CAPITAL MARKETS DEVELOPMENT IN CROATIA

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Introduction[1]

Croatia accomplished the most remarkable stabilization record among transition economies in the last three years. The exchange rate has fluctuated within a narrow band since the end of 1993 and the rate of comsumer price inflation was -3% in 1994 and 3.7% in 1995 (December level). However, the unfavourable war-time and political environment was an obstacle to growth and deeper capital market development although economic activity is picking up since 1994 (real GDP growth was 1% in 1994 and 2% in 1995). The signing of the Dayton Agreement for neighbouring Bosnia and Herzegovina, the peaceful reintegration of Eastern Slavonia (the only remaining occupied region, on the Eastern border with Serbia), and Croatia's full membership in the Council of Europe (November 1996) will undoubtedly enhance the economic effects of stabilization and reforms carried out in the period 1992 - 1995.

The purpose of this survey is to cover the most important issues related to capital market development. The first section is on monetary policy and deals with problems of the institutional role of the central bank, exchange rate policy, interest rates, as well as financial market instruments and open market operations. The second section covers the banking sector. It contains a brief review of the history, prudential regulations and bank rehabilitation. The third section is on privatization. Both privatization techniques and results are discussed. The fourth section is on organised exchanges, with special emphasis on equity markets development. The fifth section discusses external sources of finance.

[1] This survey is based on the author's contribution to the book "Capital Markets in Emerging Economies" edited by Christian Helmenstein. The book will be published in Spring 1997 by Edward Elgar.

Executive Overview

Despite the great success of a macroeconomic stabilisation program, capital markets in Croatia developed relatively slowly due to war-time and regional security risks. However, despite war-time, significant financial structural reforms were undertaken in 1993 - 1995. Hence, a favourable political environment in 1996 started to bear fruit in 1996 in terms of financial deepening and real economic growth.

The first section on monetary policy focuses on the monetary aspects of the stabilization program. Emphasis is put on the role of an independent central bank which carried out substantial reforms of instruments that helped the development of financial markets. Special comment is given on high interest rates and interest spreads which are explained by supply side factors: bad assets in large banks and weak competitive pressures coming from newly established private banks.

The structure of the banking system is the focus of section two. Relations between ownership concentration, size and interest spreads are examined and it is stressed that larger banks with lower ownership concentration have the strongest competitive potential, but their balance sheets are burdened with bad assets. Hence, bank rehabilitation is a powerful policy tool which can increase competition in the short run even if foreign banks hestitate to penetrate the market. The rehabilitation procedure is described briefly and it is stated that the beginning of credible bank rehabilitation procedures in 1996 can explain the decline in interest rates that occurred recently.

The techniques and results of privatisation are elaborated in section three. Although Croatia did not employ mass privatization scheme, the results are positive: more than 50% of nominal equity in enterprises that entered the procedure is privately owned. However, large public utilities are entirely state owned. There was no political consensus on privatization strategy for the public sector enterprises and institutions, so this remains the main policy issue till the end of the century.

Exchanges are described in section four. Special emphasis is put on equity market development. Equity markets developed strongly in 1994 due to swaps of shares held by the Croatian Privatization Fund for public debt instruments. This was a successful operation which simultaneously enhanced the size of the private sector, decreased the public debt and helped the development of the secondary markets for public debt instruments. In 1995, markets suffered from pessimistic expectations due to war-times during liberation military actions, but they have recovered strongly in 1996, driven mainly by the successful privatisation of pharmaceutical company Pliva and Zagrebacka bank, one of the most successful emerging market banks.

Finally, external sources of funds are the focus of the concluding section five. Reasons for optimistic expectations related to FDI are elaborated. It is stressed that Croatia has regularized its relations with all international creditors. A current account deficit of 5%-6% of GDP is sustainable till the end of the century in light of the very low international indebtness and good links with international financial institutions.

