tackle almost the same challenges during the transition period.

The second chapter discusses the transition period of SEE, covering seven country cases due to the dissolution of the former-Yugoslavia. The aim of this chapter is to prove, that despite the different starting points – meaning e.g. the initial sectoral structures or the level of economic development – the applied economic policies and the historical circumstances, by the end of the transition process the banking sector's structure became similar in all SEE countries. In this chapter, the most relevant features are demonstrated by the transitional recession, as the important transitional characteristics culminate in this phenomenon, and it is particularly important also from the aspect of the banking sector. During this time period – besides the “classical” transitional tasks – the countries had to face various different challenges, such as the gradual succession of SFRY coupled with military conflicts, civil unrest or embargos. In addition to these circumstances – which can be considered here as exogenous events – each country had its own specific transitional process with different starting conditions, implemented reform measures, sequencing and duration, all leading to great time and development differences within SEE. Moreover, in almost all country cases, more than one systemic collapse occurred, so the transition process rather became a non-linear, long-term and gradual process. These apply not only for the macroeconomic framework, but also for the banking system. However, finally, a rather similar template could be drawn for the outcome of the sector's development structure, with large foreign banking groups playing a pivotal role. This similarity could be explained by the mutual challenges and the financial globalisation.

The first two main chapters provide the background and core information for understanding the further and latest developments of the banking sector. The third chapter analyses the so-called “catching-up” period between 2000 and 2007. The primary goal in this case is to find a common model for the development of the sector in SEE during this period, as an outcome of the analysis. This model links the banking sector with its macroeconomic environment, and reflects the primary systemic risk factors. As a further outcome of the analysis, the chapter also reveals specific regional characteristics. The “catching-up” term can refer to the path of converging to the EU’s income levels or proceeding with the EU accession process and applying the required institutional standards. In the thesis, catching-up refers to the convergence of income levels and financial deepening. The former is simply defined and measured by the GDP per capita levels, while the latter is demonstrated by certain banking indicators, such as the ratio of total banking assets in percent of GDP. Drawing the border between the transitional and “catching-up” period is not clear-cut, because there is no strict rule for defining the end of transition, and the process differs to a great extent among the country cases. Nevertheless, regarding the banking sector and its macroeconomic environment, a wide range of characteristics can be well grouped to the pre-global crisis years. In order to represent some of the fundamental characteristics of the banking sector from a micro-level, a case study has been added to this chapter, including the local subsidiaries of two large European banking groups.

Last but not least, the fourth main chapter analyses the most relevant impacts of the global crisis on the region between 2008 and 2010, as the period of data collection has been closed by early 2011. The aim of the chapter is to demonstrate, how the simplified growth pattern of the “catching-up period” collapsed in SEE as a result of the turmoil. During the analysis, the most important common and differentiating features – such as the pace of financial deepening or the applied exchange rate policies – are being outlined, and a number of fundamental questions are being raised that ought to be answered in the near future. In the thesis, the “global crisis” term always refers to the latest global crisis, which started from the “Western” markets and reached SEE by the end of 2008 with its side effects. The strong interconnection between the macroeconomic conditions and the financial sector became very plausible again. Following the years of certain stability, the banking sector in SEE



had to tackle extraordinary challenges, such as waves of deposit withdrawals, deteriorating loan portfolios or the risk of a sudden stop in foreign financing. After the period of rapid credit expansion, sharp drop of credit growth was recorded, that could be explained by a number of factors both on the demand and supply side. Within the chapter, a brief case study illustrates some of the sectoral developments from a micro perspective.

The dissertation goes beyond a simple descriptive work and analyses the topic within the specific time period with a range of methodological tools. In order to provide a framework for this analysis, we use the following main hypothesis:

- 1) Although the countries of SEE had substantially different trajectories during the socialist and transition time period, a similar financial system has been built up by the end of the transition process, due to the similar challenges and financial globalisation.

As already mentioned by the brief discussion of the four main chapters, despite the different legacies from the socialist system, the reviewed country cases had to face similar challenges and tasks at the start of the transition process. Nevertheless, even within the group of the former-Yugoslavian countries great differences evolved. During the succession, their development paths started to diverge. This could be explained by the different historical circumstances, political attempts and applied policies. A certain kind of systemic collapse occurred in all cases, which always shifted somewhat the further development path. Although with great lags, but the countries faced similar challenges, which finally became addressed by similar policies. It is important to stress, that this similarity cannot be considered self-evident, as for instance Slovenia or other transition countries were able to create a different kind of structure within the banking sector. Also the initial attempts of the reviewed cases pointed to different directions. To sum up, the thesis proves that the countries of SEE had to face similar tasks and challenges during the transition process, which finally became addressed by similar policies. These created a specific structure within the banking sector, which led to a common development pattern in the region. This is particularly valid for the activity of the banking sector, but from certain aspects even for its macroeconomic environment.

Besides the hypothesis, there are two main theses or assumptions, which can be well defined. The reason for highlighting them is the fact, that they are discussed within almost all chapters. This is due to the fact, that these two topics are core elements of the banking sector's development in SEE.

- 1) As it can be proved for other regions in the world economy, there is a positive correlation between financial development and real GDP growth in SEE.

Generally speaking, a broad literature analyses the correlation between these two elements.<sup>3</sup> As it has already been mentioned, in case of SEE the financial sector is dominated by the commercial banks, so it is rather the banking sector that needs to be analysed. It is very clear, that macroeconomic stability – strongly related with real GDP growth – and financial development go hand in hand. Following the socialist time period, when banks primarily had merely administrative tasks, the banking sector played a significant role within the economic development. When the sector was able to fulfil its market-oriented primary roles, it was able to underpin the general economic development through various fields. On the other hand, during the times of transitional stabilisation, restructuring or crises, it has put extra burden on the fiscal authorities and contributed to the downturn of the economies.

- 2) Foreign-owned banks played a pivotal role in the banking sector's development in SEE.

As reflected by the hypothesis, the banking system's development reflected a similar pattern in the countries of SEE. The financial development's structure and main features has been determined by foreign investors to a great extent. Once reviewing the structure of the banking sector, it becomes obvious that banks with foreign-ownership exceeding 50% gained dominant positions in the region. The large international banking groups fostered the transitional process of the sector, bolstered financial deepening and contributed to its positive and negative side-effects. This implies that the foreign banks' role ought to be discussed during the analysis of the

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<sup>3</sup> For a comprehensive overview, see for instance Levine (2003).

development. It can be concluded, that the motto of the thesis refers to this latter assumption as well. Exporting stability to SEE can be considered as a well underpinned long-term goal not only from the IFIs point of view, but also from the aspect of large international banking groups present in the region.

The dissertation would like to contribute to the literature on the commercial banking sector's development in SEE, including the relevant analysis of its macroeconomic development. The thesis highlights the most important common and differentiating regional characteristics, and – based also on the relevant literature – compiles a general, bank-based economic model for the pre-crisis period. This model stresses the direct link between the banking sector's activity and certain macroeconomic developments. Despite the importance of the topic, the respective literature can still be considered somewhat rare. The region is most often reviewed from a historical point of view. The banking sector of SEE is usually discussed within the group of transition countries. Several publications of the EBRD, the Österreichische Nationalbank or Barisitz (2008) can serve as good examples. A further group of literature analysis a specific time period in SEE, such as e.g. Šević ed (2002); Sjöberg – Wyżan eds (1991) or Uvalic (2010). The literature also provides various country-specific works, see for instance Singleton (1976); Fink et al (2007) or Gligorov (2007). Nevertheless, currently we are not aware of any literature that comprehensively analysis the topic of the thesis within such a broad time span, and dedicates great attention to the macroeconomic environment during the analytical work.

### 1.1. Applied methodology

Throughout the dissertation, comparative analysis is used as a primary tool for the analytical work. Nevertheless, the thesis is multidisciplinary, because it includes elements from various scientific fields; generally economic development, macroeconomics, finance, transition economics and Kornai's system paradigm are used, but historical and political background information are also included occasionally for better understanding. With the help of these mentioned fields, both

the banking sector and its macroeconomic environment are analysed. The reason behind this is the strong link between the two. The activity of the banking sector is determined by its macroeconomic conditions, and the other way around, the macroeconomic environment is influenced by the banking sector. Nevertheless, the focus always remains on the banking sector during the analyses.

According to the requirements, the above mentioned scientific fields are used with different weights in each chapter. In case of the first three time periods – namely the socialist, the transition and the pre-crisis years – different methodologies are being used. This can be explained by the completely different systemic backgrounds, the different role of the banking sector, the available datasets and the specific challenges. In case of the period dealing with the effects of the global crisis, almost the same tools can be used for the analytical work as in the pre-crisis chapter.

In case of the socialist time period, two countries are being compared – Albania and SFRY – between the end of the Second World War and the fall of the socialist regimes. In both countries, the complete political and economic model determined the activities of the banking sector. This is the reason, why it is inevitable to analyse and understand the specific systems from a broad perspective. Also due to the lack of relevant banking sector datasets, the qualitative analysis remains dominant within the chapter. The literature on socialist models and on the specific countries is used as the base for the overview, while Kornai's model on the main line of causality provides a framework for the analysis. Following the review of the classical socialist system as a starting point, the Albanian and SFRY's prototypes are being compared, with a separate section on the respective banking systems. Various comparative tables are compiled to help to summarise the main differentiating and common characteristics.

Due to the dissolution of former-Yugoslavia, in case of the second time period the sample is expanded to the group of seven countries; Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Kosovo, Montenegro and Serbia. A strict time frame cannot be drawn for the transition period, as the starting date and duration of the fundamental changes differed in all cases. Noteworthy, that in certain aspects the transition process has still not been concluded. The relevant literature on transition policy, on banking sector transition, on the role of foreign banks and

country analyses help to review the main developments. The most important features of the transitional recession provide a guideline for the analyses of the macroeconomic framework. Based on the review of the local policies and respective features, the chapter's last section includes a comparative analysis of the development process. Finally, the available banking sector data and charts help to illustrate the main features of the sector's structure within the last section. These data are compiled from the EBRD Transition reports, EBRD statistics and the respective central banks' databases.

The next chapter analyses the pre-crisis years, which is dubbed within the thesis as the "catching-up period". The seven countries are reviewed between 2000 and 2007. The starting date can be marked as the first year, when the market economic developments evolved in all cases, although the transitional process just took off in certain countries. As for the closing date of this period, it was 2007 until the booming years could be observed. The comparative analysis is based on a comprehensive dataset of country level banking sector and macroeconomic data. These are downloaded from the respective central banks' statistics, the IMF, the EBRD, the BIS and the European Commission's Eurostat databases, or are based on own calculations. One-off or exponential effects are usually omitted by using the average or the CAGR indicators of the reviewed period. Certain figures contain the average of the last three year's data, also in order to analyse the most flourishing years. The paper includes various scatterplots to illustrate the most important links. The number of observations is too low for regression analyses, but still, the trends and the connection between the variables can be well illustrated. Also in order to increase the number of observations, the EA is included to the calculations. As an indication, the respective  $R^2$  is always added to the chapter's scatterplots.

Within this chapter, the EU is usually included to the quantitative analysis, for the sake of comparison and to demonstrate the catching-up process. However, in case of the banking sector's analysis, the EU is substituted with the EA, which can be treated as a more developed sub-region. The background of this substitution is the fact, that the broad range of financial data is rather available for the EA. Furthermore, the latter can be considered as the region where SEE and the NMS are aiming to catch-up with. In certain cases, the EU data are divided into two sub-regions, where the EA

represents a more “developed” area, while the NMS illustrates the transitional region. All in all, the conclusions of the sectoral and macroeconomic analyses, and the relevant literature – including e.g. European Commission (2009) or Sorsa et al (2007) – help to compile a common, bank-based economic model for the reviewed period valid for all SEE countries. This model links the banking sector with its macroeconomic environment, and reflects the primary systemic risk factors.

Finally, the chapter also contains a case-study to highlight the most important sectoral features from a micro-level perspective. This overviews the main, local subsidiaries of two large, EU-headquartered banking groups; Raiffeisen Bank International AG and UniCredit Group. The required data for the analysis have been downloaded from Bankscope, while the banks’ respective annual reports supported the interpretation of the figures. The data have been reviewed from 2005, due to the fact that this was the first year when both banking groups entered all of those SEE countries where they are currently present. This implies that Raiffeisen’s subsidiaries in Albania, Bosnia and Herzegovina, Croatia, Kosovo and Serbia can be overviewed, while in case of UniCredit, the local banks in Bosnia and Herzegovina, Croatia and Serbia can be analysed.

Turning to the chapter on the effects of the global crisis, the applied methodology can be considered similar to the previous chapter’s methodology. In this case, the seven countries are being analysed between 2008 and 2010. In order to illustrate the changes, country-level banking sector and macroeconomic data are being compared. The analysed data are downloaded from the respective central banks’ databases and from the IMF. Various charts help to review and compare the shifts of the indicators and the entire economic system. Most charts also contain the data from 2007, in order to demonstrate the pre-crisis levels as a starting point. The comparative analysis and the relevant literature help to illustrate how the bank-based, pre-crisis growth model collapsed during the financial stress. The compiled chart demonstrates how the model’s base and each of its building blocks have been affected by the crisis. Finally, also this chapter contains a brief case study, including the same banks and applying the same methodology as in the previous chapter.

Generally speaking, the dissertation can be considered as an empirical work, where the analyses imply both qualitative and quantitative methodologies. In the latter's case, it is very important to emphasize that the comparison of the exact data might be somewhat influenced by methodological differences. Bearing this in mind, outlining the main features and tendencies is still possible. Last but not least, it should be mentioned that the analyses are generally inductive, as the thesis tries to underpin the initial assumptions with the above mentioned methodologies.

## **2. Socialist times in Albania and SFRY – Two odd systems within the European socialist region**

Following the Second World War, both the Socialist Federal Republic of Yugoslavia and Albania started to implement the classical socialist development model. However, when SFRY broke away from the Soviet sphere it started to develop its own unique model, which could not be considered neither classical socialist nor a market economy. From this stage, the two countries' development paths and international orientations gradually diverged. Albania continued to implement the classical socialist model and isolated itself from the capitalist world, while SFRY established a unique and continuously transforming system of self-management, and built good international relations with the "West". However, despite the fact that Albania chose the Soviet path, it also emerged as a peculiar prototype in comparison to the rest of the European group of socialist countries. Both Albania and SFRY gradually became odds within the socialist bloc, but in two absolutely different ways, as they embodied two extremes.

SFRY was among the most developed economies within the group of socialist countries. It differed from the Soviet bloc in various aspects. It was the only country where the economy was based on the system of workers' self-management and remained a loose federation of the republics, where the governments had no central role in running the economy [Sjöberg – Wyzan, eds, 1991]. On the other hand, Albania was the poorest country in Europe. It rejected any major reform of the implemented classical socialist model throughout the almost half decade of communist governance. From the late 1970s, it chose complete isolation from the rest of the world. At the same time, it is interesting to note a similarity as well. What made Albania and SFRY similar from a historical point of view – and at the same time different from the rest of the Eastern European bloc – was the fact that these two countries were not forced to choose the socialist model by external power. In their cases the subservience to the Soviet government and military was not present, also meaning that the communist party lacked this kind of external support [Kornai, 1992].

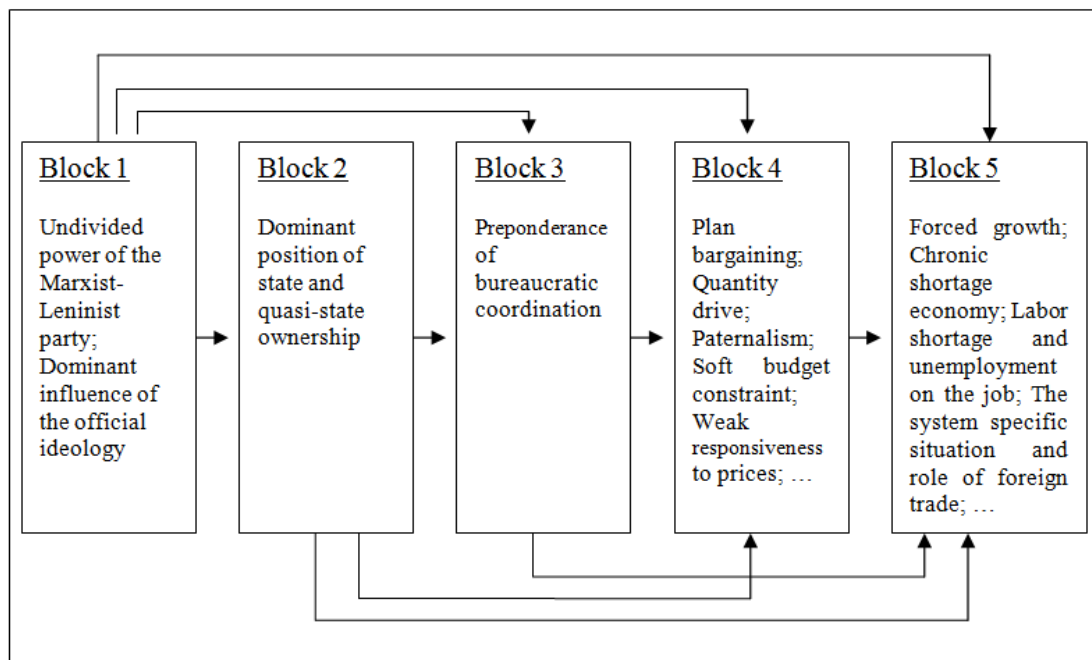


This chapter first overviews the main characteristics of the classical socialist system. Then it highlights the main similarities and differences between the Albanian and SFRY's development path by using Kornai's causality model, which provides a solid framework for the comparative analysis. After overviewing the economic background, the discussion turns to the Albanian and SFRY's banking system's development and operations. One can conclude that despite the fact that the banking sector can be considered as a pillar of a well-functioning market economy, it remained merely a secondary actor in the socialist systems. However, in the two countries the banking system had absolutely different structures and functions, but still provided somewhat similar consequences for the transition period. Finally, the chapter summarises both the differences and similarities by a comparative overview. The goal of this chapter is to help to understand the legacy of the socialist times and the challenges that had to be addressed during the transition period.

### 2.1. The classical socialist model

The so-called classical socialist system can be rather considered as a theoretical term, because such a model never existed in a pure form with all of its attributes. However, the main features were present for instance in the Soviet Union, but only for a specific time period – namely during the regime of Stalin – and not in a constant form [Kornai, 2008]. From the main phenomena of the classical socialist system, Kornai (1992) builds up the main line of causality (see Chart 1). He classifies the most important economic, political, ideological and social phenomena of the system to five main blocks depending on the interactions and layers of their effects. Finally, a coherent structure is built up, explaining the systemic mechanisms with its dominant features. The arrows of the causality line reflect how each of the phenomenon groups is affected by all of the deeper factors. The direction of the arrows shows the dominant line of causal connections.

Chart 1: The Main Line of Causality by Kornai



Source: Kornai János (1992): *The socialist system. The political economy of communism*. Oxford, Clarendon Press, p. 361.

The first block contains the system's starting point, namely the political structure, which is represented by the undivided power of the ruling "Marxist-Leninist" party, incorporating the interpenetration of the party and the state, and also the repression of any opposition. Provided the political structure and ideology, it leads to the second block of the causality line, which is the dominance of state and quasi-state ownership. Kornai (2008) even claims that the more private ownership is curtailed, the more suppression can be imposed. These first two blocks are considered as the "seeds" of the system [Kornai, 1992] and lead us to the next block, namely the preponderance of bureaucratic coordination. The exact form of this coordination shows great variety, but the elimination of market mechanisms, the centralisation and vertical dependence remain core features. So according to Kornai (2008), the political structure with its official ideology and the dominance of state ownership produces the specific bureaucratic control. For instance, the lack of dominant effects of market economic mechanisms is rather the result of the mentioned "seeds" and not the other way around. The structure of these first three blocks leads to the next layer of phenomena. This fourth block contains the actors' interest and motivation, their

behaviour and the most important features of their relations. Each of these phenomena can be separately explained by the deeper factors of the first three blocks. Finally, the fifth block holds the most typical lasting phenomena, which are explained by the logic of the causality line [Kornai, 2008].

The incentive system for the enterprise sector was based on the fulfilment of the centrally allocated output targets, and smaller additional bonuses could be achieved by the overfulfilment of the plans. This structure motivated the maximisation of the plan indicators, pointing to the distortion of both the aggregated product mix and the quality. The incentives for cost savings played only minor role. Moreover, one of the main plan indicators was calculated by adding up the outputs by using their prices, which led to cost-maximising output mix from firms. Enterprises were able even to require refinancing once the achievement of the targets was endangered. This phenomenon was regarded by Kornai (1980) as the soft budget constraint [Roland, 2000].

As for the efficiency of the central planning, the system required frequent adjustments, which were done by the economic ministries.<sup>4</sup> These functional ministries received the aggregate output targets and distributed the necessary input and output plans for the enterprises under their jurisdiction. To achieve the targets, the ministries had to intervene constantly in the enterprises' activities. These interventions were reactions to the perceived shortages, but resulted in the improvement of the ministries' aggregate plan fulfilment. This mechanism had a crucial role in the avoidance of a general output collapse, despite the lack of market mechanisms [Roland, 2000].

Plan overfulfilment was rather preferred, while shortage carried the risk of underfulfilment. The existence of shortage led to various phenomena, like the hoarding of resources or the so-called "forced substitution" resulting in quality deteriorations. The existence of shortage provided certain bargaining power for the workers, which underpinned the lack of unemployment, but also the low level of labour discipline. Workers had the possibility to switch their workplace, thus

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<sup>4</sup> Interestingly, the central planning system's adjustments to shortages led to certain investment cycles, although originally the planning system aimed to avoid such cycles (see e.g. Kornai, 1980).

managers were able to apply only positive incentives. Adding this to the phenomenon of soft budget constraints, a constant wage pressure became present, which was curtailed by centrally planning the wage levels, whereas enterprises were not authorised to set wages. This is why alternative incentives – like e.g. social services within firms – were implemented [Roland, 2000].

A non-monetary economy was built as prices, costs and profits were merely used as statistical and bookkeeping tools, and plans were generally formulated in physical units. So the financial system also implied that money had no real influence on the economy. Koźmiński (2008) – likewise Kornai – gets to the conclusion that this classical model automatically led to unbalanced growth and the phenomenon of widespread shortage. But this also pointed to inflationary pressure, which could be dampened only by artificial prices, creating the phenomenon of “repressed inflation”. This character was further heated by ample credit supply provided by the bureaucracy for ambitious projects. The prices were set by the related margins and costs, where the latter could be manipulated by the enterprises themselves. Koźmiński (2008) also mentions inflationary pressure from the wage side, which was the result of the low productivity combined with labour intensive technology, all leading to scarcer workforce that caused pressure to increase wages. Controlling this pressure with administrative tools remained a difficult task. Beside all these factors, “repressed inflation” was also heated by the phenomenon of shortage and the high prices of the black-market [Koźmiński, 2008].

Koźmiński’s (2008) description of the Stalinist system is not built on Kornai’s phenomena blocks and their causality link, but – like the various interpretations of the socialist model – it still perfectly fits the latter’s logic. Regarding the economy, Kornai’s causality line well demonstrates that in the classical model – as Koźmiński points it out – the economy was completely subordinated to the political will of the ruling regime. So it was rather politics that motivated economic decision-making – instead of profit motivation as in a market economy – but there was interdependence between the political and economic sphere. In the Stalinist system of the USSR, the internal and external political motivations required industrial and military set-up, leading to the priority of the heavy industry, which was inherited by other socialist systems as well [Koźmiński, 2008]. Furthermore, the overdevelopment of the heavy

industry – compared to the service sector – and the bias towards large enterprises could also be explained with the fact that planning was relatively easier for a smaller group of producers, while economies of scale could be better exploited. This bias was further supported by the companies' management, as they were able to attract more attention from the system's planners [Roland, 2000]. It stems from these facts that to fulfil the political aims, private property had to be eliminated and a bureaucratic apparatus had to control all processes. This apparatus had to sweep away profit maximising motivations and replace it with political goals. In the classical system, markets operated only at the margins of the system as they were considered illegal. These phenomena also meant that state ownership and bureaucracy – block 2 and 3 – reacted back to the political monopoly – block 1 – due to the fact that independent profit maximising units could no longer threaten political ambitions [Koźmiński, 2008].

Interestingly, this main line of causality can be detected from a historical viewpoint as well, since the development path of the classical socialism started by the establishment of the party's "body and soul", which is the party's organisational existence with its ideology. This "seed" almost automatically eliminates private property and curtails market activities, all requiring the coordination of a bureaucratic apparatus, and finally leading to the phenomena described in block 4 and 5. At the same time, it is important to stress that in practice secondary reverse effects coexist, so the effects are rather bidirectional. During the interaction of the elements, a natural selection process takes place, while other elements assume and strengthen each other. This development establishes the inner coherence, which results in the formation of the overall system. The logic implies that this system is not able to renew itself, as this would require reforming the two core blocks, which would nonetheless result in the abandonment of the classical system [Kornai, 2008]. In order not to lose this internal coherence with its unique stability, adjustments and reforms could remain only half-hearted, and qualitative transformation could not take place until the communist party preserved its political monopoly [Koźmiński, 2008]. However, each socialist country had/has its own individual characteristics, so the formations are far from being identical. For instance, the internal and external conditions, the degree of the Soviet Union's effect or the countries' political and economic legacy all influence the end result. So the socialist prototypes vary from

country to country and progress from period to period, but until the “seed” elements are maintained the systemic “inclinations” – reflected by the logic of the main causality line – with their own coherence prevail [Kornai, 2008].<sup>5</sup>

## 2.2. Comparing the Albanian and SFRY’s socialism

The description of the classical socialist system and Kornai’s causality model helps to demonstrate the underlying differences between the Albanian and SFRY’s prototypes. By following the logic of the main causality line and its five blocks, one can see that Albania remained loyal to the mentioned classical socialist model throughout the years, while SFRY altered both block 2 – one of the “seed” blocks – and block 3 by establishing the social ownership structure and abolishing the central planning system.<sup>6</sup> With these characteristics, SFRY could no longer be considered as a “real” socialist model, but it never became a market economy either.

### *Block 1 – One-party system*

Both Albania and SFRY had a one-party system, which was the result of years of domestic power struggles and finally the elimination of the oppositions. These ruling parties imposed their official ideology on every sphere of the society and economy, strictly repressing any counter-movements. Each country was governed by a charismatic leader almost throughout the entire socialist time period. This leader was Enver Hoxha in Albania, who was the First Secretary from the end of the Second World War until his death in 1985, while SFRY was led by Josip Broz Tito after the Second World War until 1980. Despite these similarities, major differences between

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<sup>5</sup> To read more on the main line of causality, the system’s affinity, prototypes and verification, see Kornai (1992) or Kornai (2008).

<sup>6</sup> It is interesting to note that initially the two countries started a similar development path and the communist leaders of SFRY and Albania had strong relations by the end of the Second World War, while the ties developed further during the following years. As a highlight of the relationship, the two countries signed a Treaty of Friendship, Cooperation and Mutual Aid in mid-1946, which aimed to coordinate the economic plans, to standardise the monetary policies, and to establish a common price system and custom union. In practice, this would have meant the Albanian economy’s incorporation to the SFRY system [Schnytzer, 1982]. However, the ambitious plans were never implemented, because the ties between the countries started to deteriorate rapidly from the next year and led to the final brake when Yugoslavia broke away from the Soviet sphere. To read more on the two countries’ relations see e.g. Schnytzer (1982).

the two leaderships could be detected in the content of the applied ideology – which also resulted in two absolutely different foreign policies – and the strength of the regime's grasp.

Between 1945 and the reforms of the 1990s, Albania imposed an orthodox communist system and was probably the most isolated and autarkic country within the socialist bloc [Uvalic, 2010]. It can be considered as a peculiar socialist prototype, as major economic or political reforms did not take place until the end of the 1980s, thus Albania remained the last true Stalinist state in Europe [Sjöberg – Wyzan, eds, 1991]. What also made Albania unique within the group of European socialist countries was the ideal of the so-called “self-reliance”. On an international level this implied an extreme degree of isolation from the late 1970s, while even on the regional level an intention of self-reliance [Vaughan-Whitehead, 1999]. Albania had close connections with the Soviet Union in the 1950s, but their relations severely deteriorated by the 1960s and Albania later unofficially left the Council for Mutual Economic Assistance. Following this period, the country built stronger ties with China, meaning that the latter became the dominant ally and the primary source of foreign financial aid and credit. Nevertheless, in the late 1970s Albania chose the path of isolation and even prohibited every form of foreign financial support [Vaughan-Whitehead, 1999]. All in all, throughout the socialist time period the ruling Party of Labour of Albania remained loyal to the official Marxist-Leninist-Stalinist ideology and the “dictatorship of the proletariat”. However, Albania's development path can be primarily phased by the altering direction of the foreign policy, rather than the internal progress. Nevertheless, the specific external allies always had certain influence on the domestic ideology or economic focus areas, thus the official communication and propaganda occasionally had to be adjusted to the actual foreign policy.

Unlike in Albania, in SFRY the political intention of building the classical socialist system lasted for the short time period of 1945-49 [Kornai, 1992]. After the country broke away from the Soviet bloc in 1949, the international relations became dominantly western oriented. The country was not a member of the Council for Mutual Economic Assistance, and by the late 1980s SFRY's main trading partner was the European Community [Uvalic, 1992]. SFRY was a member of the IMF and

the World Bank, and had strong relationship with these institutions [Gligorov, 1998]. Throughout the socialist time period, SFRY implemented a number of reform waves and gradually shifted from a classical socialist system to a unique model with market mechanisms and high degree of decentralisation. It is important to mention the main directions of these major reform waves already here at block 1, due to the fact that these core elements shaped the characteristics and operation of the entire system. So these reform waves adjusted or altered the phenomena of all of the blocks with the exception of block 1. Or to be more precise, even this first block was affected, as certain ideological adjustments became necessary in order to support the content of the systemic reforms and the related constitutional amendments.

The first set of major reforms in SFRY was introduced in 1949-52, after the break with the Soviet Union. This brought the reduction of state intervention and the introduction of workers' self-management [Gligorov, 1998]. Lydall (1984) mentions three main reasons for the necessity of a new high-sounding ideology and these reforms. Firstly, the deviations of the Soviet Union had to be pointed out. This was found in the system's "bureaucratic deformation" and over-centralisation. Secondly, economic challenges had to be addressed that were caused by the blockade of the Cominform. Such reforms were required that opened the trade channels to countries with market-economies and to credit lines from the "West". The third reason is connected to ethnic issues, but can be considered somewhat more minor compared to the former two. Based on historical reasons, non-Serb nations always watched political and economic centralisation attempts with suspicion. This could be only mitigated by the reforms and constitutional adjustments that provided more rights and independence to the institutions on the local levels and the republics and provinces [Lydall, 1984]. All these challenges could be simultaneously addressed by an experiment that introduced the system of self-management. Furthermore, the implementation of this new system was suitable to gain public support by the notion that it is the workers who run the factories [Kornai, 1992].

Already during the second half of the 1950s certain devolution evolved. The decision-making on major policy issues – like for instance the location of new industries – shifted from federal authorities to republican and local government agents, whereas enterprises gained the authority on the planning and sales activity of



the production. However, the allocation of investments remained under an indirect central management [Singleton, 1976]. The next wave of reforms – in the second part of the 1960s – swept away the remaining elements of central planning. This was the time when commercial banking was established in the place of state investment funds and the intention was announced to make the Yugoslav dinar convertible. The third major reform process took place in 1974, aiming to further decentralise the power of economic decision-making in order to widen the space of the republics and provinces<sup>7</sup>, while this was also the time for strengthening the self-management system. Actually this wave rather petrified the existing system than pointed to the direction of transformation. This was not the case in the forth set of reforms. As a reaction to the balance of payment crisis and rising inflation, in the period of 1982-88 major changes took place, primarily in the field of foreign trade and price liberalisation. The overall systematic reforms were introduced in late 1989, but this initial transformation process was interrupted by SFRY's disintegration, which opened a completely new chapter in the history of Yugoslavia [Gligorov, 1998].

To sum up, SFRY fulfilled the requirements of block 1 in terms of a classical socialist system. It had a one-party system, which kept control of the official ideology and the society from many aspects. What made a difference was the content of the applied ideology. Initially it was in line with the Marxist-Leninist mainstream, but shifted after the final break with the Soviet Union. Then the system of self-management was introduced, which is further discussed under block 2, as it completely altered the ownership structure.

### *Block 2 – Ownership structure*

In Albania, private property was rapidly eliminated by widespread collectivisation [Cani – Hadëri, 2002]. Firstly – already by 1946 – the complete nationalisation of public utilities and foreign-owned capital took place. The second step was taken the same year, when the collectivisation of the domestic production and the foreign trade sector was completed. This means that by 1947 the entire Albanian industry became state-owned [Schnytzer, 1982]. So in case of Albania it is obvious, that the country

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<sup>7</sup> In case of Yugoslavia, the regional interests generally meant the national groups' interests [Kornai, 1992]. Noteworthy, that the decentralisation of powers led to distinctive regional economic units and own political elites, providing a basis during the succession process [Bartlett, 1997].

fulfilled the Stalinist requirements already from the late 1940s by its rapid and widespread collectivisation.<sup>8</sup>

After the Second World War, SFRY started its way on the same path as Albania. Except for the small workshops, the industry, trade and services were nationalised during the brief period before the crack in the relation with the Soviet Union. Noteworthy, that this was not true for the peasants, probably because they had too big influence as they formed 70% of the population and around half of the Party [Lydall, 1984, p. 59]. They were collectivised only after 1949 [Lydall, 1984].<sup>9</sup> However, the collectivisation in SFRY was incomplete, as the leadership stopped the implementation of the classical socialist template at an early stage [Kornai, 1992], and started its way on a different development path. The new system was built on the unique system of self-management, which altered the classical socialist form of block 2.

It is important to provide certain information on the main features of self-management, as it remained a pillar of SFRY throughout the years. The system of self-management was introduced already in 1950 during the first reform wave, and – as already discussed – was motivated by many factors after the break away from the Soviet bloc. This shifted the centralised state property into “non-state” social property. However, the concept of social ownership is definitely not a clear-cut. Formally, assets were owned by the collectivity of citizens and were managed by the employees on their behalf [Bartlett, 1997]. However, in practice the system implied a kind of state-ownership, but without the related legal institutions of state property [Lavigne, 1999].<sup>10</sup> It was used by politicians and mainstream economists to explain the economic development and to advise the government. It was considered to be using self-management from the market economies, but in a more efficient form – as it was supposed to mobilise the collective entrepreneurship – and in a more just way

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<sup>8</sup> In 1991, the size of the private sector in percentage of the GDP was merely 5% [Papazoglou, 2005, p. 91]. For the sake of comparison, the same indicator was around 15-20% in the republics of ex-SFRY [Papazoglou, 2005, p. 91]. As a more precise data, the share of public sector on the basis of Gross Material Product using 1972 prices was 86.5% in 1987 in SFRY [Kornai, 1992, p. 72], showing that somewhat more space was left for the private sector in SFRY compared to Albania.

<sup>9</sup> To read more on the development of state, social and private ownership, see e.g. Lydall (1984).

<sup>10</sup> Lavigne (1999) also claims that this caused further difficulties during the privatisation process of the transition period, as such things had to be privatised that “did not belong to anybody”. In certain cases the social property was first nationalised to clarify the property rights.

by a kind of profit sharing method [Gligorov, 1998]. Self-management could also be interpreted as a rather socialistic element, because it could be a reinterpretation of public ownership. This is why it was considered as an unassailable taboo throughout the years, like state property in the Soviet bloc. Right until the fall of socialism, self-management remained the core element of the Yugoslavian economic system [Kornai, 1992].

### *Block 3 – Coordination mechanism*

The collectivisation of the Albanian economy was rapidly completed, meaning that a widespread bureaucratic apparatus became required to run the central planning system. A first national nine-month plan was implemented for 1947, while the first classical five-year plan was launched in 1951 [Schnytzer, 1982]. The new system applied the classical socialist methodology, leaving no room for any market mechanisms or real market competition. Within this central planning system prices and exchange rates were fixed, and were primarily used for accounting purposes and had no allocative role [Vaughan-Whitehead, 1999]. All these mean that the features already discussed at the classical socialist model applied for the Albanian case as well.

Before the caesura, also SFRY applied the usual Stalinist methodology for the central planning system, which covered all economic decisions and processes [Lydall, 1984]. Following the brake away from the Soviet Union, the economy and its management was run on new grounds. In this system the self-managing units, the unions and associations were supposed to negotiate and agree on the tasks at all levels based on social responsibility and mutual willingness [Kornai, 1992]. Nevertheless, this does not mean the complete elimination of central planning, but most of its practical relevance was lost. Indeed, enterprises and banks had only minor regard to the indicative plans, but the planning was mandatory for the so-called socio-political communities. More precisely, planning had different functions in different time periods. In the 1950s, the classical central planning system was abolished and planning became relevant only for the basic proportions. It was between the mid-1960s and mid-1970s when the planning was the loosest and remained only indicative. Following this period, the macroeconomic imbalances became stronger and required reforms. The system tried to tackle the challenges by a

kind of self-management planning that was reached by social compacts and agreements on the broad macroeconomic parameters and focused on certain priority sectors, like for instance the producers of raw materials and intermediate goods [Schrenk, 1979].<sup>11</sup> This mechanism differed just as much from central planning than from market coordination [Kornai, 1992]. In practice, the power structure always implied the usual vertical dependence on the bureaucracy to a certain extent, just like in the classical system including Albania. All these features directly led to various phenomena that are collected in the next block of the causality line.

#### *Block 4 – Relations between the actors*

The vertical dependence on superiors can be considered more obvious in case of the Albanian classical socialist system. However, even in SFRY's self-management system the connection with the superior institution was able to influence various advantages, like the amount of subsidy in case of loss, the investment credit and tax treatments or the access to foreign exchange. These imply that the phenomenon of soft budget constraint existed in SFRY as well [Kornai, 1992]. What made difference in the dependence structure between Albania and SFRY, was the fact that in the latter's case, the managers depended also on their subordinates. The workforce in the firms of SFRY gained a stronger relation with the heads, as the latter's re-election became dependent on the former group's support. This limited the enforcing power of the firms' managers and increased the possibility of unjustified wage and benefit growth. Due to the fact that managers had to gain the support of both the workforce and the bureaucracy, it was not enough for them to count on the support of the local party and union. The looser the bureaucracy was, the more "populist" actions had to be taken. The system also implied that during the negotiations with superiors, the firms' managers had a certain kind of role for representing the interests of the workforce, which was far stronger than in the classical socialist system [Kornai, 1992]. Thus one can conclude that besides the classical vertical dependence, the managers in SFRY had to cope with a kind of "double dependence".

Due to the fact that SFRY's property right did not allow workers to take their "investment" with them in case they moved to a new firm, they became unmotivated

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<sup>11</sup> To read more on the planning system, see e.g. Schrenk (1979).

in the long-term development of the firm. The system rather encouraged a short-term outlook by maximising the income and consumption of today than the investments for long-term [Kornai, 1992]. The same logic can be applied for the Albanian case.

#### *Block 5 – Typical lasting phenomena*

In this block, a few of those phenomena are briefly discussed that were general features of the economy. In most cases, the phenomenon's ideological root – that rather belongs to the first block – will also have to be mentioned for better understanding. The list of the features that are discussed here is far from being complete, but it tries to give a hint of probably the most unique or differentiating characteristics.

As already discussed, the Albanian government aimed to implement the Stalinist rules, which included a centrally planned economic system with a maximum feasible saving rate and a positive increment of the current consumption. From an external balance's point of view, economic self-reliance was meant to avoid balance of payment deficit, while fulfilling the economic growth targets [Schnytzer, 1982]. However, in Albania's case the narrow export base was not able to balance the strong import-dependence of the industrial and agricultural sector [Vaughan-Whitehead, 1999].<sup>12</sup> In practice, it was the foreign aid that was substituting the domestic savings for financing the investments for a programme of industrialisation [Schnytzer, 1982]. All this implied that when Albania chose international isolation, it severely affected the economy's sustainability, because the country strongly relied on these external funds. During this period, the country was unable to accumulate resources for investments [Sjöberg – Wyzan, eds, 1991]. Generally speaking, although the ideal of economic self-reliance was a long-term goal for the Albanian government, in practice it was never achieved [Schnytzer, 1982]. Unlike Albania, SFRY opened its economy for western trade and credit lines from the 1950s [Schrenk, 1979]. Throughout the years and the reform waves, SFRY gradually liberalised its foreign trade and tried to integrate the economy to the world market, and even took attempts for the full convertibility of the dinar. SFRY even re-established its trade contacts

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<sup>12</sup> Even the import shortages contributed to production losses. Loss-making enterprises continued to be financed by the government, leading to large budget deficits and uncontrolled monetary expansion. The applied policies led to the crack of the economy by the 1990s [Vaughan-Whitehead, 1999] and opened a new era in the country's history.

with the CMEA countries, although trade continued to be dominated by the Western European relations [Dubey et al, 1975]. Nevertheless, already by the late 1970s, the country faced large trade and current account imbalances, which could not be compensated by the increasing amount of workers' remittances [Schrenk, 1979] and required state intervention and reforms by the 1980s.

As already discussed, inflationary pressure was present in the classical socialist system as well, but was temporarily curtailed more successfully with administrative measures that covered both prices and wages. In SFRY, these measures were less complete or left more room for market mechanisms. The list of administratively regulated prices varied over time, but did not cover the entire list of products and services. As for the wages – unlike in the classical model with its compulsory wage regulations – in the system of self-management both bureaucratic and proprietorial constraints were missing. Moreover, the workforce was motivated for maximising the short-term interest, while managers tended to take decisions for increasing their popularity. This implies that the system encouraged firm leaders to raise nominal wages. In case this wage pressure meets a soft financial policy, the probability of a wage-price spiral becomes strong. So although self-management is definitely not a sufficient precondition for the spikes of the inflation rate, it did lead to a behaviour that strengthened inflationary pressure [Kornai, 1992].<sup>13</sup>

As a further difference, in the classical socialist model the rise of employment was encouraged by the expansion drive. Although the expansion drive was present in the self-management system as well, it was not financed from the companies' own resources. As large part of the income as possible was spent for the workforce's current consumption, while the investment tried to be financed by state subsidy and banking finance with negative interest rates. This means that the firms' motivation – contrary to profit interests in market economies – was the maximisation of the workforce's income, namely the income per existing worker. Firms were motivated

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<sup>13</sup> Indeed, SFRY's economy faced a number of inflationary crises, although some originated from external factors. The government took measures with price control instruments or implemented somewhat more complex stabilisation programmes to dampen the inflation, however, in most cases only with limited success. See more on this topic in e.g. Lydall (1984), Singleton (1976) or Gedeon (1987).