Monetary Policy

National Bank of Croatia

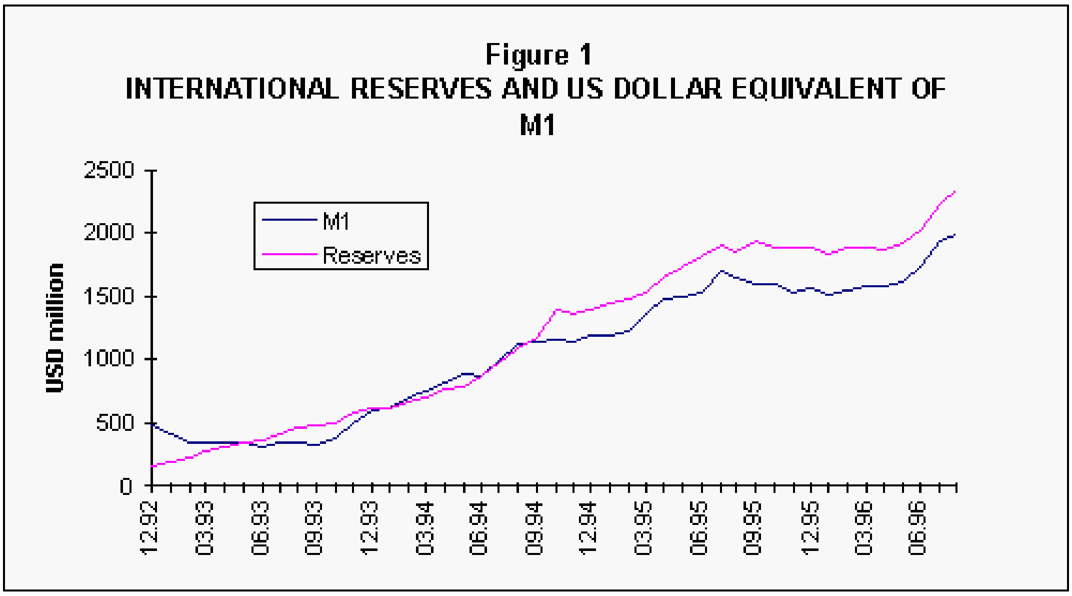
According to the Law on the National Bank of Croatia (NBC), the central bank is an independent institution whose prime goal is to insure a stable currency and liquidity in both domestic and international payments. There is no conflict of interest between stability and growth embedded in its basic regulation, and a clear collective preference towards stability is stated by the Law[2]. In addition, the Governor is elected by the parliament for a period of six years, two years longer than the election cycle. Independency of the central bank is further strenghtened by the council of the NBC. Members of the council are also elected for a six year period [3], and it is clearly stated that the members should be "independent experts". Finally, long-term loans to the government are legally forbiden. The law allows only short-term financing of government expenditures, up to 5% of the budget in the respective year. All of these loans have to be repayed within the fiscal year, and their purpose is to "bridge" short-run disrepances between public revenues and expenditures due to seasonal factors. However, these loans are usually extended on the intramonth basis.

[2] Potential conflict arises, at least theoretically, between stability and domestic liquidity. However, safeguarding liquidity in domestic payments has always been interpreted as concern about the regular functioning of the domestic payments system.
[3] The exact dates of election of individual members of the Council do not coincide with the election date of the Governor.

Money, International Reserves and Exchange Rate

Interventions at the foreign exchange market were the main monetary policy instrument since 1992 for two reasons. First, foreign exchange reserves of the National Bank of former Yugoslavia were blocked by Belgrade, and the NBC was founded without any international reserves in its portfolio. The main monetary policy target in 1992 and 1993 was the accumulation of international reserves, regardless of rapid exchange rate depreciation and high inflation. Indeed, international reserves of the NBC accumulated up to USD 500 millions in October 1993, when the stabilization program was announced. At the same time, decline in real money supply during 1992 and 1993 was so sharp that NBC's international reserves in end October 1993 exceeded the US dollar equivalent of M1 by 32.7%. Only a minor part of decrease in real money was due to reduction in real GDP. The major part of it was due to a sharp increase in money velocity driven by currency substitution, common in all high inflation episodes[4]. Hence, a credible announcement of an exchange rate based stabilization program happened at the moment when the money to reserves ratio reached a low level, which provided a guarantee for the success of an exchange rate based program. Money demand recovered strongly and immediately after the announcement, and monetary authorities were faced with a different set of options thereafter: either to expand the money supply, or to let the nominal exchange rate to appreciate.

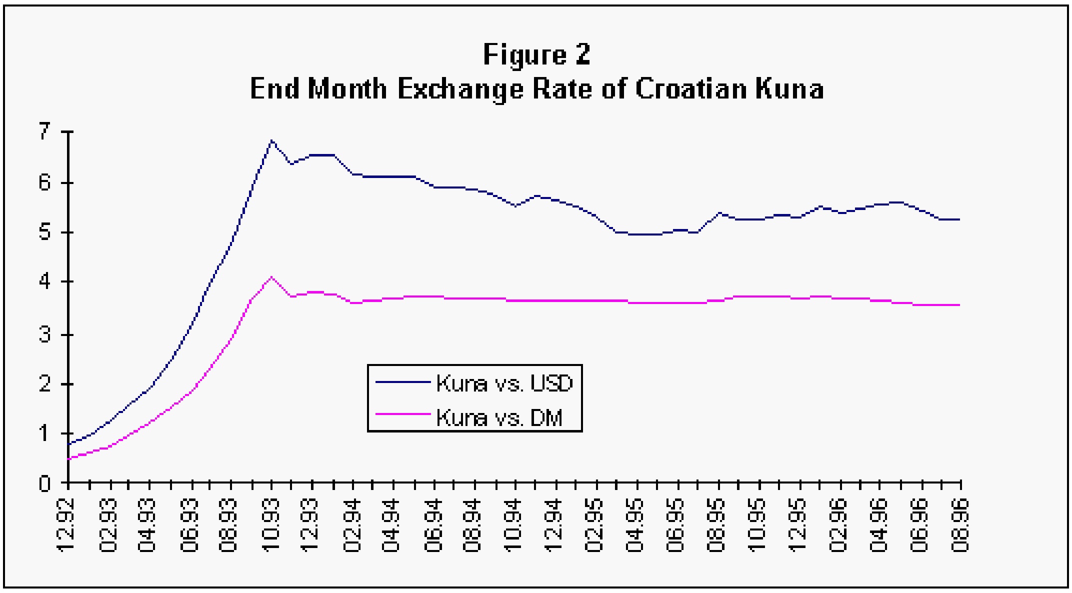
INTERNATIONAL RESERVES AND US DOLLAR EQUIVALENT OF M1



The second reason for accumulation of international reserves can be found in the post-stabilization period. Since mid 1993, and especially since the successful exchange rate stabilization and disinflation in late 1993, foreign exchange inflows into the country were boosted, and NBC had to intervene by buying out foreign exchange in order to prevent huge nominal appreciation of the exchange rate[5].

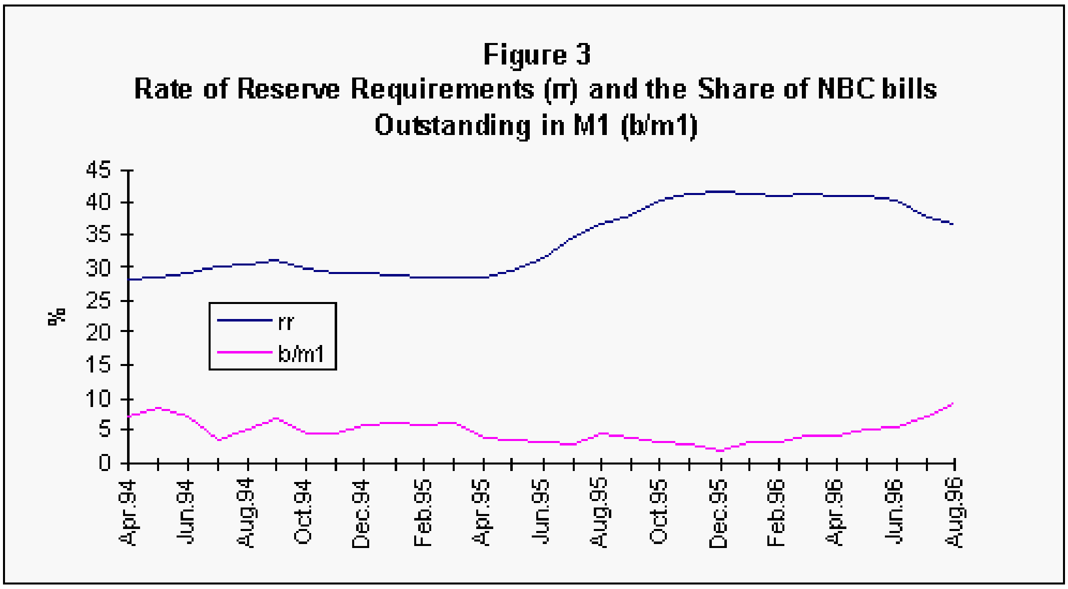
One of the key factors that can explain such a sharp change in the behavior of the exchange rate is the change in the exchange rate regime. In the pre-stabilization period international reserves were accumulated on the basis of an administrative regulation which required commercial banks to sell 35% of their foreign exchange inflows to the NBC on an obligatory basis. A new foreign exchange law that allowed a free foreign exchange market and current account convertibility was adopted in October 1993 (it was the central part of the stabilization pacage), and Croatia adopted the IMF's Article VIII in May 1995. Prior to October 1993, citizens could only sell hard currency to commercial banks, but from October 1993 hard currency is freely traded, which explains how it was possible to gain credibility within only one month at the beginning of the program.