It is also worth mentioning that due to the high inflation expectations and the fear of shortage of imported goods, piling up stocks was significant, leading to occasional shortage [Kornai, 1992].

to support capital-intensive investments with as little extra workforce demand as possible. These mechanisms led to the co-existence of inflation and unemployment [Kornai, 1992]. Unlike SFRY, Albania remained committed to the policy of full employment besides a rapidly growing population.<sup>14</sup> This implied that the priority was rather to create employment opportunities than to improve the productivity [Sjöberg – Wyzan, eds, 1991]. But the growth rate of the population also implied that – unlike in the mentioned classical socialist model – inflationary pressure was less present from the wage side.

Related to preferential sectors, it can be mentioned here that Albania did differ in certain aspects from the Stalinist model, but these differences were primarily the result of the dissimilarities of the economic development and the resources. For instance, Albanian central planners occasionally provided a more significant role for the agricultural sector, besides keeping the emphasis on the heavy industry [Sjöberg – Wyzan, eds, 1991]. Agriculture was a sector that was supposed to finance the industrial growth in certain time periods and provided some resource – given the limited amount of raw materials – for funding the industry [Prifti, 1978].

Based on all these phenomena, it becomes obvious that both Albania and SFRY had various similarities – e.g. the existence of excess demand – but also certain fundamental differentiating features compared to each other or to the classical socialist model. Generally, these differences were rooted in the applied ideological background of the system and were shaped through the causality line, leading to a final systemic “output”.

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<sup>14</sup> The number of employment increased from 384 thousand to 1,320 thousand between 1960 and 1988 [Sandström – Sjöberg, 1991, p. 936]!

### 2.3. The banking system

In every economy the financial sector has a certain kind of specific role, but the exact functions vary among the different economic models. Levine (1997), for instance, uses the existence of general market frictions – namely the existence of information and transaction costs – as a starting point to underpin the need for financial markets and intermediaries. Via the operation of these institutes, resources are allocated in a more efficient way. This is the result of five major functions that financial intermediaries fulfil: improving risk management, allocating resources, monitoring managers and exerting corporate control, mobilising savings, and facilitating the exchange of goods and services. Based on the fulfilment of these five functions, the pace of economic growth is determined through two main channels: capital accumulation is enhanced by reallocating the savings and influencing the savings rate, while technological innovation by affecting the rate of innovation. However, Levine also declares that the financial system is not an exogenous factor for economic growth, but they rather influence each other, as the economic activity also influences the structure and quality of the financial structure [Levine, 1997]. This mechanism is valid for a well-functioning, profit-driven market economy, whereas in a socialist system the financial sector has a different role.

Kornai's main line of causality can be implemented to the classical socialist banking model as well. Instead of profitability motivations – as in a market economy – the banking sector's operation was rather influenced by the ideology and the party's priorities, thus leading to a rather administrative role for the entire financial segment. Regarding block 2, the monobank was state-owned. As for block 3, the banking sector was one among the many actors of the economy that was directed by the central planning system. This implied that market mechanisms were excluded and the vertical dependence became present between the bureaucracy and the monobank. As the banking sector was rather merely a channel between the coordinators and the actors in the production sector, the features of block 4 and 5 evolved far less, but some of the characteristics – as for instance the soft budget constraint – could be traced in this case as well.



More specifically, within the classical socialist system the banking sector had its own specific functions and limited responsibilities. Generally, a one-tier banking system was established, meaning that a monobank fulfilled both the central banking tasks and crediting. These institutions primarily had accounting functions. Its branch network had the role of surveying the enterprises' plan implementation, whereas each enterprise had its account in these local branches. Payments were allowed only through these accounts. On the other hand, households were allowed to have only savings account, but their payments had to be in cash. This system provided the ability to control the strict implementation of the relevant plans [Lavigne, 1999]. Likewise other sectors, the banking sector was dominated by the bureaucratic decisions, so the decisions on investments were taken by the state apparatus bureaucratically. The relation between the banks and firms was not horizontal as in market economies, but it was more like vertical, since it could be considered as a branch of the bureaucracy that kept control of the firm [Kornai, 1992]. Nonetheless, there was a lack of incentives for the banks to harden the enterprises' budget constraints, given the fact that they themselves also had soft budget constraints [Berglöf – Roland, 1995].

Turning to the country cases, in Albania – as part of the socialist economic system – the one-tier banking system was built up in line with this classical communist pattern [Uvalic, 2010], thus the banks worked under extreme centralisation. Until the mid-1970s, the Albanian one-tier banking system consisted of one bank, the Albanian State Bank. Besides the central planning system the bank had very limited functions, because both the monetary policy and the credit distribution were based on the central plans. The bank recorded the transactions of the enterprises. Savings cash and insurance offices also operated in the system. However, unlike in a regular bank, the population's savings were not used for credit distribution but for the state budget. In the second half of the 1970s, an Agricultural Bank was separated from the Albanian State Bank for the supply of agricultural funds. In 1990, another unit – the Department for Foreign Relations – was separated and became the base for the establishment of the Albanian Commercial Bank. Its role was to finance and encourage the export activity and foreign payments [Cani – Hadëri, 2002]. So by the end of the communist regime, the banking system existed of four state-owned institutions with different functions; namely a bank for central and commercial

purposes, a rural credit institution, a bank for the collection of savings and an agent for trade finance [Vaughan-Whitehead, 1999]. Generally speaking, these banks provided very limited range of financial services, as they primarily performed cash transactions and the clearing of invoices for transfers between various enterprises or between the government and the enterprises. Credits continued to be available for the corporate sector, all based on the central planning process.<sup>15</sup> In case of funding difficulties, credits were automatically extended. Throughout the years, the interest rates were set by the State Bank of Albania and were rarely shifted [Clunies-Ross – Sudar, 1998].

As already represented during the general economic overview, SFRY's economy provided a completely different case and its banking system can not be discussed so briefly as the Albanian example, due to the fact that SFRY's banking system showed different structures and features over time. The banking system has been gradually restructured parallel with the major reform waves and the general economic system's developments. Within the framework of SFRY's specific economic system, banks played an important role – unlike in Albania – due to the fact that they controlled a substantial part of the investment funds. Although enterprises were theoretically authorised to invest their own funds, in practice they had to transfer 80% [Singleton, 1976, p. 151] of their profit-before-tax to the government until the mid-1960s, meaning that the remaining resources did not cover investments. This is the reason why investments were financed from social investment funds. The General Investment Fund – which was accumulated by the tax of enterprises – was managed by three federal banks with different business fields; investment, agriculture and foreign trade. This kind of structure was available on a local level as well, with local investment funds managed by local communal banks. As a substantial feature – discussed by Kornai (1992) under the term of vertical dependence – the management of these banks was appointed by the federal or local political authority respectively. This implies that the management of the banks served rather political than profitability interests, and could be considered even as a financial arm of the governing bureaucratic bodies. Generally speaking, the federal banks aimed to support the underdeveloped southern region, whereas local banks tried to bolster

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<sup>15</sup> It was not until the reforms of the 1990s, that enterprises became allowed to use bank credits – and their own profits – to finance their investments [Sjöberg – Wyzan, eds, 1991].

their local commune, with only minor regard to the optimal distribution [Singleton, 1976].

1961 brought a reform wave for the banking system. All communes established their own commune banks, due to the fact that the credits for the enterprises had to be streamlined through these new local banks. Parallel with this – as an important pillar of a two-tier banking system – it became prohibited for the national bank to provide credits directly. Republican banks were also established to provide each government with a dedicated institution for their own particular investments. As an instrument of central supervision, a substantial part of the deposits had to be transferred to the central bank, which lent it back to the banks for certain projects. This new system took a step in the direction of economic interests, leading to a co-existence of the economic and political motivations in the investment decision procedure [Singleton, 1976]. It also gave more independence for the commercial banks from the central bank, which can be reflected by the fact that while in 1961 70% of the credits originated from the central bank's loans, by 1965 this proportion dropped to 43% [Singleton, 1976, p. 153].

The gradual restructuring culminated via the reforms of 1965-66. Besides various economic decisions – including also price realignment and dinar devaluation – the banking system has been reshaped. The new laws abolished the concept of the so-called territoriality. This implied that in theory the former federal, republican and communal banks were able to compete over the territory of SFRY, which was absolutely against the mechanisms of the classical socialist regime. The new measures led to an impressive increase of the enterprises' own investments, thanks to the liberalisation of the earned enterprise income distribution, and the rise of investments financed by banks, while the role of government financed investments dropped. As a further important effect, the political influence on the system became limited. Managing the banks became the role of those enterprises or political agents who had deposits in the special founders' funds. This became the base of the voting strength, which however was maximised at 10% for all agents, thus limiting even the potential political influence. In most cases even the bank employees had a representative. The founding enterprises managed the bank's credit activity and became the owners of the banks' profits. All this implied that the banks emerged as a

kind of special units of the founding enterprises' group and could be considered as secondary members of the economy [Singleton, 1976; Lydall, 1984]. Interestingly, these unique institutions could be considered as special socialist prototypes of the well-known stock companies in market economies.

One might think that the system created certain competition within the sector, but in fact, as the banks were run by localised enterprises and the former banking framework contained the territorial restrictions, banks continued to be localised in their activities. This character remained present even after waves of mergers, which led to the decrease of the number of banks.<sup>16</sup> The former federal banks could be considered as exemptions, due to the fact that they merged with banks from other regions as well. This regionalisation was particularly important in the aspect of the federal government policy on interest rates. The federal authority had the power to impose interest rate ceilings, which often resulted in negative real interest rates. This became the primary source of the lack of real competition, because banks rather financed only their own founding enterprises' projects.<sup>17</sup> This policy led to the inappropriate functioning of the interest rate's allocative role and to the minimal mobility of capital. Generally, the locally accumulated savings were redistributed within the relevant region. Interregional or inter-republic funds were typically the federal government's funds, which served development purposes for the underdeveloped republics and Kosovo [Singleton, 1976]. Table 1 reflects the large and increasing differences among the republics and provinces of SFRY. The negative interest rates also implied that investment decisions were rather based on bureaucratic decisions with references to the social plans [Lydall, 1984].

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<sup>16</sup> In 1980, 162 "basic" banks operated in SFRY, and except in Croatia, they were combined to 8 "associated" banks, which were supposed to manage large bank loans and foreign exchange transactions [Lydall, 1984, p. 117].

<sup>17</sup> Typically, the former federal banks represented the most relevant exemptions from this logic [Singleton, 1976].

Table 1: Increasing differences among the constituent republics and provinces of SFRY

		SFRY	BH	Croatia	Kosovo	Macedonia	Montenegro	Serbia (core)	Slovenia	Vojvodina
GMP per capita	1953	100	83	122	43	68	77	91	175	94
	1988	100	68	128	27	63	74	101	203	119
Average growth of GMP as a whole per capita	1956	4.9	4.6	4.6	5.1	5.1	5.0	5.1	5.2	5.3
	1988	4.0	3.3	4.8	2.6	4.1	3.9	4.3	4.5	4.8

Source: Pleština, 1992, p. 181.

Throughout the years, the corporate sector in SFRY typically undertook investment projects that were not covered by their own funds [Gedeon, 1987]. Moreover, the gross flow of credits to enterprises generally exceeded the net requirements. This implied that the sector was indebted to the banking sector to a large extent. However, due to the mentioned reform measures, which allowed the firms to reinvest their profits, the proportion of own resources for investments increased from 62% in 1961-65 to 74% by 1971-75 [Lydall, 1984, p. 115]. Noteworthy, that the growing amount of credit was channelled by the banks from the increasing amount of various compulsory deposits from enterprises and savings [Lydall, 1984]. Despite the expanding activity, banks were often loss-making, given the negative or very low interest margins and the fact that many of the financed firms were loss-making themselves.<sup>18</sup>

It is important to mention, that in SFRY even a specific capital market existed already before the 1970s, due to certain kind of bond issuances. As an important factor, the limitation for non-socio-political authorities was abolished in the 1970s. This meant that certain enterprises were also able to issue bonds – occasionally underwritten by banks – but interests were legally maximised. To make these bonds more attractive, price concessions on the enterprise's products, special credit facilities or even lotteries were offered. On the other hand, also from the 1970s,

<sup>18</sup> E.g. in 1980, almost 10% of the firms reported uncovered losses [Kornai, 1992, p. 491].

profitable banks were obliged to return their profits to their investors. This was supposed to prevent from a capital market being “manipulated” by the banking sector and the creation of independent financial institutions, which already started to emerge from the 1960s<sup>19</sup> [Singleton, 1976]. Generally speaking, the room for financial manoeuvres could be represented by the fact, that by the 1980s, firms had a whole variety of ways to meet their funding requirements; e.g. by borrowing from each other, by requiring credits from banks, by extending voluntary trade credits, by issuing bills of exchange that could be used as a kind of cheque, by reducing the amount of money on the balance sheets, by using part of the assets from the amortisation funds or other kind of deposits [Gedeon, 1987]. Indeed, the range of these possibilities could be considered exceptional among the socialist countries.

Nevertheless, certain market activities led to major shocks in the system. Among them, the most significant occurred by the end of the socialist time period and became known as the case of frozen FX deposits. From the 1970s and 1980s, credit institutions borrowed FX loans on international markets with sovereign guarantees, and financed projects that were supported by the authorities related to these funds. Meanwhile, fostered by the growing amount of remittances and incomes from tourism, the increasing sum of FX deposits was to a large extent redeposited at the national bank in exchange for dinar credits. However, from the 1980s the dinar was often devalued as inflation gained momentum, while as a further risk, the central bank’s FX reserves started to decline. The large amount of households’ FX deposits that were previously transferred to the central bank in Belgrade – as a consequence of the monetary system’s problems – became irretrievable and “frozen” [Barisitz, 2008]. This was the first major shock that undermined the confidence in the banking sector for long-term, while the compensation of the household sector is still an unsettled issue in most of the successor states.

Last but not least, the monetary authority must be further mentioned. Led by the National Bank of Yugoslavia, republican or provincial central banks were established to decentralise the system, in line with the territorial principle [Šević et al, 2002]. In theory, the monetary policy authority was at the level of the republics and provinces,

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<sup>19</sup> However, foreign investors gained a special guaranteed position, in order to attract foreign capital to the country [Singleton, 1976].

while the monetary system was supposed to be the same on a state-level. In practice, this meant that the decisions were made on the state-level in general, where the federal authority felt it has lost its independence. Regarding the local central banks, they merely had a narrow range of limited functions and felt that – despite the decentralisation attempts – they had acquired only limited responsibilities [Gligorov, 1998].<sup>20</sup>

#### 2.4. Conclusions and comparative overview

After the Second World War, the two counties started their development with the same concept, but in the upcoming years their roads diverged and led to two extremely different socialist prototypes. Albania represented a special case within the European socialist bloc, with its constant loyalty to the classical socialist system and its isolation. SFRY shifted to the other end and became probably the most unique prototype, due to the fact that it could not be treated as a simple mixture of market oriented and socialist elements. Gligorov (1998) points out that the SFRY's economy included free, repressed and missing markets; market clearing conditions and shortages; prohibitions, restrictions and exceptions in a parallel form. On the one hand, the country abolished central planning and was opened to the world market. Moreover, it even cooperated with the international financial institutions. On the other hand, SFRY kept the restrictions on private ownership, did not allow the creation of markets, did not liberalise the trade and the currency was kept unconvertible [Gligorov, 1998]. Loss-making enterprises were regularly subsidised, whereas investment decisions were rather based on social or political factors than on profitability criteria [Singleton, 1976]. As for the price system, most of the products and services had free prices, meaning that administrative prices were applied only for a small range of goods [Kornai, 1992]. The economy had free, multiple and black market prices at the same time. This also referred to the multiple exchange rates, due to the fact that official, export-subsidised, inter-industry, black-market and various special exchange rates coexisted, causing an unclear system. Also the fiscal system

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<sup>20</sup> Nevertheless, after the dissolution of Yugoslavia these monetary institutions were transformed to national banks in the new countries [Šević et al, 2002].

could be seen as a unique case, because SFRY had a kind of fiscal federalism, with significant decentralisation of fiscal rights and responsibilities [Gligorov, 1998].

The case of Albania is a perfect example for one of Kornai's (2008) conclusions on the viability of the classical socialist system. He claims that in a medium-term view the classical system is viable. Indeed, Albania was able to preserve its system by maintaining the coherence of the classical socialist system, avoiding any deep structural reforms and keeping a hold on the society by the political leadership. This was not the case of SFRY, and one might ask the question how this unique system could function and maintain its internal coherence throughout the decades. Kornai (2008) mentions that the country took steps in the direction of a third way socialism and did not choose exclusively state or private ownership, while coupled bureaucratic and market coordination with "social compacts". However – despite the alternating official policy – in practice the dominance of bureaucratic coordination was maintained. At the same time, any wave of transformation was strictly forced for implementation, keeping a continuous hold of the structure. Furthermore, one can argue that the leaders of SFRY – by implementing several significant reform packages, part of them as a reaction to crises – continuously gave new impetus for the system's survival.

Due to the fact that Albania did not undertake any major political or economic reforms during the 45 years of communist regime, it had the least experience with the mechanisms of a market economy. Throughout the years, it fulfilled the main requirements of a classical socialist system. Generally, these features were not valid for SFRY's case, which regularly reshaped its economy via certain reform waves. It implemented a whole range of market economic elements, but limited their room by various administrative measures, all leading to a unique mixture of the elements of a socialist and a market economic model. So by the 1970s, SFRY's system shifted closer to a capitalist model, but market mechanisms remained limited due to the related administrative measures. The most important outcomes of the Albanian and SFRY's economic models have already been discussed in a more detailed form, so here only the most relevant differences are summarised by Table 2. The comparison is made for the time period starting from the 1970s, as this is the term when the differences became the most significant.



Table 2: Main differentiating features between the Albanian and SFRY's economic model

	<b>Albanian model</b>	<b>The model of SFRY</b> (all valid from the 1970s)
<b>Ownership</b>	State-ownership	Social-ownership
<b>Planning</b>	Central planning system	Social plans
<b>Employment aims</b>	Full employment	No such central aims
<b>Investment priorities</b>	Favouring labour-intensive investments	Favouring capital-intensive investments
<b>Wage constraints</b>	Limited by central plans	Room for bargaining
<b>Managers' dependence</b>	Dependence on superiors	Dependence on superiors and subordinates
<b>Disposal over the firms' own profits</b>	No	Yes

*Source: Own compilation*

As shown by Table 2, even the ownership structure differed in the two countries, which can be considered as a fundamental element of any economy. Albania favoured the classical state-ownership structure with an almost negligible share of the private sector. On the other hand, from the 1950s SFRY altered the original concept of centralised state property and implemented the so-called self-management system with its “non-state” social property. With this structure, assets were supposed to be owned by the collectivity and managed by the employees on their behalf. This led to different planning mechanisms. Albania had the original central planning system, whereas in SFRY central plans had different – but usually secondary – functions over time. The management of the economy was based on social plans on all levels, which was supposed to be the outcome of the negotiations between the self-management units and the unions and associations. Based on these fundamental differences, distinctive features evolved in the two systems. In Albania, an official aim was to provide full employment, which could be seen as a real challenge with a rapidly increasing population. SFRY did not declare such a goal centrally, whereas the management of the self-managed units had just the opposite intention, namely to maximise the income per worker. This directly led to a further difference, as the Albanian model would rather favour labour-intensive investments, while the system

of SFRY was supporting capital-intensive investments instead. The previously mentioned features apply different wage policies as well. While Albania was able to imply wage constraints via its central planning system, in SFRY more room remained for bargaining, which stemmed from the missing bureaucratic and proprietorial constraints. Moreover, in SFRY wage growth was motivated by the managers' themselves, because their re-election depended also on the subordinates. So unlike in the classical socialist model, including Albania, where the vertical dependence on superiors was dominant, in SFRY the managers depended also on their subordinates, leading to a kind of double dependence. This limited the managers' enforcing power, while encouraged unjustified wage and benefit growth.

Finally, Table 2 mentions the firms' disposal over their own profits. This is a fundamental element in a market economy, but it contradicts with a central planning system. In SFRY, enterprises were able to invest their own funds theoretically, and from the 1970s the firms were able to dispose over their income and reinvest their profits also in practice. Such intention was not implemented in the socialist Albania. In addition to all these characteristics, with varying intensity – occasionally linked to measures taken after crises – SFRY took steps in the direction of foreign trade or price liberalisation, particularly in the final decade of the country's existence.

Besides these fundamental elements, also the banking system showed basic differences, as the general development paths of the two countries apply here as well. While the Albanian banking system remained in line with the classical socialist model, in SFRY the banking sector developed parallel with the general economic reform waves and incorporated various market economic elements over time. As a fundamental difference, SFRY established a two-tier banking system from the 1960s, when local banks were established and the central bank became prohibited to channel credits directly. In contrast to this model, Albania preserved its one-tier banking system. This implies that the Albanian banking sector merely had administrative role besides the central planning system. As for SFRY, its banking segment gradually gained more and more independence from the bureaucracy via the reform waves. From the second half of the 1960s, banks became unique SFRY prototypes of the capitalist stock companies with the so-called founders' funds. These funds were added up from the special deposits of those enterprises and political agents that

managed the banks and this determined their voting strength – similarly as in a market economy. These “owner” enterprises became the owners of the banks’ profits. From the 1970s, banks were obliged to return their profits to their investors, in order to curb the development of a bank-led “manipulated” capital market. Other market mechanisms were prevented as well. For instance, from the mid-1960s banks were able to compete with each other over the territory of SFRY, as the concept of “territoriality” became abolished. However, in practice real competition did not take place, because banks continued to operate on their local levels, while with the imposed interest rate ceilings – resulting in negative or very low interest rate margins – the expansion of the business activity was prevented.

Nevertheless, a few market economic elements did function to a certain extent in SFRY. Even the basic role of the “commercial” banks was similar as in a market economy, due to the fact that they channelled the locally collected savings to the investors through their crediting activities. This did not hold for Albania, where savings were rather transferred to the state budget. Furthermore, by the 1970s SFRY had a special kind of capital market. For instance, corporate bonds could be issued – although with limitations – and by the 1980s a whole variety of options existed for enterprises to meet their financial needs. This was in contrast with the Albanian and the classical socialist practice. To sum up, unlike in Albania, SFRY implemented certain market economic elements to its banking system, but still the system was prevented to be driven by market mechanisms. Meanwhile, the creation of independent financial institutions was curtailed. These restrictions were achieved by the applied indirect measures. Some of the above mentioned, most significant differentiating features between the Albanian and SFRY’s case are summarised by Table 3.

Table 3: Main differentiating features between the Albanian and SFRY's banking model

	<b>Albanian model</b>	<b>The model of SFRY</b> (all valid from the 1970s)
Two-tier banking system	-	√
Bank management led by bureaucracy	-	~
Disposal over the banks' own profits	-	~
Competition in the banking sector	-	(Only in theory)
Channelling savings to investors	-	√
Existence of capital market elements	-	√

Note: - Nonexistent, ~ Partly existent, √ Existent

Source: Own compilation

Table 4 summarises the most important requirements for the financial intermediaries in a well-functioning market economy. Risk management, the efficient allocation of resources, the shock absorbing capacity was missing in both countries. The mobilisation of savings existed to a certain extent in SFRY. Monitoring of managers and exerting corporate control existed in both countries, but as banks in the socialist time period were not profit-driven institutions, the aspects and motivations were different compared to a market economy. Last but not least, as a basic function, the exchange of goods and services was supported by the sector. It can be seen that – although the two countries applied different models – both Albania and SFRY fulfilled almost none of these functions, meaning that during the transition period these had to be established almost from scratch. It can be concluded, that throughout the years the banking systems in the two countries had limited or no experience ...

- ... as a financial intermediary, because its role was rather limited on recording transactions in Albania and remained narrow in SFRY,
- ... in the credit evaluation and risk management methods and tools,
- ... in international accounting, as accounting rather served the monitoring of the plan fulfilments,

- ... in – generally speaking – banking in a “real” market economy [Cani – Hadëri, 2002].

Table 4: The role of financial intermediaries in a market economy

	<b>Albanian model</b>	<b>The model of SFRY</b> (from the 1970s)
Improving risk management	-	-
Efficiently allocating resources	-	-
Absorbing financial and real economic shocks	-	-
Monitoring managers and exerting corporate control	~	~
Mobilising savings	-	~
Facilitating the exchange of goods and services	√	√

Note: - Nonexistent, ~ Partly existent, √ Existent

The categories of the table are gained from the work of Levine (1997) and ECB (2010b).

*Source: Own compilation*

This chapter provided a comparative overview of the main differences between the socialist Albanian and SFRY’s economic systems. This comparison was prepared through the framework of Kornai’s causality model, as for understanding the fundamentals and mechanisms of the two economies, the systems’ “seeds” had to be reviewed as well. Furthermore, special focus was given to the banking sector, which can be considered as a core actor in market economies, but merely had supporting functions in the socialist models. It can be concluded that the development paths of Albania and SFRY gradually diverged during the socialist time period, leading to two completely different models. This tendency applied also for the banking system. However, when reviewing the two banking sectors’ legacy, more similarities can be traced, meaning that during the transition period similar challenges had to be addressed in Albania and in the successor countries of SFRY.

### **3. Transition times – Approaching stabilisation from systemic collapse**

As discussed already, Albania and SFRY implemented completely different economic models during the socialist time period, thus the countries inherited two kinds of systems.<sup>21</sup> Throughout the years, Albania remained loyal to the “classical” socialist model, whereas SFRY applied a system of workers’ self-management and implemented various market economic elements, although with limited room. However, interestingly, neither of the reviewed countries had experience with well-functioning free market mechanisms and had to cope with the “classical” transitional challenges. All these features apply for the banking system as well. Albania had a regular socialist monobank, while SFRY had a two-tier system with large number of socially-owned local banks. Nevertheless, the tasks and challenges remained similar during the sector’s transition process.

During the socialist time period, the constituent republics of SFRY – and in many aspects even the provinces – enjoyed certain independence and formed heterogenic, separated blocks. The transition process of Yugoslavia started already in 1988, but was not carried out due to the internal conflicts and the split up of the country. In 1991, the devastating war within former-SFRY began and the first phase of the country’s succession lasted until 1995. With the exception of Slovenia and to a certain extent FYR Macedonia, this war and its aftermath had serious economic consequences on all republics. This is why the countries of former-SFRY differ from the standard transition pattern and lagged behind the CEE development process. The stabilisation and restructuring attempts were overshadowed by military conflicts. Nevertheless, the specific starting conditions, the impacts of war and the incumbent governments’ policy differentiated the countries even within SEE<sup>22</sup> to a great extent. Further external and internal differentiating actions, as embargos or civil unrest

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<sup>21</sup> Part of this chapter will be published in an edited version:

Kazinczy, Eszter (2013a): The transition times of the banking system in south-eastern Europe. From systemic collapse to stabilisation. Köz-Gazdaság, Budapest, Faculty of Economics at the Corvinus University of Budapest, expected date of publication: February 2013

<sup>22</sup> Starting from this chapter, SEE refers to the region of Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, Serbia and Kosovo.

added to this list. All these imply that the specific transitional processes show great variety.

The transition of the financial sector evolved – or is still evolving – parallel with the general economic transition. However, due to its complexity and the widespread factors that influence its activity, its development was an even slower and more gradual process with occasional meltdowns. Still, by the end of the main restructuring process the banking sector's structure converged to a similar pattern.

This chapter analyses the transition period of SEE, focusing on the banking sector that dominates the financial system in the region. First, the general features of the transition period are analysed, paying special attention on the reasons and effects of the transitional recession. The latter is given attention for two main reasons. Firstly, the impact of wide range of transitional features culminated in this phenomenon, and second of all, it is especially important also in relation of the banking sector's development. The next section discusses the transition and stabilisation of the banking system itself. It is obvious that despite the great differences in the starting positions, the implemented measures, their sequencing and duration, a rather similar template could be outlined for the banking sector's development path, where large foreign banking groups played a pivotal role. These two main sections are strongly linked, as the macroeconomic stability and the banking sector's development go hand in hand. Nonetheless, no special focus is given for the restructuring of the enterprise sector, which however is particularly relevant for both blocks. Furthermore, although the regulatory and supervisory framework and the system's transparency have a primary role in the financial sector's development, it is only mentioned in this chapter. Finally, a comparative overview helps to conclude the chapter.

### 3.1. The “classical”<sup>23</sup> transition process

The transition period can be defined as the time when the former-socialist economy with its bureaucratic coordination has been transformed to a market-led capitalist system. During this period, the former system’s fundamental components, such as the political system with its ideology, the ownership structure and the coordination mechanisms have been completely transformed.<sup>24</sup> This is what differentiates these changes from the reforms of the socialist system. In practice, this process creates an interim system with a mixture of the two system’s elements. Although the former institutions are supposed to cease their activities, the old routines and mechanisms remain in place, but the new system still does not function. Gomulka (1998) describes the period of transition reforms as the time when the existing economic arrangements have been swiftly abolished, but the results of efficiency and growth were still not present for a longer time. In all economies, the governments had to tackle severe macroeconomic challenges and bring stability to the system. Some of the reform measures were determined by the initial conditions, but another part was based on the decisions of the incumbent governments. However, according to Gomulka (1998) various studies concluded that the speed of the applied macroeconomic stabilisation programs were able to influence the time of the transitional recession, but were not able to mitigate its cumulative magnitude. Generally speaking, solving the problems of the transition period brought more difficulties and took longer time than initially expected.

Deep and lasting recession seems to have been an unavoidable phenomenon in the transitional economies. Still, the contraction’s magnitude and duration was unexpected. The phenomenon’s explanations can be grouped by two main hypotheses; one concentrates on the impacts of the diverse inherited initial conditions, while the rival group emphasises the effects of the implied particular reform policies [Gomulka, 1998]. Nevertheless, most studies use a specific range of factors that led to the recession, but the emphasises show great variety. The most

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<sup>23</sup> „Classical” refers to a theoretical case study, where individual internal and external factors – e.g. major structural reforms during the socialist time period or civil war – have no significant impacts on the transition process.

<sup>24</sup> These elements constitute the first three blocks of Kornai’s main causality line. To read more on the causality line, see Kornai (1992).



widespread reasons that have been pointed out are for instance the price liberalisation, the termination of the “sellers” market, the collapse of the CMEA or the contraction of the state investments. The influencing factors of the transformational recession can also be grouped to the various demand and supply-side shocks and their direct and indirect effects. Nonetheless, one must stress that these factors influenced and strengthened each other causing an overall impact. By reviewing these significant influencing factors, a general overview can be provided to understand the most relevant phenomena and challenges of a “classical” transition period.

Starting briefly with the macroeconomic demand-side, the four components – namely the private consumption, the gross investments, the government spending and the net export – were separately influenced by the transition process, but also affected and reinforced each other. From the consumption side, real incomes contracted caused directly by factors as for instance the increasing unemployment and inflation. Regarding investments, following the “classical” socialist system’s expansion drive the investment activity dropped during the transition period, due to the caution related to the uncertain economic situation. This was strengthened by the backwardness of the financial sector with its high interest rate levels and the lack of tax incentives. Furthermore, based on the deteriorating fiscal conditions even the governmental investments decreased sharply. As for the net export, as a general tendency imports contracted, but the drop of exports exceeded this magnitude. In case of the CEE countries, this was particularly due to the collapse of CMEA and the Soviet market. Finally, the fiscal conditions left no room to compensate these drops, as fiscal revenues decreased. The bottom line is that the four components of the GDP’s demand-side were one by one hardly hit by the negative effects of the transition process. It can be emphasised in this case as well, that these impacts could be partly dampened – or at least their duration shortened – by well chosen governmental measures [Kornai, 1994].

Turning to the supply-side, in a slightly more detailed form, such factors can be listed as the shifts of input prices and the impacts of the new tax regimes. Kornai (1994), for instance, points to five main dimensions that proved to be underlying reasons of the transitional recession. It is important to stress again that also these

factors and their impacts overlap each other, and they can be rather grouped to the supply-side.

- *Transformation to a demand-constrained economy*: A “sellers’” kind of market had to be shifted to a “buyers’” market. This transition can also be viewed as switching from a supply-constrained economy to a demand-constrained. This transformation had to be controlled by both the monetary and fiscal policy, and the pricing policy [Kornai, 1994]. The restructuring was supposed to create market competition, while abolishing the former shortages and forced substitutions [Gomulka, 1998].

- *Restructuring the real sector*: The real sector transformed in various aspects. After the price and trade liberalisation, actors had to adjust to a new system of relative prices, indicating widespread economic restructuring. The proportions among sectors altered, as industrial production dropped sharply but the share of services started to increase only gradually. The property structures changed as well. Generally, the segment of large, state-owned firms contracted intensively, whereas the small, private-owned service sector slowly expanded. All these involved a natural, but painful selection process.

- *A new coordination mechanism*: The former bureaucratic coordination had to be transformed to a dominantly market-led coordination mechanism.<sup>25</sup> This transformation proved to be a long-lasting process for several reasons. Although theoretically the former behaviour of the actors stopped functioning, it took time to learn and adjust to the new norms.<sup>26</sup> The fact that market mechanisms hold significant risks and uncertainty was unfamiliar for market actors. Generally speaking, the institutions of the socialist bureaucratic coordination ceased their operations, but the establishment of the new market institutions started only with a lag and needed time to start functioning efficiently. The same applies to the network of market actors, which could be built only slowly. Also the information structure of the actors had to be developed, while the assessment and processing of the new system had to be learnt.

- *Restricted financial discipline*: The time of pervasive soft budget constraint ended and financial discipline hardened, leading to wide range of macroeconomic consequences. This could be detected for instance by the new bankruptcy legislation.

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<sup>25</sup> Noteworthy, that in certain countries the central planning system ceased to function already before the transition period [Gomulka, 1998].

<sup>26</sup> The reasons of recession can be further discussed from a behaviour perspective [Ellman, 1993].

Regarding the privatisation process, in the short-term it increased unemployment and reduced demand, thus contributing to the recession.<sup>27</sup>

- *A backward financial system*: This dimension is incorporated in the former two, but has special relevance, due to the fact that a backward financial system is not able to support the economic development process. During the socialist time period, the crediting activity was driven by non-profitability motivations, leading to the lack of risk assessment and irresponsible processes. Supporting loss-making companies could be considered a general phenomenon. During the transition period, this system completely changed, as crediting became a risky activity with potential losses. This generated a situation, where the financial sector became too cautious to lend on a broad scale, while borrowers found it too risky to draw credits. The former stemmed from low real interest rates related to the high inflation and the general uncertain economic environment. As for the latter group, Kornai believes that borrowers were not keen to take credits due to the general uncertainty, which is related to the unstable legal environment, property relations, taxation, inflation and the economic forecasts. Furthermore, the institutional network for a healthy and stable financial system was missing or remained immature. It must be underlined, that these features refer not only for the banking system, but also for the broader financial sector. To sum up, the excessive frictions and the low efficiency did not provide an efficient intermediary system between the economies' savers and borrowers, thus contributing to the recession through this channel [Kornai, 1994].

During the transition period, these five mentioned dimensions effected and reinforced each other, which inevitably led to the economies' recession. However, in case of all these dimensions the losses could be mitigated and the development period shortened by various state initiatives, the legal framework or supervisory institutions. This stresses that the governmental sector had a pivotal role in handling the recession [Kornai, 1994]. There is a broad literature, including debates, on the importance of the mentioned phenomena.<sup>28</sup> Still, it is obvious that regarding both the demand and supply-side, these factors had their particular role in the recession.

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<sup>27</sup> This can be connected to the "big bang" vs. gradualism dilemma.

<sup>28</sup> Gomulka (1998), for instance, names the inappropriate product structure as the primary reason for the deep recession. Calvo and Coricelli (1993) focus on the widespread effects of the credit crunch, while other studies reject the pivotal importance of this factor (see e.g. Berg – Blanchard, 1994).

Although the extent of their particular effects can be argued, and some factors might have merely secondary role, but nevertheless each of them are still relevant.

During the transition period, the economic stabilisation, the institutional and structural changes had to be completed. These three groups of tasks are strongly interrelated and they overlap each other [Ellman, 1993]. Generally speaking, the sequencing, the extent and the speed<sup>29</sup> of the applied measures differed in each country's case, and provided the base for an intensive theoretical debate and an extensive literature<sup>30</sup> [Lavigne, 1999]. It was a widespread consensus, that in the first stage the macroeconomic stabilisation had to take place, which could be followed by the structural transformation. The stabilisation packages usually had to focus on wide range of elements; liberalising prices and domestic trade, balancing the fiscal budget, implementing a restrictive monetary policy, establishing an incomes policy, liberalising foreign trade, devaluating the domestic currency<sup>31</sup> and making it internally convertible to a certain extent. After the initial stabilisation, institutional and structural measures were launched which included privatisation programs, the introduction of competition rules, free labour market, a new tax system, a new industrial policy, transforming the social safety net, the establishment of the financial sector. The latter had connections with the stabilisation attempts, due to the fact that a two-tier banking system with an efficient interest rate policy supported the monetary and fiscal consolidation [Lavigne, 1999]. The structural changes are partly components or consequences of the institutional changes, and refer to the new composition of the GDP, the changing efficiency of the various sectors, the demonopolisation of the economy or the reorientation of foreign trade [Ellman, 1993].

Kornai (1994), for instance, emphasises additional fields as well, but with a rather similar sequencing. He mentions four fields that had to be urgently addressed during the first stage of the transformational process: controlling the countries' indebtedness

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<sup>29</sup> This can be referred as the "big bang" vs. gradualism dilemma. Both approaches had their advantages and disadvantages.

<sup>30</sup> For summaries, see for instance Ellman (1993) or Lavigne (1999).

<sup>31</sup> Noteworthy, that the countries that chose currency devaluation to support the export sector, had to face the trade-off between inflation and exports [Kornai, 1994]. According to the mainstream doctrine, the exchange rate policy was supposed to promote external equilibrium, while the monetary and incomes policies were in charge of mitigating inflation [Gomulka, 1998].

and liquidity position, halting increasing inflation rates, curbing unemployment and establishing a new welfare system. Regarding other fundamental problems, they rather required a long-term strategy of structural reforms: general technical backwardness, widespread and worsening poverty, development of education, health services and infrastructure [Kornai, 1994]. Gomulka (1998) promotes the importance of domestic savings, FDI, low and stable inflation, free international trade, and the transfer of technologies and skills, which can be supported by the institutional structure. He summarises that the macroeconomic environment should be stable, and the microeconomic liberal and competitive. When turning from theory to practice and experience, it can be concluded that both the stabilisation and structural programs had mixed results. In the former's case, the internal and external imbalances, and the recession proved to be deeper and more persistent than expected. In the latter's case, the reforms lagged behind and brought mixed or controversial results.<sup>32</sup>

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<sup>32</sup> In many cases, the stabilising and restructuring programs were supported by the technical and/or financial assistance of the IFIs. The "one size fits all" free-market development policy favoured by the IMF, World Bank and leading governmental agencies during the 1980s and early 1990s, and systematised by John Williamson, is dubbed as the Washington Consensus. The approach incorporates the following ten main points: fiscal discipline; redirection of public expenditure priorities towards health, education and infrastructure; tax reform, including the broadening of the tax base and cutting marginal tax rates; unified and competitive exchange rates; secure property rights; deregulation; trade liberalisation; privatisation; elimination of barriers to FDI; financial liberalisation. The Washington Consensus brought mixed or occasionally adverse results, due to its oversimplified free-market approach, neglecting market frictions and disregarding such substantial issues as the improvement of human capital or widespread poverty [Todaro – Smith, 2009; Williamson, 1994; Hausmann et al, 2006]. The critics and experience brought major revisions and from the second half of the 1990s the so-called New Consensus or Post-Washington Consensus became relevant [Todaro – Smith, 2009]. (To read more on the topic, see e.g. Todaro – Smith, 2009; Meier – Stiglitz, 2000; Birdsall – Fukuyama, eds, 2011.) Hausmann, Rodrik and Velasco (2006) propose a completely new approach to reforms, where instead of the former complex methodology only the most severe distortions would be targeted. For the identification of these distortions they use a decision tree methodology. Here it is important to underline that the development of the financial sector embodies a pillar of this tree.

### 3.2. Transition process – Country cases in SEE

Now it is inevitable to turn to the most important country-specific characteristics of the transitional and war-time recession, including the most relevant external and internal shocks, in order to understand the similarities and differences among the country cases. Related to the recession, the stabilisation attempts are also mentioned, which incorporate the establishment of the central banks, the introduction of the domestic currencies and FX regimes. A hint on the further prospects is also included. Table 5 and 6 helps to follow the most important actions of the discussed country cases. Due to the strong links and spill-over effects, this section is particularly relevant for the local banking sector's development path, which will be discussed in the next section. Furthermore, in most cases the stabilisation programs embodied the banking reform or stabilising measures.