END MONTH EXCHANGE RATE OF CROATIAN KUNA



So, the accumulation of NBC's international reserves continued after stabilization, and the money supply continued to grow by high rates while prices and exchange rates remained stable at the same time. The velocity of M1 declined from 27 (annual level) at the beginning of stabilization, to 10 in mid 1996. Besides, the NBC sterilized part of the effects of foreign exchange interventions. In late 1994 and 1995 NBC relied extensively on reserve requirements, since financial markets were not developed enough to support required sterilization by open-market operations. The rate of reserve requirements increased from 28.9% in end 1994 to the maximum of 41.4% in end 1995. In 1996, as financial markets developed, the reserve requirements started to lose their central role. The rate of reserve requirements fell to 36.7% in August, as NBC bills, short-term financial instruments auctioned regularly by the NBC, started to play the central role. The share of the volume of the NBC bills outstanding in M1 increased from 2% in end 1995 to 8.8% in end August 1996.

RATE OF RESERVE REQUIREMENTS (rr) AND THE SHARE OF NBC BILLS OUTSTANDING IN M1 (b/m1)



Therefore, a fundamental change took place in the structure of NBC's portfolio. The share of foreign assets in total assets increased from 0% in end 1991 to 94% in end 1995 and 97,3% in end August 1996.

Table 1: **Structure of the NBC balance sheet**

	End December 1991	End December 1995	End August 1996
ASSETS	100.0%	100.0%	100.0%
Foreign assets	0.0%	94.2%	97.3%
Domestic assets	100.0%	5.8%	2.7%
- credits to gvt.	39.0%	3.7%	2.6%
- credits to banks	61.0%	2.1%	0.1%
LIABILITIES	100.0%	100.0%	100.0%
Cash in circulation	44.0%	31.5%	32.3%
Required and excessreserves	39.0%	32.7%	38.2%
Gvt. deposits	0.0%	3.7%	5.3%
Other liabilities*	17.0%	32.1%	24.2%

* Includes foreign liabilities (IMF credits), restricted and blocked deposits, deposits of other domestic sectors, capital accounts and other items net.
Source: Author's calculations based on the NBC Bulletin and Main Statistical Indicators.

The share of domestic assets droped from 100% to 2.7%. Net credits to the government came down from 39% to 0% in end 1995 and -2.6% in end August 1996, mainly due to the transfer of the government deposits from commercial banks to the NBC and because of sound fiscal policy[6]. Besides, the level of international reserves reached 2.3 bln USD by end August 1996 and it corresponds to 12.1% of GDP or 3 average monthly values of imports of both goods and services.

[4] M1 velocity is estimated to have been at an extreme value of 27 at annual level in end October 1993.

[5]The strength of the inflows was due to reverse currency substitution. The private sector accumulated hard currency foreign exchange which was either held in cash or transfered to West Europen banks during years of high inflation and war-time. Starting from end 1993, reversal of these flows puts a strong pressure on the domestic currency to appreciate. Indeed, the present level of the exchange rate vs. deutsche mark, which is the reference rate in Croatia, is 19.9% stronger in nominal terms than the rate at the beginning of stabilization.

[6]The consolidated government sector recorded an overall surplus of 0.6% of GDP in 1994 and a 1% deficit in 1995.

Instruments of Monetary Policy

Monetary instruments have been reformed. General and earmarked quotas (selective refinancing facilities for agriculture and exports) were the centerpieces of the old monetary policy regime, and they have been phased out during 1993 and replaced by indirect instruments of monetary management. Besides foreign exchange interventions, the lombard credit facility became the most important instrument (starting from 1994). Lombard credits are extended up to 50% of NBC bills that commercial banks have in their portfolio. The lombard rate has been determined as a markup of 1.5% over the interest rate on NBC bills, but from August 1996 it is determined by the council of the NBC in light of prevailing market conditions. Presently, the rate is set at 11%, which is 3% higher than the interest rate paid on NBC bills and approximately 1%-2% higher than the average interbank money market interest rate. Besides, there is a daily credit which smoothes intraday liquidity. Banks who are not able to cover their position at the interbank money market are forced to use intervention credits. This is a very expensive facility (the interest rate is 19%) that bears penalties for banks, since the bank and its clients have their accounts blocked as long as the bank has to repay the intervention credit. If intramonth liquidity appears to be extremely volatile, NBC sometimes uses repurchase auctions of NBC bills and foreign exchange.

NBC bills are the sterilization instrument developed in order to allow for open market operations, with 7, 35 and 91 day maturities. This paper is auctioned weekly and its interest rate is market-determined. When money market interest rates were very high, the outstanding volume of NBC bills was small. The cost of sterilization implied by high money market interest rates was too high for the NBC, so it decided to rely on reserve requirements, which were remunerated at lower rates. When money-market interest rates dropped in 1996 (due to the beginning of credible bank rehabilitation), an NBC bills market developed.

Interest Rates

These developments bring interest rates into the focus of our analysis. All interest rates reported in table 2 are market determined (except the rate of remuneration which is set by the NBC). The tax on lending interest rates was imposed for two moths in spring of 1994, but it was abolished because policy makers perceived it to be ineffective.

End-1993 data show extremely high interest rates and a large interest spread because the expectations of market participants did not adjust immediately after exchange rate and price stabilization occured in November 1993. Nominal interest rates decreased in 1994 due to rising credibility of the ongoing programme and due to price deflation (real lending interest rates in 1994 were strongly positive, amounting to more than 18%), and then increased again in 1995, mainly due to rise in inflation (real interest rates rose only marginaly compared to 1994). However, it is the interest rates spread that rose significantly in 1995.Sonje, Kraft and Dorsey (1996) found that this is due to very high and growing overhead administrative expenses in banks, and the costs of exchange rate volatility[7] that are passed on to clients. Finally, note that the share of foreign exchange deposits in total liquid deposits increased in 1995 due to stronger inflow of foreign exchange to domestic bank accounts. The public does not yet have strong long-run confidence in the economic policy, so that people keep large parts of their portfolio in foreign currency, mainly in DM.

TABLE 2: END PERIOD INTEREST RATES AND FINANCIAL RATIOS*

	1993	1994	1995	1996:8
1 Money Marekt Interest Rate	86.9	17.8	27.2	9.8
2 35 Days NBC bills Rate	63.1	12.0	25.5	9.5
3 Lending Rate (kuna credits)	59.0	15.4	22.3	20.8

4 Deposit Rate (kuna depos.)	27.4	5.0	6.1	5.5
(foreign currency depos.)	n.a.	n.a.	4.6	4.2
5 Interest Spread (kuna)	31.6	10.4	16.2	15.3
6 Rate of Remuneration	2.0	5.6	7.9	6.1
7 Total kuna deposits/M4	32.6	34.5	28.6	28.5
8 Total F.C. deposits/M4	53.7	50.2	57.5	58.9

* Lending and deposit rates are weighted averages of all commercial banks, and interest rate spread is a simple difference between them.
Source: Author's calculations, NBC monthly Bulletin, 1996.

Interest rates on domestic public debt instruments vary, depending on the type of the instrument. Overall domestic debt is low, and it amounts to 18% of GDP. The main part of it are so-called "counterparts to blocked foreign exchange deposits". These foreign exchange deposits accumulated in Croatian banks while Croatia was a member of the ex-Yugoslav federation, and all foreign exchange inflows had to be sold at administrative exchange rates to the National Bank of Yugoslavia. After the break-up of the former state, claims on NBY became non-performing and the Croatian government declared them as public debt payable in 20 half-year instalments with 5% annual interest rate (principal is indexed to the exchange rate). Three-year bonds with 12% and 8.5% annual interest rate were issued recently as a marketable refinancing instrument. Besides, Croatian external debt (after adjustment for the London and Paris Club agreements) amounts to 26% of GDP, so that the overall public indebtness of about 34% of GDP is relatively low.