Table 5: Real GDP growth and inflation in the 1990s in SEE

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
	Growth of real GDP (real change in %)									
Albania	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-10.9	8.6	13.2
Bosnia and Herzegovina	-23.3	-12.1	-30.0	-40.0	-40.0	20.8	86.0	37.0	15.6	9.6
Federation of BH										
Republika Srpska										
Croatia	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.8	2.1	-1.5
FR Yugoslavia	-7.9	-11.6	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-18.0
FYR Macedonia	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	3.4	4.3
	Inflation (change in annual average retail/consumer price level, %)									
Albania	0.0	35.5	226.0	85.0	22.6	7.8	12.7	33.2	20.6	0.4
Bosnia and Herzegovina									-0.3	3.4
Federation of BH			73.1	44069.0	780.0	-4.4	-24.5	14.0	5.1	-0.3
Republika Srpska			7461.0	2233.0	1061.0	12.9	16.9	-7.3	2.0	14.0
Croatia	609.5	123.0	665.5	1517.5	97.6	2.0	3.5	3.6	5.7	4.0
				117						
FR Yugoslavia	593.0	121.0	9237.0	trillion	3.3	78.6	94.3	21.3	29.5	37.1
FYR Macedonia	608.4	114.9	1664.4	338.4	126.5	16.4	2.5	2.6	-0.1	-0.7

Source: EBRD Transition reports (various years) and EBRD statistics

Table 6: Real GDP growth and inflation in the 2000s before the global crisis

	2000	2001	2002	2003	2004	2005	2006	2007	2008
	Growth of real GDP (real change in %)								
Albania	6.5	7.9	4.2	5.8	5.7	5.7	5.4	5.9	7.7
Bosnia and Herzegovina	5.5	4.3	5.5	3.0	6.3	3.9	6.7	10.8	6.0
Croatia	3.0	3.8	5.4	5.0	4.2	4.2	4.7	5.5	2.4
FYR Macedonia	4.5	-4.5	0.9	2.8	4.1	4.1	4.0	5.9	4.8
Kosovo	39.0	5.6	-2.4	-0.1	2.0	3.9	4.0	4.0	5.4
Montenegro	3.1	1.1	1.9	2.5	4.4	4.2	8.6	10.7	7.5
Serbia	5.2	5.1	4.5	2.4	9.3	5.6	5.2	6.9	5.5
	Inflation (change in annual average retail/consumer price level, %)								
Albania	0.1	3.1	5.2	2.3	2.9	2.4	2.4	2.9	1.1
Bosnia and Herzegovina	5.0	3.2	0.4	0.6	0.4	3.8	6.1	1.5	7.3
Croatia	4.6	3.8	1.7	1.8	2.1	3.3	3.2	2.9	6.1
FYR Macedonia	5.8	5.5	1.8	1.2	-0.4	0.5	3.2	2.3	8.3
Kosovo			2.0	1.2	-1.4	-1.4	1.5	4.4	9.4
Montenegro	97.1	22.6	16.0	6.7	2.4	2.3	3.0	4.2	8.3
Serbia	70.0	91.8	19.5	11.7	10.1	16.5	12.7	6.5	12.4

Source: EBRD Transition reports (various years) and EBRD statistics

Albania had to tackle “only” the “classical” transitional challenges after the fall of the communist regime in 1990. However, as described already, the related internal and external shocks affected all areas of the economy, which added up and led to transitional recession, external and domestic imbalances, spikes in inflation, rising unemployment. Between 1989 and 1991, large foreign debt has been built up, also as the result of the central bank’s speculating activity on the international FX market. The export contracted partly due to the collapse of the CMEA area and the world recession meaning shrinking demand for raw materials. Fiscal balance deteriorated as revenues decreased, while investments and subsidies required continuous funding. Already during this period, the large amount of remittances and even foreign aid played a crucial role. Although this was not able to rebalance the external imbalances, but it nevertheless contributed to the survival of Albania during the worst years of transition [Pashko, 1996]. In 1991, the real GDP dropped by 28% and inflation reached its peak the next year with 226% [EBRD statistics]. This spike of inflation was mainly driven by the sharp devaluation of the exchange rate [Muço et al, 2004]. As in Albania foreign currency was widely used due to the high amount of

remittances and certain smuggling activity, the correlation between the FX rate and inflation became dominant [Šević et al, 2002].

Albania was able to stabilise its economy first in the region. The initial pillars of the stabilisation program were set by 1991. This included measures that pointed to the transitional process; certain privatisation programs – including reforms in e.g. banking or agriculture<sup>33</sup> –, the liberalisation of prices and economic relations, the establishment of the new social security system, and macroeconomic stabilisation efforts were introduced. A more coherent program followed the same year, being implemented in 1992 and supported by the IMF's stand-by arrangement. Within the framework of this program, price liberalisation was completed, and on the back of the newly established two-tier banking system monetary and fiscal reforms and tightening<sup>34</sup> took place [Pashko, 1996]. The money growth was treated as the core nominal anchor, which was supported by a tight fiscal policy, abolishing the possibility of monetary deficit financing [Muço et al, 2004]. Within the framework of the new monetary policy, a fully convertible Albanian lek and a market-determined floating exchange rate with a new interest rate approach has been introduced. The motivation behind this was the required adjustment of the external imbalances and the lack of the sufficient amount of foreign exchange reserves [Šević et al, 2002]. This program can be considered as a cornerstone of the Albanian transition process, and its results could be reflected in the macroeconomic indicators; the GDP expanded from 1993 and the inflation rate started to drop returning to the single-digit zone among the first countries in SEE. This tendency was temporarily interrupted in 1997 by a financial meltdown, caused by the collapse of large pyramid schemes, which will be discussed in the next section.

As for SFRY, starting already in 1979 with the world crisis, the country experienced its longest and deepest economic and social crisis during the 1980s. Economic growth halted, real incomes contracted, while inflation surged and economic

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<sup>33</sup> Agriculture had a primary role in the Albanian economy. In 1990, for instance, it provided 35.9% of the GDP, and it employed almost half (49.4%) of the country's total workforce [Pashko, 1996, p. 69].

<sup>34</sup> During the transition period, Bank of Albania implied deposit rate ceilings as part of the stabilisation policy. Only after the consolidation of the banking system did it switch to indirect instruments, like the establishment of the refinancing window or imposing rules for the required reserves or the liquidity [Muço et al, 2004].



imbalances caused even debt repayment problems<sup>35</sup> [Bićanić, 1989]. Various stabilisation programs were drafted,<sup>36</sup> but they were rather turned down or their implementation remained incomplete. By the end of 1989 and 1990, the social unrest and the tension among the republics intensified, thus the ambitious stabilisation program – which could have opened a new era of transition and was supported by an IMF stand-by loan – remained unimplemented [Lavigne, 1999]. Finally, the economic transition and development process was interrupted by the dissolution of the country in mid-1991. Five new states were formed: Bosnia and Herzegovina<sup>37</sup>, Croatia, FYR Macedonia, Slovenia and the Federal Republic of Yugoslavia. The latter consisted of Serbia – including its two provinces of Kosovo and Vojvodina – and Montenegro. In 2003, the FR Yugoslavia was transformed to the State Union of Serbia and Montenegro. The two republics formed a loose confederation, with own economic policies and currencies. Montenegro gained its full independence after a referendum held in 2006. Kosovo unilaterally declared its independence in 2008, but its status is still disputed by many countries.<sup>38</sup>

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<sup>35</sup> To read more on the crisis, see e.g. Bićanić (1989) or Lavigne (1999).

<sup>36</sup> In 1983, for instance, a program was adopted with the support of the IMF, but its implementation never took place [Lavigne, 1999].

<sup>37</sup> The development path of BH is continuously affected by its unique state structure. The end of the war in BH is marked by the signing of the Dayton Peace Agreement in 1995, which has set up the institutional framework for the country. It established a special state structure with two entities; the Bosnian-Croat entity called the Federation of Bosnia and Herzegovina and the Serb entity named Republika Srpska. The former is further divided into cantons. Beside the two entities there is a small territory called Brčko District, which has a special status, as its case remained unresolved during the negotiations. The Dayton Peace Agreement has also built the Office of the High Representative, which was primarily responsible for the implementation of the Agreement. The High Representative is considered to be the last resort and is empowered even to replace politicians or implement new laws [OHR]. On the one hand, it can be concluded that the Agreement successfully ended the war in the country, but on the other hand it created a cumbersome state structure. The drawback of the structure is the evidence that both during the transition period and the EU accession process, the reforms are continuously being blocked or slowed by the lack of cooperation between the three national groups. The High Representative occasionally imposed measures to overcome the deadlock and continuously supports the dialogue between the parties. It is worth mentioning that like in the case of Kosovo, in BH the state structure and institutional system was created by the guidance of the international actors. The core of the system, namely the Dayton Peace Agreement, was constructed by the representatives of the USA, the EU and Russia, while the implementation of the agreement was continuously controlled by the High Representative. It might be considered strange that it is again the international community – more precisely the EU – that pushes for reforming the current framework, in order to achieve a smoother functioning of the current state structure. The EU sets these reforms as preconditions for the development of the accession process.

<sup>38</sup> Kosovo represents a unique development path with an unclear status, but here it is treated as a separate country case. Already more than one third of the UN member states have formally recognised its independence, among them the USA. On the other hand, many countries, including Russia and Serbia, consider Kosovo's step as an illegal act which is against the international law [Kazinczy, 2008]. As no new UN resolution has been imposed, Serbia filed a request for Advisory Opinion to the International Court of Justice, but Kosovo's status still remains disputable. To read more on the related topic, see e.g. International Court of Justice: Accordance with International Law of the

Besides the “classical” transitional process, the successor states of former-Yugoslavia were hit by further severe shocks, although to different extent. The region experienced various military conflicts throughout the years. The dissolution of the SFRY was accompanied by years of devastating war between BH, Croatia and the FRY, ending only in 1995. In addition, FRY was later in conflict with the Albanian Kosovo Liberation Army. This military conflict was stopped by the 1999 NATO bombing.<sup>39</sup> Two years later in 2001, in FYR Macedonia a civil war took place between ethnic Albanians and the government. Under the Ohrid Agreement a certain compromise has been reached between the two groups, but the achieved balance remained fragile. Besides the military conflicts, FRY was struck by severe UN sanctions almost throughout the 1990s and FYR Macedonia by the Greek embargo [Uvalic, 2010]. All these actions caused an extreme delay or pause in the countries’ transition and development process, including also their EU accession path and the lack of confidence from the side of international investors.

The dissolution of Yugoslavia had its economic perspective as well. Even the fact of this process can be explained by economic reasons to a certain extent. Some stress the large differences among the regions’ development levels<sup>40</sup> – which nevertheless determined the initial inequalities among the successor states – and others argue that the redistribution among the republics became unsustainable, while a third group emphasizes the continuous failures to achieve sustained economic growth [Bicanic, 1996]. It can be concluded, that all of these problems were relevant in SFRY, but the dissolution was nevertheless particularly driven by political, social and historical factors. As for the process, regarding the corporate sector, the republics implemented their own privatisation policies by altering the initial federal plans. Legal discrimination became general, and interestingly, the republics organised plant ownership swaps to create enterprises that remained active in a single republic. Bilateral payment deals were signed between the new countries that were not in conflict with each other to support mutual trade. Fiscal discrimination also evolved,

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Unilateral Declaration of Independence by the Provisional Institutions of Self-Government of Kosovo (Request for Advisory Opinion), (<http://www.icj-cij.org/docket/index.php?p1=3&p2=4&code=kos&case=141&k=21>), or UNMIK’s (<http://www.unmikonline.org/>) and EULEX’s homepage (<http://www.eulex-kosovo.eu/?id=2>).

<sup>39</sup> For an analysis on the impacts of the Kosovo crisis in the region, see EBRD (1999).

<sup>40</sup> For related statistics, see Table 1 in the previous chapter.

and republics gradually refused to transfer their federal revenues to the federal budget. The former fiscal federalism made it easier to create the separate fiscal units. As for the monetary policy, the federal system stopped functioning when Serbia unilaterally implemented its expansionary monetary policy by the end of 1990. The republics could build their own monetary authorities on the ground of the inherited republican monetary institutes that have been established during the socialist time period. The republics introduced their own domestic currencies one by one, as tools for their own monetary policies for macroeconomic stabilisation [Bicanic, 1996].

Now more country-specific characteristics are discussed of SFRY's successor states. Starting with the country that – apart from Albania – was directly the least affected by the military conflicts of the 1990s, FRY Macedonia had the mildest drop in its GDP. However, the country's recession lasted for the longest time period, until 1995, and was coupled with high inflation rates with a peak value of 1664% [EBRD statistics]. FYRM replaced the Yugoslav dinar by the Macedonian denar in 1992. From the beginning, the central bank was established as an independent monetary authority with the primary goal to maintain the price stability in the new country. The hyperinflation of 1992 was swiftly decreased by money supply controls determined by the applied monetary targets. This policy was replaced by an exchange rate target in 1995, which remained a core element of the applied monetary policy throughout the years. FYRM applies a pegged exchange rate regime, anchoring the domestic currency to the German mark and later to the euro. In the early years of transition, this was supported by the significant inflow of "hard currency" via foreigners working in the country, by foreign aid and by remittances [Šević et al, 2002]. In addition to the pegged exchange rate, from 1994 other major structural reforms and macroeconomic stabilisation attempts were introduced. The program incorporated strict fiscal and monetary policy. Furthermore, wages were temporarily frozen and price control was introduced for the energy and main foodstuff [Šević et al, 2002]. It was only this program that ended the long years of recession. Although the war related to the dissolution of Yugoslavia affected FYRM only mildly in comparison to most of the other countries in the region, it also had to face non-transitional challenges. In 1994, Greek embargo was imposed and was lifted in the next year. In 1999, the country had to cope with the large influx of Kosovar refugees. The next shock wave was the civil war of 2001, which led to a 4.5% drop of the real GDP

[EBRD statistics]. Since then, FYRM performed low inflation rates and a solid economic growth each year. However, when comparing the real GDP growth rates to the rest of the SEE countries', one can conclude that FYRM's growth remained below the SEE average in most cases. The inflation returned to the single-digit territory, but was occasionally volatile.

In contrast to FYRM, the most severe drop of GDP was recorded in BH. The devastating war left the new country with less than one-fourth of its pre-war GDP level, with around 10% of the pre-war industrial production, and an almost completely destroyed infrastructure [EBRD statistics; Šević et al, 2002]. Most of the big firms were destroyed and those which survived had dropped behind due to the lack of development during the war. Over the years of military conflict, extreme values of inflation rate or even hyperinflation were recorded in both entities. The domestic currencies represented a unique situation, because prior to the introduction of the convertible mark as a sole legal tender, three separate currencies and payment systems coexisted. In the Serb entity the Yugoslav dinar was used and the payment system remained in Belgrade's network. The Bosniaks introduced the Bosnian dinar in 1993, and their central bank controlled their payment system. As for the Croat areas, the Croatian kuna was used with a separate payment system from the inherited Yugoslav network [Šević et al, 2002].

After the end of the war in BH, international institutions launched a four-year reconstruction program and with their assistance the country recorded remarkable GDP growth rates in the following years but from an extremely low level. In RS, the recovery started only with a lag, as the international assistance was available only after a new government was willing to implement the Dayton Peace Agreement in 1997 [Šević et al, 2002]. Within a year, the inflation was rapidly reduced from the prior extreme values in both entities. In the first years of the post-war period the GDP growth was primarily foreign aid driven [Stojanov, 2004] and the economy was not prepared for self-sustained development. In a next phase, the growth was driven by the service sector and light industry, with small and medium enterprises having a large share. It was only during the pre-global crisis years that the export sector started to revive and had an increasing contribution for the economy's growth. As for the monetary system, from 1996 the Bosnian dinar became convertible for current

account transactions, just as the kuna. RS used the Yugoslav dinar until late 1998, which remained unconvertible during this period [Šević et al, 2002]. The Central Bank of Bosnia and Herzegovina was established in 1997 in line with the Dayton Peace Agreement. It introduced the convertible mark as the domestic currency and applied a currency board regime to facilitate monetary stability [CBBH]. It became the sole agency responsible for the monetary policy and currency issuing in BH. Meanwhile, the central banks of the national groups, which operated during the years of war, have been gradually closed down. Throughout the years the applied currency board regime remained an anchor for the economy and it contributed to the achieved price stability in BH. The convertible mark was first linked to the German mark and later to the euro [Šević et al, 2002].

Turning to the most developed and open country in SEE, Croatia, it had and has the highest level of GDP per capita and the GDP's structure<sup>41</sup> is the most similar with the matured economies' [Uvalic, 2010]. During the years of war, Croatia recorded a sharp drop of GDP and extreme levels of inflation. Likewise in the other countries, the high inflation rate was partly due to the fact that prices were denominated in German mark, while the exchange rate depreciated parallel with the inflation, leading to a "price-exchange rate-price" spiral [Šević et al, 2002]. In the end of 1991, Croatia switched its sole legal tender from the Yugoslav dinar to the Croatian dinar. This temporary currency was replaced already in 1994 by the kuna, within the framework of the stabilisation program. As the national bank started to accumulate foreign reserves right after the country's independence, the kuna was properly backed by the time of its introduction [Šević et al, 2002]. This is also why the stabilisation program, which was implemented in 1993, was able to be based on the restrictive monetary policy, including also the exchange rate. Croatia implemented a managed float FX regime. The program led to the gradual drop of inflation from the four-digit levels and supported the economic growth. After 1995, a second phase of the stabilisation program was implemented, focusing on the basic structural reforms, which included the restructuring of the loss-making public enterprises and banks and speeding up the privatisation process. After the implementation of the stabilisation program, Croatia showed fair GDP growth rates, although the annual growth was usually lower

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<sup>41</sup> At the same time, Croatia also inherited such non-competitive industries as the shipbuilding segment.

compared to most of the other countries in SEE. On the other hand, Croatia's GDP growth started from a higher base compared to the other countries in the region. This development was once interrupted by a severe banking crisis – which will be discussed later – that led to a GDP drop in 1999.

Last but not least, the group of Serbia, Montenegro and Kosovo has to be discussed. The 1990s could be considered as the “lost decade” for this group. During the military conflict, FRY's economy declined steeply, which was coupled with years of hyperinflation. In 1992, the economy was also affected by the UN sanctions, all leading to a 28% drop of the real GDP that year [EBRD statistics]. In 1992-93, the extreme level of hyperinflation and a collapse of the monetary policy contributed to a further drop of GDP, thus by 1993 the level of GDP was merely 40% of its 1989 level [Šević et al, 2002, p. 309]. During these years, beside the demonetisation, the German mark acted as the most important flight currency. In 1994, the Program for Monetary Reconstruction was launched. It introduced the new dinar and applied a currency board regime with the dinar pegged to the German mark. Widespread price controls were also introduced. The program was able to rapidly cut inflation rates to single-digit levels within months, but the success lasted only for a year. As there was a growing pressure for money issuing besides the lack of the sufficient amount of foreign reserves, the currency board regime was abandoned the same year it was introduced [Barisitz, 2008]. Due to the fact that the mentioned monetary program was not followed by any major structural reforms, FRY returned to double-digit inflation rates. Regarding the level of GDP, after a few years of initial mild recovery, in 1999 the Kosovo conflict and NATO bombing caused another sharp drop of the GDP. As a result, in 2001 its level was still only 50% of its pre-war value [EBRD statistics]. 2000 can be marked with the fall of the Milošević regime. After the “lost decade”, the transition process gained momentum. Most price controls were relaxed, which caused a temporary surge in the inflation rates, but by 2002 the annual price growth was lowered to the 10-15% range, where it mainly remained in the upcoming years [EBRD, 2001; EBRD statistics]. The Serbian central bank applied a managed float exchange rate regime for the dinar from 2001 [NBS]. The economy continued to expand from 2000 with generally favourable real GDP growth rates.

Montenegro's separate development started when a more reform oriented administration gained power from 1997, favouring more independence from Serbia and starting a new transitional era. In 1999, the German mark became a parallel legal currency to the dinar in Montenegro, then from the next year it was adopted as the sole legal tender and later switched by the euro. In late 2000 the central bank was established [EBRD, 2001]. In the first half of the 2000s, Montenegro usually achieved a much lower GDP growth compared to Serbia, but this shifted after Montenegro gained its independence. However, it is important to emphasise that Montenegro's GDP production remained limited, as it was based on the service and real estate sector, and on the production of one large aluminium plant that was strongly dependent on the international raw material prices. These sectors brought great boom to Montenegro before the pre-global crisis period, but then collapsed [EBRD, Transition reports, various years].

After the 1999 NATO bombing, in accordance with the UN Security Council's Resolution 1244, Kosovo's separate and unique transition period started under the administration of the UNMIK. Initially, UNMIK had the responsibility for all civilian affairs in Kosovo. Under its administration, the institutional system has been artificially and gradually built up. Parallel with this process, the power has been shifted to the local people step by step. During this period, Kosovo became a functioning state with its own institutions [UNMIK; Kazinczy, 2008]. As a cornerstone of the development path, in early 2008 the Assembly of Kosovo unilaterally declared Kosovo an independent state, which nevertheless was considered as an illegal act by e.g. Serbia [Kazinczy, 2008]. Turning back to the economic aspect, Kosovo remained the poorest area in Europe, with immense and pervasive unemployment, many inherited unrestructured or closed down firms, a minor export base leading to massive trade deficits.<sup>42</sup> Generally speaking, Kosovo's stagnating economy remained dependent on foreign financial assistance and the significant amount of remittances [Gligorov, 2007]. As far as the financial sector is concerned, after the war there was a complete lack of financial infrastructure. Step by step, the financial sector, and the regulatory and supervisory framework has been built from scratch. The Banking and Payments Authority of Kosovo has been

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<sup>42</sup> For related statistics, please visit the central bank's homepage, <http://www.bqk-kos.org>.

established, which gradually shifted into a de facto central bank and was transformed in 2006 into the Central Banking Authority of Kosovo, handling all the regular monetary and certain supervisory functions. Regarding the domestic currency, after years of double-digit inflation, in 1999 the German mark – and later on the euro – has been adopted as the sole legal tender, which contributed to the achieved price stability. After 2002, inflation remained low, while occasionally even deflation was recorded reflecting the structural deficiencies [Gligorov, 2007; Kazinczy, 2008]. The bottom line is that Kosovo remained the poorest, most vulnerable and least self-sustaining economy in SEE.

All in all, despite the fact that the transition process started already in 1989 in the SFRY, and the former republics already had experience in certain free-market mechanisms, the so-called transition recession was long lasting and deep in the region (see Table 5 and 6). The reason behind this was primarily the political reluctance and military conflicts coupled with embargos. Furthermore, with the dissolution of the SFRY the former economic unit was pulled apart and new self-sustainable units had to be built. In SEE, each of the countries implemented complex reform programs in several steps to adjust to the new economic environment and to assess and remedy the weaknesses. These programs were often supported by the technical assistance of various IFIs, primarily meaning the IMF, World Bank and EC.

To sum up, in SEE – likewise in the “classical” transitional model – generally two phases could be separated during the transition process. In the first phase, the stabilisation of the macroeconomic environment, and the strong progress in the liberalisation and privatisation process took place, while the tasks of the second phase were related to the development of the institutional framework and the related policies and practices [EBRD, 1997]. The starting point and the time span of these phases showed large variety within SEE. Albania was the first country to implement swift economic reforms and to stabilise its economy, while Serbia was the last actor to start its transition process after a “lost decade”. Furthermore, the region represented large diversity even when reviewing e.g. the various stabilisation



programs, the privatisation methods<sup>43</sup> or the implemented exchange rate regimes, while on the other hand, the main tasks and challenges that the countries had to face had more in common.

### 3.3 The transformation of the banking sector

The literature distinguishes bank-based financial system from market-based. Both types of financial structures imply different characteristics, but regarding the general economic development neither form can be stated as more preferred than the other. In a bank-oriented model, individuals' savings are typically kept in banks, which also act as the main external source for corporate financing. It is rather the banking sector that invests in the equity and corporate debt market, and – given a certain financial development level – they even sell them to their clients as investment products [Kawalec – Kluza, 2001]. Generally, in a bank-based system monitoring is cheaper and long-term financing is more feasible [Thiel, 2001]. As for the capital market-oriented model, individuals dominantly invest directly or through nonbank intermediaries – like pension or investment funds – in the capital market, and banks

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<sup>43</sup> When reviewing the starting dates and chosen privatisation methods, one can find a significant diversity within the countries of the region. After the fall of the socialist regimes, Croatia chose a gradual privatisation process. On the other hand, Albania and FYR Macedonia applied rapid liberalisation – including the liberalisation of domestic prices, foreign trade and foreign exchange market – and the reduction of state intervention. Albania privatised the small-scale enterprises in the first phase of its transition process, while the privatisation of the large-scale segment took longer time. The sectors of finance, infrastructure, mining and petroleum were privatised during the years. This process was supported by the end of the Kosovo conflict in 1999, which helped to attract foreign investors to the region. However, years of war caused a lag in most of the countries of former-Yugoslavia, despite the fact that among the socialist countries SFRY had the most liberalised system [Šević et al, 2002].

BH can be considered as another interesting example. The privatisation process started there with a great delay, only nearly after five years of the end of the war. The privatisation of the small-scale enterprises started in 1999 via auctions and tenders. Many small firms were established with the help of the donations of IFIs, aiming to support the country's reconstruction. The large-scale privatisation process required a longer time period and was considered much more controversial, just as in the case of other transition countries. Furthermore, as a unique feature the privatisation process has been run separately in the two entities, thus it could be mocked as "ethnic privatisation" and in some cases it even split big companies into geographical parts [Stojanov, 2004].

Both Albania and Croatia chose management-employee buy-out privatisation as primary method and voucher privatisation as a secondary tool. FYR Macedonia also used primarily the former method, but secondarily applied direct sales, while BH chose voucher privatisation as the primary method and direct sales as the secondary [EBRD, 1999]. Although the methods showed large variety in the transition economies, in SEE the dominance of the management-employee buy-out and voucher privatisation could be explained by the so-called social property system of former-Yugoslavia [Šević et al, 2002].

have smaller role in corporate financing as well [Kawalec – Kluza, 2001]. On average, in this case the actors of the market-based structures are more flexible and less risk averse [Thiel, 2001]. The relevant literature suggests that to a large extent the differences of certain financial structures can be explained by the applied legal systems and the broadly defined institutional background.<sup>44</sup>

The financial system in SEE is dominated by the banking sector as other financial institutions typically play only minor or supplementary role. The amount of corporate debt or stock market capitalisation, the number of IPOs and listed companies is still very low and does not have a significant impact on the SEE economies. This feature can be taken as quite persistent, as international investors view the region as a group of small and illiquid markets with relatively high risk, while domestic households can be characterised by strong habit persistence. On the other hand, there are great differences in the capital markets' development level. While it is still at an absolutely initial phase in for instance Kosovo, Croatia has a growing and developing capital market. Noteworthy, that besides the related regulations, governments can also influence the capital market via e.g. the pension system or the sovereign debt market. These are the main reasons why SEE's financial system still remains a bank-based model, and this chapter concentrates on the banking system and only mentions the development of the capital market.

A range of literature provides analysis on the financial sector of transition economies.<sup>45</sup> Their conclusions are generally valid for the SEE region as well. Bokros (2001), for instance, states that the financial sector of transition economies in 2000 could be characterised by the low level of financial intermediation – also in percentage of GDP –, poor asset quality and undercapitalisation of the actors, limited service range – particularly in the nonbanking sector – immature external and internal governance structures, gradually sophisticating legal and regulatory framework with weak implementation and enforcement. Furthermore – as Bokros – Keren and Ofer (2003) describe two groups of bad loans in the transitional banking

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<sup>44</sup> Differences between bank-based and market-based financial structures are elaborated by e.g. Beck-Levine (2000), Demirgüç-Kunt – Maksimovic (2000), Rajan-Zingales (2000), Stulz (2000).

<sup>45</sup> It is important to mention, that when the literature provides a more detailed analysis on the complete spectrum of the transitional countries, then separate country groups are constructed based on the related development and reform levels. See, for instance, Fries – Taci (2002), Fries et al (2002) or Bokros (2001).

system. The first group is inherited from the socialist time period. The second group is the total amount of new loans that have been granted either by freshly established banks that operate under a supervisory system of liberal and lax capital and know-how requirements or by the old banks that carry on the same lending mechanism. Regardless of which group is considered, the knowledge of risk assessment, project monitoring and corporate governance remained weak or was missing. Despite these characteristics, many of the transitional countries experienced intensive crediting activity – unlike mentioned in the “classical” transition process – followed by the meltdown of certain banks or brokerage companies. This could cause a widespread credit crunch with macroeconomic imbalances, and even the drop of real GDP and a high degree of risk aversion. In most cases, these shocks finally led to the tightening of monetary policy and prudential rules [Bokros, 2001; Keren – Ofer, 2003]. In case of SEE, such crises fostered systemic restructuring and selected market players, but on the other hand, created a great burden for the fiscal authority during the stabilisation process and increased risk aversion. All in all, the above mentioned general remarks were all valid for the banking sector in SEE countries, though the timing showed great differences. SEE itself experienced a certain development lag compared to the countries of CEE, and even within SEE the differences of timing were large. These variations primarily stemmed from the specific government policies, stabilising measures and reforms.

Likewise in case of the general economic transition process, a range of tasks could be listed for the banking sector’s transformation. This means, that a certain kind of „Washington consensus” could be set up for the banking sector as well. This included the separation of the commercial banks and the central bank, the abolition of restrictions on the internal convertibility of money, the interest rate liberalisation, the restructuring and privatisation of state banks including their enterprise borrowers, the entry of new private banks. Parallel with these tasks, in order to curtail the risk of the rapid market liberalisation process – which could not be achieved in case of SEE – the state played a crucial role in building the regulatory and supervisory system. This also included building up the physical and human capacity of related authorities and courts. As a further pillar, the enterprise reforms could be considered complementary to the banking reforms. Particularly the areas of bankruptcy and corporate governance were crucial for the banking sector’s sound development. Not

only in SEE, but generally within the range of transition economies, both the pace and sequencing of these steps showed great differences [Fries – Taci, 2002]. Nevertheless, the institutional framework had to remain dynamic in order to adapt to the changing market environment. This required a continuous development process from the side of policy makers.

The primary and theoretical goal of the reforms was to build a sound banking system which fulfils the tasks that are required in a well-functioning market economy. These are the improvement of risk management, the allocation of resources, monitoring managers and exerting corporate control, the mobilisation of savings, facilitating the exchange of goods and services, and absorbing financial and real economic shocks [Levine, 1997; ECB, 2010b]. As discussed already, the banking system contributed to the transitional recession, but was also able to take its part in the economic development once properly fulfilling its functions. Based on the wide-range of literature,<sup>46</sup> we can conclude that financial development does have a significant impact on economic growth [Demirgüç-Kunt – Levine, eds, 2001], while this does not contradict with the fact that this relation is bidirectional, and there is a demand and supply-sided incentive system of financial services [Patrick, 1966]. Also common sense leads to the conclusion that a more mature financial system offers additional opportunities for all economic sectors, while economic prosperity creates new demand for the banking industry, in terms of volume and product range as well. These statements are particularly relevant for SEE, given the initial characteristics of low capital level and underdeveloped financial system.<sup>47</sup>

The EBRD index of banking sector reform summarises with a single score the level of banking reform and interest rate liberalisation for transitional countries. The scores are available from 1 to 4+, where 1 refers to minor progress beyond the establishment of the two-tier banking system, while 4+ means the adaption of the advanced industrial economies' norms.<sup>48</sup> With the help of this index, Chart 2 reflects

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<sup>46</sup> For a good, extended overview see Levine (2003).

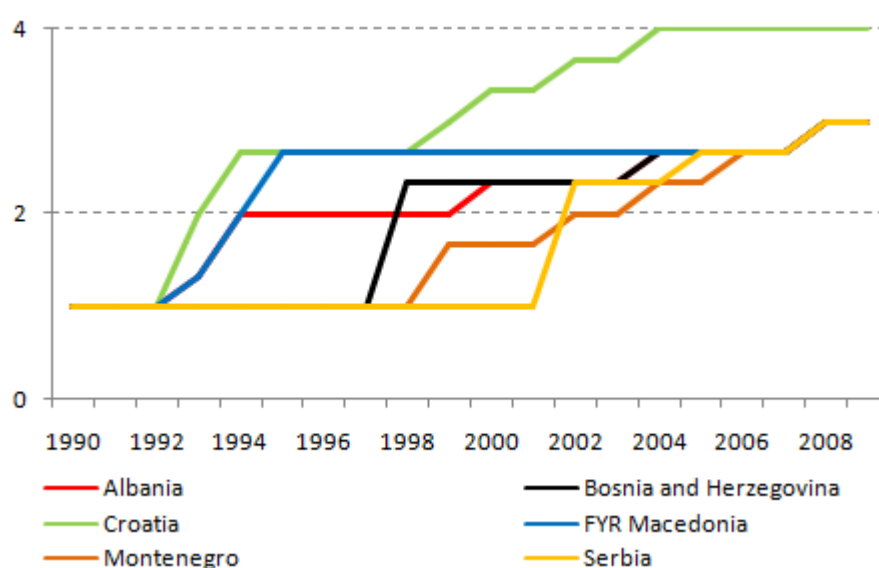
<sup>47</sup> Noteworthy, that on the other hand the global crisis shed some light on the trade-off between financial development and systematic risk, and on the importance of a well-functioning regulatory and supervisory framework.

<sup>48</sup> The following explanation is provided for the specific scores related to the banking reform and interest rate liberalisation:

“1: Little progress beyond establishment of a two-tier system.

an overview of the banking system's transition dynamism in the SEE countries. The mentioned differences of timing and development level can be very well observed. The starting date of the major restructuring varied over a decade, but all countries converged to the same development level and reached index 3, with the exception of Croatia, which achieved a more dynamic progress and a higher score compared to the rest of the SEE countries. Now the background of these differences and similarities will be highlighted.

Chart 2: EBRD index of banking sector reform for SEE countries



Note: Kosovo n.a.

Source: EBRD statistics

2: Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.

3: Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.

4: Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.

4+: Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.”

(Source: Transition indicators methodology,

[http://www.ebrd.com/pages/research/economics/data/macro/ti\\_methodology.shtml](http://www.ebrd.com/pages/research/economics/data/macro/ti_methodology.shtml), downloaded: 15/04/2011)

Turning to the country cases in SEE, the former chapter discussed the main legacies of the socialist time period. In the light of the transition process, the most important stability programs and monetary reforms have already been mentioned in the previous section. The stabilisation and the establishment of a market-oriented banking system was usually part of these general stability and reform programs. Before the transition, banks in SEE were characterised by a very high ratio of non-performing loans, high lending rates and lack of competition, which was coupled with an environment of transitional recession and high inflation. Furthermore, in case of the successor states of Yugoslavia, the banking system had to cope with the aftermaths of the “frozen” FX savings trauma, which was already mentioned in the previous chapter. Taking all these into consideration, it is quite evident that the inherited banking system collapsed in each SEE country and had to be consolidated and rebuilt by large state support. As seen during the discussion of the stability programs, the starting positions, the particular mechanisms, sequencing, timing and duration showed great differences. In case of the banking sector, this was true in a magnified form.<sup>49</sup>

Starting with the country, which inherited a “classical” socialist system, in Albania – as part of the stabilisation program and implemented in 1992 – the two-tier banking system was established following the adoption of the central bank and commercial banking laws. On the remains of the former monobank, a central bank and three universal banks were created – the Agriculture and Development Bank, the Savings Bank and the Import-Export Commercial Bank. Furthermore, the central bank was separated from both the commercial banks and the fiscal authority – abolishing automatic budget deficit financing<sup>50</sup> – by law. This meant that the central bank – renamed as the Bank of Albania – gained a completely new ground and remained in charge only of the monetary policy with strict rules on issuing money. During the first years of transition, bankruptcy procedures could not be initiated, and most medium and large-enterprises were still not privatised. These features led to a massive inter-enterprise crediting activity of which a substantial amount became bad debt. Furthermore, just as in the previous regime, the still non-privatised firms

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<sup>49</sup> This topic is discussed country by country in a detailed form in e.g. Barisitz (2008) or Šević et al (2002).

<sup>50</sup> A credit ceiling was implied, which was 10% of the previous year’s revenues.

continued to require funds from the government or as a secondary solution they borrowed at negative interest rates<sup>51</sup> [Pashko, 1996; Dushku, 2010]. The transition process of the banking sector lasted a decade. During the early 1990s, the three state-owned commercial banks dominated the market accumulating large debts. One of them was liquidated in 1998 and another was privatised in 2000, while the largest of the three with broad national coverage was privatised to a foreign investor only in 2003. Beside these, several foreign banks penetrated the market by acquiring licences with the fulfilment of the requirements of the banking law, which was gradually strengthened throughout the years [Šević et al, 2002].

The favourable development in Albania, which started after the stabilisation of the economy, was abruptly shattered by the collapse of several large pyramid schemes, which held a large part of the population's savings. Pyramid companies in Albania operated already from the early 1990s, but their activities culminated in 1996. Many people even sold their belongings, including for instance farms or homes, expecting 50-100% interest within a matter of weeks. The growth of the large pyramid companies was supported by their coordinated publicity campaigns, and was not interrupted by warnings or measures from the government or authorities [Biberaj, 1998]. Based on conservative estimations, almost USD 0.5 billion was invested in various pyramid funds [Biberaj, 1998, p. 317]. The collapse of these pyramid schemes in 1997 led again to a major turmoil in Albania, including social unrest and governmental failure. According to estimations, the amount of the affected total liabilities reached almost half of the annual GDP [Šević et al, 2002, p. 28]. Due to the fact that the people have lost their savings, the consumption fell sharply, the real GDP contracted by 11%, while inflation exceeded 33% [EBRD statistics]. Foreign intervention was needed to regain a certain level of public order, and thanks to an economic recovery program, the country was able to return to a period of low inflation and fair GDP growth within a year. The new program focused on a wide range of fields, including the development of the institutional system, the social and economic policies and boosting the economic activity [Šević et al, 2002]. However, just as in the case of the "frozen" FX savings in Yugoslavia, the collapse of the pyramid schemes had a similar, long lasting psychological effect on the financial

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<sup>51</sup> These phenomena fuelled the rapid growth of broad money and inflation.

behaviour of the Albanian population. To conclude, after the transition process with its temporary shock waves the banking sector gained stability, but the financial deepening remained low, with one of the highest ratio of cash per GDP among the transition countries [Šević et al, 2002].

The already mentioned template described by Bokros (2001) was particularly relevant for Croatia's case and shows many similarities with the Albanian experience. Likewise in the other countries, by 1990 the Croatian banking system was insolvent or had problems related to the settlement of claims. Domestic savings were either part of the "frozen" amounts or were transferred to other countries during the upheaval. The first Banking Law was adopted in 1993 and has set up the minimum capital requirements of the system and liberalised the entry for new banks. Rehabilitation measures were taken already in 1991, but this was rather a one-off bookkeeping operation. In 1994, the State Agency for Bank Rehabilitation and Deposit Insurance was established, which started a case-by-case rehabilitation for the largest banks in the sector [Barisitz, 2008]. Following this period, the amount of savings – especially FX deposits – increased sharply, proving the growing confidence in the system. Attracted by the higher interest rates, savings from foreign banks were transferred to domestic banks and savings from "mattresses" were deposited [Šonje – Vujčić, 1999]. The deposit base of the banks became FX dominated again. At the same time, by 1995 large part of the enterprise sector was unable to repay its debts to the banks. The government supported these companies by issuing special bonds, which were used for the repayment of the debts. This resulted in the large amount of public debts in the banking sector's balance sheets [Šević et al, 2002].

All in all, the rehabilitation of Croatian banks featured cash payments and required large amount of sovereign issuing. Meanwhile, prudent lending policy was still lacking and loan repayments remained problematic. Furthermore, the bankruptcy policies were applied in a poor manner. In cases of mergers and acquisitions the experience was often missing. With the dominance of FX base, banks became particularly vulnerable to FX market movements. In addition, small and medium-sized banks offered higher interest rates for FX deposits to outperform their competitors. These were coupled by the international financial crisis of 1997-98,



which limited the access to foreign credits. All these weaknesses and vulnerabilities led to a second major banking crisis in 1998 [Barisitz, 2008; Šević et al, 2002]. Few banks were rehabilitated and – following a budget revision – insured deposits of bankrupt banks were paid out. According to estimations, in the period of 1991-99 the cumulative government debt that was issued for bank rehabilitation reached around 32% of the GDP [Barisitz, 2008, p. 51]. This second wave of the banking crisis brought a major shift in both the government's and the banking sector's policy and practice. The banking market swiftly changed, as many small and medium-sized bank exited, the state gradually withdrew from the sector while foreign strategic investors entered the market by acquiring stakes in leading credit institutions that have been rehabilitated in the former years. After this period, the supervision strengthened and banks became more cautious in their banking activity, noting that the creditor rights were still insufficient in the real sector [Barisitz, 2008].

Turning to FYRM, the privatisation in the banking sector was conducted within the programme of enterprise privatisation, but additional special measures were not taken. The Banks and Saving Banks Act came into force in 1993 and it determined the capital requirement for the sector. It was quite widespread that banks continued to finance loss-making enterprises with low debt servicing capacity, which could partly be explained by debt-equity swaps, where banks collected enterprise stocks. To respond to these problems, in 1995 the policy makers took measures to restructure and rehabilitate the banking sector. In the previous year a rehabilitation agency was established to collect bad loans from the enterprise sector and link it with the rehabilitation of the banks. The cost of rehabilitation reached 42% of the GDP, with 12% referring to the cleaning of bad loans from the banks' balance sheets and 30% to the repayment of the "frozen" foreign saving [Šević et al, 2002, p. 277]. However, the stabilisation of the system took place only after the banks' were restructured as well by new owners. These steps gradually pointed to the banking system's increasing profitability, led to comfortable capitalisation ratios and the drop of bad loans [Šević et al, 2002].

One of BH's most notable differentiating feature stems from its unique state structure. This means that – likewise in case of the general economic development – the banking system in the Federation and in RS developed separately. The lag in the

sector's rehabilitation and restructuring originated from the war and the unclear state structure. A further delay was caused by different priorities, as healing the banking system was not included to the initial economic stability measures. The Federation Banking Agency started its operation in 1997 and in the next year the legislation for bank privatisation was passed. The Banking Agency for the RS was established in 1998 and the privatisation started somewhat later, but with a quicker pace. The privatisation or liquidation of the banks began by the preparation of opening balance sheets. The insolvent banks were shut down in 2000. The banks' impaired assets and liabilities were transferred to the Ministry of Finance, with the balance sheets cut by 80%. The amount of the "frozen" foreign currency deposits reached more than 80% of the total assets. Capitalisation was low at the beginning, thus the capacity for the lending activity was limited [Šević et al, 2002]. However, a gradual development started from the 2000s in both entities. It is worth mentioning that even the supervisory and regulatory system mirrors the scattered state structure, because separate agencies operate in both entities, but even a state-level coordinating authority became necessary. Moreover, separate agencies have been established for the banking, insurance and securities sector.<sup>52</sup> This means that to cover the complete financial sector, nine agencies need to cooperate with each other, which can be considered unique even within SEE.

Among the countries of the region, the largest lag in the banking sector's development could be observed within the group of FR Yugoslavia. This implies that the "lost decade" term refers not only for the general economic reforms, but also for the complete financial sector's transition process. During the 1990s, no major banking sector restructuring took place, only certain legal documents were passed.