In conclusion, nominal interest rate developments in the post-stabilization period can be clasified in four phases. In the first phase, at the very beginning of stabilization, real and nominal interest rates reached high levels due to inertia in expectations of market participants. In the second phase, during 1994, expectations adjusted and nominal interest rates declined. In the third phase (1995), nominal interest rates and the interest spread increased again, mainly due to lack of credibility of reforms and unfavourable war and political environment. Bank rehabilitation lagged behind other macroeconomic reforms, markets remained underdeveloped, and budget priorities were attached to financing the liberation of occupied regions. The NBC had to rely on reserve requirements instead on open market operations in order to sterilize excess liquidity created by foreign exchange interventions. In the fourth phase (beginning in 1996), credible bank rehabilitation began, money market interest rates dropped (as well as the costs of sterilization), and open market operations took the central place as a main tool of domestic monetary management. Hence, the sequence of phases has been largely determined by the speed of restructuring in the banking sector.

[7] Bole (1996) offered a similar explanation for Slovenia, emphasising exchange rate volatility itself, while Sonje, Kraft and Dorsey (1996) stressed the role of the sudden exchange rate depreciation of the kuna that occured in September 1995.

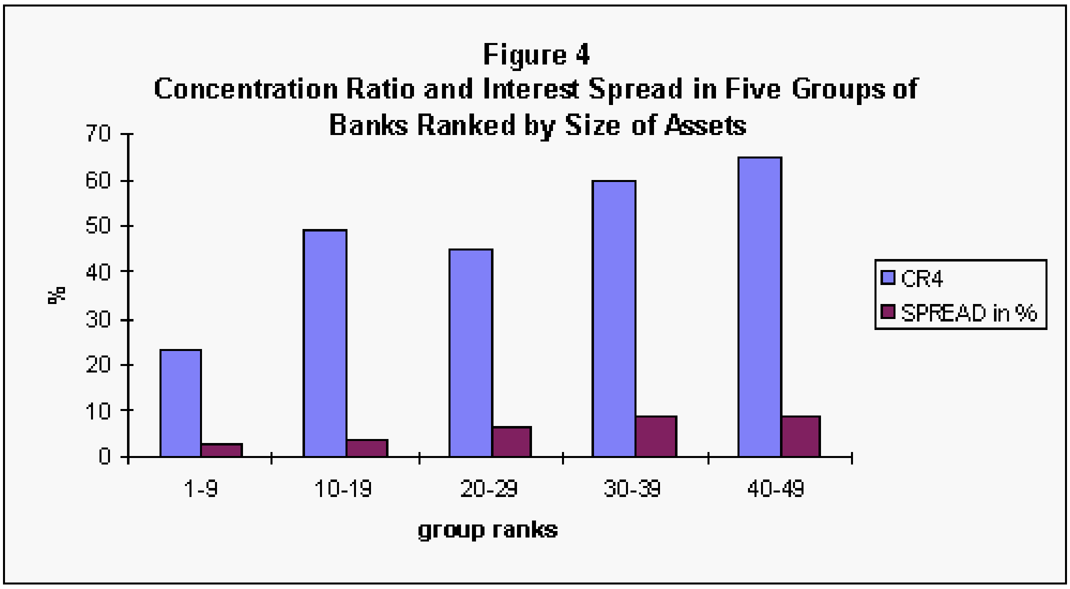
The Banking Sector

Concentration, Ownership and Prudential Regulation

Although Croatian banks were transformed into joint stock companies (owned mainly by enterprises) already in 1989, they continued with practices divorced from profitable banking, such as lending to related parties. Moral hazard and adverse selection were fuelled by war hardships, leading to a high share of non-performing assets in banks' balance sheets[8]. They have been estimated at almost 50% of total assets, and some informal estimates for four problem banks pointed to 60%-80% of bad assets. Besides, the Croatian financial industry is highly concentrated: the two largest banks (Privredna banka and Zagrebacka banka) comprise 50%-55% of both total assets and total capital.

Concentration did not change a lot in the last few years, when the number of banks grew considerably (from 20 in 1989 to 60 at the end of 1996). High interest rates and interest spreads enabled profitable operation for small banks of a size which is far below optimum. Recent research which has been conducted on a sample of 49 banks has shown that ownership concentration is lower and interest spread is larger in smaller banks. Banks have been classified in five groups according to size of assets as of end 1995. Ownership concentration has been measured by concentration ratio four, that is by the share of the four largest owners in total equity capital of the bank. Interest spread has been measured by the difference between interest earnings and interest costs over total assets. The result is shown in figure 4, and it can be interpreted as follows: Smaller banks are under the strong influence of owners' expected (high) dividends. Greater ownership concentration implies better coordination of a small number of influential owners. The management of the bank is too weak to retain profits and invest in expansion. Hence, small banks which operate with higher interest spreads serve myopic owners' interests. They did not contribute to the lending price competition.

Concentration Ratio and Interest Spread in Five Groups of Banks Ranked by Size of Assets



Source: Sonje, Velimir, 1996. "Banking System in Croatia: Evolution, Structure and Performance" in: Rohatinski et. al. Privatization Process in the Republic of Croatia. Open Society Institute - Croatia and Central European University, in printing.

On the other hand, low interest spread (which is measured by net interest earnings over assets) in large banks may be underestimated becase the denominator, total assets, includes non-performing assets in these banks. However, the 1993 Banking Law introduced Western regulatory standards such as: minimum capital (15 mln DEM for the full licence), capital adequacy ratios in accordance to BIS standards, limits on credits to related parties, limits on investment in buildings, land and equipment, obligation to independtent audit of accounts etc. Loan loss provisions became obligatory, and some additional prudential regulation measures have been imposed by the central bank. The most important one is the limit on the foreign exchange exposure which ensures sound banking business in times of strong capital inflows. A limit is set on currency missmatch at 30% of bank's liable capital[9], and banks are obliged to redeposit 53% of new short-term foreign exchange savings abroad[10]. All of these prudential measures might have slowed down the growth of non-performing asssets, but main part of it has been inherited from the past.

So, the impact of non-performing assets on low interest spreads in large banks might be a much more important factor than lower ownership concentration and/or larger size of the bank. Cross section regression on a sample of 49 banks has been performed in order to analyse this problem. Net interest earnings over assets (NIEA) is a dependent variable, concentration ratio (CR4) and the size of assets (A) are independent variables. Two regression results are presented (t statistics in parenthesis). The second eqation contains a binary variable PROBLEM which equals one six times (zero otherwise): for four problem banks and for two other banks that were regular users of interbank loans for coverage of negative balances at their accounts in some periods in the past.

$$\begin{array}{l} NIEA = 3.7132 + 0.0513CR4 - 0.0231A \\ \qquad\quad (3.026) \quad (2.481) \qquad (-1.516) \end{array}$$

$$\begin{array}{l} NIEA = 4.1534 + 0.0479CR4 - 0.0001A - 3.8659PROBLEM \\ \qquad\quad (3.469) \quad (2.405) \qquad (-0.559) \quad (-2.177) \end{array}$$

The concentration ratio parameter is significant in both equations. This confirms the role of myopic owners and explains why a growing number of (small) banks with high ownership concentration is not a sufficient condition for strenghtening the lending price competition on credit markets. Size of assets plays the expected role in the first equation, indicating insufficient scale economies in smaller banks. However, the binary variable PROBLEM diminishes the role of the size of assets in the second equation and makes the conclusion less obvious. Undoubtedly, problem banks have lower net interest earnings over assets, but this might be due to higher interest costs on very expensive interbank loans (see table 2). It is not at all clear how the elimination of problem banks would affect net interest earnings over assets, but it can be stated that lending interest rates would probably drop when relatively larger banks with lower concentration ratio become viable competitors. This is what is actually going on in 1996.

[8]Contrary to some other countries, such as Poland, where high inflation depreciated part of the nominal value of non-performing claims on enterprises. This did not happen in Croatia, where the indexation of loans became a widespread habit during a long high -inflation history starting in early 70's.

[9] Equity capital plus reserves up to 50% of the value of equity capital.

[10]This is a common measure in transition economies experiencing capital inflows. In Slovenia, the measure is called "forex minimum" and it amounts to 68% (Bole, 1996).

Bank Rehabilitation

The Law on Agency for Deposit Insurance and Bank Rehabilitation was enacted by the Parliament in 1994 and the agency started operations in 1995. Two large state owned banks are currently undergoing rehabilitation (Splitska banka, Rijecka banka), and one bank (Slavonska banka) has already finished rehabilitation. The beginning of the procedure has been announced for the last and the biggest problem bank (Privredna banka). Four problem banks comprise 36.5% of the total liable capital of the banking system and 45.6% of the total assets.