<sup>52</sup> Table 7: The scattered structure of the regulatory and supervisory system in BH

Agency	Goals, mission	Source
Central Bank of Bosnia and Herzegovina	Coordinating the activities of the BH Entity Banking Agencies	<a href="http://www.cbbh.ba/index.php?lang=en">http://www.cbbh.ba/index.php?lang=en</a>
Banking Agency of the Federation of Bosnia and Herzegovina	Bank licensing and supervision in the FBH	<a href="http://www.fba.ba/en/">http://www.fba.ba/en/</a>
Banking Agency of Republika Srpska	Bank licensing and supervision in RS	<a href="http://www.abrs.ba/index_eng.htm">http://www.abrs.ba/index_eng.htm</a>
Insurance Agency of Bosnia and Herzegovina	Coordination between entity agencies	<a href="http://www.azobih.gov.ba/cms/index.php?lang=en">http://www.azobih.gov.ba/cms/index.php?lang=en</a>
Insurance Supervisory Agency of Federation of Bosnia and Herzegovina	Supervision of insurance companies in the FBH	<a href="http://www.nados.ba/eng/index.html">http://www.nados.ba/eng/index.html</a>
Republika Srpska Insurance Supervisory Agency	Supervision of insurance companies in RS	<a href="http://www.azors.org/">http://www.azors.org/</a>
Securities Commission of the Federation of Bosnia and Herzegovina	Supervision and regulation of the capital market in the FBH	<a href="http://www.komvp.gov.ba/bih/index.php?option=com_frontpage&amp;Itemid=1">http://www.komvp.gov.ba/bih/index.php?option=com_frontpage&amp;Itemid=1</a>
Republic of Srpska Securities Commission	Supervision of the security market in RS	<a href="http://www.sec.rs.ba/en/">http://www.sec.rs.ba/en/</a>

Such document was the Law on Banks and Other Financial Organisations, which came into force in 1993 and applied a new regulatory framework for the system. During the years of hyperinflation, the value of the dinar assets and liabilities were wiped out of the banks' balance sheets. By the second half of the 1990s, the banking sector was in a catastrophic shape, as the ratio of bad loans amounted to around 90% and the sector was saddled with negative capital. Despite these features, the central bank required the largest banks to keep the credit lines open for the reviving real sector [Barisitz, 2008].

Within the group of FRY, fundamental reforms in Serbia started only in the 2000s after the fall of the Milošević regime. 2001 was spent for the assessment of the system and plans were set for the restructuring strategy with the help of the IFIs. Likewise in other SEE cases, the confidence in the banking system became very low, due to the painful experience of “frozen” FX deposits and the various pyramid scheme scandals of the 1990s. The level of public mistrust could be well measured by the euro cash changeover in 2002, as the cash needed to be deposited for the conversion process. EUR 4 billion was paid in and converted, but following this action three-quarter of the amount was withdrawn again. In 2002, the authorities issued state bonds in exchange for the repayment of the “frozen” savings, and the restructuring of the banking system was launched. As a first set of the actions, a few banks were closed or equity capital was written off. Later in 2002, the authorities converted state claims to shares in many medium-sized banks, thus nationalising them and prepared them for the privatisation or resolution. The consolidation and privatisation of the largest banks was carried out case-by-case, thus requiring a longer time period [Barisitz, 2008], but by 2010 the process still remained incomplete.<sup>53</sup> Nevertheless, by the end of the day the sector regained its stability and started its way on the regular transitional SEE development path.

Montenegro also had to experience the boom and bust of large pyramid schemes in the late 1990s. This shock took the banking sector to the verge of meltdown and ruined public confidence further [Barisitz, 2008]. In case of the tiny Montenegrin

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<sup>53</sup> The privatisation of the largest state-owned bank – Komercijalna Banka – has been planned for years, but in mid-2011 it was still not carried out. For a hint on the related public debate, see e.g. <http://www.ekonomskisavetdss.com/english/2011/01/ivan-ninic-dangerous-intentions-of-the-regime/> (downloaded: 01/05/2011).

market, the banking sector's assessment and the start of the consolidation took place in 2001. So compared to Serbia, the starting date was the same but the sequencing was somewhat different. Two banks were liquidated, a few banks were nationalised and prepared for privatisation or resolution. The largest bank was temporarily put under the central bank's administration, its balance sheet was cleared and was sold to foreign investors in 2003 [Barisitz, 2008]. Public confidence was further enhanced by the Deposit Protection Fund, which was established in 2006. As in case of Serbia, the Montenegrin banking system was able to recover and gained its stability as a result of the implemented measures. Parallel with this, public confidence slowly started to recover. Both Serbia and Montenegro experienced reviving credit growth and increasing deposit base from the mid-2000s.

In Kosovo, after the NATO bombing, the banking infrastructure was missing, meaning both the physical presence and the framework. This means that the financial sector and its supervisory and regulatory system had to be built from scratch. Kosovo's banking sector recovered under the administration of the UNMIK and the guidance of IFIs. Many microfinance institutions were established by the support of international institutions and had an important role in building the banking sector<sup>54</sup> [Barisitz, 2008], which was less typical in other SEE countries. Likewise in case of Serbia and Montenegro, Kosovo's banking industry had a swift development from the mid-2000s, although from a very tiny base and low sophistication. Foreign banks penetrated the market and local banks were established. The central bank became responsible for all licensing, supervisory and regulatory functions. The gradual development of the banking system represents the growing confidence in the system in a typically cash-based economy. Likewise in case of other SEE countries, Kosovo's banking system became dominated by foreign-owned banks [CBK, 2010].

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<sup>54</sup> For instance, in mid-2010 8 commercial banks (of which 6 were foreign-owned), 11 insurance companies, 2 pension funds, 29 financial auxiliaries and 17 microfinance institutions operated in Kosovo [CBK, 2010, p. 25].

### *3.3.1. The entry of foreign banks – A win-win situation?*

As discussed in the previous chapter, both the socialist Albania and SFRY provided a challenging legacy for the countries of SEE. There was a lack of experience with the modern capitalist banking techniques and environment. However, through the parent bank-subsidiary channel, foreign banks contributed to the region's economic transition from a socialist model to a market economy. This channel was supported by the brisk globalisation of the banking sector.

Generally, in transition economies foreign banks were able to enhance the transfer of various benefits and resources, including, know-how, international accounting and auditing standards, managerial skills, IT technology, risk management techniques, loan monitoring methods, business network, relevant market information, product innovation [Barisitz, 2008; Fries – Taci, 2002; Karas et al, 2010]. As for the latter, during the development process the banking sector penetrated to everyday life, while the range of products and services widened. E.g. new investment products, mortgage loans, credit cards, alternatives for consumer finance, dedicated products for small and medium-sized enterprises became more and more widespread in the region. Via the product innovation, banks “teach” the household and corporate sector to use new products, all leading to an increasing degree of intermediation.<sup>55</sup> Furthermore, for a region that was poor in capital, the foreign funding played an important role in the expansion and development of the banking sector. Through their parent banks, subsidiaries were able to have market access to cheaper funding from more developed financial markets and to a certain kind of implicit deposit insurance [Barisitz, 2008; Karas et al, 2010; EBRD, 2004]. Generally, as competition intensified, interest spreads narrowed and efficiency increased in the sector [Kraft, 2002; Vujčić – Jemrić, 2001]. The bottom line of the literature on the efficiency of the transition economies' banking system is that foreign banks are usually more efficient than their domestic partners [Fries – Taci, 2004], whereas there is mixed evidence on the comparison of the domestic private and public institutions.<sup>56</sup>

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<sup>55</sup> To read an overview on the access to domestic finance, see e.g. EBRD (2004).

<sup>56</sup> For a literature review on this topic, see e.g. Karas et al (2010).

It is also important, that in almost all transitional countries there was a lack of trust and confidence in the local banking system – which was particularly true for SEE – so the entry of foreign banks with good international reputation helped to increase the amount of domestic savings that could be then channelled to proper investments [Keren – Ofer, 2003]. Keren and Ofer (2003) argue that foreign banks may improve even the financial regulatory system, as it is their own interest to create a transparent environment where insider networks and corruption does not provide advantage for local actors. They even describe a vicious circle, where foreign banks are not willing to enter the new market until the legal environment and supervision allows unrealistic advantages for domestic banks, which finally leads to a potential financial crisis. On the other hand, the entry of foreign banks may support the improvement of the regulatory and supervisory system, thus generating the vicious circle.

All in all, these facts do *not* mean that foreign takeovers provide the one and only route for the establishment of a well-functioning banking sector, moreover it even incorporates particular risks<sup>57</sup>, but nevertheless it definitely bolsters the development process compared to a home-grown system [Barisitz, 2008]. As a macroeconomic result of the banking system's transition, the complete economies' transaction and payment system developed, while savings and resources were mobilised across the economy [Keren – Ofer, 2003]. Despite the dominance of these positive effects, political motivations or nationalistic creeds often blocked the entry of foreign banks but even the privatisation process, which was then often enforced by a banking crisis [Bokros, 2001; Keren – Ofer, 2003]. This caused great differences in the development of the country cases, even within SEE. However, in a matter of time, finally most of the transition economies and all SEE countries started a rather similar financial development path with the dominance of a foreign-owned banking sector.

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<sup>57</sup> There is a wide range of risks that became particularly relevant during the global crisis period. Such risks can be highlighted, as e.g. the case of a banking group pulling out from a specific country, the import of home country shocks or the too strong pressure of competition indicating to take too high risks by the banks. Many of the risks can be mitigated, but can never be completely avoided by the regulatory and supervisory framework.

Stiglitz et al (1993), for instance, has three arguments in favour of restrictions on the competition from foreign banks; a certain kind of infant industry argument can be adapted for the domestic banking sector, discrepancies can be observed between social and private returns in case of lending that leads to different investment patterns, international banking groups have the advantage of not having so strong pressure or control from the governments. Stiglitz describes seven market failures in the financial sector and is in favour of governmental intervention, which however can generate corruption and assumes “wise” governments.

As Hryckiewicz and Kowalewski (2008) show in their empirical study on central European countries, foreign banks' engagement depends on the potential of the market and the degree of financial sophistication. While usually in developed countries the banks expand rather in developed markets, in central Europe the case is just the opposite. According to Williams' (2002) "defensive expansion hypothesis", banks follow their clients abroad, as information on clients is among the most important values of the banks. However, according to Mérő-Valentinyi (2003), in emerging markets this hypothesis does not apply. It is rather the need for monitoring via physical presence. Hryckiewicz and Kowalewski (2008) find that in the beginning of the transition process the "defensive expansion hypothesis" holds, while at a later phase this motivation is replaced by the "search for client's behaviours". They also show that the poor creditor rights, the common law and the geographical distance are among the main determinants of foreign bank entries. The latter can be very well seen in case of SEE as well. Furthermore, it is interesting that evidence can also be found for religious links, as e.g. in Bosnia and Herzegovina banks operate also from Muslim countries.

Based on the literature and empirical evidence, from the large European banking groups' point of view, the privatisation process in SEE offered a unique opportunity to gain new markets in a neighbouring region that is better known and understandable for the European culture. In most of the economies, gradually a more stable and thus tempting legal and regulatory environment has been established. Moreover, SEE countries are taking part in the EU accession process, which provides the advantages of the EU common policies and the financial support of the programs. Beside these factors, the most important is that foreign banks were able to start building up a stable market position at an early stage of the catching-up and real convergence process. This offers a higher growth potential<sup>58</sup> even on long-term and higher profitability indicators, e.g. interest margins, ROA, ROE, which are able to compensate the higher risk factors that emerging economies carry. In addition, large banking groups were also motivated to diversify their portfolios in a further

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<sup>58</sup> Albertazzi and Gambacorta (2006) analyse the pro-cyclical nature of banking profitability. Among other conclusions, not surprisingly, they find that GDP affects both the net interest income through the lending activity and the loan loss provisions by the credit portfolio quality.

European region [Clarke et al, 2001; Haas – Lelyveld, 2003, Inotai et al; 2006]. Finally, it must be mentioned that when analysing market entry and the increase of capital flows, it is also important to bear in mind the home countries' market conditions. The strategic opening of EU banks to emerging Europe was underpinned by the stable economic environment in the home countries, which included low money market rates – thus low funding costs – and healthy financial conditions without capital pressure. All these resulted in the fact that SEE became one of the most dynamic and profitable banking regions in Europe, with very favourable outlook. As market competition intensified<sup>59</sup> and the banking market became more mature, profitability indicators slightly decreased and converged to the EA average, but this impact was well compensated by the effect of dynamically increasing volumes.

### 3.4. Conclusions and comparative overview

The SEE countries started their transition process with completely different starting points and legacies, but still rather faced similar tasks and challenges. Albania isolated itself from the rest of the world and implied a “classical” socialist system with the lack of democratic traditions. In contrast to SFRY, Albania remained the poorest<sup>60</sup> and probably the most backward country in Europe. Regarding the successor states of Yugoslavia, the countries had to face double fundamental changes during the first half of the 1990s. First of all, Yugoslavia broke up to several new countries, which was coupled by devastating military actions in many areas. From an economic perspective, new independent units had to be created and the scenes of destruction had to be rebuilt. In addition, the countries were occasionally directly or indirectly affected by the embargos on Serbia and FYR Macedonia. Second of all, parallel with these processes, Yugoslavia and the new states had to address the challenges of the “classical” transition process. Although SFRY represented a unique

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<sup>59</sup> It is assumed, that the higher market concentration indicates bigger profits. However, empirical studies contradict with this belief (see e.g. Havrylchyk-Jurzyk, 2006), as foreign banks might charge lower interest rates in order to increase market share, thus generating competition. One can find mixed evidence when comparing the profitability of domestic and foreign-owned banks (see e.g. Mérő-Valentinyi, 2003).

<sup>60</sup> See, for instance, the statistics from the EBRD or the IMF.

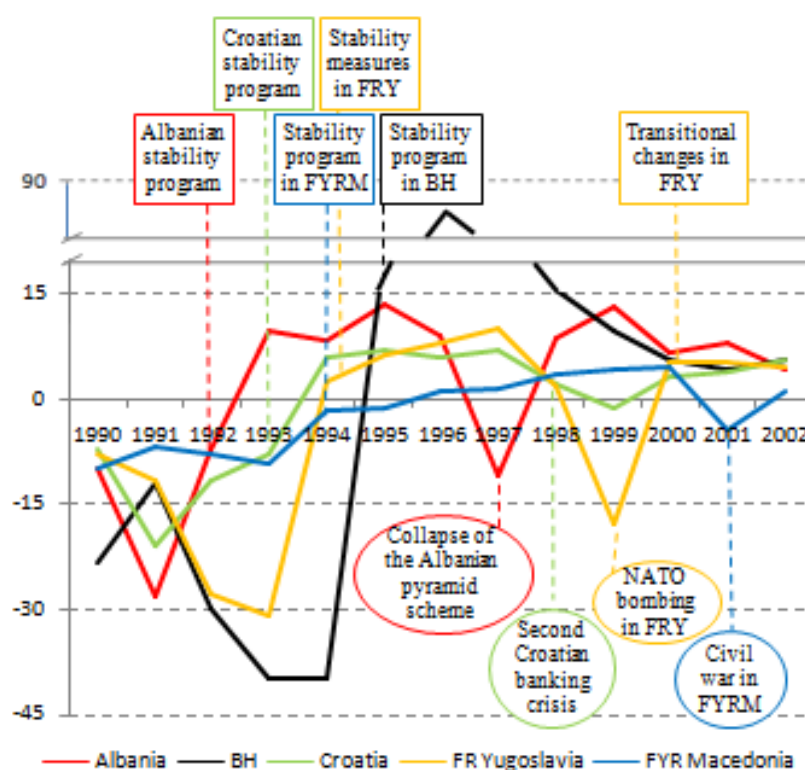


case among the European socialist countries with its system of self-management and various implemented market-economic elements, a completely new institutional framework had to be established, while actors still did not have ample experience with real capitalist mechanisms. Even during the socialist time period, large differences were present regarding the development of the republics, but following the dissolution of Yugoslavia this heterogeneity increased further, due to the new countries' applied policies and their internal and external shocks. To add up, the following three groups of factors differentiated the countries of SEE:

- the initial development level, institutional system and self-sustainability,
- the impacts of military conflicts, sanctions and embargos,
- the starting date, sequencing, duration and methods of the stabilising and restructuring policies.

Regarding the stability attempts and restructuring, also certain similarities can be pointed out, which apply for most of the SEE countries. Generally, the stability programs were not supported by loans from the international community, but IFIs provided technical assistance. However, it is worth mentioning that foreign aid played a crucial role in the survival of Albania and BH during the first years of transition and post-war revival. The same applies for Kosovo, which nevertheless remained aid dependent for a longer time period. A further similarity is that significant amount of foreign direct capital did not enter the countries at the early stage of transition. Furthermore, with the exception of Albania and FRY, the successor states of former-Yugoslavia had no foreign currency reserves and had to accumulate it during the years of transition. Last but not least, neither of the observed countries could achieve long lasting macroeconomic stability and had to implement more than one stability package. In almost all cases, this was coupled with the fact that a certain kind of systemic collapse occurred. So in each country's case the transition process has been a non-linear, long-term and gradual process.

Chart 3: Real GDP growth in SEE during the transition process (%)



Source: EBRD Transition reports (various years) and EBRD statistics

Chart 3 shows the real GDP growth rates of the SEE states during their transition period. It reflects the different timing of the most relevant restructuring and stability measures, which have set the specific countries on their growth track. As seen on Chart 3 and its boxes, all countries launched a major transitional and stability program between 1992 and 1995. The exception was FRY with its stop-go-policy, where only temporary stability measures – also mirrored by the inflation rates in Table 5 – were implemented until the fall of the Milošević regime, thus the 1990s could be considered as a kind of “lost decade”. This is valid for Serbia and partly for Montenegro. In Kosovo, the new path began under the UNMIK administration in the same time period. Albania was the first country to stabilise its economy and Croatia was the next. FYRM experienced the longest but mildest recession followed by a modest growth trend. The most striking drop was recorded by the war-struck BH, where stability measures took place only after signing the Dayton Peace Agreement. Thus the impressive growth rates in the upcoming years should be judged from a very low base. Chart 3 and its bubbles also reflect that the development was non-linear and occasional external or internal shocks caused temporary drops in the real

GDP growth rates with the exception of BH. In case of Albania and Croatia these drops were directly linked to the collapse of the financial system. In FRY and FYRM, the downturn was caused by military conflicts or civil war. As also seen in Table 6, it was not until 2002 that all states in SEE returned to their growth tracks. Here the only exception was Kosovo, where this was valid only from 2004.

It is particularly interesting that completely different exchange rate policies have been implemented in the region during this stabilisation and transitional period. Moreover, FR Yugoslavia and Croatia had to introduce new currencies more than once as part of the stability measures. Furthermore, in Croatia and in BH multiple currencies were in use during certain years of war, when different ethnic areas used the home countries' currencies. By the end of the transitional period, following shifts or the complete restructuring of the FX regimes, a group of small, vulnerable countries used the applied exchange rate policies as nominal anchors for their economies. The trade-off in their case was the positive contribution to price stability versus the limited room left for monetary policy manoeuvres. Kosovo and Montenegro unilaterally started to use the euro as sole legal tender, and BH applied a euro-based currency board regime. FYR Macedonia chose a de facto peg against the euro. Croatia belonged to an intermediate group with its tightly managed floating FX policy. As for the third group, Albania and Serbia applied independent or managed floating regimes against the euro.<sup>61</sup> These policies became particularly crucial during the global crisis in the light of widespread FX lending and the room for monetary policy adjustments. The former had major impact on the entire banking system's stability that had a significant spill-over effect on the macroeconomic indicators.

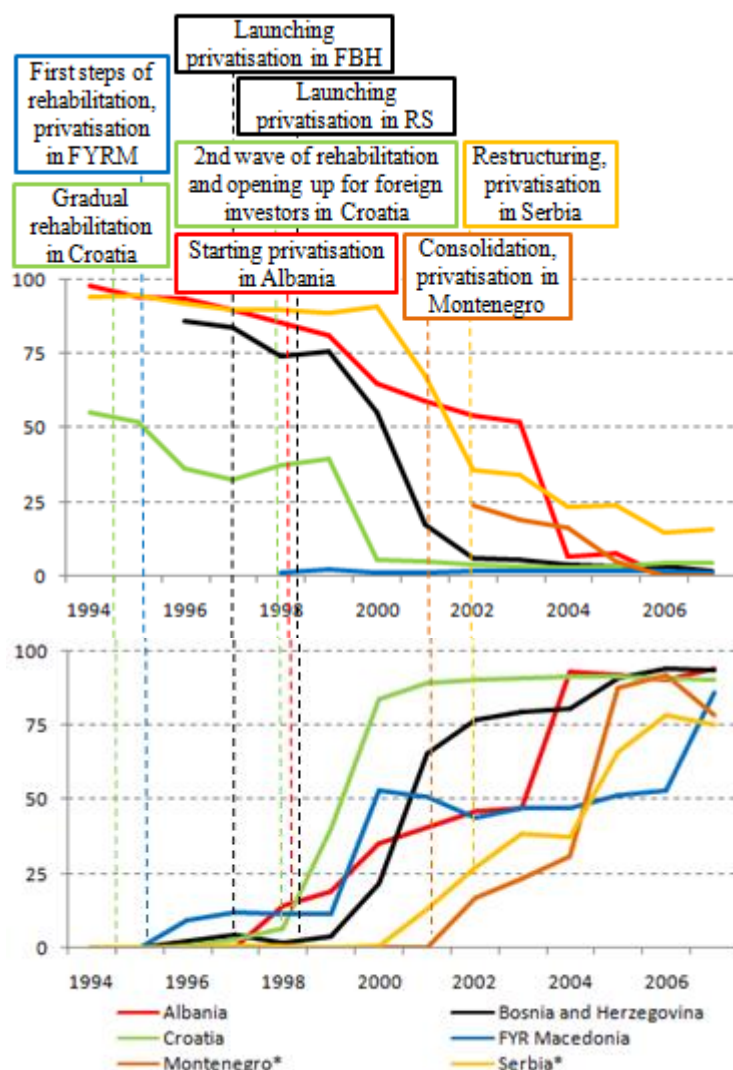
Turning to the banking sector, the institutional structure that the former-socialist system has left behind was completely different in Albania and in the successor states of Yugoslavia. In the former case, the socialist monobank was the ground for the restructuring. Regarding the latter, a two-tier and scattered banking system with large number of small, local banks has been inherited. However – as discussed in the previous chapter – the problems and tasks still remained similar; a socialist model had to be transformed into a market-led capitalist system. During the transition

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<sup>61</sup> Please see the respective central banks' homepage.

process, a range of country-specific internal and external shocks affected the banking sector's operation. In certain countries even a second banking crisis or the collapse of large pyramid schemes caused shockwaves or meltdown in the financial sector. As already discussed, the methodology, pace and sequencing of the banking sector's restructuring showed great variety. Still, by the end of the day, the institutional structure became similar. So despite the great differences in the starting points, one can specify a regional template for the banking industry's development: following a systemic collapse large European banking groups penetrated the local markets, swiftly gained terrain at an initial phase, contributed to the sector's restructuring and fuelled rapid credit growth in a next stage.

Chart 4: Decreasing asset share of banks with state ownership exceeding 50% (%) and increasing asset share of banks with foreign ownership exceeding 50% (%)



\*1994-2001: FR Yugoslavia

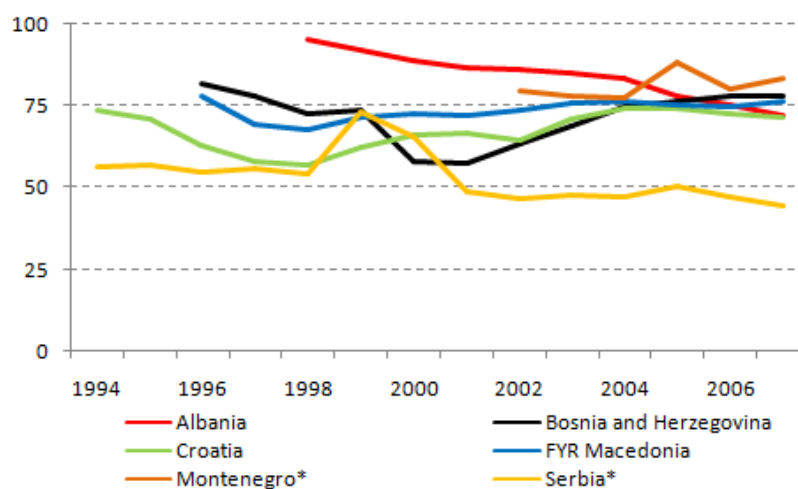
Note: Time series are not available for Kosovo, but for instance in June 2010 the share of foreign-owned bank assets amounted to 89.8% of the total banking sector assets [CBK, 2010, p. 28].

Source: EBRD Transition reports (various years), EBRD statistics, respective central banks' homepage

Chart 4 reflects the different starting dates of the banking sector's rehabilitation and privatisation. The lines and boxes represent the milestones in each country. Generally, rehabilitation was conducted before the privatisation, but in some cases the privatisation could be considered as the cornerstone, or the two processes have

been run in a parallel form. The slopes show the different paces of these processes. The most important outcome is that in each and every case, the asset share of banks with majority foreign ownership converges to the range over 75%. With the exception of Montenegro and Serbia, it is even over 85%. In the latter's case, this lower number can be explained by the lag regarding the starting date of the sector's restructuring, which resulted that despite the plans, one of the largest state-owned banks has still not been privatised. So the decreasing trend of state-ownership, and parallel with this the increase of foreign-ownership proves well, that the large foreign banking groups penetrated the markets in SEE and achieved dominant positions. Furthermore, Chart 5 shows that the market concentration is high. With the exception of Serbia, the asset share of the largest banks is around 75%, which means that a limited number of large European banking groups<sup>62</sup> dominate the market in SEE.

Chart 5: Share of total assets of five largest banks



\*1994-2001: FR Yugoslavia

Note: Time series are not available for Kosovo.

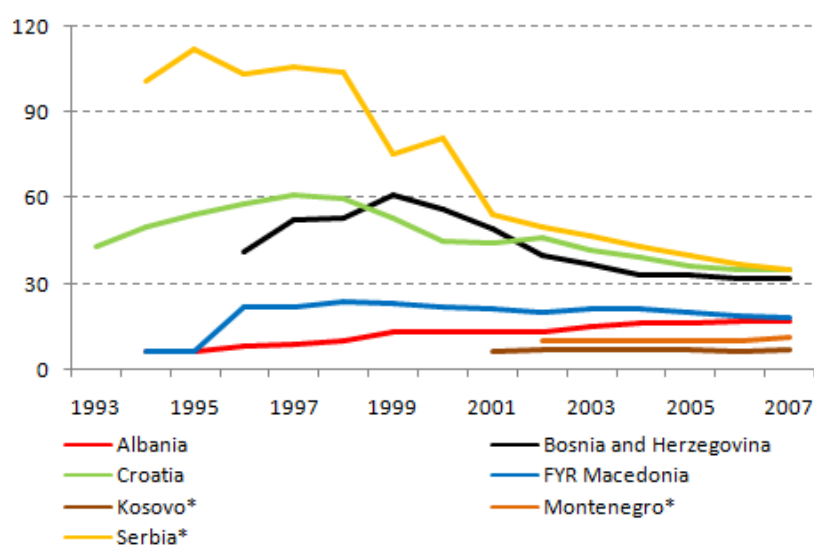
Source: EBRD Transition reports (various years), EBRD statistics, respective central banks' homepage

The market structure is further elaborated by Chart 6, and shows how the number of banks stabilised in the region. This chart demonstrates well the different initial

<sup>62</sup> For more information on the ownership structure, please see the local central banks' homepage.

market structure of Albania and the former-Yugoslav states. The former started its transition process from a monobank system and has gradually increased the number of banks. The latter inherited large number of local banks, while their numbers decreased as the result of bankruptcies, and the active mergers and acquisition process. Nevertheless, Table 8 reflects that the number of banks per capita shows significant differences.

Chart 6: Total number of banks



\*1994-2001: FR Yugoslavia

Note: Includes branches of foreign banks

Source: EBRD Transition reports (various years), EBRD statistics and CBK various statistical bulletins

Table 8: Number of banks per capita (2007, multiplied by 1 million)

Albania	5.31
Bosnia and Herzegovina	8.42
Croatia	7.95
FYR Macedonia	9.00
Kosovo	3.50
Montenegro	15.71
Serbia	4.67

*Source: EBRD Transition reports (various years), SOK, own calculations*

It can be concluded, that throughout the transition process, the banking system played a primary role in the economic development in two senses. During its stabilisation and restructuring, it has put extra burden on the fiscal authorities, while on the other hand, once it was able to fulfil its market-oriented primary roles, it was able to support the economic development in various fields. This includes, for instance, the support of economic growth or the channel of monetary policy. Foreign banks played a particular role within this financial development process. They contributed to the system's transition through the transfer of various benefits and resources, and the enhancement of competition. They played a pivotal role in the banking sector's penetration to everyday life – both horizontally and vertically – via financial deepening and product innovation. Furthermore, they contributed in restoring public confidence in a region where a significant part of the population has lost their savings more than once – due to e.g. hyperinflation, “frozen” FX savings or collapse of pyramid schemes. Foreign banks also underpinned the system's stabilisation, as during the 1990s NPL ratios skyrocketed and capitalisation remained low, while during the next decade these indicators reached acceptable levels.<sup>63</sup> On the other hand, one must also stress the related systemic risks that foreign banks carry. For instance, foreign banks had a major role in the rapid credit growth in SEE, which could be considered as a primary macroeconomic risk factor and became particularly relevant during the global crisis. Nevertheless, throughout the booming

<sup>63</sup> On this topic, see the various additions of EBRD's Transition reports.



“catching-up” period the entry of foreign banks could be summarised as a certain kind of win-win situation for both sides.

Following the transition period, a new phase began, which could be dubbed as the “catching-up period”. It goes without saying that the starting date and end of these periods are not clear-cut, but certain dominating features can be grouped to each phase. While during the transition period the macroeconomic stabilisation and the establishment of the institutional framework was the primary task, the “catching-up period” provided new challenges in many aspects. Then the most important task was the long-term stabilisation and the constant fine-tuning of the economy and its institutional background. In SEE, following the severe transitional and war-time recession, promoting stable and long-term economic growth became a key factor. In case of this region, the “catching-up” refers to the adoption of the “Western” – primarily EU – institutional standards, besides gradually converging to their GDP per capita levels and participating in the EU accession process. These require in all time periods a flexible and dynamic institutional background, which is able to respond to the timely challenges and requirements. As seen in the next chapter, during this “catching-up period” the financial sector played a crucial – and occasionally controversial – role in the economies via for instance rapid credit growth.

#### **4. Catching-up period – A fragile development model dominated by credit growth**

The previous chapter provided an overview of the banking sector's structure by the end of the transitional period – or to put it the other way around – the years before the global crisis.<sup>64</sup> In all SEE countries, the sector became dominated by foreign-owned banks as the asset share of banks with a majority foreign ownership expanded over 75%. Parallel with their increasing market position, state-owned banks held less than 15% of the total assets. As a further relevant feature, by the second half of the 2000s, the number of banks stabilised in the region and the market concentration became high. These also imply that the banking market became dominated by a narrow group of large European banking groups.

The current chapter reviews the post-transitional or pre-global crisis period, though some of the characteristics have already been discussed in the previous chapter, as strict time limits cannot be drawn. From one aspect, the transition process has still not ended, as for instance, in certain countries the transitional reforms are still on their way to be implemented, privatisation cases have not been completed or the banking sector's supervisory system has remained weak. On the other hand, the institutional framework has already been established and the banking market's structure has stabilised. However, as seen in the previous chapter, large differences and lags could be outlined among the SEE country cases. All in all, a certain time period can be determined before the global crisis with its own specific characteristics.

Within this chapter, the period between 2000 and 2007 is being reviewed. As for the starting date, 2000 can be marked as a year, when the Milošević regime fell and the Kosovo conflict ended. Thus the market economic development can be analysed in all countries, though the transitional process has just started in the latter cases. Indeed, representing a lag compared to the other countries of SEE, Serbia and

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<sup>64</sup> Part of this chapter will be published in an edited version:

Kazinczy, Eszter (2012): The catching-up of the banking sector in south-eastern Europe. A fragile development model dominated by credit growth. *Society and Economy, Journal of the Corvinus University of Budapest*, Budapest, Akadémiai Kiadó, expected date of publication: first semester of 2013 (online version expected from December 2012)

Montenegro started to restructure and privatise their banking sector only in the early 2000s. This also means that certain countries were still at an initial phase of the transition process. This is one reason why the reviewed period's last three years have special focus. This was the period when the banking sector flourished the most. Regarding the end date of the reviewed "catching-up period", it is 2007 until the booming years can be analysed, as from the next year the first waves of the global crisis reached the region and opened a new era.

This time period can be dubbed as the "catching-up period". The term refers to the catching-up process with the EU countries' standards and converging to their income levels. In this chapter, catching-up or convergence refers to the GDP per capita on a macro level and financial deepening regarding the banking sector. Generally speaking, during these years the macroeconomic stabilisation has already taken place and the banking sector's institutional system has been established, so the main challenge here was achieving a long-term stabilisation and economic growth, while fine-tuning the institutional background for the support of this process. During this "catching-up period", the banking sector played a crucial role. It was already able to fulfil one of its most important market economic tasks, namely it channelled savings to investors. But more was allocated, as via the foreign funding channel it distributed significant amount of credits to the household and corporate segment, which nonetheless led to major imbalances. Likewise in case of the transitional time period, here as well a simplified template could be outlined, where foreign-owned banks funded swift credit growth, which underpinned favourable GDP growth rates, but nevertheless caused severe micro and macro level imbalances. This chapter reviews the most important characteristics and macroeconomic outcomes of this simplified template, and aims to reflect the similarities of the development pattern in the reviewed time period.

During the analysis, general macroeconomic and banking sector data are used. This means that with the exception of a case study subchapter, county level sectoral indicators are used. They are collected from the respective central banks' statistics, the IMF, the EBRD, the BIS and the European Commission's Eurostat database. In this case as well, it has to be emphasised that the data quality is uneven and methodologies might differ within the region, so comparing the exact numbers

should be done with caution. Nevertheless, the analysed tendencies and the general conclusions of the chapter hold. One-off or exponential effects are often disregarded by using the average or the CAGR indicators and the total growth of the reviewed period. Certain charts contain the average of the last three year's data, also in order to analyse the most flourishing period. The chapter includes various scatterplots. The number of observations is too low for regression analyses, but still, the trends and the connection between the variables can be well demonstrated. Also in order to increase the number of observations, the EA is included to the calculations. As an indication, the respective  $R^2$  is always added to the scatterplots.

For the sake of comparison and to demonstrate the catching-up process, the region of EU is usually included to the quantitative analysis. Nevertheless, when reviewing the banking sector the EU is substituted with the EA,<sup>65</sup> which is supposed to illustrate a more developed sub-region. The reason behind this is that the broad spectrum of financial data are rather available for the EA itself, while it is again the EA which can be considered as the region where both SEE and the NMS are aiming to catch-up with. However, the EU data are occasionally divided into two sub-regions; the more “developed” area is represented by the EA, while the transitional region is tagged as the NMS.<sup>66</sup>

In order to underpin the most important statements, a brief case study has been added to the current chapter. This overviews the main local subsidiaries of two large European banking groups; Raiffeisen Bank International AG and UniCredit Group. The relevant data have been downloaded from Bankscope, while the banks' annual reports helped the interpretation of the respective figures. The data are reviewed from 2005, as this was the date when both of the banking groups entered all of those SEE countries where they are currently present. This means that in case of Raiffeisen, the subsidiaries in Albania, Bosnia and Herzegovina, Croatia, Kosovo and Serbia, while related to UniCredit the local banks of Bosnia and Herzegovina, Croatia and Serbia can be overviewed.

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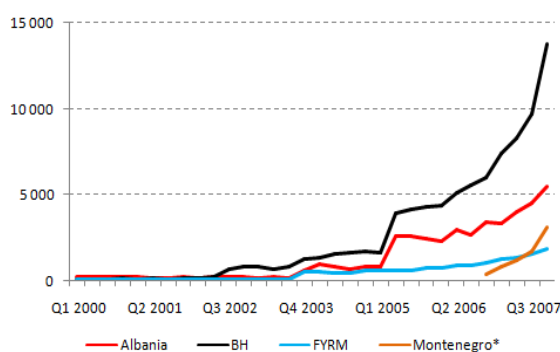
<sup>65</sup> Euro area covers those EU member countries, which have adopted the euro at the time to which the statistics relate.

<sup>66</sup> The New Member States of the EU include Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia.

#### 4.1. The banking sector's development

As discussed in the previous chapter, foreign banks played a pivotal role in the transition process of the banking sector and the related financial deepening. During this development process, typically EU-headquartered banks penetrated the markets and gained dominant positions. This important feature also implies that the banking sector became a pillar of European economic integration. Despite its importance, it is difficult to quantify the flows from the parent banks to their subsidiaries. There are no appropriate databases for this purpose and the relevant data are occasionally subject to confidentiality. A simplified proxy would be the sum of equity, subordinated debt and hybrid capital gained by the subsidiaries. However, in their quarterly reports the origin – whether it's the subsidiary's own profit or the funds received from the parent bank – is usually not available. Chart 7 and Chart 8 demonstrate the BIS data on consolidated foreign claims. These time series can be considered merely as oversimplified proxies for the total volume of funds received by the subsidiaries from the parent banks. Nonetheless, these data are used here to illustrate the increasing ties and flows between the parent banks and their subsidiaries in SEE within the reviewed time period.

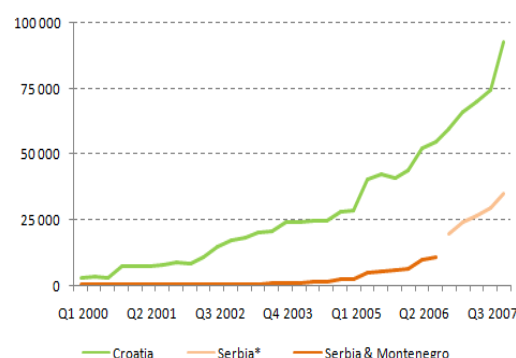
Chart 7: Consolidated foreign claims of BIS reporting, EU-headquartered banks I. (USD mil.)



\* Data for Montenegro are available from the fourth quarter of 2006.

Source: BIS Banking statistics

Chart 8: Consolidated foreign claims of BIS reporting, EU-headquartered banks II. (USD mil.)



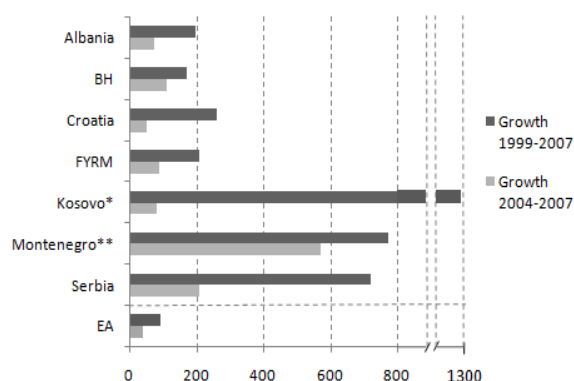
\* Data for Serbia are available from the fourth quarter of 2006.

Source: BIS Banking statistics

The degree of financial deepening is often measured by the banking sector's volume of total assets or by the indicator of total assets in per cent of the GDP. When reviewing the data for SEE, it can be concluded that the growth of the indicators were high in all countries, which reflects the dynamic expansion of the sector. However, the volume itself – e.g. compared to the GDP – could still be considered low. Chart 9 shows the overall growth from the start of 2000 – meaning end-of-period data from 1999 – until the end of 2007, and the growth during the last three years of the reviewed period. The former indicators can be misleading due to the particular consolidations related to the transition process. Furthermore, in case of Kosovo the extremely high growth was the result of the fact that the banking sector had to be built from scratch. This is why the data for the last three years of the “catching-up period” represent the conditions better, as it omits one-off and base effects. These three years can be considered as the booming years of the period. It is clear, that the growth was rapid in all countries, but could be considered extremely high in case of Montenegro. In Serbia, the expansion was also very dynamic, which could only partly be explained by the discussed transition lag.

When reviewing the average annual growth rates by the CAGR indicator (see Chart 10), it can be concluded that the growth of total assets was rather exponential, underpinning that the expansion of the banking sector peaked in the last three years of the “catching-up period”. There were only two exemptions; as in case of Kosovo the base was extremely low, while in Croatia there was merely a slight difference between the two periods. This could partly be explained by the already reviewed earlier start of the development process, and the regulatory authorities' attempts to curb credit expansion in the country. Nevertheless – with the exemption of the mentioned Croatia – the CAGR of total assets in the last three years was over 20% in all countries. Serbia and particularly Montenegro, well exceeded even the region's average with extremely high CAGRs. All in all, both in terms of volume growth and the CAGR, SEE exceeded the expansion of the euro area. The growth rates of the region could be interpreted as the result of dynamic financial deepening, which was part of the catching-up process.

Chart 9: Total volume growth of total assets (%)

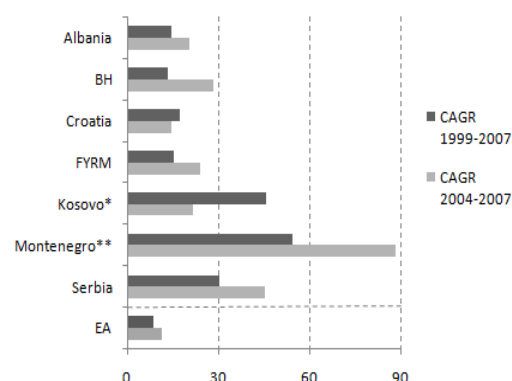


\* Base date: 2000

\*\* Base date: 2002

*Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations*

Chart 10: CAGR of the volume of total assets (%)



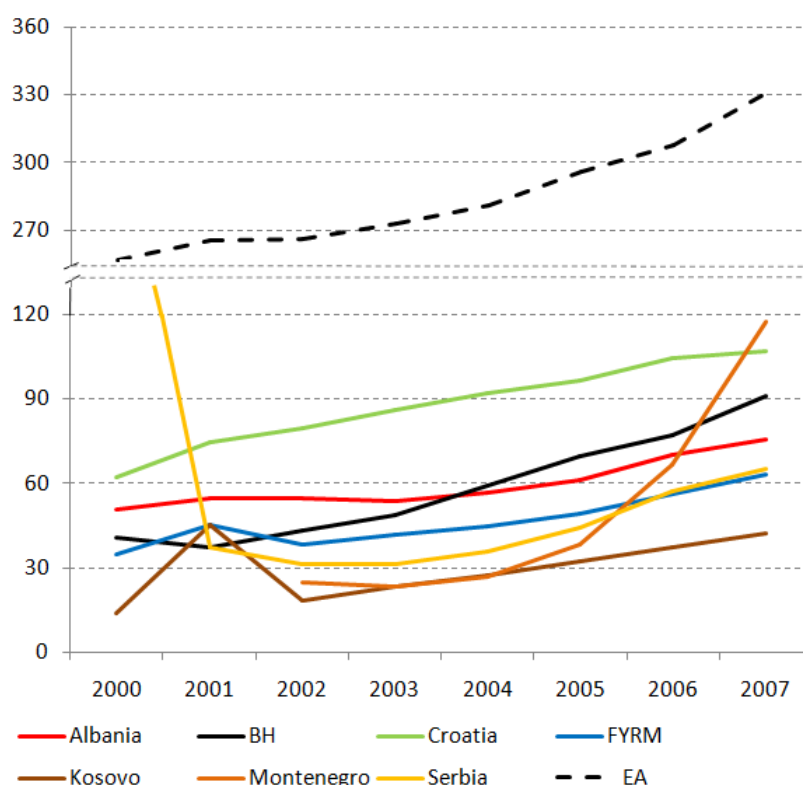
\* Base date: 2000

\*\* Base date: 2002

*Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations*

As far as the indicator of total assets in per cent of GDP is concerned – often used for demonstrating the degree of financial intermediation – it reflected a stable growth pace in all SEE countries (see Chart 11). As illustrated by the chart below, the case of Montenegro could be considered extraordinary with its exponential growth. It is also important to highlight, that Serbia's initial ratio is misleading, as it reflects the data before the restructuring of the banking sector, while the GDP was affected by the Kosovo related military conflict. Generally speaking, it can be concluded that there has been a significant upward trend with similar growth paces in almost all country cases. Nevertheless, the level of the indicators has remained well below the EA's average level, showing great room for the catching-up process. The EA itself has also recorded high growth rates – with the exception of the period of the dot-com bubble's burst – though the divisor increased with a slower pace, compared to SEE. To sum up, following the banking sector's transition, the catching-up process took off with a rapid pace of financial deepening.

Chart 11: Volume of total assets in per cent of GDP (%)



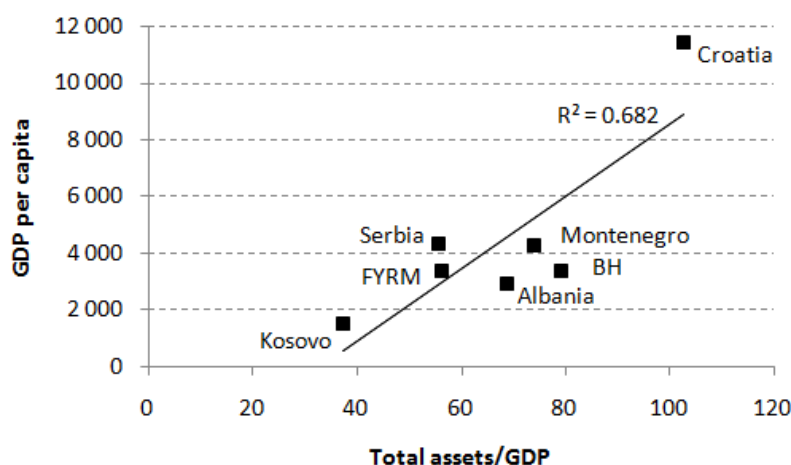
Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

Last but not least, still related to the amount of total assets in per cent of GDP, the correlation with the GDP per capita should be illustrated. The connection between these two indicators demonstrates the link between financial deepening and economic development. As reflected by Chart 12 and Chart 13, the growth of these two indicators goes hand in hand. This means that as the GDP increases, so does the banking sector develop. In the previous chapters the related literature has been briefly discussed on the effect of financial deepening on economic growth. The charts below do not reflect the direction of this link, but the connection is well illustrated. Nevertheless, within the literature review it has also been discussed that the link between the two factors is rather bidirectional, meaning that financial development bolsters economic growth, but the latter factor also enhances the financial development itself.



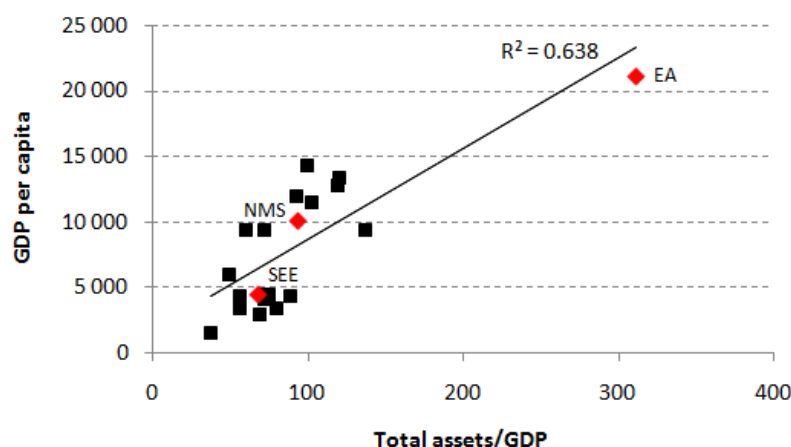
While Chart 12 illustrates the connection between these two fundamental indicators within SEE, Chart 13 includes the region of NMS and the EA. It should be mentioned, that the EA reflects the weighted average of its member states, while NMS and SEE has been calculated by taking the simple average of the relevant countries. Nevertheless, this does not cause significant distortion, but demonstrates well the correlation between the two indicators. Both charts show that the “poorer” countries or regions have a lower level of bank intermediation, while the more “developed” ones are ahead on the financial development path. Chart 13 demonstrates that the transitional countries of SEE and NMS were well below the EA levels, leaving ample room for the catching-up process. The chart highlights again the development lag of SEE compared to NMS.

Chart 12: GDP per capita (in USD, 2005-2007, average) and total assets in per cent of GDP (% , 2005-2007, average) in SEE



Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

Chart 13: GDP per capita (in USD, 2005-2007, average) and total assets in per cent of GDP (% , 2005-2007, average) in SEE, NMS, EA



Notes: Slovenia adopted the euro in January 2007, thus it has been included to the region of EA.

Average regional data are marked with red.

SEE and NMS demonstrates non-weighted average, while EA illustrates the weighted average of the member states.

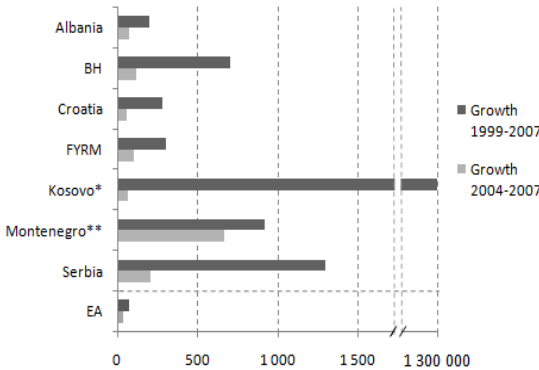
*Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations*

Turning to the main components of the banks' balance sheets, the categories of deposits and loans should be briefly analysed. Starting with the liability side, it is important to emphasise that the increasing amount of deposits and other asset under management categories represent the gradually returning confidence in the banking system. As discussed already, foreign-owned banks largely contributed to the process of regaining public confidence. However, bearing in mind the former crises in the region – which usually have been coupled with hyperinflation – depositors could still be considered more cautious compared with the clients of other European regions. Also as a consequence of these crises, the region has been characterised with a very high level of euroisation (see Chart 20 for the ratio of FX deposits, primarily meaning euro deposits). This was also an outcome of the significant amount of remittances which were typically not converted to the local currency. On top of these, in countries with large tourism – particularly meaning Croatia – the revenues from the sector were usually kept in foreign currency. As a further factor, during the

introduction of the euro in the EA, in almost all countries the conversion could only be done on bank accounts. Showing the increasing confidence, most of these sums were left in the banks, providing a significant boost for the banking system's liability side [Barisitz, 2008].

As expected, Chart 14 and Chart 15 show similar tendencies with Chart 9 and Chart 10 which illustrate the changes of total assets. The expansion of deposit volumes well exceed the growth rates registered in the EA. Here it should be noted, that the extremely high growth rates for Kosovo are due to the fact that its banking system had to be built from scratch. Montenegro could also be considered as a special case with its late and very swift expansion. Nevertheless, in all cases the growth could be considered high, which is well reflected by the charts below.

Chart 14: Total volume growth of total deposits (%)

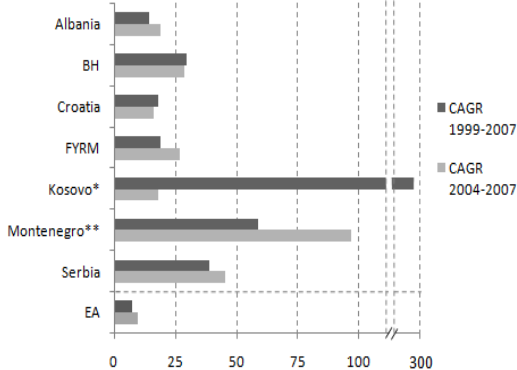


\* Base date: 2000

\*\* Base date: 2002

Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

Chart 15: CAGR of the volume of total deposits (%)



\* Base date: 2000

\*\* Base date: 2002

Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

As a further feature related to the liability side, SEE – likewise other transitional countries – lacked the tradition of sophisticated instruments or securitisation, and the long-term investment approach was still not typical. So it was rather the banks,

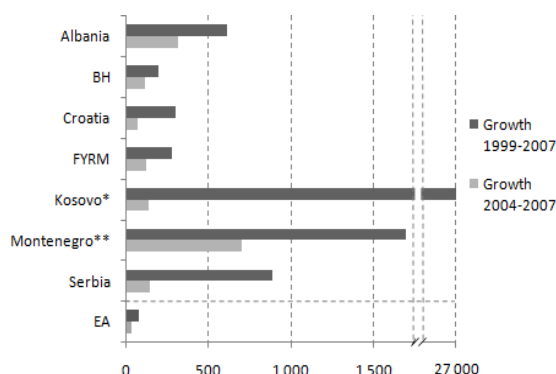
which initiated product innovation and introduced new investment products. Banks could reach bigger margins on these products, while clients were able to diversify their investment portfolios. Still, the need had to be built from the banks' side by a certain kind of client education process via the advisory services. Tellers had to have the appropriate incentive system for this activity. But as the significant lags have been emphasised regarding the banking systems' development, these lags were particularly relevant for the slow procedure of investment product innovation. So, as for instance, in Croatia already a broad investment product range was available for the clientele, in Montenegro almost no alternatives were available for term deposits. However, the maturities for the deposits gradually increased in all countries. The bottom line is, that during the reviewed time period, clients' savings were typically held on current accounts or term deposits. This is the reason why only these categories – namely the deposits – are being analysed when speaking of the clientele's asset under management.<sup>67</sup>

Turning to the dominant category of banks' assets, swift credit growth became an important feature in the region (see Chart 16 and Chart 17). Both the total volume growth and the average annual growth were much higher than the EA's average. Furthermore, these growth rates far exceeded such macroeconomic indicators as the annual nominal GDP growth rate or the inflation. Regarding the specific country cases, Kosovo's growth rates for the complete reviewed period should be judged again in the light of the fact that its banking system has been built from the ground. The case of Montenegro should be highlighted in this case as well for its extreme growth rates. Croatia could be pointed out for its modest growth rates compared to the regional average, which was due to the higher base levels and the strict monetary policy. On the one hand, the credit to GDP ratios could be considered very low in the reviewed countries, in comparison with non-transition EU countries. Furthermore, its expansion started from a very low base. On the other hand, when reviewing the swift pace of credit growth compared to e.g. the level of GDP growth or inflation, the concerns of quality and overheating could be raised.

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<sup>67</sup> For related statistics, see the relevant central banks' statistical publications.

Chart 16: Total volume growth of total loans (%)

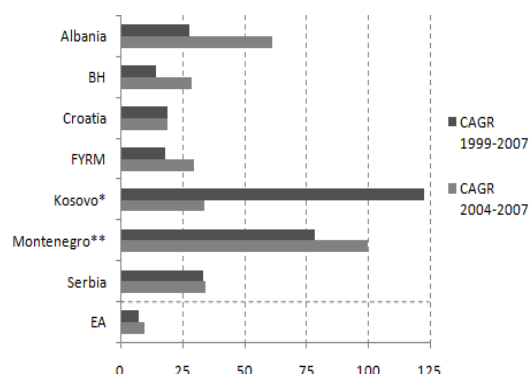


\* Base date: 2000

\*\* Base date: 2002

Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

Chart 17: CAGR of the volume of total loans (%)



\* Base date: 2000

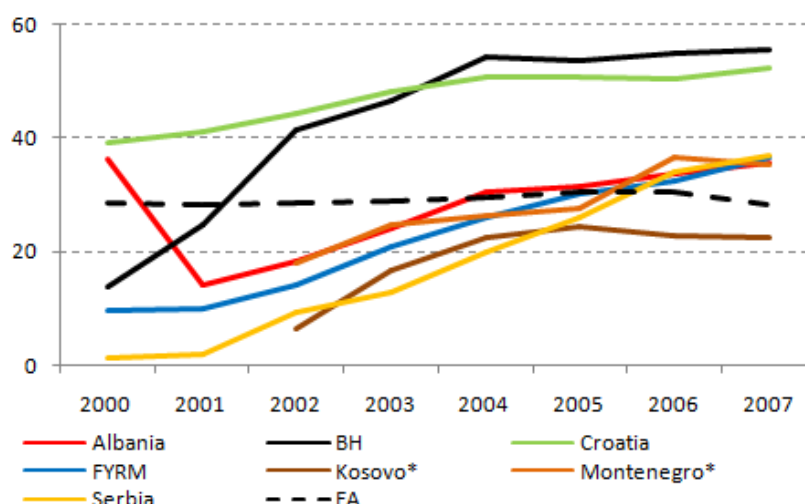
\*\* Base date: 2002

Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

During this “catching-up period”, credit growth has been dominated by private sector credits, particularly household lending and mortgage loans. This also means, that although the corporate sector’s share used to dominate the credit portfolio during the transition, its share gradually decreased. The same applied for the public sector<sup>68</sup> [Backé – Walko, 2006]. Chart 18 illustrates the increasing share of household credits on the loan market. The common feature in this case was the increasing tendency of the households’ share, but the exact values reflected significant differences. Furthermore, these differences did not demonstrate the development level of the financial systems. This also means that there was no convergence in this sense to the EA levels. So it is not clear, that if the global crisis would not have interrupted these tendencies, how these values would have changed on the long-run. It is worth underlining here, that the growing share of household credits also implied increasing consumption levels, all leading to certain macroeconomic vulnerabilities which will be discussed later.

<sup>68</sup> For related statistics, see the respective central banks’ statistical publications.

Chart 18: Domestic credit to households share in per cent of total loans (%)



\* The respective data are available from 2002.

Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

Credit growth in SEE was fuelled by both the demand and supply side of the loan market. The former was characterised by a consumption propensity exceeding the savings propensity, a consumption-smoothing attitude and a real converge process. As for the supply side, under the pressure of increasing competition and slowly converging interest margins, the product and service range widened and new lending products emerged. Banks competed with each other to attract new clients and to expand their market share. However, the evaluation of creditworthiness was often poor, as there was a lack of reliable credit history, credit registries, decent data on the borrowers' background or reliable financial disclosure. Furthermore, the methodology or infrastructure for the assessment procedure was underdeveloped, so accounting and auditing standards often remained poor. This was coupled with the mentioned pressure of market competition, which did not point to the willingness of appropriate client assessment. Noteworthy, that from a legal perspective the legal framework – including creditor protection and the related use of collateral – became particularly important in the light of widespread mortgage lending. Last but not least – as discussed below – in many countries the FX denominated or indexed lending could be considered as the primary risk factor in cases of unfavourable FX movements. These facts all added to the risk of increasing NPLs, especially in cases

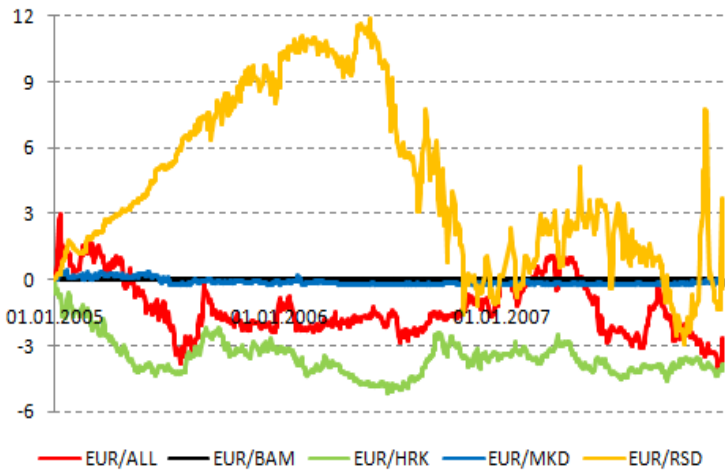
of internal or external shocks, which emerged during the global crisis [ECB, 2008; Sorsa et al, 2007; European Commission, 2009]

So during the “catching-up period”, borrowers tended to have FX – especially euro – denominated or indexed loans. From the banks point of view, this did not generate significant exposure to currency mismatches, given that FX assets were covered by FX liabilities, primarily channelled from the parent banks. So from one side, FX loans could be considered as a natural hedge for banks. However, banks still became exposed to currency mismatches in an indirect form, because the borrowers themselves were typically exposed to FX risk. Furthermore, given that FX lending was widespread in the retail segment, it is generally believed that this feature increased the banking sector’s risk, because usually households are the least hedged to unfavourable FX movements. So even though on a macro level the large share of FX loans might have been covered by FX deposits, on a micro level the currency mismatch was still relevant [Sorsa et al, 2007; EBRD, 2006a].

As far as the borrowers are concerned, they were motivated to choose FX loans by the lower interest rates and the expectations of appreciating local currencies in which they usually earned their incomes. Preferring FX loans could also be a reaction to the unstable macroeconomic framework, including high inflation volatility [Sorsa et al, 2007; EBRD, 2006a]. Martin and Zauchinger (2009) provide a brief literature overview on the main determinants of FX lending in SEE and CEE, thus giving a hint on other factors. Analyses revealed further determinants from both the borrowers’ and banks’ point of view, such as the trade openness in case of the corporate sector, the income per capita levels, the country size or the regulatory policies. The underlying role of the banks could be reflected by the results of an OeNB survey, which revealed that many of the clients chose FX loans as this has been advised by their banks. This means, that borrowers were often motivated by the banks to take FX credit, without thinking over the consequences of potential unfavourable FX movements. Last but not least, there has been mixed evidence for the important factors of exchange rate volatility or remittances, which strengthened the leading role of the banking sector.

The topic of FX lending is particularly interesting in the light of the applied exchange rate policies, which have been discussed in the previous chapter. Kosovo and Montenegro uses euro as a sole legal tender, Bosnia and Herzegovina applies a euro-based currency board regime, FYR Macedonia has a de facto peg against the euro, Croatia uses a tightly managed floating FX policy, while Albania and Serbia apply independent or managed floating regimes against the euro. This implies that in cases of euro-based or indexed credits, FX risk is particularly relevant in Serbia and Albania, while in Croatia the volatility is somewhat more modest. As for Bosnia and Herzegovina, the currency board leads to stability in this respect, while in FYR Macedonia the volatility is negligible. Chart 19 and Table 9 demonstrate the volatility of exchange rates in the reviewed period. It is clear, that it was Serbia which recorded major FX movements even before the global crisis. However, in all countries in cases of major economic shocks, there is a particular risk of FX adjustments, which might indicate even a shift of the applied exchange rate policies.

Chart 19: FX volatility (percentage change, based on daily data, 01.01.2005 = 100%)



Note: ALL – Albanian Lek, BAM – Bosnian Mark, HRK – Croatian Kuna, MKD – Macedonian Denar, RSD – Serbian Dinar

Source: Respective central banks' statistics, Reuters

Table 9: Standard deviation of the local currencies against the euro (2005-2007, based on daily data)

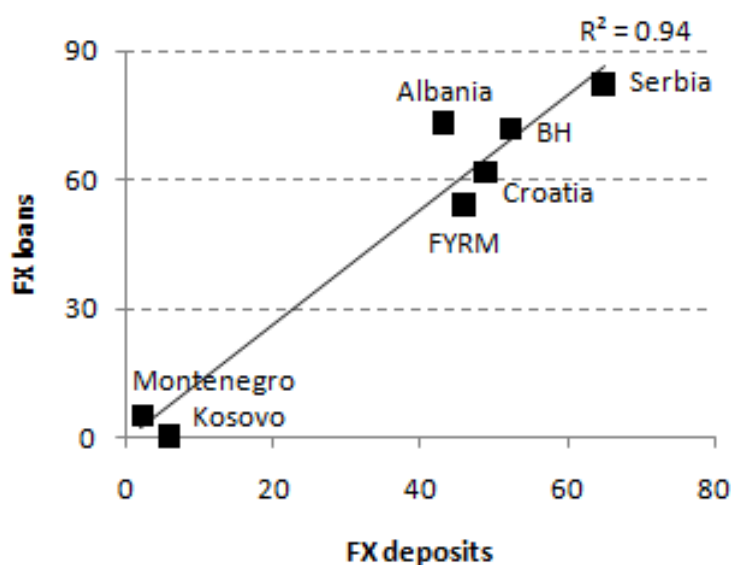
Currency	Standard deviation
EUR/ALL	1.583
EUR/BAM	0.000
EUR/HRK	0.064
EUR/MKD	0.086
EUR/RSD	3.073

Source: Respective central banks' statistics, Reuters, own calculations



Chart 20 provides an overview of the ratio of the FX denominated and indexed loans compared to the total volumes. It is clear, that in Montenegro and Kosovo – due to the euroisation – the amount of FX lending and deposits were almost negligible. In all other cases, the percentage of FX loans and deposits were high. It has already been discussed, that on the deposit side the economic history explains this characteristic, while on the loan side there were both demand and supply reasons for the phenomenon. The chart also shows that there was a strong correlation between the two variables. This proves that the FX risk in SEE could be considered smaller in comparison to the CEE countries, where the ratio of FX deposits was much lower [Backé – Walko, 2006]. Nonetheless, the individual and systemic FX risk was still relevant also in the region of SEE, as usually the savings of the borrowers did not cover the amount of loans. This was true both on the micro and the macro level. Furthermore, the great maturity mismatch added to the risks.

Chart 20: Volume of FX denominated and indexed loans as a percentage of total loans (% , 2007) and volume of FX denominated and indexed deposits as a percentage of total deposits (% , 2007)

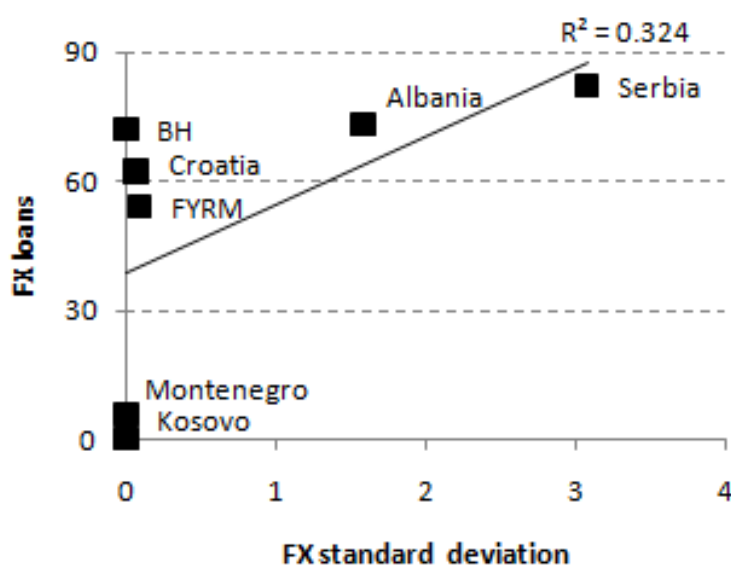


Source: Respective central banks

It is worth underlying, that there was no strong connection between the applied exchange rate regimes and the ratio of FX loans. Chart 21 shows that the correlation

between the ratio of FX loans and the standard deviation of the local currencies against the euro was very weak. However, the chart also shows that FX lending was rather typical in those countries where the local currency was more volatile. For instance, Serbia recorded the highest FX credit ratio, while the Serbian Dinar was the region's most volatile currency. From the clientele's point of view, a rational explanation would be the expectation of appreciating domestic currencies, while on the deposit side the amount of FX savings could provide a hedge against potential depreciation. Nevertheless, this is just a potential theoretical explanation, which does not cover the reality. FX lending rather strengthened the risk factors.

Chart 21: Volume of FX denominated and indexed loans as a percentage of total loans (% , 2007) and standard deviation of the local currencies against the euro (2005-2007, based on daily data)

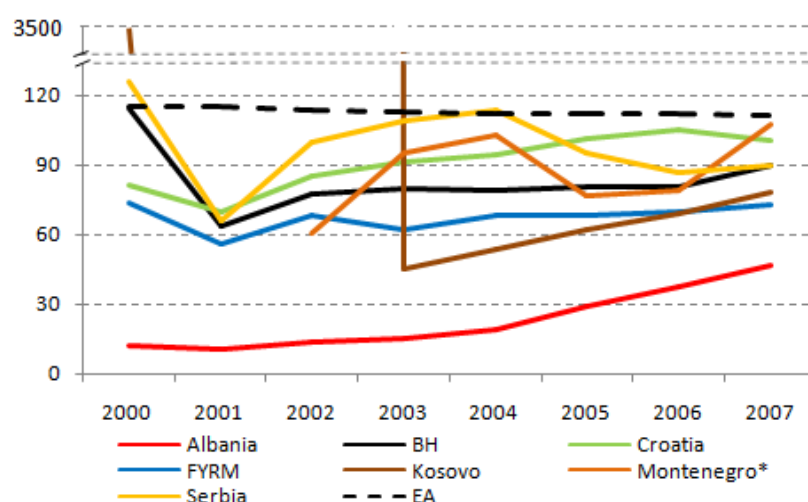


Source: Respective central banks' statistics, Reuters, own calculations

Some of the former charts showed that a very strong volume growth has been recorded regarding both deposits and credits. The important question in this respect is, whether the amount of deposits was able to cover the volume of the credit portfolio. In Chart 22 the loan-to-deposit ratios show a significant upward trend in all SEE cases. The initial extreme values for Kosovo are due to the low base, while in case of Serbia and Bosnia and Herzegovina the ratios increased after the

consolidation. Chart 22 also shows that by the end of the reviewed period, the loan-to-deposit ratios in SEE were still below the EA average, but they gradually converged to the latter. However, despite the upward trend, by the end of the “catching-up period” the loan-to-deposit ratios – with the exception of Croatia and Montenegro – still didn’t reach 100%. This proves that generally speaking the deposit growth was able to cover the rapid pace of credit expansion, implying a milder systemic risk factor. Backé – Walko (2006) compared the regional characteristics of SEE and CEE, and came to the conclusion that due to the brisk deposit growth in case of SEE, the growth of the loan portfolio required less foreign funding as in case of CEE.

Chart 22: Loan-to-deposit ratio (% , 2007)



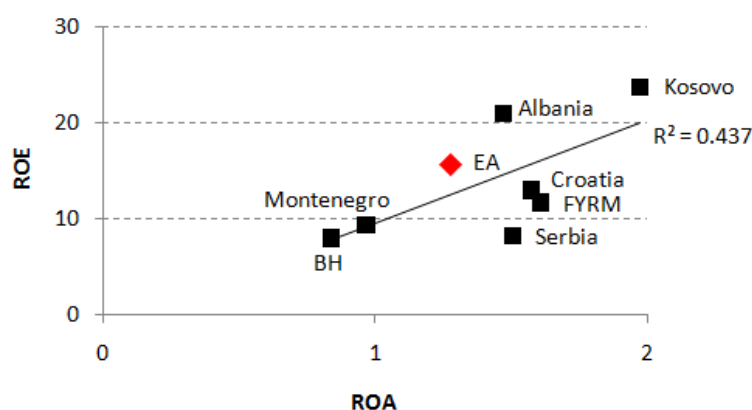
\* Data for Montenegro are available from 2002.

Source: Respective central banks’ statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

Turning to the banking sector’s prudential indicators and KPIs, one can see that following the transitional period the sector’s capitalisation became solid, the profitability reached fair rates and the NPL ratios decreased to decent levels in the region [European Commission, 2009]. These imply that during the reviewed period the sector gradually stabilised and became part of the banking groups’ profit pool. These developments evolved parallel with the process of financial deepening.

Starting with profitability, it can be stated that the relevant KPIs reached the positive zone following the banking sector's restructuring, but could be considered volatile.<sup>69</sup> Nonetheless, the indicators gradually converged to a common zone, meaning that from 2005 the ROA, for instance, increased over 0.5% in all cases (for an overview, see Chart 23). Following the large costs of transition, the market environment missed large shocks, and the expanding credit portfolio combined with high interest margins resulted in reasonable incomes. However, SEE's average profitability indicators were not able to exceed the average CEE level [Backé – Walko, 2006], and some of the countries were not able to perform higher profitability than the EA (see Chart 23). Furthermore, the degree of profitability showed great differences within the region. All these facts were partly due to the development lag – compared to CEE, but also compared to each other within the region – which has been stressed during the discussion of the transition period. This lag indicated lower efficiency causing higher operating costs. Generally speaking, these costs eroded the higher levels of interest incomes, which were typical in the region [Backé – Walko, 2006].

Chart 23: ROA (% , 2005-2007, average) and ROE (% , 2005-2007, average)



Source: IMF: *Financial Soundness Indicators*, Central Bank of the Republic of Kosovo, ECB: *SDW*

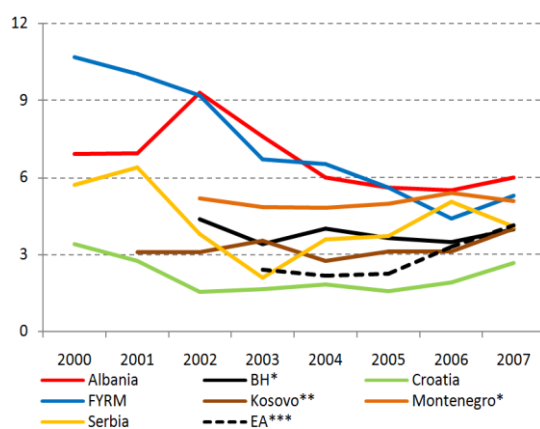
Chart 24 and Chart 25 show the interest rates for deposits and loans, while Chart 26 and Chart 27 covers the real interest rates respectively. These charts serve one purpose, namely to demonstrate the trend of these interest rates. It is clear, that in all

<sup>69</sup> For relevant time series, please see the Financial Stability Reports of the respective central banks.

cases the rates converged and decreased to the same zones. Unfortunately, the exact numbers cannot be compared, as the maturities and occasionally even the respective currencies differ. So any further conclusion regarding the exact numbers would lead to false conclusions. Furthermore, in certain countries negative real deposit interest rates are illustrated. In case of e.g. Croatia, these refer merely to the kuna deposits, but not for the FX indexed or FX interest rates, which were more widespread and offered fair interests. So while bearing in mind all these weaknesses of the charts, the decreasing tendencies and the convergence to a common zone should be highlighted.

Also due to the charts mentioned weaknesses, an appropriate spread indicator cannot be calculated from the data. Nevertheless, two important conclusions can be drawn; namely there has been a clear decreasing tendency of the interest spreads during the analysed period, and secondly, this spread has remained well over the EA levels. The downward trend of the interests and the spread itself could be attributed to the stabilising environment and the fierce competition. The second conclusion is well illustrated by Chart 28. Although this chart shows the NIM instead of the spread, the former can be drawn from the latter. The chart reflects the connection between the NIM and the degree of financial intermediation, which is represented by the total assets per GDP ratio. The data on NIM are not available for Kosovo for this period, but based on the high level of spread, Kosovo would undoubtedly fit in to the negative correlation illustrated by the chart. So it can be stated, that the more developed the financial system is, the lower is the NIM. Noteworthy, that due to the strong correlation between the GDP per capita and the total assets per GDP, this also means that there is a tendency for countries with higher GDP per capita to have lower NIMs and the other way around.

Chart 24: Deposit interest rate (1 year, in per cent per annum, end-year)



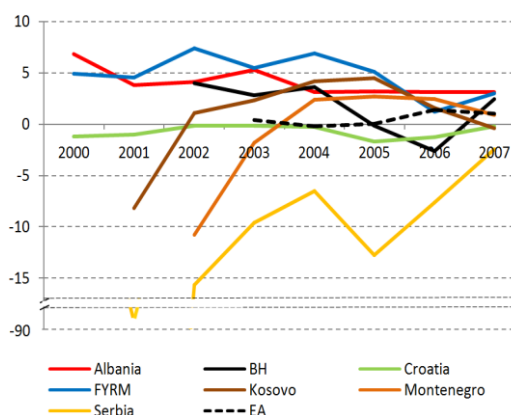
\* Available from 2002.

\*\* Available from 2001.

\*\*\* Available from 2003, over 1 and up to 2 years maturity, for households and non-profit institutions serving households

Source: EBRD statistics, ECB: SDW

Chart 25: Real deposit interest rate (1 year, in per cent per annum, end-year)



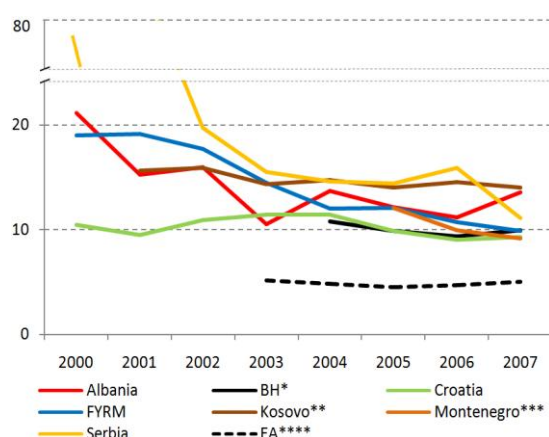
\* Available from 2002.

\*\* Available from 2001.

\*\*\* Available from 2003, over 1 and up to 2 years maturity, for households and non-profit institutions serving households

Source: EBRD statistics, ECB: SDW, own calculations

Chart 26: Lending interest rates (different maturities, in per cent per annum, end-year)



\* Available from 2004.

\*\* Available from 2001.

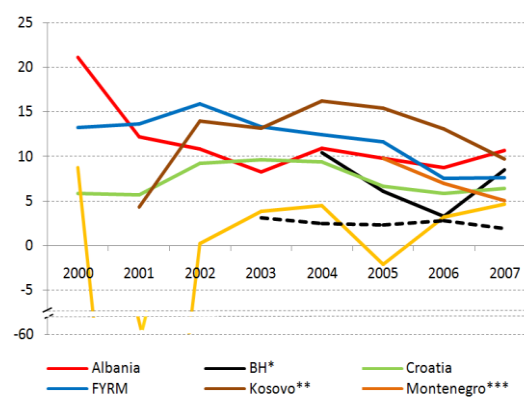
\*\*\* Available from 2005.

\*\*\*\* Available from 2003, lending for house purchase, over 1 year maturity, households and non-profit institutions serving households

Note: Comparing the exact values is misleading, as the country data illustrate different maturities.

Source: EBRD statistics, ECB: SDW

Chart 27: Real lending interest rates (different maturities, in per cent per annum, end-year)



\* Available from 2004.

\*\* Available from 2001.

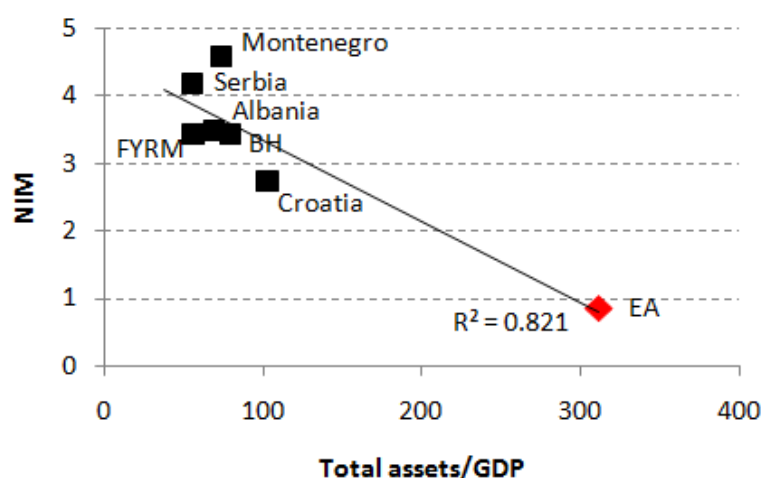
\*\*\* Available from 2005.

\*\*\*\* Available from 2003, lending for house purchase, over 1 year maturity, households and non-profit institutions serving households

Note: Comparing the exact values is misleading, as the country data illustrate different maturities.

Source: EBRD statistics, ECB: SDW, own calculations

Chart 28: Net interest margin (net interest revenue to total assets, %, 2005-2007, average) and total assets in per cent of GDP (% , 2005-2007, average)



Note: Data on NIM for Kosovo are not available.

Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

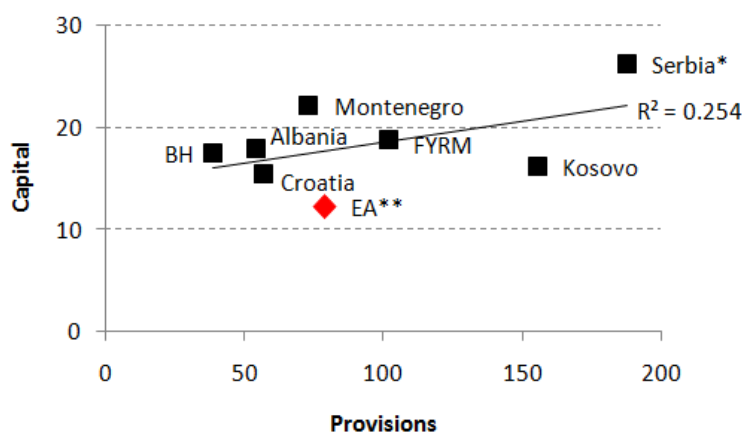
Turning to the quality of the balance sheets of the banking sector, certain features of the capitalisation, provisioning and NPLs are demonstrated. Starting with the capitalisation, it reached stable levels in all countries and was well over the Basel benchmarks, exceeding also the CEE data. It goes without saying that the capital adequacy ratios fluctuated, but in two cases – Montenegro and FYR Macedonia – it even decreased due to the rapid credit growth. Although the exact numbers should be judged with special caution, as methodologies differ across countries, the mentioned conclusions still stand [European Commission, 2009; Backé – Walko, 2006]. Chart 29 proves, that the banks have built significant capital buffers, while the capitalisation itself could be considered higher compared to the EA.

In most cases, the development lag of the region initially caused weaker asset quality, which directly led to higher provisioning needs, occasionally deteriorating the sector's profitability [Backé – Walko, 2006]. According to Sorsa et al (2007), the fact that FX credits were often provided to unhedged borrowers was usually still poorly reflected by the banks' provisioning policy. Proving these statements, Chart 29 demonstrates the great differences regarding the provisions in per cent of NPLs within SEE, and reflecting that in many countries the ratios were significantly lower



compared to the EA. These imply, that in case of a crisis, provisioning would lead to significant burden on banks' profits.

Chart 29: Bank provisions in per cent of NPLs (% , 2005-2007, average) and bank regulatory capital in per cent of risk-weighted assets (% , 2005-2007, average)



\* In case of provisions, the data are available only from 2008, thus the value for 2008 has been included here.

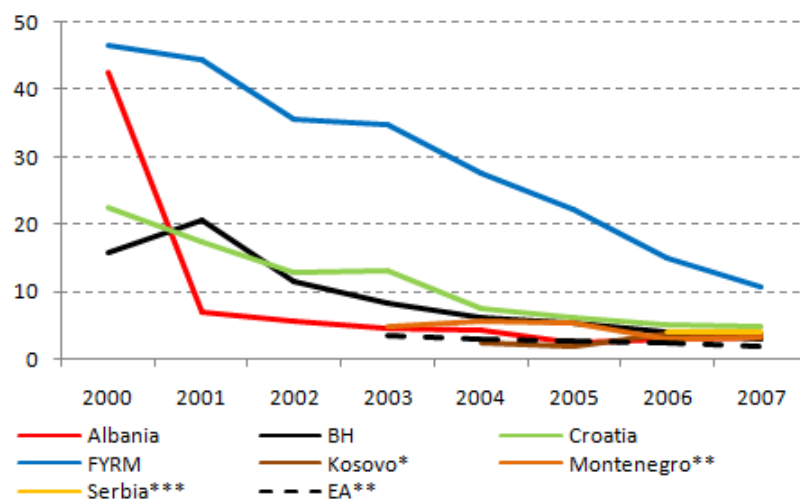
\*\* Changing composition, non-weighted average. In case of provisions, the data for Finland, France, Luxembourg are missing, while in case of the Netherlands the data for 2007 is not available.

Source: IMF: *Financial Soundness Indicators*, Central Bank of the Republic of Kosovo

The problem of the development lag was particularly true for the case of NPL ratios. Nevertheless, it clearly continued to decrease in the region, but showed great differences among the reviewed countries. The development was due to the increasing assets, and somewhat improving credit assessment policies leading to better asset qualities. By the end of the reviewed period, FYR Macedonia recorded the highest NPL ratios, but with a continuously decreasing trend. Occasional increases – e.g. in case of Serbia – were particularly caused by tightening the relevant classification rules or the cleaning of banks' balance sheets [European Commission, 2009; Backé – Walko, 2006]. Data for the NMS are not provided here, but according to Backé – Walko (2006), some countries exceeded the CEE average, while others were able to reach even lower levels. Chart 30 reflects the decreasing

tendency of NPLs and the convergence to the zone below 5% in the region. However, the comparison of the exact numbers must be done with particular caution due to the great methodological differences. Furthermore, it is well known that NPL ratios can be considered as lagging indicators, as they tend to be biased downward during credit booms, but increase only with a certain lag as general economic conditions deteriorate [Backé – Walko, 2006]. All in all, between 2000 and 2007, the burden of NPL ratios represented a decreasing burden for the banking sector in the region of SEE.

Chart 30: NPL ratios (share of total non-performing loans of banks in total loans, %)



\* Available from 2004.

\*\* Available from 2003.

\*\*\* Available from 2006.

*Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a*

From the aspect of systemic risks, mentioning the relevant activity of the supervisory and regulatory authorities cannot be omitted. In order to mitigate the pace and to manipulate the composition of the credit expansion, the institutions employed various regulatory and prudential measures. These included the implementation of higher reserve requirements or certain administrative measures as introducing credit

ceilings for instance<sup>70</sup> [European Commission, 2009]. The central banks' interest rate policies could be employed only in a limited number of countries, where the exchange rate policy was less constrained [Backé – Walko, 2006]. This also means that the authorities were often not able to use traditional monetary policy instruments. The case of Croatia should be mentioned for its broad spectrum of measures. During the observed period the Croatian National Bank fought against the overall and the FX credit growth in a very active form.<sup>71</sup> Although the measures seemed to have only temporary effects, the credit expansion in Croatia could be considered somewhat modest compared to other SEE countries.

It is worth emphasising, that it is difficult to judge and quantify the effect of the implemented monetary measures, for two main reasons. Firstly, the measures rather had temporary results, as it was a matter of time for the banking sector to find the loopholes, limiting the effect. Second of all, cross-border borrowing or direct flows from abroad to the non-banking – particularly corporate – sector strengthened as a result of the restrictions, thus adding to the overall macroeconomic risk factors [European Commission, 2009]. These generate a shift in financing to other segments of the economy, which also transmits the related risks. All in all, the pace of credit growth reflects that in most countries the regulatory authorities did not act to mitigate the tendency, or their measures were able to curb the overall or FX loan growth only temporarily.

#### 4.2. Macroeconomic relations

Turning to the broader macroeconomic environment of the banking sector, following the transitional recession and post-war recoveries, SEE started its gradual convergence to the EU region, as its real GDP growth rates outperformed the EU average, but the gap between the regions still remained large (see Chart 31 and Chart 32). Related to this catching-up process, a range of literature analyses the drivers of

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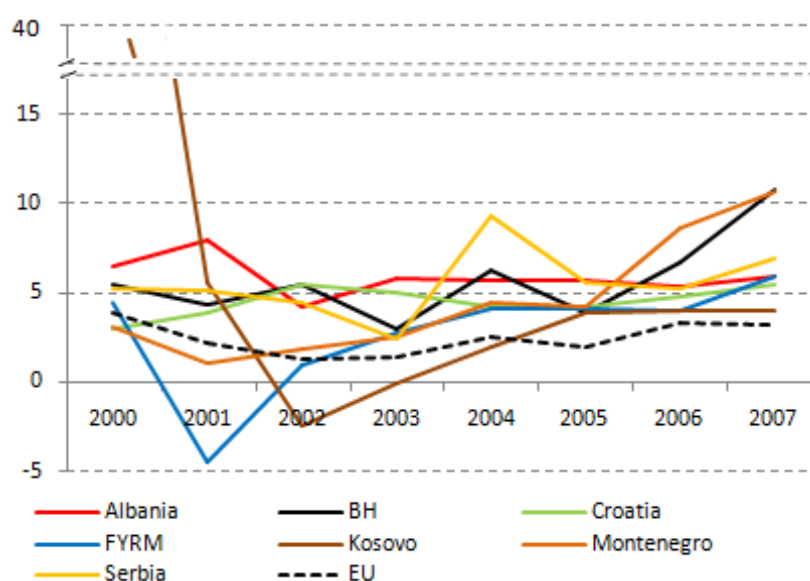
<sup>70</sup> For detailed information on the implemented measures, see the respective central banks' homepage.

<sup>71</sup> For a good overview on the implemented measures during the “catching-up period”, see ECB (2008).

economic growth in SEE, some focusing also on the effect of financial development. As shown by Vamvakidis (2008) or Borys et al (2008), the main driver of the real convergence was the growth of total factor productivity. Capital deepening also had a significant impact, while labour merely had a marginal effect on economic growth. Furthermore, Borys et al (2008) show that the development level of the institutional system, including financial intermediation, had an indirect but notable growth-enhancing impact. They reveal that in case of countries that have a more developed financial sector, there is a stronger link between growth and credit.

EBRD's (2006a) analysis also concludes that financial market development can significantly increase economic growth and enhance the catching-up process, but they reveal that this is particularly relevant in less advanced transition states. They focus primarily on the channel of reaching external finance by the corporate sector. The work shows that bank loans bolster firms' performance, especially in cases of older and larger corporations, which are able to use these resources more efficiently. However, the report reflects that bank loans generally play only a limited role in enterprise financing in the transition region. Borrowing from abroad or cross-border loans can ease the financial constraints only for a narrow group of large firms. Haiss and Kichler (2009) also find a positive link between finance – more specifically credit growth and leasing activity – and economic growth. Nevertheless, this link seems to be stronger in case of CEE, compared to SEE, because the first years of their reviewed time period were still affected by shocks in the latter region. This again reflects the development lag between the two regions.

Chart 31: Real GDP growth rates (% , 2000-2007)



Source: EBRD statistics, Eurostat

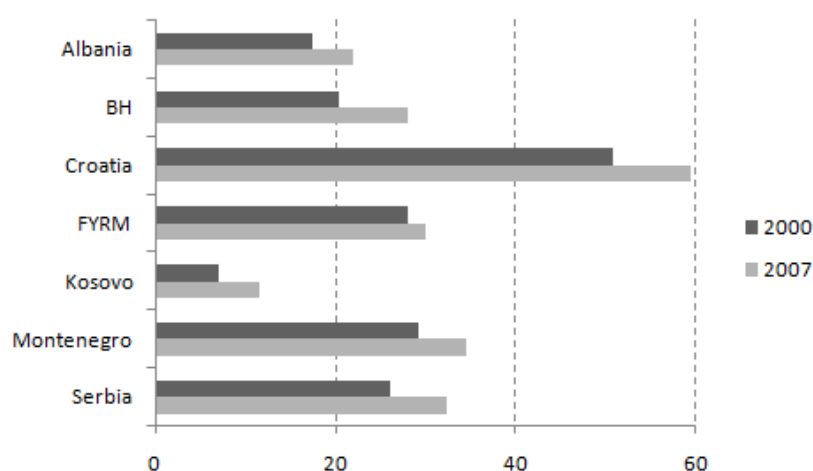
Chart 31 demonstrates that SEE's real GDP growth rate was well over the EU's average, though starting from a much lower base as reflected by Chart 32. During the reviewed time period, both external and internal conditions have usually been favourable for SEE countries. High international commodity prices underpinned the export of raw materials and base products, while countries like Croatia or Montenegro could also expand on the back of real estate boom and tourism. Chart 31 shows, that there were only two cases when the GDP growth reached the negative zone. One was FYRM in the year of civil war, which was then followed by solid growth rates, though below the SEE average. The other one was the unique case of Kosovo, which started the 2000s with very high growth rate as a consequence of the rebuilding process and aid inflows. However, in the upcoming years Kosovo was still not able to create its self-sustaining economy and remained aid dependent with an artificial economic structure [EBRD, Transition report, various years].

Based on the indicator of GDP per capita<sup>72</sup> compared to the EU average, Chart 32 reflects a certain kind of catching-up of the SEE countries with the EU region. It demonstrates, that Croatia could be concerned as the most developed country in this

<sup>72</sup> There are notable methodological differences for calculating GDP per capita (see, for instance, Borys et al, 2008). In this chapter, the IMF's and the EBRD's statistics are primarily used.

respect, while Kosovo and Albania remained the poorest regions of Europe. Both Kosovo and Serbia have shown fair pace in this catching-up process, but this has been less appealing when considering the fact that the starting date was just after the Kosovo conflict and the fall of the Milošević regime. This means that the base could be considered low.

Chart 32: GDP per capita (% , based on purchasing-power-parity, EU = 100%)



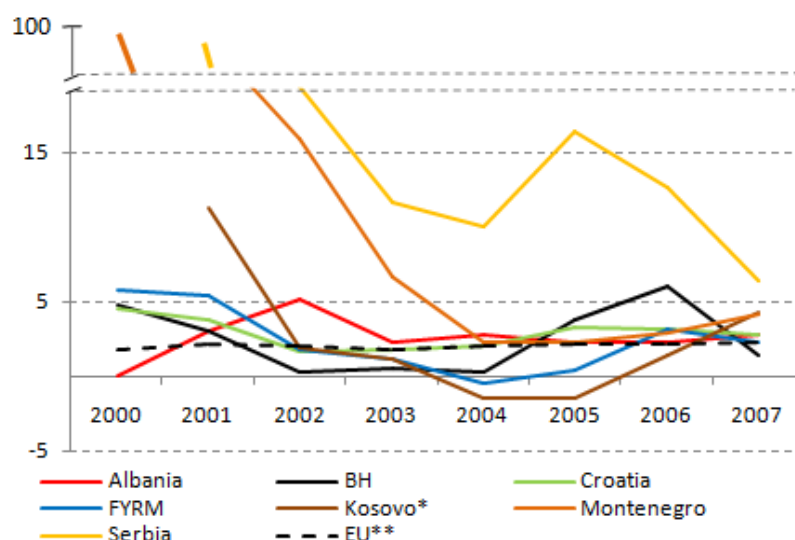
Source: IMF World Economic Outlook Database, Eurostat, EBRD statistics, own calculations

Inflation can be considered a crucial indicator for the banking sector, as it can be a base for the pricing policy and it reflects the stability of the particular economy. With the exemption of Serbia, inflation could be considered fair in the region from 2003. This holds for all countries, disregarding the applied exchange rate policies or the high international commodity prices. Due to the military conflict, Serbia recorded extreme levels of inflation; 70.0% in 2000 and 91.8% the next year [EBRD statistics]. Throughout the reviewed time period, Serbia's central bank had to fight against soaring inflation rates. It was only in 2007, when the rate could be curbed to the single-digit category, which is when the principles of the quasi-inflation targeting regime have started to be implemented [National Bank of Serbia]. Montenegro started the 2000s with similar inflation rates as Serbia – 97.1% in 2000 [EBRD statistics] – but was able to curtail price growth more efficiently. The malfunctioning economy in Kosovo has also been reflected by the prices, as even deflation has been

recorded in certain years. Inflation in Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia could be considered quit low, though a bit volatile in the latter case [EBRD, Transition report, various years]. Worth mentioning, that in Bosnia and Herzegovina a single spike in the inflation was caused by the one-off effect of the introduction of the value-added tax. Otherwise, the applied currency board regime was able to keep price growth low [Central Bank of Bosnia and Herzegovina].

To sum up, with the exception of Serbia, inflation was not considered as a major risk factor for the banking sector in SEE. Nonetheless, there has been certain inflationary pressure in some countries. This was the result of overheating risks, the accelerating growth of monetary aggregates and high global commodity prices. When reviewing the data for core inflation, one can state that the upward price pressure was less significant, but still incorporated the effect of high domestic demand.<sup>73</sup> Last but not least, compared to the EU, prices could be considered more volatile (see Chart 33).

Chart 33: Consumer prices (annual average, percentage change)



\* The related time series for Kosovo start in 2001.

\*\* HICP (Harmonised Index of Consumer Prices)

Source: EBRD statistics, Central Bank of Bosnia and Herzegovina, Central Bank of the Republic of Kosovo, ECB: SDW

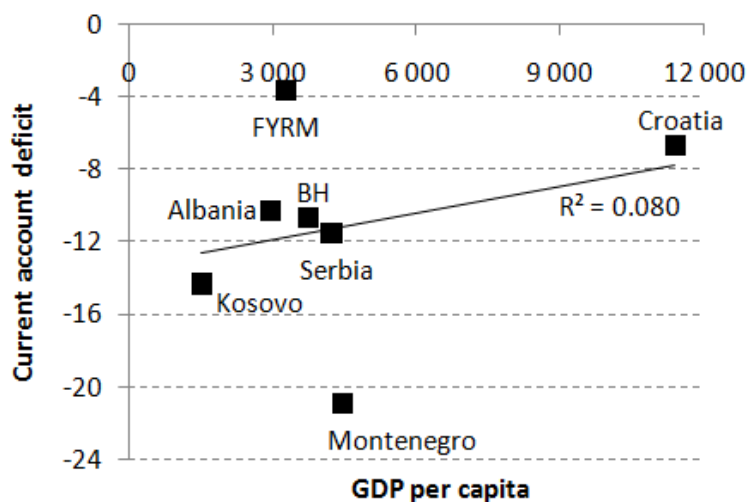
<sup>73</sup> For statistics on core inflation and the expansion of broad money, see the respective central banks' statistics.

Turning to the balance of payments, external imbalances – particularly trade deficits – widened and reached high levels in the region. Imports increased as a result of the heated domestic demand, which was boosted by the discussed credit and wage growth. Noteworthy, that as already mentioned, the domestic sector's indebtedness increased not only via local banks, but also by the direct loans from abroad or intercompany credits [Sorsa et al, 2007]. In addition, during the discussed period the spikes in commodity prices – especially food and energy prices – added to the growth of import amounts. These tendencies led to high levels of current account deficits and external debt, generating one of the primary macroeconomic risk factors of the region. On the other hand, these deficits were also considered as a natural outcome of the living standards' convergence [Martin – Zauchinger, 2009; European Commission, 2009].

According to the literature, in Europe a country's income has a negative correlation with the amount of its current account deficit. Financial integration leads to the possibility for poorer countries to borrow from abroad, while richer countries tend to lend abroad. Moreover, the literature also states that larger current account deficits increase economic growth – particularly in poorer countries – meaning that this external imbalance contributes to the convergence process [Haan et al, 2009]. When checking the correlation between current account deficit and GDP per capita, the link seems to be very weak in case of transition countries (see Chart 35). This can be explained by the great heterogeneity, and by the outlier group of the natural resource exporter countries of the CIS region. Nevertheless, when turning to SEE within the group of transition countries, the correlation becomes somewhat stronger, though still insignificant (see Chart 34). When omitting the two outliers, FYR Macedonia and Montenegro – the former for its low, the latter for its extremely high current account deficit –  $R^2$  increases to 0.815. However, the size of the sample becomes too low. The bottom line is, that generally speaking, in a simplified form, “richer” countries tend to have lower, while “poorer” countries have larger current account deficit levels. The logic of the mentioned literature only partly holds for the region of SEE. Nevertheless, larger current account deficits might be considered as an outcome of the catching-up process.

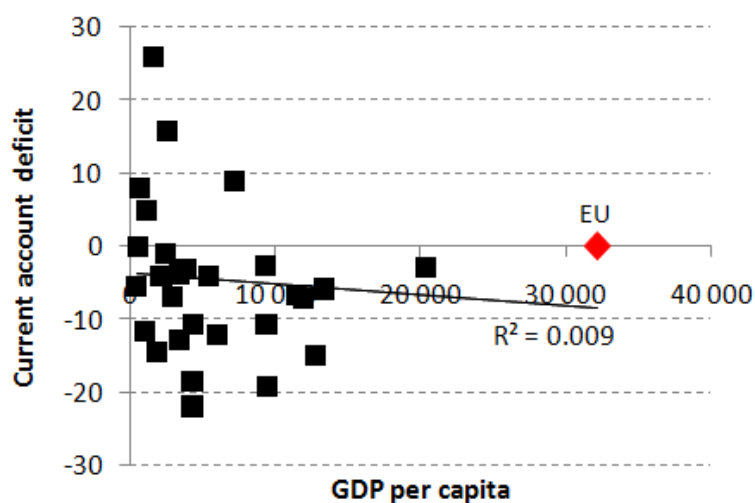


Chart 34: Current account deficit in per cent of GDP (% , 2005-2007, average) and GDP per capita (in USD, 2005-2007, average) in SEE



Source: EBRD statistics

Chart 35: Current account deficit in per cent of GDP (% , 2005-2007, average) and GDP per capita (in USD, 2005-2007, average) in transition countries<sup>74</sup>

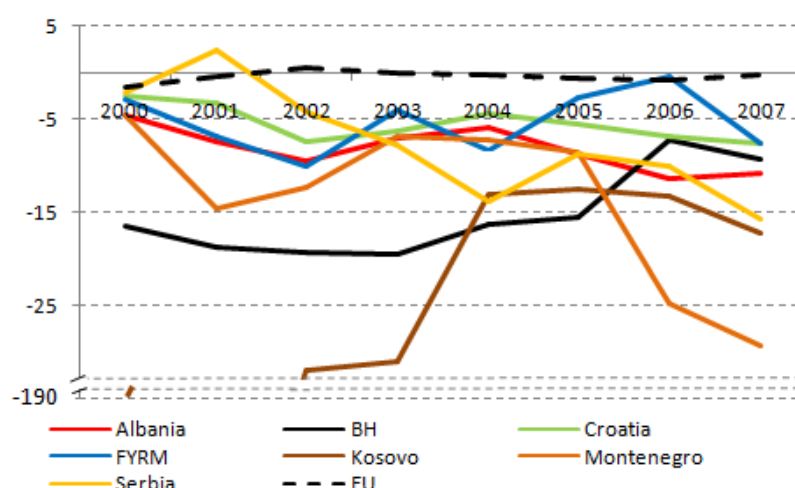


Source: EBRD statistics, ECB: SDW

<sup>74</sup> The group of transition countries includes the following states: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

When reviewing the exact levels of the current account deficit per GDP ratios, certain fluctuation can be noted and the tendencies somewhat vary (see Chart 36). The common feature is that the level of the deficits can be considered high, well exceeding the EU levels and typically reaching the double-digit territory. One of the most extreme examples is Montenegro, where current account deficit per GDP increased sharply from 2006, reaching almost 30% by the next year [EBRD statistics]. As a unique case, Kosovo started the 2000s with immense deficit levels, due to the aftermath of the military conflict. The deficit reached 189% compared to the GDP in 2000 [EBRD statistics]. In the next years, the deficit continued to be very high as a result of the weak export sector. Also due to the Kosovo conflict and the embargo, Serbia started with a surplus, which gradually increased to double-digit levels. Likewise Serbia, Albania also recorded a gradually increasing tendency of current account deficit. FYR Macedonia's deficit level rather fluctuated without too extreme levels. In case of Bosnia and Herzegovina, current account deficit was among the primary macroeconomic problems, reflecting the weaknesses of the economy. Though the deficit levels decreased in Bosnia and Herzegovina, the ratios remained among the highest in the region. Croatia can be considered as an exception, in the aspect that it was the only country within SEE, where the current account deficit per GDP ratio didn't reach the double-digit territory while it fluctuated. All in all, it was rather the increasing tendency of current account deficits that dominated the region of SEE, causing one of the most typical macroeconomic vulnerabilities of the region [EBRD statistics].

Chart 36: Current account in per cent of GDP (% , 2000-2007)



Source: EBRD statistics, ECB: Statistics Pocket Book, Eurostat

Typically FDI and remittances were able to finance trade deficits in SEE. FDI is considered to be a more stable form of trade deficit financing, compared to e.g. short-term portfolio investments [Martin – Zauchinger, 2009]. On the other hand, although FDI inflows were able to finance a significant share – or occasionally the complete – trade deficit, a part of these inflows incorporated also intercompany loans increasing private debt levels [Sorsa et al, 2007]. Furthermore, despite the improvement, both FDI and foreign loans remained biased towards consumption and the non-tradable sector, thus having less effect on the productivity or the export base [European Commission, 2009]. Generally speaking, FDI inflow remained very volatile during the years, depending on large-scale privatisation projects or individual inflows<sup>75</sup> [Martin – Zauchinger, 2009].

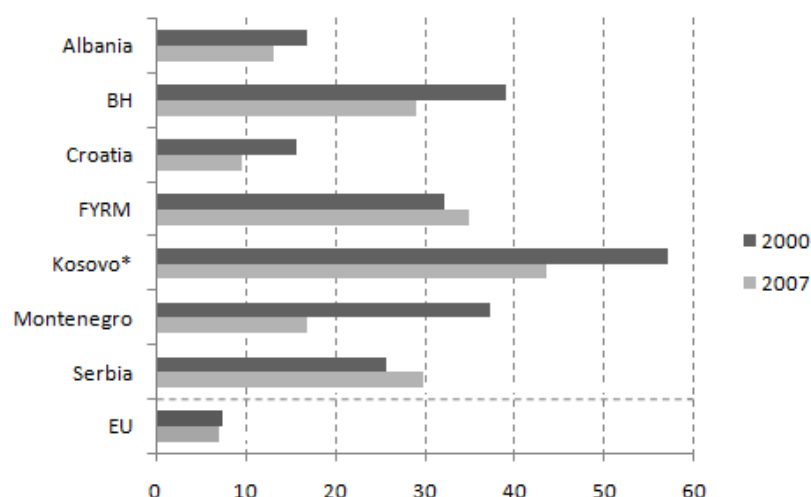
As for the remittances, it is difficult to gauge its exact amount due to the informal channels, but it is undoubtedly among the most important external sources in the region. For instance, in 2005 in Bosnia and Herzegovina, Serbia and Montenegro and Albania its inflow exceeded 10% of the annual GDP, and reached 22.1%, 17.3% and 13.5% respectively [EBRD, 2006a, p. 3]. In these cases its inflow amounted to higher numbers than the net FDI, and it even proved to be more stable in the pre-crisis period. The inflow even exceeded the amount of export revenues in case of

<sup>75</sup> For related statistics, see e.g. the EBRD's relevant Transition reports.

Albania and Bosnia and Herzegovina and was around its level in Serbia and Montenegro. Remittances were primarily used for consumption, thus boosting the trade deficits, but it was secondarily also used for financing investment and enterprise creation, or helped to increase the amount of bank loans. The latter is particularly true for micro-enterprises which tend to face the biggest difficulties in accessing bank loans [EBRD, 2006a]. The EBRD mentions an indirect advantage as well, namely as the migration and the related flow of remittances contribute to lower unemployment levels, it may support a more rapid transition process for policy makers.

Related to the macroeconomic characteristics, a further weakness must be mentioned; namely the high level of unemployment rates in SEE, which well exceeded the EU's average (see Chart 37). Unemployment ratios are important indicators also for the banking sector, as usually there is a positive correlation between the change of unemployment and NPL ratios, though with a certain lag. But generally speaking, it is among the important indicators which demonstrate the condition of the specific economy. Regarding the particular unemployment rates, all countries had figures massively in the double-digit territory. The only exception was Croatia, which decreased its unemployment rate slightly below 10%, but only in 2007. However, some countries – Albania, Croatia and Montenegro – were able to gradually temper unemployment. In case of Bosnia and Herzegovina, the rate rather fluctuated, and the development was merely caused by a change of the applied methodology. Regarding FYR Macedonia, a similar fluctuation could be observed without significant development. Also the two latecomers of transition – Kosovo and Serbia – were not able to record a decreasing tendency, so the unemployment rate rather fluctuated. In Kosovo, also this extremely high level of unemployment represented a malfunctioning economy. When analysing the unemployment rates of SEE, one must underline that typically there was a large segment of grey and black economy, which somewhat mitigated the problem. Nevertheless, unemployment could be considered high in SEE, reflecting certain structural weaknesses of the economies [EBRD statistics; EBRD, Transition report, various years].

Chart 37: Unemployment in per cent of labour force (%)



\* The time series for Kosovo start in 2001.

Source: EBRD statistics, ECB: Statistics Pocket Book

#### 4.3. The model of the “catching-up period”

Generally speaking, the above mentioned characteristics of the economies led to similar growth models in the observed country cases; GDP growth has been fuelled by strong domestic demand, which has been boosted by rapid credit expansion, particularly household lending. This activity was often financed by the parent banks, having good access to international capital markets. Noteworthy, that during the observed period swift real wage growth<sup>76</sup> also contributed to the strong domestic demand, but it was still the financial sector which had the primary effect. These features also led to spiralling asset price growth and a real estate boom. As for the supply side, it fits well to this pattern, that services and construction accounted for large share of the economic growth. Generally speaking, these characteristics led to overheating risks in many countries [European Commission, 2009].

Chart 38 summarises the main elements and the logic of this growth pattern in a simplified form. So, it has been the foreign funding and the volume growth of deposits which supported credit growth, often meaning FX lending. As SEE

<sup>76</sup> Statistics on wage growth are published in e.g. European Commission (2009).

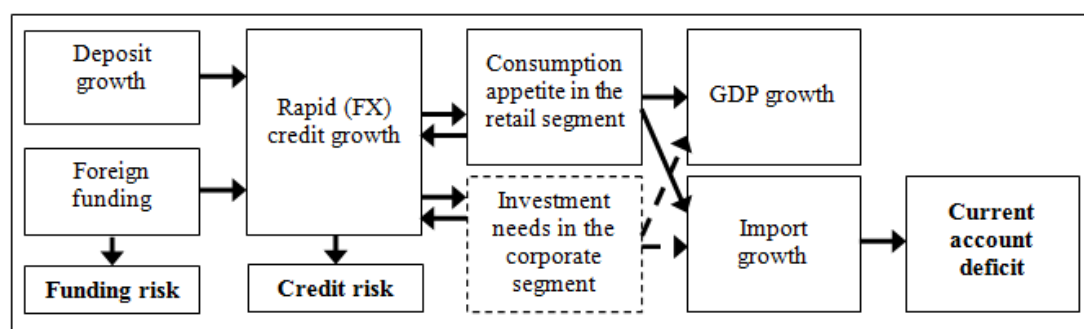
countries have a relatively lower level of disposable income than the propensity to consume, the domestic demand had to be financed by these external sources as well. So the available loan facilities have boosted domestic demand, particularly household consumption. Investments rather had secondary role, thus this category is drawn with broken lines. The arrows pointing back to the credit growth reflect that the connection has been bidirectional, because both households and firms have had their own “appetite” to consume and invest via loans. These phenomena have directly boosted GDP growth from the demand side. This has caused certain development in the catching-up process regarding GDP per capita. As a further side effect of the strong domestic demand, imports exceeded the amount of exports, leading to soaring trade deficits, meaning also large current account deficits. Generally speaking, the modest inflation rates reflect that the fast credit growth did not cause severe inflationary pressure – apart from increasing the real estate and construction prices – but rather led to higher amount of imports.

Regarding the vulnerabilities, many analyses have pointed out that beside the favourable convergence process, the level of external imbalances, credit growth and currency mismatches raised sustainability concerns and the risk of overheating.<sup>77</sup> Giving a summarisation, Sorsa et al (2007) point to three main groups of vulnerabilities; the inflows were generally channelled to the nontradable sector often financing consumption, the high level of leverage and balance sheet mismatches have caused currency and credit risks, and the dependence on a small number of foreign banks could reflect biased risk pricing through their aggressive profit targets and the risk of sudden stops. These vulnerabilities have all been stressed within this chapter. In the chart below, from the macro side the level of external imbalances, while regarding the banking sector the funding and credit risk are stressed, all written with bold letters. Related to the foreign funding, it is interesting to highlight the strong dependence between the parent banks and their subsidiaries. Parent banks’ financial results have been affected by the subsidiaries’ performance, while the latter group has depended on the foreign funding.

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<sup>77</sup> See, for instance Vamvakidis (2008) or Sorsa et al (2007).

Chart 38: A fragile growth pattern



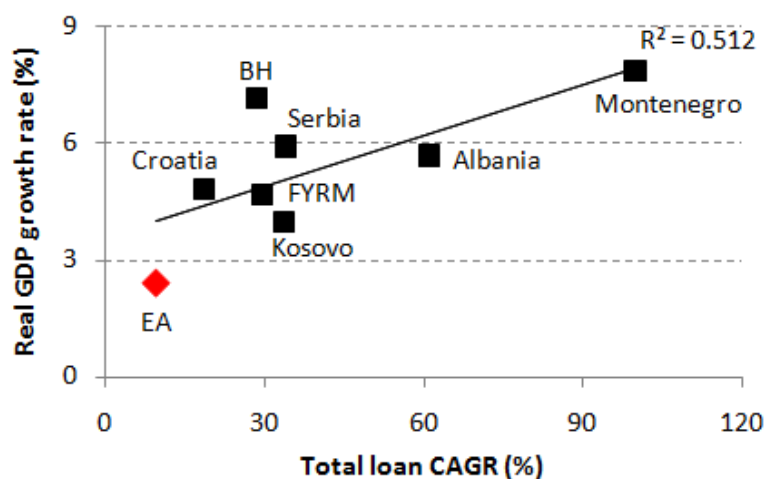
Source: Own compilation

This model is in line with the well-known problem of pro-cyclicality in bank lending. In theory, during economic booms, default rates are lower, leading to lower risk premiums and loan rates. This also means lower capital requirements, which allows the expansion of the crediting activity. This cyclical bias can be underpinned by a psychological effect as well; namely the defaults' subjective probability decreases during economic booms [Haan et al, 2009]. In case of SEE, during the reviewed period, the relation between credit expansion and economic growth was definitely bidirectional. On one hand, banks wanted to increase their profitability in an environment of developing economy, and on a financial market characterised by pressing competition. This boosted credit expansion from the banks' side. From the retail clients' point of view, they tended to finance their consumption needs and real estate purchases by accepting the tempting loan offers, while the corporate segment also tried to gain advantage from the bank financing possibilities, often neglecting potential risks. All in all, the pro-cyclicality in bank lending supports the connection between GDP growth and credit expansion.

Chart 39 illustrates the link between the total loan amount's average annual growth rate and the respective countries' real GDP growth rate. Both indicators are computed by taking the last three years' average. In this case, Bosnia and Herzegovina can be considered as an outlier, as its loan growth was somewhat modest compared to the other cases. The next chart – Chart 40 – compares the loan CAGR with the volumes of the current account balance in per cent of the GDP. Here Kosovo can be pointed out as an outlier, as its unique economy generated massive

trade deficits, while the pace of loan expansion was more modest. In both charts, the number of observations can be considered low, but still the connection between the indicators can be illustrated. Though there is no indication for the causality in these cases, the specific links fit to the logic of the above demonstrated simplified model, where the process of financial deepening, meaning brisk credit growth, strongly contributed to the GDP growth, but also to the widening external imbalances. These links connect the banking sector's development process with the main features of the macroeconomic environment.

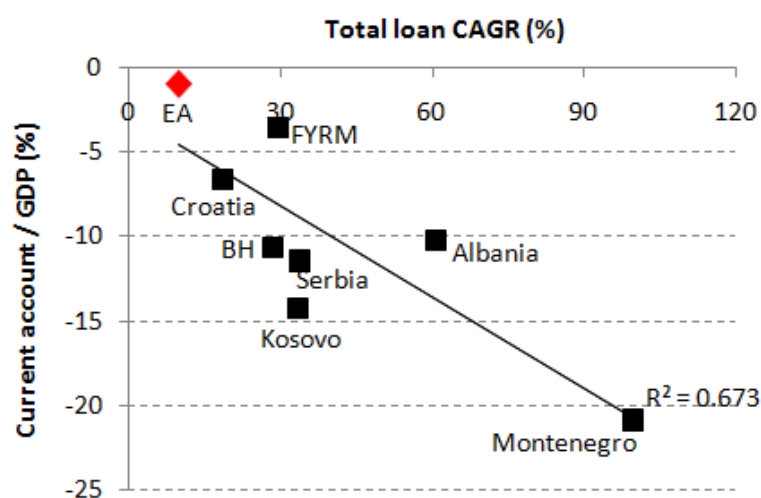
Chart 39: Total loan CAGR (% , 2005-2007, average) and real GDP growth rate (% , 2005-2007, average)



Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations



Chart 40: Total loan CAGR (% , 2005-2007, average) and current account in per cent of GDP (% , 2005-2007, average)



Source: Respective central banks' statistics and Financial Stability Reports, EBRD statistics, EBRD 2006a, own calculations

#### 4.4. Case study – Two European banking groups in SEE

Two large European banking groups have been chosen for a brief case study. Raiffeisen Bank International AG (Raiffeisen) is a fully-consolidated subsidiary of Raiffeisen Zentralbank Österreich AG, which is the central institution of the Austrian Raiffeisen Banking Group [Raiffeisen, 2011]. In 2007, it had subsidiary banks, leasing companies and a range of other financial providers in 16 markets across CEE, SEE and the CIS, and had representative offices in further two countries. By the end of 2007, 58,365 employees in 3,015 outlets served approximately 13.7 million customers [Raiffeisen, 2007, p. 50]. Raiffeisen recorded a very impressive expansion through the mentioned regions during the period of 2000 and 2007. This expansion could be attributed both to the range of foundations and acquisitions, but also to the impressive growth figures in the specific countries. In 2007, the balance sheet total reached EUR 72,743 million [Raiffeisen, 2007, p. 0], while in 2002 for instance, it amounted to EUR 14,381 million [Raiffeisen, 2005, p. 0]. In the same time, the profit before tax was EUR 1,238 million [Raiffeisen, 2007, p. 0] and EUR 569 million respectively [Raiffeisen, 2005, p. 0], also reflecting a remarkable growth.

Turning to the region of SEE, Raiffeisen had subsidiary banks, leasing companies and financial providers in Albania, Bosnia and Herzegovina, Croatia, Kosovo and Serbia.

- It entered the market in Albania via the acquisition of the old state savings bank in 2004. This implies that Raiffeisen had to transform the bank and build the loan portfolio from a low base [Raiffeisen Albania, 2005]. Nevertheless, it remained the largest bank in Albania in terms of total assets [Bankscope]. In 2006, Raiffeisen founded a leasing company as well [Raiffeisen, 2007].
- In Bosnia and Herzegovina, Raiffeisen acquired a partly local bank in 2000 and a further bank the next year. The two institutions merged from 2003. A leasing company and other financial service providers have been founded as part of the Raiffeisen Group [Raiffeisen, 2007]. Throughout the reviewed time period, Raiffeisen remained the largest bank in Bosnia and Herzegovina regarding the amount of total assets [Bankscope].
- Raiffeisen founded its bank in Croatia already in 1994, and by the 2000s it became one of the largest banks in the country. A range of other subsidiaries have also been founded for providing leasing, building society or insurance services [Raiffeisen, 2007].
- Raiffeisen Bank Kosovo was founded as American Bank of Kosovo in 2001. By the end of the next year, Raiffeisen started to acquire the bank. It finalised the acquisition and renamed the bank in 2003, becoming one of the largest banks in Kosovo [Raiffeisen, 2007].
- Following the political changes, Raiffeisen gained licence and started its operation on the Serbian market in 2001. It was the first completely foreign-owned bank in the country [Raiffeisen, 2007]. As a result of the dynamic growth, it became the largest bank in Serbia in terms of total assets between 2004 and 2006 [Bankscope]. Raiffeisen also founded a leasing company and provided investment services via different institutions [Raiffeisen, 2007].

As for the other large banking group, by the integration of major European financial institutions, UniCredit Group (UniCredit) had its roots in three European countries; Austria, Germany and Italy by 2007. The region of SEE has been managed by the so-

called CEE Division within Bank Austria. Nevertheless, UniCredit had subsidiaries and other financial service providers in 23 countries across Europe, and had representative offices in 27 further countries. Regarding its market share, the bank had a leading position in the broad region of CEE, SEE and CIS [UniCredit, 2007]. In 2007, approximately 170,000 employees served around 40 million customers in 9,714 branches [UniCredit, 2007, p. 11]. In the same year, the total assets amounted to EUR 1,021,758 million [UniCredit, 2007, p. 11], while the operating profit reached EUR 13,346 million [UniCredit, 2007, p. 11]. Compared to the data from 2002 – EUR 217,131 million and EUR 4,670 million [UniCredit, 2003, p. 20] respectively – very high growth can be reported. In 2005, UniCredit merged with HypoVereinsbank and Bank Austria Creditanstalt, creating one of the largest European banking groups [UniCredit, 2005]. It should be underlined that HypoVereinsbank is excluded from the review, so the quantitative analysis contains its figures only after the merger of the two banks.

Regarding the region of SEE, UniCredit had subsidiaries in Bosnia and Herzegovina, Croatia and Serbia, and had representative office in FYR Macedonia and Montenegro. The latter two are excluded from further analyses.

- In Bosnia and Herzegovina, UniCredit Zagrebačka banka, Mostar, and HVB Central Profit Bank, Sarajevo merged into a new UniCredit Bank during 2007, following the merger of the two large banking groups in 2005. In the Serbian entity, Nova banjalučka banka – acquired by Bank Austria Creditanstalt in 2005 – continued its operation as part of the UniCredit Group. When adding the figures of the two banks, UniCredit could be considered as the largest bank in Bosnia and Herzegovina [UniCredit, 2007].
- UniCredit acquired one of Croatia's largest saving banks in 2002. Due to the strong brand awareness, the name of Zagrebačka banka has not been changed. The bank was also the co-owner of UniCredit Bank in Mostar, Bosnia and Herzegovina [UniCredit, 2012]. During the observed period it was the largest bank in Croatia regarding the amount of total assets [Bankscope]. On a group level, UniCredit merged with HypoVereinsbank in 2005, which enabled to expand the network of the two groups in Croatia as well. Furthermore, the same year, Zagrebačka banka acquired Dresdner Bank Croatia [UniCredit,

2005]. UniCredit has further financial service providers in Croatia, related to real estate or asset management [UniCredit, 2012].

- UniCredit entered the Serbian market via the merger with HypoVereinsbank in 2005 [UniCredit, 2005].

The list above gave a quick overview of the most important cornerstones. It can be seen, that depending on the market opportunities, both types of market entries – acquisition and foundation – were present, which also imply different strategies. In certain cases, the subsidiaries themselves acquired further financial institutions. In other cases, the parent banks had to manage the merger of a number of local banks. It can be stated, that regardless of the entry type the banks required diverse approaches in each country, due to the different traditions and sizes of the acquired banks. The tradition refers not only to the bank's history and client attitude, but also to the corporate versus retail approach, which has not been indicated within this subchapter. Also related to the traditions, it is interesting to see how the parent banks gradually implemented the group-level branding strategy. Nevertheless, in certain cases – e.g. at Zagrebačka banka – the name of the original bank has not been changed due to the strong brand awareness.

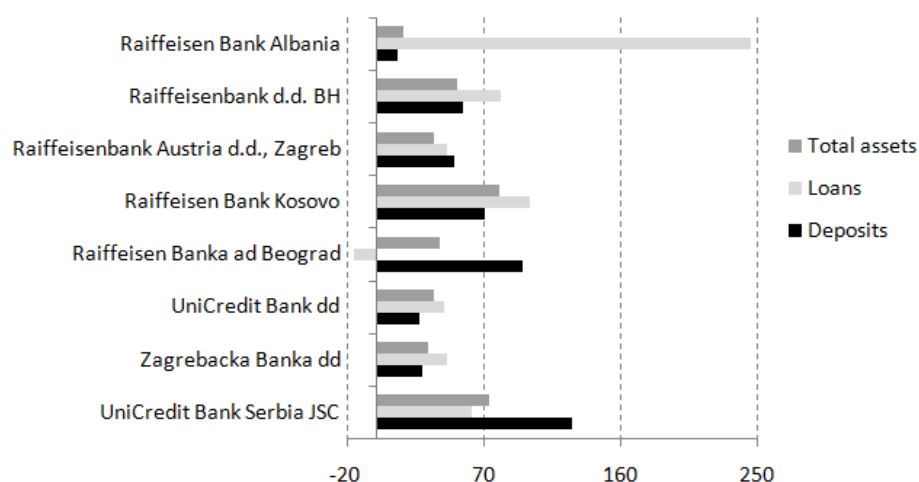
Following the general overview, some of the most important indicators will be illustrated. The booming period between 2005 and 2007 will be included, as it was 2005 when both banking groups entered all the markets in SEE where they are currently present. This implies that the 2004 end-of-period data are omitted in this case. Only the main subsidiaries will be analysed, meaning that those banks which have not been merged or other financial service providers are not included here (see Table 10).

Table 10: Banks included to the case study's analyses

Official name	Country
Raiffeisen Bank Albania	Albania
Raiffeisenbank d.d. Bosnia and Herzegovina	Bosnia and Herzegovina
Raiffeisenbank Austria d.d., Zagreb	Croatia
Raiffeisen Bank Kosovo	Kosovo
Raiffeisen Banka ad Beograd	Serbia
UniCredit Bank dd	Bosnia and Herzegovina
Zagrebačka Banka dd	Croatia
UniCredit Bank Serbia JSC	Serbia

Starting with the amount of total assets, loans and deposits, Chart 41 demonstrates that within two years extraordinary growth figures have been recorded in both banking groups. Apart from certain cases, this growth was irrespective from the market entry dates, and no major difference could be seen between the two banking groups. One exemption is for instance, Raiffeisen Bank Albania, as the extreme growth of its loan portfolio could be explained by the very low base following the acquisition of the old savings bank. The decreasing loan amount in the Serbian subsidiary of Raiffeisen was due to a one-off operation in 2006. It is worth highlighting the almost identical growth figures of Raiffeisen's and UniCredit's loan portfolio in Croatia, which could partly be explained by the regulatory restrictions.

Chart 41: Case study – Total volume growth of bank balance sheet items (% , 2005-2007)



Source: Bankscope

Table 11 and Table 12 illustrate basic indicators of the subsidiaries, underpinning the statements of the current chapter. Very high volume growth has been recorded of equities in all the reviewed banks. This growth could reflect various factors, such as the regulatory requirements or the banks' intention to underpin stability. Nevertheless, these increasing volumes also demonstrated the parent banks' long-term commitment to the subsidiaries in SEE. As the growth of the equity far exceeded the total assets' growth, ROE did not increase – or even dropped – as impressively as the ROA. Still, the latter KPI reflected the fair profitability of the region. These indicators were generally also in line with the local markets' average, as they were the lowest in Bosnia and Herzegovina and among the highest in Kosovo. As far as the NIM is concerned, a clear tendency cannot be pointed out. Even within the same country, as in case of Serbia, the indicators changed differently at Raiffeisen and UniCredit. However, only three years are reviewed here. Still, as it has already been discussed, the “poorer” countries had higher NIMs compared to the more advanced cases.

Also related to the profitability, the changes in the amount of loan loss provisions reflected great differences. As it has been demonstrated by the overall market data, NPL ratios<sup>78</sup> followed a decreasing trend, so it was rather the intention to strengthen stability and to fulfil the regulatory requirements that led to increasing amounts of provisions. In case of Raiffeisen's Albanian subsidiary, the new market entry could also explain the growth of provisions. Regarding the total capital ratios – and in case of Raiffeisen Bank Kosovo the tier 1 ratio – they showed mixed shifts. Even within the same countries the changes of the two banking groups might have differed. Nevertheless, generally these ratios could be considered high.

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<sup>78</sup> NPL ratios are not included here, as the relevant time series are incomplete. The provisioning policy may reflect the changes of the NPL portfolios.

Table 11: Case study indicators I. (2005-2007)

	ROE (%)			ROA (%)			NIM (%)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
<b>Raiffeisen Bank Albania</b>	37.41	41.02	31.73	1.25	1.68	2.06	3.35	4.31	3.98
<b>Raiffeisenbank d.d. BH</b>	15.96	14.99	10.88	1.07	0.99	0.76	4.23	4.26	4.34
<b>Raiffeisenbank Austria d.d. Zagreb</b>	17.36	15.59	11.08	1.12	1.41	1.07	2.85	3.05	2.69
<b>Raiffeisen Bank Kosovo</b>	34.50	31.95	28.52	3.34	3.37	3.45	10.68	9.58	9.85
<b>Raiffeisen Banka ad Beograd</b>	25.09	15.51	15.91	1.82	1.85	2.97	5.38	6.33	7.63
<b>UniCredit Bank dd</b>	16.84	18.33	18.23	1.33	1.45	1.48	4.90	5.03	5.30
<b>Zagrebacka Banka dd</b>	17.33	14.18	13.21	1.53	1.31	1.53	3.13	3.04	3.47
<b>UniCredit Bank Serbia JSC</b>	13.09	18.79	15.39	1.21	2.24	2.60	7.22	6.89	5.80

Source: Bankscope

Table 12: Case study indicators II. (2005-2007)

	Equity (EUR th)			Loan loss provisions (EUR th)			Total capital ratio (%)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
<b>Raiffeisen Bank Albania</b>	56 135	84 592	126 145	1 653	2 191	3 544	n.a.	n.a.	15.88
<b>Raiffeisenbank d.d. BH</b>	86 613	102 412	146 280	7 260	10 737	17 077	14.10	12.90	12.90
<b>Raiffeisenbank Austria d.d. Zagreb</b>	300 524	460 611	493 520	23 253	5 172	17 577	12.77	n.a.	11.30
<b>Raiffeisen Bank Kosovo</b>	23 400	44 200	58 900	1 100	3 600	5 200	8.70*	12.80*	12.30*
<b>Raiffeisen Banka ad Beograd</b>	119 885	270 300	439 965	8 603	13 812	8 089	15.80	16.07	20.71
<b>UniCredit Bank dd</b>	63 144	75 774	90 856	8 232	6 238	409	15.70	15.40	14.60
<b>Zagrebacka Banka dd</b>	889 331	1 020 721	1 746 669	27 741	19 737	14 716	15.45	13.72	19.84
<b>UniCredit Bank Serbia JSC</b>	48 391	120 522	183 460	6 650	-1 171	3 319	n.a.	17.80	17.77

\* Tier 1 ratio (%)

Source: Bankscope

It can be concluded, that by 2005 both Raiffeisen and UniCredit entered the markets in SEE in which they are currently present. Nevertheless, the entry type, the strategy and the subsidiaries' profile showed great variety. Furthermore, by 2005 all of the

subsidiaries were able to contribute to the banking groups' profit pool. The reviewed data underpin the main findings of the current chapter, meaning that the reviewed subsidiaries' total assets, loans and deposits increased with a high pace. This includes that the banks supported the financial deepening process of the region, implying high loan portfolio growth which was partly covered by the increasing amount of deposits. Generally speaking, the KPIs of the subsidiaries of both banking groups have been in line with the main market characteristics.

#### 4.5. Conclusions

In case of SEE, during the reviewed period a quick financial deepening became a primary characteristic of the economy. This process shows that after the transition of the financial sector, a catching-up process took off. This financial deepening could be interpreted both vertically and horizontally. As shown by this chapter, the former could be demonstrated by the swiftly increasing amount of total assets or credits in per cent of the GDP. As illustrated by the simplified model of the economies, this financial deepening became a pillar of the countries' development process, implying both advantages and various risk factors. As far as the horizontal changes are concerned, the gradually broadening supply of financial services could be stressed. In the initial phase of the financial development process, the banking activity remained limited to the "core" businesses. However, step by step the diversification of the activities – e.g. by introducing asset management or leasing – could be observed in all country cases. This required innovation from the banks point of view and a learning process from the clients' side. Nevertheless, these also imply that granting loans and deposit collection remained the pillars of the banking activity.

It can be concluded, that during the "catching-up period" the countries' development showed a range of important common features. These regional characteristics made SEE a unique case compared to any other European region. The following list summarises the most important local features which have been discussed in this chapter:



- Regarding the banking sector's development and economic growth, a convergence process to the EU could be observed. From the macroeconomic point of view this meant real GDP growth rates exceeding the EU levels and a catching-up process with the EU's GDP per capita level. From the banking sector's point of view the financial deepening could be illustrated by the indicator of total assets per GDP. This increased rapidly during the observed period and showed strong correlation with the GDP per capita.
- As for other relevant macroeconomic indicators, high current account deficits and soaring unemployment rates have been typical in SEE. As far as the inflation is concerned, during the "catching-up period" it has reached fair levels with the exception of Serbia.
- When reviewing the main KPIs of the banking sector, it can be concluded that the indicators converged to a common zone. The KPIs related to profitability reached the positive zone, though their levels had significant differences. Also related to profitability, the interest rate spreads gradually decreased. Nevertheless, the NIMs still remained on high levels, but showed a negative correlation with the degree of financial intermediation. As far as the balance sheets' quality is concerned, during the "catching-up period" high level of capital buffers have been built, while NPL ratios gradually decreased to a common zone. However, the provisioning policy showed significant differences within SEE.
- It is difficult to find an appropriate benchmarking for the category of excessive credit growth. Nonetheless, loan growth rates were well over the GDP or inflation growth rates, raising concerns on asset quality and overheating. Generally speaking, the development model of the region could be outlined by excessive credit growth as a basic feature. This credit expansion was boosted by both external funds from parent banks' and increasing deposit volumes. The growth of the loan amount bolstered domestic demand, which led to high imports and trade deficits in the region. Based on these characteristics, three main risk groups could be outlined: risk

of a sudden-stop of foreign funding, credit risk and the relevant risks of large external imbalances.

- As a kind of natural feature of transitional countries, the gradual crowding-in of the private sector has decreased the public sector's share on the loan market. Swift credit growth in all cases was primarily attributed to the private sector, more specifically to the household segment, usually incorporating mortgage lending.
- One of the most important regional features was the fact, that the FX usage has been very high on both the asset and liability side. The only exceptions were Kosovo and Montenegro, where the euro is used as the sole legal tender. Otherwise, the applied exchange rate policies did not reflect the degree of FX usage. The high level of currency substitution also implied milder systemic FX risk compared to e.g. CEE. On the deposit side, this feature was attributed to the countries' economic history, the high amount of remittances or incomes from the tourism sector. As for loans, the large share of FX lending originated from both the demand and supply side. The former was motivated by lower interest rates and appreciating domestic currencies, while the latter by lower currency mismatches.
- It has been a very important differentiating regional characteristic, that the rapid credit expansion has been largely financed by swift deposit growth. The latter was also an outcome of the increasing public confidence in the banking system, the large amount of remittances and such one-off effects as the euro changeover. These features meant that compared to e.g. the region of CEE, less external funding was required to cover the amount of loans [Backé – Walko, 2006].

So on the one hand, the tendencies of the development were similar. On the other hand, the level, structure and quality of financial deepening have been different among the analysed countries. The differences stem from the initial conditions – which have been discussed while analysing the features of the transition period – and the applied policies. These characteristics led Croatia to be an outlier within SEE. On

the economic development path, the country was well ahead the region's average, and according to the indicators that are supposed to represent a country's development level, Croatia rather belonged to the region of NMS. From these aspects, the case of Kosovo could be concerned just the opposite with its late and artificial development. Kosovo needs a catching-up process even with the region of SEE. From a somewhat similar point of view, Serbia became another latecomer within the region. From other aspects further outliers could be picked. For instance, related to the pace of financial deepening, Montenegro stood out with its exponential growth, while FYR Macedonia and Bosnia and Herzegovina showed a rather modest growth pace. Nevertheless, while bearing in mind the differences, one could state that the bank intermediation developed in all the analysed cases and it started to fulfil its market economic tasks. However, parallel with this development, similar vulnerabilities have been built.

The subtitle of this chapter – A fragile development model dominated by credit growth – represents these vulnerabilities of both the banking sector and its macroeconomic environment. On one hand, SEE was usually able to reach remarkable real GDP growth rates during the observed time period. This growth was boosted by the rapid development of the commercial banking sector's activity. Here it must be mentioned, that economic growth and financial development started from a low base, compared to other European regions. On the other hand, great imbalances have been built during these years. From the macroeconomic point of view, the large external imbalances and secondly the occasional inflationary pressure must be stressed. The former was particularly caused by the large amount of imports – fuelled by consumption – and the slow and unstable revival of the export sector. Regarding the banking sector, the indirect FX risk of unhedged borrowers became a primary risk factor in most analysed countries. Second of all, the quality of credit growth remained poor in most cases, as risk assessment did not develop in the required pace and market competition became fierce. All of these mentioned vulnerabilities became particularly important, when the first waves of the global crisis reached the region in 2008 and the credit-based growth model collapsed.

Related to the banking sector's brisk development, the strong presence and activity of the large European banking groups also means that a certain kind of financial

integration took place in the observed period, and banks in SEE became linked to the EU's financial system. Being a pillar of a market economy, the banking system also became a pillar a European economic integration. According to the literature, financial integration can bring various benefits, like the possibility of risk sharing and diversification, a more efficient capital allocation, and higher growth potential. On the other hand, financial integration points to a higher risk of cross-border contagion [Haan et al, 2009]. During the reviewed booming period, it was rather the advantages that dominated the financial integration, while as the effects of the global crisis reached SEE the risks came to the front.

Last but not least, the current chapter included a brief case study to underpin the most important statements from a micro point of view as well. By 2005, Raiffeisen was present in Albania, Bosnia and Herzegovina, Croatia, Kosovo and Serbia, while UniCredit entered the markets of Bosnia and Herzegovina, Croatia and Serbia. Both of the banking groups represented different entry types in the region, depending on the acquisition opportunities. The subsidiaries' profile also showed great variety, requiring different applied strategies. Nevertheless, by 2005 all of the subsidiaries contributed to the profits of the banking groups. The reviewed data are in line with the main statements of the current chapter. The total assets, loans and deposits of the local subsidiaries reflected a remarkable growth pace, thus contributing to the financial deepening process in the respective countries. This also meant a rapid growth for the amount of loans, which however was partly covered by the increasing deposit portfolios. As far as the other reviewed indicators are concerned, they were generally in accord with the market average. They also underpinned such connections, as the link between a countries' economic or financial development and the level of the average NIM.

## 5. Crisis period in SEE – The collapse of the former models

As it has been illustrated, the banking sector of SEE highly depended on the activity of large, EU-headquartered banking groups.<sup>79</sup> During the years of transition, they contributed to the stabilisation and modernisation of the sector. During the pre-global crisis period, these banking groups boosted the local economies via rapid credit growth. The expansion of the loan portfolio underpinned the domestic demand, which became a primary driver of the GDP growth, but also led to major imbalances and raised concerns for overheating. Regarding the banking sector, the quality of the loan portfolio and the potential sudden-stop of foreign financing became the major risk factor, while from the macroeconomic point of view the large external imbalances could be considered as the primary risk. As the impacts of the global financial turmoil reached the region, there was a growing concern for potential negative spill-overs.

The first waves of the western markets' turmoil had no major effect on SEE. The lagging financial development seemed to be a blessing, as the region did not have significant exposure to the so-called “toxic” structured products<sup>80</sup> and securitisation remained low. However, the “decoupling story” did not seem to be strong enough, as the overwhelming negative side effects reached the region by the end of 2008. This was unavoidable, due to the strong integration with the western European economies through the financial and trade channels. Finally, SEE became hardly hit, likewise other regions of emerging Europe. The deterioration became plausible in almost all sectors, like e.g. the real estate, the tourism or the reviving export sector. Securities' markets collapsed and the FX regimes came under pressure. Regarding the fiscal authorities, budget revenues declined due to the lower GDP and consumption level, while the expenditure side is typically less elastic as the revenues. In order to overcome the pressure on fiscal policy, certain governments had to require financial assistance packages from the IMF and the EC. In addition to this, the IFIs increased their assistance for all countries in emerging Europe. As for the banking sector, when

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<sup>79</sup> Part of this chapter will be published in an edited version:

Kazinczy, Eszter (2013b): Crisis period in the banking sector of Southeast Europe. The collapse of the former models. *Köz-Gazdaság*, Budapest, Faculty of Economics at the Corvinus University of Budapest, expected date of publication: February 2013

<sup>80</sup> For the exposure to American “toxic” products, see e.g. Department of Treasury (2009).

the debt markets stopped to fulfil their original tasks and the interbank markets froze, the subsidiaries became more dependent on their parent banks. Nevertheless, the parent banks themselves were just as hardly hit by the effects of the financial tension. This stress could only partly be eased by the measures of the monetary authorities, governments and IFIs. Still, during the reviewed time period, no parent bank has pulled out from SEE and there were no fire sales.

The goal of the current chapter is to demonstrate, how the simplified growth pattern – which has been demonstrated in the previous chapter – collapsed in SEE as a result of the global crisis. During the analysis, the most important common and differentiating features are being outlined. The chapter analyses the developments of the period between 2008 and 2010. This is the reason why past tense is used during the review, despite the fact that the crisis has still not ended. So currently, the outcome of these changes is far from being clear, but it definitely opened a new era in the development of the region. In order to illustrate the changes, country-level banking sector and macroeconomic data are used. These are downloaded from the respective central banks' databases and from the IMF. Various charts help to review and compare the shifts of the indicators and the entire economic system. Most charts also contain the data from 2007, in order to demonstrate the pre-crisis levels as a starting point.

A case study is included to this chapter as well, serving two purposes. First of all, it demonstrates the fundamental changes from a micro level perspective, thus underpinning the general conclusions of the current chapter. Second of all – as the same banks are included to the analysis as in the previous chapter – it provides the possibility to compare the changes of the specific subsidiaries between the “catching-up” and the crisis periods. Here as well, the data for the case study are downloaded from Bankscope and interpreted with the help of the respective banks' annual reports.

The current chapter is organised as follows: First the impacts on the banking sector are being analysed, continued by a short review of the most relevant macroeconomic indicators. The third section illustrates the collapse of the former economic model, and raises a number of questions which ought to be answered in the near future. This

section is followed by the above mentioned brief case study. Finally, the main statements are being concluded.

### 5.1. The banking sector – Hardly hit by the crisis

The previous chapter demonstrated the remarkable pace of financial deepening, which became a pillar of the general economic development. Parallel with the development of financial intermediation, the main KPIs of the banking sector followed positive trends. As a result of the crisis, all of these tendencies changed completely. Due to the turmoil, liquidity became scarce and all funding sources became affected to a certain extent. Having an impact on various operations, the global risk aversion intensified. Via these transmission channels, the general international tendencies gradually reached the domestic funding markets [ECB, 2010a]. In addition, the local markets themselves experienced certain confidence shocks, which occasionally caused small-scale deposit withdrawals. The current section proves, that these spill-over effects led to fundamental changes in the banking sector, raising a number of underlying questions for the upcoming years.

It is worth emphasising at the beginning, that monetary policy authorities took various measures to support and stimulate the banking sector and the overall economies; they cut monetary policy rates, eased the reserve requirements, and implemented other liquidity and prudential measures. Depending on the applied exchange rate regimes and the depreciation of the local currencies, FX interventions also took place.<sup>81</sup> However, as in most cases the exchange rates are used as nominal anchors, while currency substitution is particularly widespread in SEE, the monetary authorities' room for manoeuvre remained quite limited. Besides the local authorities, IFIs provided funding packages within the framework of the so-called Joint IFI Action Plan. The aim of this program was to underpin the banking sectors and to support their lending activity to the real sector in CEE, including SEE [EBRD

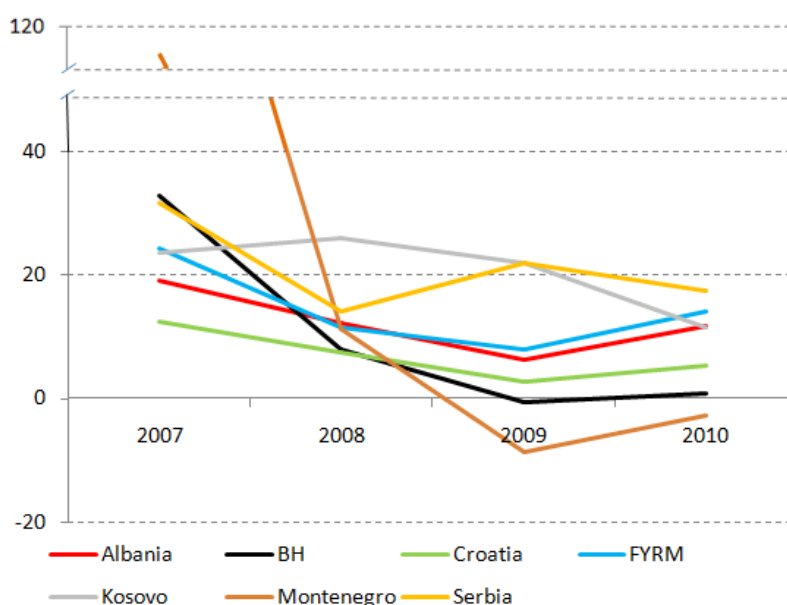
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<sup>81</sup> For detailed information on the various measures, see the respective central banks' website. European Commission (2009) reviews the initial policy steps. In case of Croatia and FYR Macedonia, ECB (2010a) provides a comprehensive overview until 2009.

et al, 2011]. Nevertheless – as shown by the current section – the various measures were not able to avoid the downturn and had limited effects.

Chart 42 shows the annual volume growth of total assets, which can be considered as an indicator of the financial intermediation' development. The data from 2007 still represent a booming year of the pre-crisis period with swift growth rates. The downturn started the next year, when with the exception of the least developed economy – Kosovo – the growth rate of the total assets started to decline in all countries. Most of them reached the lowest levels in 2009, some of them recording even a drop of the amount of total assets. Montenegro could be considered as the most unique case with the largest volatility. By the end of the pre-crisis period, the growth of total assets was extraordinary, raising concerns for overheating. However, its banking sector was hit hard by the crisis, leading even to a contraction of the indicator. The case was somewhat similar in Bosnia and Herzegovina, though with a much milder volatility.

Chart 42: Annual volume growth of total assets (%)



*Source: Respective central banks' statistics and Financial Stability Reports, own calculations*



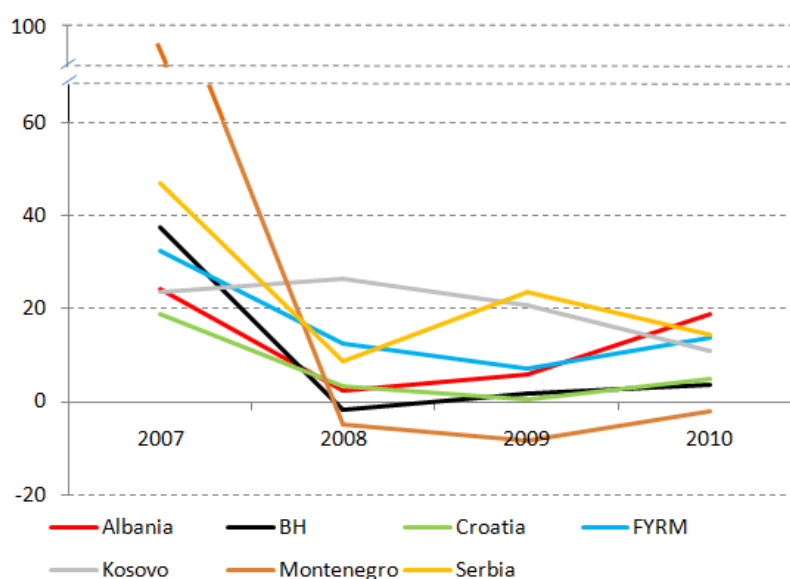
Turning to the largest component of the liability side, during the “catching-up period” the amount of deposits provided a major financial resource for the banking sector. The previous chapter revealed, that the rapid credit expansion was largely financed by the swift deposit growth. It is important to stress, that this was valid even for the category of FX loans due to the large share of FX savings. However, in cases of major shocks, one of the primary risks of this category comes to the forefront; namely that deposits can be withdrawn at no or short notice. Chart 43 shows, that following the large growth rates of deposits in 2007, its expansion dropped the next year. Again, in case of Kosovo the annual downturn could be recorded with a one year lag. In case of Bosnia and Herzegovina and Montenegro the deposit volumes even decreased, indicating significant withdrawals, particularly in the latter’s case. From the subsidiaries’ point of view, deposits became even more important when interbank markets dried out and the parent banks themselves faced financial challenges. This is the reason why in certain countries the banks even competed for this funding source by offering higher interest rates [Lahnsteiner, 2011].

Nevertheless, due to the confidence shocks, temporary deposit withdrawals were recorded in all countries. As it has been discussed, the clientele in SEE is particularly sensitive, due to the major systemic shocks which they experienced in the past. This was also coupled by both the retail and corporate clientele’s increasing liquidity needs. However, large-scale deposit withdrawals were avoided, partly as a result of the appropriate measures of the local authorities. Related to the deposit insurance system, the amount of guaranteed recovery on the deposits has been raised in those cases where the limit was below 100%. In case of Kosovo, the project on deposit insurance has been fostered. Furthermore, all central banks stressed the sufficient level of capital buffers and the general stability of the local banking system as part of their communication.<sup>82</sup>

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<sup>82</sup> For more details, please visit the respective central banks’ homepage.

Chart 43: Annual volume growth of total deposits (%)



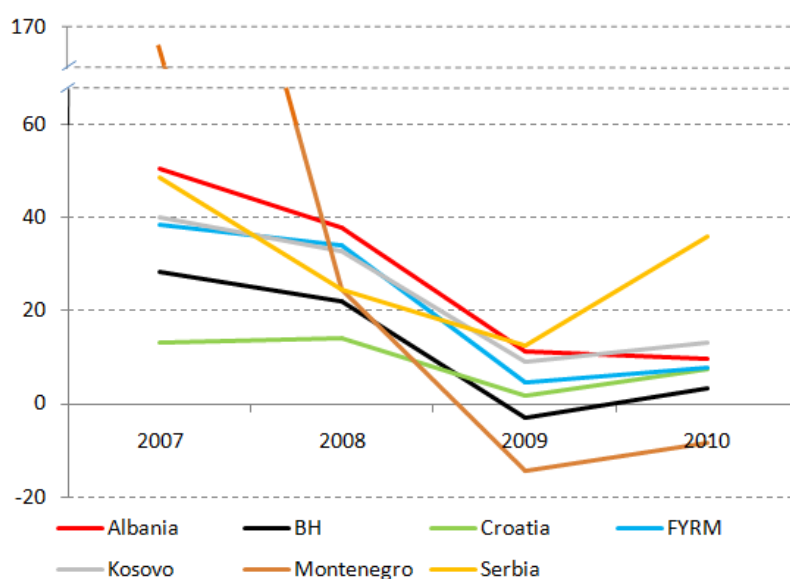
*Source: Respective central banks' statistics and Financial Stability Reports, own calculations*

As far as the loans are concerned, the sharp drop of credit growth could be explained by various factors both on the demand and supply side. The latter was affected by the banks' capital and liquidity situation, the growing concern for the credit quality, the still present risk aversion which could be linked to the sector's general situation and prospects, and the strategic factors such as the market competition. As for the former, the potential clients' credit "appetite" has been dampened by the tighter loan conditions and the macroeconomic environment, which has been reflected for the corporate sector by e.g. the decreasing domestic and external demand or for the retail segment by the weaker labour market conditions.

Chart 44 illustrates how the growth rate of total loans declined and even turned negative in certain cases. The chart also shows the high growth rates registered during the last year of the "catching-up" period, indicating the risk of overheating. The pace of growth started to decrease in 2008 and reached the lowest levels the next year. In case of Bosnia and Herzegovina and Montenegro, the volume of loans even declined. The extraordinary boom-bust cycle could be the best noticed in the latter's case, where the volume growth was negative still in 2010. The lowest volatility could be noticed in Croatia, also as a result of the strict regulatory measures dampening the

credit expansion during the pre-crisis period. Still noteworthy, that in case of Serbia the amount of credits increased remarkably already in 2010, which could be particularly attributed to the sum of corporate loans, including also the effects of incentive programs [NBS, 2010]. All in all, the severe decline of credit expansion indicated that the former domestic demand driven economic growth model stopped functioning.

Chart 44: Annual volume growth of total loans (%)

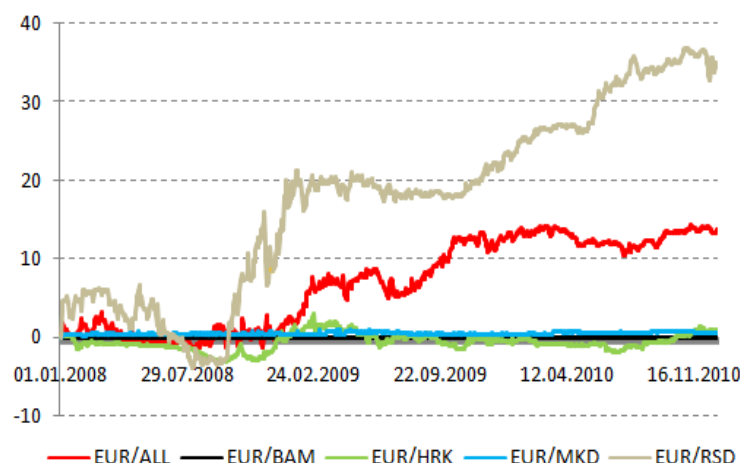


*Source: Respective central banks' statistics and Financial Stability Reports, own calculations*

Related to the loan portfolios, FX volatility must be briefly overviewed. The high ratios of FX lending – as illustrated in the former chapter – became particularly important during periods of extreme exchange rate volatility. As it has already been discussed, Kosovo and Montenegro uses the euro as the sole legal tender, Bosnia and Herzegovina has a euro-based currency board regime, FYR Macedonia applies a de facto peg against the euro, Croatia uses a tightly managed floating exchange rate policy, while Albania and Serbia apply independent or managed floating regimes against the euro. These imply, that the clientele in the latter two countries are particularly vulnerable to unfavourable FX movements. Chart 45 and Table 13 prove

that Albania and Serbia recorded major FX volatility – depreciation – during the first years of the global crisis, strengthening the risk of increasing NPL ratios.

Chart 45: FX volatility (percentage change, based on daily data, 01.01.2008 = 100%)



Note: ALL – Albanian Lek, BAM – Bosnian Mark, HRK – Croatian Kuna, MKD – Macedonian Denar, RSD – Serbian Dinar

Source: Respective central banks' statistics, Reuters

Table 13: Standard deviation of the local currencies against the euro (2008-2010, based on daily data)

Currency	Standard deviation
EUR/ALL	6.739
EUR/BAM	0.000
EUR/HRK	0.076
EUR/MKD	0.103
EUR/RSD	9.338

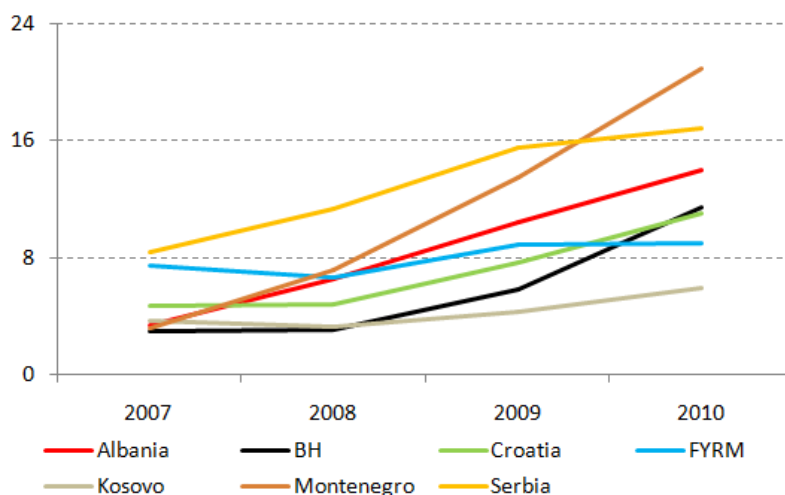
Source: Respective central banks' statistics, Reuters, own calculations

As it has been illustrated in the previous chapter, NPL ratios in SEE followed a clear downward trend between 2000 and 2007. In certain countries this continued even in 2008, but from 2009 NPL ratios started to increase in all cases (see Chart 46). The chart also shows, that NPL ratios became the highest in those countries, where flexible, floating exchange rate regimes have been implied. However, the ratio became the highest in Montenegro, where the pace of financial deepening has been strikingly high before 2007. Generally speaking, most banks provided the possibility to restructure problematic loans in order to support the clientele's solvency.<sup>83</sup> These steps also indicated the expectation for better mid-term conditions. However, these measures could lead only to temporary solutions. Bearing in mind, that the NPL ratio

<sup>83</sup> For further details, please visit the respective central banks' homepage and the local commercial banks' website.

is a lagging indicator – as it has already been discussed – high levels are expected to maintain in the region, remaining a primary risk factor.

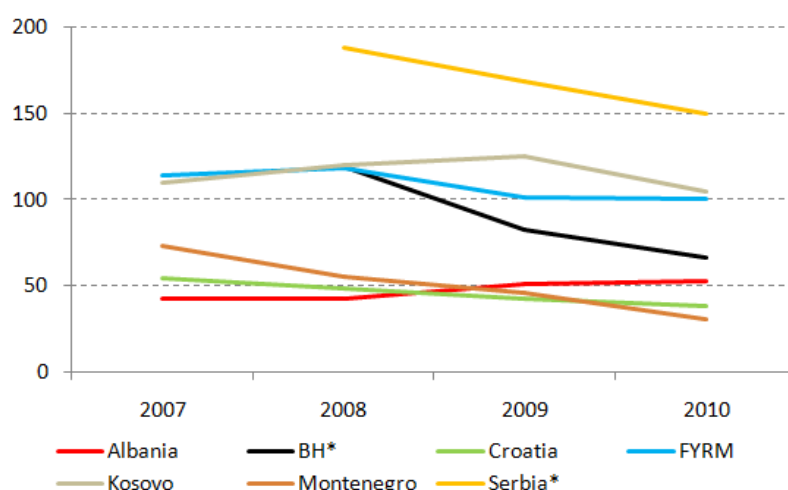
Chart 46: Increasing NPL ratios (share of total non-performing loans of banks in total loans, %)



Source: IMF: Financial Soundness Indicators, Central Bank of the Republic of Kosovo

The increasing NPL ratios have put extra burden on the banking sector, requiring higher loan loss provisions. But banks did not maintain the provisions per NPL ratios in most countries (see Chart 47). Usually, certain drop has been recorded, with Bosnia and Herzegovina, Serbia and Montenegro showing the sharpest downturn. These are the same countries where the growth of NPL ratios was among the highest. However, the level of the provisions still didn't turn critical, at least in the former two cases. All these imply, that due to the sharp rise of NPL ratios as divisors, the amount of provisions clearly increased, eating up a significant part of the banks' returns.

Chart 47: Bank provisions in per cent of NPLs (%)

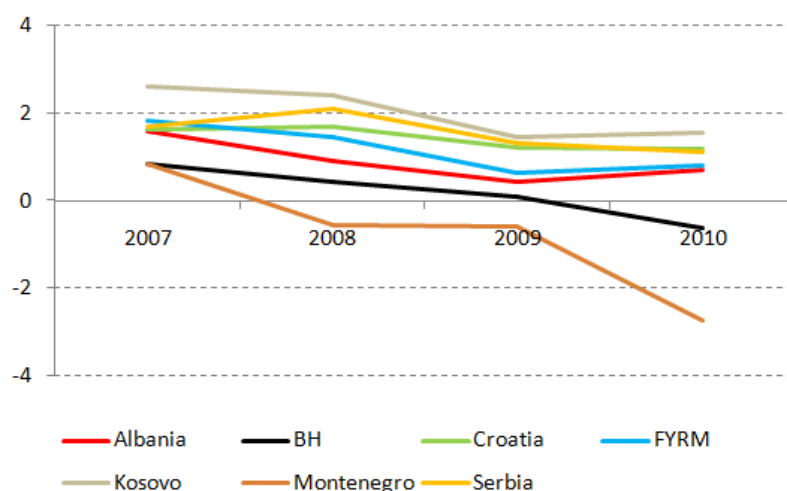


\* Data are available from 2008.

Source: IMF: Financial Soundness Indicators, Central Bank of the Republic of Kosovo

These tendencies – deteriorating market conditions, increasing provisioning needs and funding costs – had a major impact on the banking sector’s profitability. Compared to the end of 2007, ROA decreased in all SEE countries (see Chart 48). Also this indicator illustrates, that the most significant systemic problems occurred in Montenegro, where the average ROA decreased to negative levels implying great losses. In 2010, this indicator turned negative even in Bosnia and Herzegovina, and declined further in Serbia. In case of the other countries, the ROA reached the lowest levels in 2009. All in all, the profitability deteriorated throughout the region of SEE, which could be illustrated by the level of ROA. The indicator declined, despite the slower – or even negative – growth of the divisor; the amount of assets. However, it is worth underlying that with the exception of Montenegro and Bosnia and Herzegovina, the profitability did not turn negative, thus still contributing to the respective banking groups’ profits.

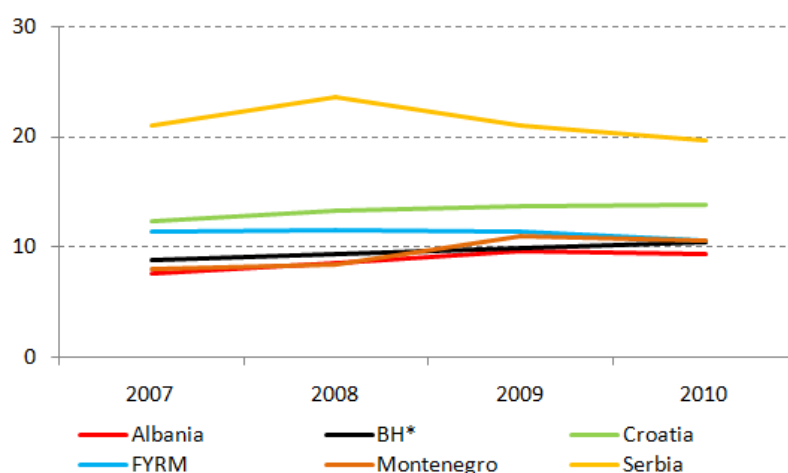
Chart 48: ROA (%)



*Source: IMF: Financial Soundness Indicators, Central Bank of the Republic of Kosovo*

Reviewing the capital ratios, as indicators for stability, Chart 49 demonstrates the level of bank capital in per cent of assets. Though comparing the exact numbers of the chart might be misleading, but noting that major shifts have not taken place is important. Moreover, the indicator rather increased in almost all countries. This indicates, that banks continued to maintain high capital ratios – compared to the Basel requirements – providing ample shock-absorbing capacities. This can also be considered as an indication of the parent banks to maintain their local positions. Noteworthy, that certain changes could be attributed to stricter regulatory requirement, as for instance, by raising the risk weights in FYR Macedonia [ECB, 2010a]. Still, the bottom line is that the indicator remained stable in the reviewed countries, providing decent capital buffers.

Chart 49: Bank capital to assets (%)



\* Tier 1 capital

Note: Data for Kosovo are available from 2010, when the indicator was 9.4%.

Source: IMF: Financial Soundness Indicators

#### 5.1.1. The European Bank Coordination Initiative

Likewise in case of the transition and “catching-up” periods, the underlying role of foreign banking groups has been stressed. Within this section, the parent bank-subsidary relation is being overviewed through the introduction of the European Bank Coordination Initiative, better known as the so-called Vienna Initiative. As it has been mentioned, the tension on the global financial markets led to limited and expensive international and inter-bank borrowings. This implied, that as a further challenge the banking sector had difficulties in financing the external funding needs. This is the reason why the parent banks’ funding support gained more importance, and became a primary risk factor. Namely, in case the parent banks themselves have financial shortages, they might withdraw funds from other regions, or in a worst case scenario they might sell or abandon their subsidiaries. However, by the end of the reviewed period, no major banking group has pulled out from SEE, while the parent banks even continued to refinance their subsidiaries. Based on these facts, the presence of foreign banks could be considered as a stabilising factor in the region.



The funding risk directly leads to a certain “prisoner’s dilemma”, where the group of commercial banks intend to cooperate and maintain their positions in the host countries, while in the short-term the individual banks would prefer to be the first to withdraw. In order to mitigate this recognised risk in all European transition countries, the IFIs – namely the IMF, the World Bank Group, the EBRD, the EIB and the EC – brought together the parent banks and the national authorities of the home and host countries. This forum was established in early 2009 and is known as the so-called Vienna Initiative. The goal was to define the relevant responsibilities and foster the coordination between the participants, while maintaining the most important banking groups’ engagement [EBRD, 2009].

Within the Vienna Initiative, the EU-based large parent banks expressed their intention to support the subsidiaries with funding, capital and expertise if necessary, while maintaining their overall exposure. In the countries that were under the auspice of the IMF – namely Bosnia and Herzegovina and Serbia – this commitment took the form of letters from the parent banks. The 10 largest banks of Serbia and the 6 biggest foreign-owned banks of Bosnia and Herzegovina signed the commitment in Vienna to maintain their overall exposures in the specific country. The precondition was to keep the IMF-backed programmes on track. From the commercial banks’ side, participants emphasised the countries’ long-term growth prospects and the investments they’ve already made, thus underpinning their intention to remain committed to their subsidiaries. From the other angle, the document acknowledged that by the time parent banks have supported the subsidiaries with funding, capital and various types of expertise. The document also mentioned an important macroeconomic dimension, namely the foreign-owned banks’ role in achieving a successful macroeconomic reform program and maintaining the sustainability of the medium-term balance of payments [IMF, 2009a,b]. Although the commitments were legally non-binding, the intention could be well underpinned by the parent banks’ overall strategy in SEE and the region’s favourable long-term growth perspective.

Also within the consultation of the Vienna Initiative, the home governments of the parent banks expressed their intention not to imply any restrictions on funding the subsidiaries, when setting up the framework of the national support packages. This helped to eliminate the risk of parent banks legally unable to support their

subsidiaries in the transition economies. From the host countries' side, governments assured the counterparties to provide liquidity support and deposit insurance regardless of the banks' ownership, and expressed their intention of providing supportive macroeconomic policy response for the crisis. As a further important result of the consultation, a group of IFIs – the EBRD, the EIB and the World Bank Group – launched the already mentioned, so-called Joint IFI Action Plan with the aim to support the stability and lending activity of the transition economies' banking sector by a package of EUR 25 billion [EBRD, 2009, p.18] for the period of 2009-2010 [EBRD, 2009].

Based on the relevant literature, evidence shows that parent banks provide capital support for their subsidiaries in cases of financial tension. As for the opposite examples – e.g. in East Asia – the long-term engagement was rather missing, which could be proved even by the type of the allocated resources.<sup>84</sup> The situation during the reviewed period was unique, because both the parent banks and their subsidiaries have been hit by the effects of the crisis, and even the diversification on a global level was not able to ease the stress. It can be concluded, that the commitments of the Vienna Initiative and the support of parent banks<sup>85</sup> underpin the assumption, that the headquarters of the large banking groups have included the region of SEE to their long-term strategy. The reason behind this is that they expect fair profits, and the continuation of the catching-up process in terms of income levels and financial deepening. Lahnsteiner (2011), also mentions the reputational risk in case of sudden fund withdrawals. According to Mitra et al (2010), a parent bank's decision to roll over credit lines to its subsidiary depends on the expected return or loss during the decision's time, the degree of uncertainty about the future returns, and the willingness to handle this uncertainty. The commitments and rollover rates prove the positive expectations regarding these factors. Nevertheless, the funding always depends on the conditions of the parent banks themselves and of the overall banking group. All in all, from the perspective of SEE, foreign banks rather had a stabilising role during the reviewed period of the current crisis.

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<sup>84</sup> See for instance, Haas – Lelyveld (2008) or Cull et al (2007).

<sup>85</sup> As a certain proxy for foreign financing, please see the Banking statistics of the BIS.

## 5.2. Macroeconomic implications

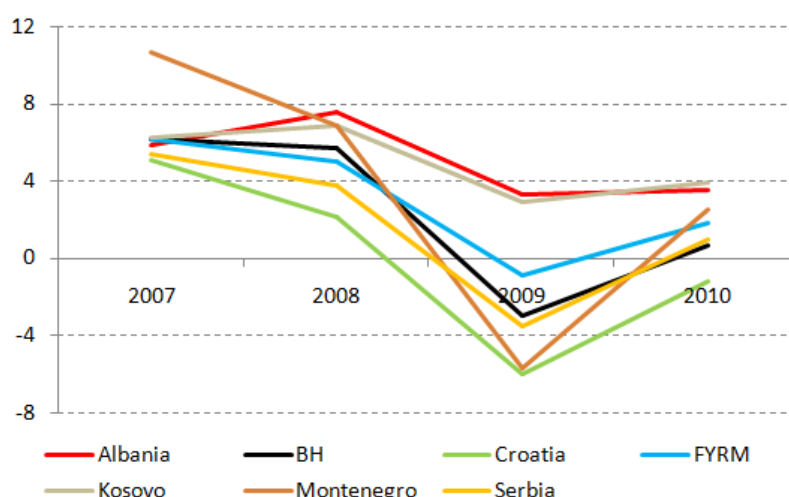
Due to the fact, that the economies of SEE are strongly linked to the EU and world economy, the effects of the global turmoil reached the region through various channels. As an internal factor, the former credit growth stopped boosting the domestic demand. The drop of international commodity prices and the downturn of major economic partners hit the export sector and the overall economies. Furthermore, such external sources as the amount of remittances and capital flows declined sharply. The former was affected by the worsening labour market conditions of advanced economies, causing difficulties for the group of migrant workers. The latter was also the outcome of the challenges experienced by the advanced economies and the intensifying global risk aversion. Fiscal incentives<sup>86</sup> or the IFIs increasing financial assistance were not able to compensate the shortfalls [ECB, 2010a]. As far as the inflation is concerned, it dropped in all of the reviewed countries and reached the lowest levels – with the exception of Albania – in 2009. This was also a result of the mentioned changes and the lower inflationary pressures from import prices. In case of FYR Macedonia this also meant significant deflation [IMF: World Economic Outlook Database]. The unemployment rate – a further relevant indicator for the banking sector – increased in almost all countries as a result of the deteriorating market conditions [IMF: World Economic Outlook Database].

In most of the countries, the effects of the global turmoil materialised in 2008. The real GDP growth rates – apart from Albania and Kosovo – decreased by then. The downturn continued, reaching the lowest levels or recording even recession the next year (see Chart 50). It is worth highlighting, that the lowest growth rate was in the most advanced country – namely Croatia – while the two least developed cases – Albania and Kosovo – performed the highest GDP growth within SEE. The latter group could be considered less integrated to the EU, thus these countries proved to be more resilient [European Commission, 2009]. The second largest drop of the indicator was in Montenegro, where the economy has been formerly boosted by extreme credit expansion and strongly depended on the performance of the steel industry.

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<sup>86</sup> To read more on the fiscal condition, see e.g. European Commission (2009) or ECB (2010a).

Chart 50: Real GDP growth rates (% , 2007-2010)



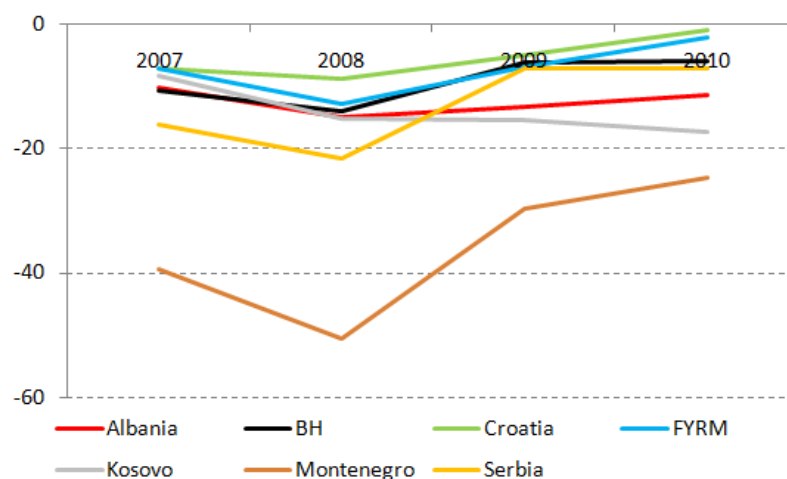
Source: IMF: World Economic Outlook Database

The massive external imbalances were considered as one of the primary risk factors of SEE. As a result of the global risk aversion and increasing funding costs, the possibility of a certain kind of twin crisis – including the collapse of the financial sector and a current account crisis – emerged. During the reviewed period, on the one hand, trade deficits were negatively affected by the shrinking global demand. On the other hand, the drop of commodity prices and the adjustment of the domestic demand rather had a positive impact. This means that both volume and price factors contributed to the fall of imports [European Commission, 2009]. Noteworthy, that as an external current account adjustment factor, the real effective exchange rate depreciation could add to the development in cases of floating FX regimes. Nevertheless, rather the internal factors – the drop of real GDP growth and import growth – led to a significant current account adjustment in the region. Adding up all of these developments, trade deficits declined, which caused a substantial current account adjustment process.

Chart 51 reflects, that generally speaking the largest amounts of current account deficits in per cent of GDP were recorded in 2008. This means, that in annual terms the adjustment took off with a certain lag from 2009. It is interesting to note that the two least developed cases – Albania and Kosovo – performed minor or no adjustment, due to the lower level of international integration. Montenegro showed the largest decline of the deficit, though starting from an extreme high level. All in

all, as a favourable side-effect, the crisis caused a significant current account adjustment in SEE.

Chart 51: Current account in per cent of GDP (% , 2008-2010)



Source: IMF: World Economic Outlook Database

Beside the positive development of the current account deficit, it became difficult to obtain financing from abroad to cover imbalances. During the pre-crisis period, FDI and remittances were able to cover large part of the current account deficit. However, due to the international tendency of strengthening risk aversion, deleveraging and rising unemployment, the amount of FDI, remittances and portfolio investments decreased sharply during the crisis [European Commission, 2009]. This is one further reason why the favourable changes of the trade deficits were welcomed.

Last but not least, the timely international response of IFIs should be mentioned. Financial assistance became necessary for some countries, as financing budget deficits and government debt became limited and more expensive. In order to avoid government defaults, to strengthen the region's financial conditions and to boost private sector confidence, international and European institutions stepped in already at the beginning of the crisis. During the reviewed period, the IMF provided new stand-by arrangements for Bosnia and Herzegovina, Serbia and Kosovo, which had a major role in handling the effects of the crisis [IMF, 2011]. Besides the IMF, other international organisations – the World Bank, the EBRD or the EIB – also increased

their financial assistance to SEE to tackle the negative impacts. It can be concluded, that IFIs helped to avoid government defaults and to stabilise the financial conditions, thus mitigating somewhat the effects of the crisis.

### 5.3. The collapse of the former growth pattern

Based on the respective data and the relevant literature, the former chapter illustrated a common growth pattern for the region. A fundamental pillar of this model was the rapid pace of credit growth, which was financed both by the expansion of the deposit portfolio and foreign funds. The increasing credit boosted consumption in the retail segment and supported investments for corporations. Nevertheless, the link was rather bidirectional, as the households themselves had the strengthening desire to consume, also as a natural outcome of the catching-up process. In the other segment, corporations tried to fulfil their investment needs via the tempting loan offers. However, this latter block is drawn with broken lines in Chart 52, as this category rather had a secondary effect. All in all, the swift credit growth boosted the domestic demand, which underpinned a dynamic GDP growth in the region. To fulfil this demand, imports also increased with a high pace, causing massive current account deficits. This became one of the main risk factors within this model, written with bold letters in the chart. The other two risks related to the banking sector. The first one was the risk of a sudden-stop in respect of the foreign funding channel, while the other one was connected to the quality of the credit portfolio. Namely, the rapid pace of credit growth raised concerns for the quality of the loan assessment procedures.

Chart 52 summarises those changes that have been discussed so far and led to the collapse of the described pre-crisis growth pattern. The features which had an impact on the elements of the model are included to the grey-coloured boxes. The dynamic growth of deposits stopped, moreover, even temporary deposit withdrawals took place. This was caused by the concerns over the banking sector's stability. But the lower level of deposit growth was also an outcome of the households and corporations increasing financial need, e.g. to cover the higher loan instalments. The lower level of income growth and increasing unemployment could also contribute to

the lower pace of deposit growth. Foreign funding also became limited for the banks, as the financial turmoil reached a global level. This implied, that interbank and debt markets dried out, and the parent banks themselves had to face financial difficulties. As parent banks provided a significant share of financing, this meant a major funding risk. Nevertheless, during the reviewed period, parent banks rolled over credit lines and continued to support their subsidiaries.

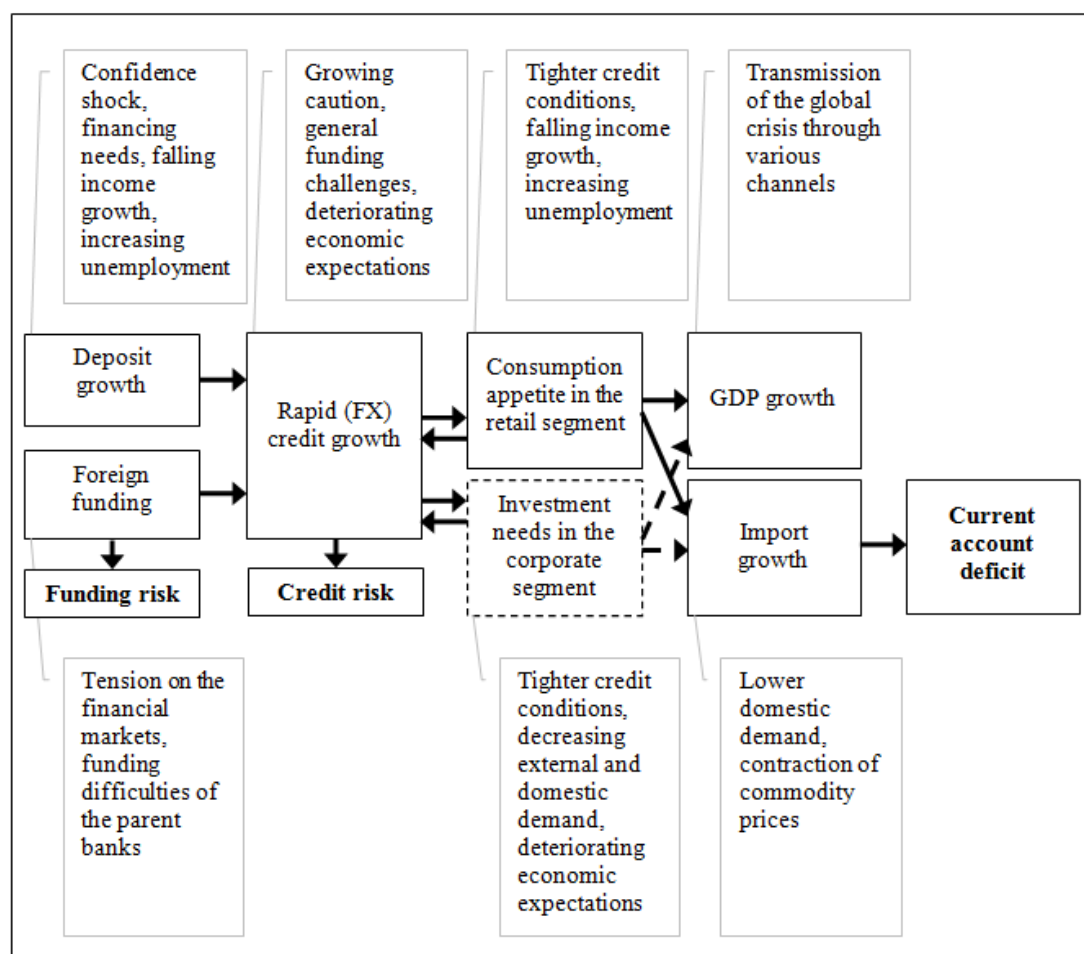
These two elements – the falling deposit growth and the foreign funding risks – contributed to the sudden stop of credit growth. The overall funding risks and challenges, and the strengthening risk aversion led to the drop of credit expansion. The latter factor meant that banks became more cautious in lending. As the funding possibilities became more limited, the economic environment worsened, the number of company defaults rose and NPL ratios started to increase, banks started to apply a stricter assessment procedure, and increased the interests and limited the loan amounts. All these factors meant, that both the demand and the supply of credits declined, causing a major drop of the loan growth.

The low, or even negative, level of credit growth meant that this category stopped functioning as a driver of domestic demand. The tighter credit conditions of banks, the drop of income growth and the rising unemployment caused a major adjustment of the consumption level. As for the investments, it was also dampened by the credit conditions, but also by the decline of the domestic and external demand, and by the deteriorating future expectations. From the banking sector's perspective, these factors could be considered as the demand side factors of the crediting activity.

All of these changes led to shrinking domestic demand and imports. Due to the fact that the former boosted the GDP growth during the pre-crisis period, the deceleration of GDP was caused by this factor as well. From the demand side, GDP decreased as a result of the drop of consumptions and investments. Even in case government spending could be expanded, it was not able to compensate the shortfall of the former two. The level of exports also fell, as the external demand shrank and generally the respective prices also decreased or grew with a slower pace. On the other hand, as it has been demonstrated, imports usually reflected a larger drop compared to the exports. Nevertheless, this still did not support the GDP growth, but caused a major

adjustment of the current account balances. This implies, that despite the worsening funding possibilities, the respective risks of the current account deficit became less significant. This means, that related to the former growth pattern, the risks of the banking sector became more stressed.

Chart 52: A reversal of the “catching-up” growth pattern



Source: Own compilation

Chart 52 overviews the major changes of the former growth pattern. The logic of this system implies, that as the base of the system – deposit growth, foreign funding or credit growth – has been influenced by the crisis, the further elements in the line had to be affected as well. But the elements of the grey boxes show, that the crisis also had an impact on each of the building blocks. Adding up all of these effects, it became clear that the former, bank-based growth pattern collapsed during the crisis.



### *5.3.1. Questions of the “post-crisis” period*

What will be the pillars of the new growth model in SEE? Under the pressure of the global crisis, the credit-based macroeconomic framework collapsed. Following the crisis period, a shift in the former macroeconomic mechanisms would be necessary. As demonstrated in the previous chapter – unlike in CEE – large part of the loans were covered with deposits in SEE. Nevertheless, external financing needs ought to be partly substituted by domestic savings for further stability. If the saving propensity would be able to increase, this would inevitably dampen the domestic demand, which tended to be the driver of economic growth in the pre-crisis period. At the same time, salaries are often frozen and are expected to increase with a milder pace throughout the region. The slowly reviving export sector and more investments, including the infrastructure as well, should substitute for this effect, leading to a healthier balance of payments structure.

How will the volume of (FX) lending change on the long-run? In countries where the dominance of FX loans caused major vulnerabilities, the demand can be mitigated from two sides; by making FX loans more expensive or by making the domestic currency denominated loans cheaper. The former can be met by e.g. increasing the related reserve or provisioning requirements, or by applying administrative ceilings for its growth level or for the related loan-to-value ratios. The latter can be reached by stabilising the macroeconomic environment, which leads to lower interest rates and mitigates the volatility of inflation, or by developing the local currency money and bond markets. The banking sector’s credit policy will also experience fine-tuning. Following the recent spike of non-performing loans, banks will definitely apply a more prudent and careful client assessment procedure. This will be supported by building databases for track records, which can help to strengthen the banks’ client assessment procedure.

Is further financial deepening desired at all or what would be a healthy pace of the financial expansion? Beside its growth enhancing effects, financial deepening – meaning the growth of the credit per GDP or the total assets per GDP ratio – implies wide range of vulnerabilities as well. These might lead even to systemic meltdowns during crises. One might say that a healthier pace of the growth would be required,

but there is no rule of thumb for defining the optimal level and vulnerabilities will never be completely omitted.

Will alternative – non-banking – financing take over the banking sector's role? As a result of the limited and expensive bank credits, clients may require non-banking solutions for their financial needs. On the other hand, the banks themselves may look for certain loopholes as a result of the stricter regulatory and supervisory framework. So this question is also related to the regulatory and supervisory authorities, as alternative financing solutions – e.g. inter-company loans – are currently out of their scope. Nonetheless, these methods may cause just as severe vulnerabilities as the strictly speaking banking sector itself.

Will the large European banking groups continue their activities in SEE? The banking network can be treated as one of the pillars of the European economic integration, not only from a financial aspect, but also from the related corporate client base. The large EU-headquartered banking groups have built up their long-term strategy with a focus on CEE – which in their terminology includes also SEE – as part of the profit pool. This strategy does not need a reversal, as the real convergence and financial deepening is expected to continue, although with a slower pace. This is why the parent banks did not tend to pull out from SEE, and the fruitful cooperation between the two sides may continue, although with a milder intensity and more caution. Nevertheless, the new waves of the current crisis may force the parent banks to withdraw from the region. Their home country's conditions and the general international environment are just as important as the development in SEE itself.

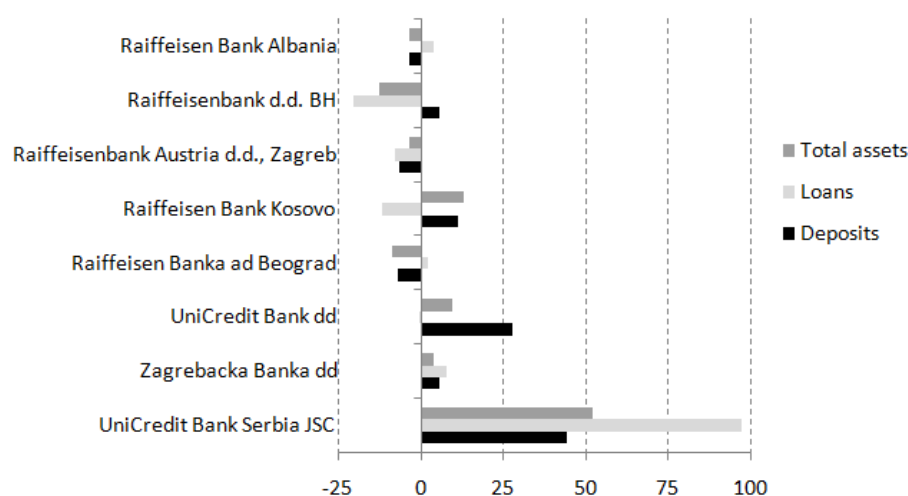
How would an optimal regulatory and supervisory framework look like? The vulnerabilities of the banks' balance sheets became plausible. Regulatory and supervisory authorities need to establish a more balanced environment with healthy banking balance sheets. The task seems to be more than challenging, due to the fact that former measures seemed to have only temporarily or mild effects, as large international banking groups were able to find the loopholes of the system. In order to mitigate this possibility, international coordination between the authorities is inevitable. However, it is hard to set up the most appropriate system, as a dilemma

emerges even regarding the level of the supervisory and regulatory activity. Regulations that are imposed on a national level help to protect the national system's assets and stability, but on the other hand, it limits the possibility of liquidity and capital transfers within the specific banking groups. Furthermore, the logic of the European single-market policy would rather imply the supervision of the multinational banks on a consolidated level. This does not definitely require supranational authority, but implementing the so-called Basel rules or harmonising the national regulations on an international level. Last but not least, it is difficult to find the balance between the support of the economy and cautiousness.

#### 5.4. Case study – Shifts in line with the crisis

The current short case study includes the same banks as the previous chapter. This gives the possibility to compare the changes between the two reviewed periods. The other purpose of this case study is to illustrate the changes during the crisis period from a micro level perspective. As it has already been illustrated, between 2005 and 2007 a remarkable growth has been recorded regarding the amount of total assets, loans and deposits. With the exception of the Serbian subsidiary of UniCredit, this growth tendency came to a halt (see Chart 53). The growth of these indicators became negligible compared to the previous period or in many cases even a significant decrease has been recorded. This is valid even for the deposit volumes, providing evidence for a certain level of withdrawals. A pillar of the “catching-up” growth pattern – the rapid loan growth – stopped increasing or even declined, showing a complete change of the past tendencies.

Chart 53: Case study – Total volume growth of bank balance sheet items (% , 2008-2010)



Source: Bankscope

Turning to the indicators of Table 14 and Table 15, the changes can be further underpinned. The profitability dropped in all subsidiaries, regarding both the ROE and the ROA. In Raiffeisen Bank Kosovo and UniCredit Bank dd, the profitability touched bottom in 2009, but this could partly be explained by the lower provisioning in the former case. Other banks were able to show a slight improvement at least in terms of the ROA. Nevertheless, it is clear that the profitability of the subsidiaries dropped significantly, but did not reach the negative zone. Still related to the profitability, the NIMs rather decreased, which was also a result of the intention of deposit collection or lower loan portfolios.

Turning to the amount of equities, it can be noted that following the rapid pace of its growth during the “catching-up period”, it increased only mildly during the crisis. In one case – at Raiffeisen Banka ad Beograd – it even declined somewhat. This reflects a certain shift of priorities. Due to the fact that the time series for NPLs are incomplete, the amount of loan loss provisions are illustrated here as certain proxies. This indicator increased sharply in all subsidiaries, even compared to the “catching-up period”. This also implies a great burden on the banks’ profits. Last but not least, the total capital ratios rather increased slightly during the reviewed period, even compared to the “catching-up” years, reflecting the intention of having sufficient capital buffers and maintaining confidence.

Table 14: Case study indicators I. (2008-2010)

	ROE (%)			ROA (%)			NIM (%)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
<b>Raiffeisen Bank Albania</b>	28.96	21.19	20.56	2.07	1.85	2.02	4.41	4.78	5.03
<b>Raiffeisenbank d.d. BH</b>	8.63	2.30	1.60	0.68	0.20	0.15	4.19	3.53	4.08
<b>Raiffeisenbank Austria d.d., Zagreb</b>	11.08	7.52	6.77	1.27	1.02	0.94	2.84	3.20	3.59
<b>Raiffeisen Bank Kosovo</b>	22.69	9.00	11.80	2.80	1.09	1.50	10.10	7.26	6.11
<b>Raiffeisen Banka ad Beograd</b>	16.16	6.97	5.74	4.00	1.80	1.50	9.21	6.81	5.42
<b>UniCredit Bank dd</b>	12.68	8.32	9.03	1.20	0.87	1.01	6.29	4.87	4.99
<b>Zagrebacka Banka dd</b>	11.29	9.25	8.89	1.54	1.32	1.28	3.55	3.21	3.54
<b>UniCredit Bank Serbia JSC</b>	16.01	12.78	12.97	3.43	2.48	2.37	7.04	5.91	5.19

Source: Bankscope

Table 15: Case study indicators II. (2008-2010)

	Equity (EUR, th)			Loan loss provisions (EUR, th)			Total capital ratio (%)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
<b>Raiffeisen Bank Albania</b>	161 828	177 517	199 000	13 814	27 448	30 825	16.43	17.94	17.11
<b>Raiffeisenbank d.d. BH</b>	183 913	187 650	190 160	18 407	28 474	36 580	14.40	14.30	14.90
<b>Raiffeisenbank Austria d.d., Zagreb</b>	753 603	742 539	762 204	9 478	67 652	53 493	11.82	13.92	16.70
<b>Raiffeisen Bank Kosovo</b>	74 200	81 400	91 500	3 800	12 900	5 700	15.60*	16.60*	18.70*
<b>Raiffeisen Banka ad Beograd</b>	502 704	491 505	467 760	10 760	29 275	27 179	20.69	n.a.	29.05
<b>UniCredit Bank dd</b>	172 869	188 515	214 749	8 948	11 658	13 499	14.80	15.30	15.80
<b>Zagrebacka Banka dd</b>	2 005 194	2 150 555	2 151 265	37 492	83 474	108 195	17.39	19.09	18.48
<b>UniCredit Bank Serbia JSC</b>	234 350	242 586	299 860	5 654	8 578	10 208	16.80	16.52	17.10

\* Tier 1 ratio (%)

Source: Bankscope

The above illustrated data were more or less in line with the market average. For instance, as it has already been demonstrated, the ROA slightly improved or stagnated in most SEE countries between 2009 and 2010. Likewise the local market's average, the profitability increased in terms of ROA at Raiffeisen Bank Albania or Raiffeisen Bank Kosovo. The similar tendencies could be pinpointed on the country and micro-level data on capitalisation. As for the amount of total assets, deposits and loans, the cases differed. The massive slowdown could be very well determined, but the scales were occasionally different on the country and micro-level. However, this was a natural variance among the local banks. The most important fact is, that the rapid adjustment or slowdown of the financial deepening process, and the drop of profitability could be well reviewed even within the current case study.

### 5.5. Conclusions

Likewise in other parts of the world, the financial sector in SEE had to tackle extraordinary challenges; stop the waves of deposit withdrawals, handle the problem of the continuously deteriorating loan portfolios and face the risk of a sudden stop in foreign financing.

- Large deposit withdrawals were primarily caused by the widespread confidence shock that stemmed from the global financial turmoil. This could not be tempered by the increased deposit insurance schemes or by communicating the sound capitalisation of the financial institutions. Citizens in the region still lack solid confidence in the banking sector, which can be explained even by the negative experience of the 1990s. Beside this confidence factor, part of the deposit withdrawals – typically in the corporate sector – were due to cover loan repayments, as clients were hit by the real sector's downturn or the FX pressure. In all countries, both the central banks and the governing bodies took various steps in order to regain the confidence and to support the system's stability.

- As a longer lasting factor, the loan portfolios' quality carries a primal risk. The deterioration of the loan portfolios is caused by several factors. In those countries where the devaluation of domestic currency is combined with a high proportion of foreign currency loans, unhedged borrowers face extraordinary challenges. This is coupled by the downturn of the real sector and the related growing unemployment, which directly leads to the worsening of debt servicing capabilities and growing NPL ratios with a lag. Although banks offered the possibility to restructure problematic loans to maintain the clients' solvency, while expecting better conditions on mid-term, these methods can only partly or temporarily mitigate the problem. Moreover, as the deterioration of loan portfolios usually lags behind the real sector's recession, the problem is expected to remain present even on the mid-term.
- The region's banking sector also had to cope with the difficulties of financing their external funding needs. During the turmoil, international and inter-bank borrowing became limited or expensive, thus the parent banks' financial support gained an even more vital role. On the one hand, this channel could be treated as one of the most important risk factors, due to the possibility of withdrawing funds from the region in case the parent banks need to cover their own shortages. According to the outlined worst case scenarios, the parent banks could even sell or abandon their subsidiaries. On the other hand, as during the reviewed period no major bank has pulled out from the region and parent banks continue to refinance their subsidiaries, the foreign banks presence emerged as a stabilising factor.

Despite the various challenges, the banking sector avoided a systemic meltdown, due to the former capitalisation, the measures of the local authorities, and the official and private international response. There was a sudden-stop or adjustment in the financial deepening process in terms of total assets and loans. Due to the negative feedback loops between the real economy and the banking sector, or the depreciation of the local currencies in case of floating exchange rates, NPL ratios started to increase sharply. This required extra provisioning, denting the amount of returns. Profitability dropped throughout the region, but the negative zone was reached only by Montenegro and Bosnia and Herzegovina. Nevertheless, capitalisation rather

stagnated or increased slightly. As a further underlying factor, parent banks continued to roll over credit lines and maintained their exposure to their subsidiaries in SEE. This commitment was documented within the framework of the Vienna Initiative. Although this arrangement was of a voluntary nature and did not cover all countries, it provided certain coordination and avoided first-mover problems.

The previous chapter outlined a simplified growth model for SEE for the pre-crisis years. A pillar of this model was the swift pace of credit growth, which boosted domestic demand. This became a primary driver of the region's dynamic GDP growth, but also caused large trade deficits. As further risk factors, the quality of the rapidly expanding loan portfolio and the potential sudden-stop of foreign financing could be stressed. As the first waves of the current global crisis reached the region, the negative effects had a major impact on both the fundamentals and the specific building elements of the system. The intensifying risk aversion, confidence shocks, deteriorating economic conditions and expectations caused major changes both on a domestic and international level. Generally speaking, the analysed indicators touched bottom in 2009 and showed slight development by the next year. This means that the first shock waves had their major impacts during 2009, and both the real economy and the banking sector adjusted their policies to the new environment by 2010. The domestic and international authorities applied certain measures, which were also able to somewhat dampen the spill-over effects of the crisis. Nevertheless, the external and internal changes caused the collapse of the bank-based, pre-crisis economic model and opened a new era.

Beside these similar tendencies, the different initial conditions, the applied policy measures, the real economies' challenges or the respective exchange rate regimes differentiated the countries within SEE. The charts of the current chapter illustrated that the relevant indicators' tendencies were generally similar, but the starting points and slopes showed great variety. Occasionally, the starting date of the downturn or the year of the worst levels differed. For instance, the effects of the global crisis reached Kosovo with almost a one year lag. Furthermore, the downturn itself could not be considered as steep as in other countries of the region. This could be explained with the fact, that its economy – including the financial system – could be considered the least developed, still depending on the contributions of various international



organisations. This implies that Kosovo's economy was the least integrated to the world economy, feeling the effects of the global turmoil less. The Albanian case showed many similarities in this respect, while Croatia could be picked as the opposite example. Croatia – the most developed and most integrated to the European economy – recorded the deepest recession. On the other hand, its banking sector was not so severely affected by the turmoil, also as a result of the regulatory authorities' former, strict measures. Montenegro could be considered as another unique case among the reviewed countries. During the years of the pre-crisis period, it performed extreme growth levels regarding a number of indicators. This is particularly true in respect of the annual growth of total assets and loans, raising concerns for overheating. The country's financial system and real sector was hit hard by the effects of the global crisis. Thus the largest volatility of the reviewed indicators was recorded in case of Montenegro.

The current chapter illustrated how the common, bank-based growth model of SEE collapsed during the global crisis. Furthermore, it also highlighted some of the underlying differences among the reviewed countries. It is an important finding, that in line with the statement of the European Commission (2009), the development and international integration level of the economies affected the resilience of the countries. Furthermore, as the case of Montenegro and Croatia proves, the regulatory and supervisory authorities had/have a major impact on the “non-avoidance” or the avoidance of the build-up of boom-bust cycles. It is important to stress, that the outcome of the crisis cannot be concluded yet, as new shock waves continuously emerge. Still, during the crisis period the following question can/should be answered:

- What will be the pillars of the new growth model in SEE?
- How will the volume of (FX) lending change on the long-run?
- Is further financial deepening desired at all or what would be a healthy pace of the financial expansion?
- Will alternative – non-banking – financing take over the banking sector's role?
- Will the large European banking groups continue their activities in SEE?
- How would an optimal regulatory and supervisory framework look like? How would the authorities be able to maintain financial stability, and find the

balance between the support of the economy and cautiousness? How to avoid financial fragilities and boom-bust cycles?

The global crisis opened a new era in the development of SEE. Finding the optimal answers to the questions above is inevitable for further economic success within the region.

## **6. Conclusions**

The dissertation analysed the commercial banking sector's development in SEE between the end of the Second World War and the current global crisis. The topic is particularly important from various aspects. First of all, it can serve as a useful case study for other emerging regions. Second of all, SEE's development remains in the focus of a number of international organisations and especially the EU. The reason behind this is the fact, that all SEE countries participate in the EU accession process and strong economic linkages have been built after the transition of the region. SEE's development is also relevant for the large international banking groups, which own a number of subsidiaries in the region. All these imply, that as the motto of the thesis emphasises, it is better to export stability and long-term development to SEE from various international actors' point of view than the other way around.

Generally speaking, the commercial banking sector itself has great importance in the development of any well-functioning market economy. As it has been reflected by the dissertation, it is often able to determine the overall development of an economy. Nevertheless, the link between the banking sector and its macroeconomic environment is bidirectional, as the financial development and economic growth reinforce and influence each other. Analysing the banking sector has particular importance during the years of the current financial turmoil, as the sector's supporting or destructive role gained special attention.

The hypothesis of the dissertation provided a general framework for the reviewed topic's analysis. The hypothesis stated, that despite the countries' different trajectories during the socialist and transition time period, a similar financial system evolved during the transition process as a result of the similar challenges and the financial globalisation. Based on the comparative analysis and the relevant literature, the thesis proved the hypothesis, as despite the different initial conditions, historical circumstances, political intentions and applied policies, by the end of the transition period a common, bank-based economic growth pattern could be outlined for the region. In addition, various common and differentiating characteristics have been specified. For instance, widespread FX usage could be revealed on both the asset and

the liability side in almost all country cases, whereas the pace of financial deepening reflected significant differences. Furthermore, the thesis also included the most important features of the macroeconomic environment and highlighted the strong link between these two fields. Last but not least, the thesis showed the fundamental role of foreign-owned banks in the economic development of SEE.

The first main chapter compared two odd socialist prototypes, Albania and SFRY. The former could be considered unique for its constant loyalty to the classical socialist system and its isolation from the rest of the world. The latter gradually created its own special prototype, which included both market oriented and socialist elements. By the 1970s, SFRY shifted closer to a capitalist model, but limited the market-oriented mechanisms by administrative measures. The chapter's comparative analysis is based on the literature of e.g. Gligorov (1998); Kornai (1992); Lavigne (1999); Lydall (1984); Schnytzer (1982); Singleton (1976); Sjöberg – Wyzan, eds (1991); Vaughan-Whitehead (1999). All in all, the two countries could be considered as two extremes within the socialist bloc. Such underlying features as the ownership structure or the planning mechanisms differed in the two countries.

Besides these fundamental elements, the features of the banking system demonstrated basic differences, just as the two countries' general development paths. The relevant literature – including e.g. Barisitz (2008); Clunies-Ross – Sudar (1998); Gedeon (1987); Lydall (1984); Singleton (1976); Vaughan-Whitehead (1999) – provides a good overview on the socialist banking systems' main characteristics. It can be concluded, that the two banking models could be considered completely different. Albania implied a one-tier banking system, which merely had administrative role. On the other hand, SFRY had a two-tier system with a commercial banking sector gradually gaining more and more independence from the bureaucracy. Various capitalist elements have been included to the system, but due to the indirect administrative restrictions, market mechanisms were not able to rule the system.

Despite the fact that SFRY implemented various capitalist elements, neither of the two countries' banking sector fulfilled the market oriented functions. One may conclude, that the banking systems had limited or no experience in banking in a

“real” economy, in the credit evaluation and risk management methods, in international accounting or as financial intermediaries. All these imply, that although the development of the two countries diverged, the banking sectors’ legacy could be considered similar by the end of the socialist time period, meaning that similar challenges had to be addressed during the transition process. This conclusion can be considered the most interesting finding of the chapter analysing the socialist time period. Within the first main chapter, Table 2-4 highlight the most relevant differentiating features of the two socialist economic models, their banking sector and the sector’s inherited “knowledge” for the market economic system.

During the years of transition, Albania and the successor states of former-Yugoslavia had to face the “classical” transition tasks. However, the latter group of countries were also affected by the dissolution of a single system, coupled with devastating military conflicts and embargos. Neither of the reviewed countries could achieve long lasting macroeconomic stability and certain systemic collapse occurred in all cases. These internal shocks required more than one stability package during the transition process. Based on the relevant macroeconomic time series and literature – including e.g. Bicanic (1996); the EBRD’s Transition reports; Pashko (1996) or Šević et al (2002) – the analysis reveals three groups of factors that differentiated the countries of SEE during the transition period:

- the initial development level, institutional system and self-sustainability,
- the impacts of military conflicts, sanctions and embargos,
- the starting date, sequencing, duration and methods of the stabilising and restructuring policies.

These factors increased the heterogeneity among the SEE countries and caused great lags regarding the transition process. The analysis demonstrates that the transition was a non-linear, long-term and gradual process in all country cases.

As for the banking sector itself, a range of internal and external shocks affected its activity. In certain cases the authorities had to face more than one banking crisis or the collapse of large pyramid schemes. These caused major shockwaves or even the meltdown of the financial system. With the help of the literature – including for instance Barisitz (2008); Fries – Taci (2002); Keren – Ofer (2003); Pashko (1996) or Šević et al (2002) – it can be concluded, that the methodology, pace and sequencing

of the sector's restructuring showed great variety. However, by the end of the transition process the institutional structure of the sector became similar. The main finding for the transition time period is the fact, that despite the great differences of the initial systems and development levels, a common regional template could be specified for the banking sector's development: following a systemic collapse, large European banking groups penetrated the local markets and gained terrain at an initial phase, and contributed to the sector's transition process from various aspects.

Generally speaking, the banking sector played a substantial role during the transition time period. As a negative factor, during the sector's stabilisation and restructuring, it has put extra burden on the fiscal authorities. On the other hand, once it was able to fulfil its market-oriented primary roles, it was able to support the economic development in various fields. During the transition process the asset share of banks with majority foreign ownership converged to the range over 75%.<sup>87</sup> By the second half of the 2000s, the number of banks stabilised in the region, while the market concentration became high. These imply, that the sector became dominated by a narrow group of large European banking institutions, whereas these banks had a primary role during the banking sector's transition process. Foreign banks transferred various benefits and resources, and enhanced competition. They contributed to the banking sector's penetration to everyday life both horizontally and vertically. As a further factor, they had an important role in restoring public confidence in a region where large part of the population experienced multiple banking crises or shock waves. Furthermore, foreign banks helped to underpin the system's stabilisation, as NPL ratios gradually decreased, while the capitalisation reached fair zones. All in all, the foreign banks' role could be considered rather positive during the transition time period. It can be concluded, that the dissertation was able to prove the pivotal role of foreign-owned banks in the sector's development, which was one of the main theses.

Following the years of transition, the reviewed countries' development demonstrated a range of underlying common features, which made SEE a unique region within Europe. The thesis highlights these characteristics via the analysis of a comprehensive dataset and the relevant literature – as for instance, Backé – Walko

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<sup>87</sup> For relevant statistics, please see the EBRD's Transition reports and statistics, and the respective central banks' homepage.

(2006); the EBRD's Transition reports; European Commission (2009) or Sorsa et al (2007). The following list summarises the most relevant statements for the pre-crisis period:

- Regarding both the banking sector's development and economic growth, a significant convergence process took-off. We highlight – thus underpinning one of the theses of the dissertation – that the well-known correlation between the indicator of the total assets per GDP and the GDP per capita was valid for the case of SEE as well.
- As for further relevant macroeconomic indicators, current account deficits and unemployment rates could be considered very high, while inflation rates reached fair levels with the exception of Serbia.
- The banking sector's main KPIs converged to a common zone, including positive profitability indicators and gradually decreasing interest rate spreads. We reveal that the NIMs showed negative correlation with the degree of financial intermediation in the region. Significant capital buffers have been built, while NPL ratios continued to decrease. Noteworthy, that the provisioning policy reflected significant differences within the region.
- Though there is no strict rule for defining the category of excessive credit growth, the rapid pace of credit expansion raised concerns on asset quality and overheating. The credit growth boosted the domestic demand, which underpinned the GDP growth, but also led to various vulnerabilities.
- As a general transitional feature, the gradual crowding-in of the private sector lowered the public sector's share within the loan portfolios.
- Confirming the finding of Backé – Walko (2006), one of the most specific regional characteristics was the fact, that the FX usage was very high on both the asset and liability side. The exceptions were those countries where the euro is being used as a sole legal tender. This somewhat dampened the respective FX risk of the banking sector. Nevertheless, it is an important outcome of the analysis that the applied exchange rate policies did not reflect the degree of FX usage.
- In line with the statement of Backé – Walko (2006), we state that large share of the rapid credit growth has been financed by the swift deposit growth.

It must be emphasised, that during the analysis the thesis also reveals significant differences among the countries. This refers to the level, structure and quality of the financial deepening. These differences could be explained by the initial conditions and the applied policies. For instance, Croatia could be considered the most developed country within the region, while Kosovo the least developed from various aspects. Serbia remained a latecomer, due to the lost decade of the 1990s. Montenegro became an outlier with the extreme pace of financial deepening, whereas Bosnia and Herzegovina and FYR Macedonia recorded a rather modest growth pace.

Based on the mentioned common characteristics, the analysis of the respective data and the relevant literature – e.g. Backé – Walko (2006); European Commission (2009); Sorsa et al (2007) and Vamvakidis (2008) – the thesis compiles a common growth pattern for the region. The model is in line with the well-known problem of pro-cyclicality in bank lending. This pattern also helps to highlight the links between the banking sector and its macroeconomic environment. From the banks' point of view, foreign funding and deposit growth underpinned the rapid – often meaning FX – credit growth. As the retail clientele generally had a lower level of disposable income than the propensity to consume, there was a strong demand for loans. On the other hand, the available loan possibilities boosted the household consumption, so the link here was bidirectional. Investments rather had a secondary role. All in all, these factors fuelled the GDP growth, but also led to large import demand causing soaring current account deficits. This simplified growth model highlights three main risk factors. From the banking sector's side the funding and credit risk should be stressed. The latter refers to the credit quality and the FX risk of unhedged borrowers. From a macroeconomic perspective, the mentioned high level of external imbalances is emphasised. These vulnerabilities became particularly relevant as the first waves of the global crisis reached the region and the illustrated fragile growth pattern collapsed.

Likewise on a global level, the financial sector in SEE had to face extraordinary challenges as the impacts of the crisis reached the region:

- Due to the widespread confidence shock, waves of deposit withdrawals had to be stopped.



- Also as a result of the negative feedback loops between the real economy and the banking sector, the continuously deteriorating loan portfolios had to be handled. Profitability sharply dropped in the region, though usually remained positive.
- The banks had to face the risk of a sudden-stop in foreign financing. However, during the reviewed time period, parent banks continued to maintain their exposure to their subsidiaries. All in all, during the first years of the crisis the foreign banking groups played at least a neutral or even a positive role, which also reflected their long-term interest in SEE.

As a general feature, a sudden-stop or adjustment occurred in the former financial deepening process in terms of total assets and loans. Nevertheless, the banking sector avoided a systemic meltdown as a result of the former capitalisation, the local authorities' measures, and the international response from private and official institutions.

Due to the widespread negative impacts, the illustrated pre-crisis growth pattern collapsed during the crisis. The intensifying risk aversion and confidence shocks, the deteriorating economic conditions and expectations led to basic changes both on a domestic and international level. As a result, the system's base – the deposit growth, the foreign funding or the credit growth – became hardly hit by the crisis. This had a direct spill-over effect on the further building blocks. However, the crisis had a major impact on each and every building block.

The thesis also reveals, that beside the similar tendencies, certain differentiation could be made among the countries. This could be explained by the different initial conditions, the applied policy measures, the challenges of the real economy or the respective exchange rate regimes. During the analysis we illustrate, that the relevant indicators' tendencies were generally similar, whereas the initial conditions and the intensity of the changes reflected great variety. We find, that – in line with the statement of European Commission (2009) – the respective economies' development and their international integration level determined the resilience of the countries. Furthermore, the thesis reveals that the regulatory and supervisory authorities' policy had a significant impact on the avoidance of the build-up of boom-bust cycles.

Adding up all of the effects of the global crisis, it can be concluded that the former bank-based model collapsed in SEE, opening a new era with various questions:

- What elements will provide the pillars of the new growth model? Will there be a common model for SEE?
- How will the volume of (FX) lending change on long-term?
- Is further financial deepening desired at all or what would be a healthy pace of the financial expansion?
- Will alternative – non-banking – financing take over the banking sector's role?
- Will the large EU-headquartered banking groups continue their activities in SEE?
- What would be the framework of an optimal regulatory and supervisory system? How would the authorities be able to maintain financial stability, and find the balance between cautiousness and economic incentives? How to avoid financial fragilities and boom-bust cycles?

Finding the optimal answers in the near future is inevitable for SEE's further, long-term economic stability and success.

Besides the listed questions of the last main chapter, there are three main directions that provide the possibility for further analysis. First of all, the reviewed time span can be expanded. The thesis reviews the sectoral development in SEE until 2010, but the analysis should be carried on for the latest episodes of the current global crisis. This is particularly relevant, as new shock waves continuously emerge. These have strong impacts on both the parent banks and their subsidiaries, but influence also the macroeconomic conditions and the policies of various authorities.

Second of all, the spectrum of the covered regions can be broadened. It would be worth including further regions to the comparative analysis of the banking sector's development. As it has already been mentioned, the literature often reviews SEE within the group of transition countries or CEE. However, comparing SEE with the region of CEE or the CIS would provide a base for further analysis. Although these countries can be tagged as transition cases, great sectoral differences can be outlined. Furthermore, an interesting comparison could be made by including regions from an even broader perspective, as for instance East Asia. In this case, the historical and

political background could often be considered completely different, implying specific environment for the various banking groups. In case of these topics, the analysis can be carried out both on a sectoral and micro level, meaning two perspectives.

A third direction would be the detailed analysis of the banking sector's impact on a specific macroeconomic indicator. The thesis illustrated certain links between the sectoral development and the GDP per capita or the current account balance. The inflation rate is a further variable that can be added to the list of possible variables. A comprehensive analysis can be carried out for each of these links, including even regression analysis. The connections between these variables can be reviewed for one or a number of regions.

We hope, that the thesis may help to understand the unique development of the banking sector in SEE. It demonstrates the region as a single economic unit with its own history, characteristics and development path. On the other hand, we also intended to highlight some of the differentiating features among the country cases to illustrate SEE's diversity. Analysing the region in a broad time frame provides the possibility to understand the roots and background of SEE's economic development, thus it can also support finding the optimal solutions for the current challenges.

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