The rehabilitation procedure implies changes in the management and the ownership of the bank. First, the NBC estimates the "economic justification for the rehabilitation" which includes estimation of potential losses and a proposal for the rehabilitation program. The proposal is submitted to the government which takes further steps via agency. Second, estimated non-performing loans are written off against capital. If the capital-adequacy ratio falls below the legal standard (8%), the bank is recapitalized by the government. Recapitalisation occurs in the form of cash and bonds in order to improve both the solvency and liquidity of the bank. The agency, which is an independent institution funded by the state budget, acquires bad assets against an ownership share in the bank. The share has to privatised in the final step.

The procedure will significantly alter the ownership structure in the Croatian banking system. But this will happen in the medium run. However, significant improvements have occurred at the money market already in the short run. Since bad banks generated interest rate inelastic demand for funds, the money market interest rate exceeded an average annual level of about 30% in early 1996. This type of demand vanished after the beginning of credible rehabilitation procedures (due to initial liquidity injections), and the money market interest rate suddenly started to reflect supply and demand conditions more accurately. The interbank money market interest rate dropped to about 9% until August 1996.

Table 3: **Banking system ownership structure**

	Share in total assets		Number of banks	
	1994	1995	1994	1995
State	62.3	58.9	19	19
Private	37.7	41.1	31	34

Source:Sonje, Kraft and Dorsey, (1996)

Hence, there is a link between the solution of the problem of non-performing assets and interest rates. In section one, I emphasised that the unfavorable structure of the banking system prior to its rehabilitation was reflected in both height of the rate of reserve requirements and interest rates. There is no straightforeward causality between the two, because both were driven by supply-side factors. On the one hand, since money was issued by foreign exchange interventions and since foreign liabilities of domestic banks expanded rapidly after stabilization (mainly due to inflows of foreign currency savings into domestic bank accounts of the households sector), the central bank was understandably afraid of rapid worsening banks' solvency and liquidity if credits were allowed to grow by too high rates while important banks were still fragile. Reserve requirements were used as a prudential measure: instead of letting free funds flow into loans of suspicious quality, the funds were used to improve the reserve position of the commercial banks.

On the other hand, competitive pressures were not strong enough to induce greater sensitivity to interest rates. War-time risk contributed to the rigidity of the banking structure. Foreign banks have hesitated to enter the Croatian market, and numerous small, newly established private banks were doing business below an optimum scale, being unable to compete with large banks in retail banking. They mainly used capital as a source of funds, so that their capital adequacy and loans to deposits ratios were remarkably high. Indeed, the estimated capital adequacy ratio ranges from 65% in small private banks to 18% in large old banks. Because of the suboptimal scale, small banks were not able to improve lending price competition, but acted as "cream-skimmers" (Sonje, Kraft and Dorsey, 1996), taking away good clients willing to pay high interest rates from the old banks. That led to a kind of "bad credit market equilibrium" high interest rates and large interest rate spreads reflected that smaller private banks charged higher interest rates than larger and older state owned banks.

Only an exogenous shock could move the system away from this sub-optimal equilibrium. The shock could come from strong foreign entrants and/or from credible bank rehabilitation and privatisation[11]. Both shocks occured in the first half of 1996, leading to a sharp decline in money market interest rates and a milder decline in lending interest rates and spreads, giving hope for future credit market development which will finally depend on the availability and the term structure of funds.

It is interesting to look at the way the NBC took advantage of these developments. After the beginning of rehabilitation, when interest-rate inelastic demand for money market funds vanished, the National Bank of Croatia started to diminish the rate of reserve requirements gradually. Required sterilization was achieved by open market operations, i.e. by auctions of NBC bills. The market demand for NBC bills picked up because all banks, especially those under rehabilitation procedures, wanted to build up their reserve position [12]. The other reason was a sharp drop in the money market interest rate, which sharply diminished profits available in the interbank business and increased the relative attractiveness of an open market instrument. This is a clear case of a good coordination between supply-side measures (bank restructuring) and monetary policy measures and instruments, coordination which paved the way for financial market development.

[11] EBRD made an important equity investment in a medium sized Croatian bank (Varazdinska banka), and Zagrebacka banka, the second largest and private bank, successfully sold 10% of its equity to US investors in the form of GDRs. Its shares are listed at London and Zagreb Stock Exchanges, and presently it is estimated that 20% of its equity is held by foreign portfolio investors. Austrian Reiffeisen bank has been operating in Croatia since 1994, and through mid 1996 licences have been extended to Bank Austria and Hypobank from Austria, Banca di Risparmio di Trieste from Italy, while Societe Generale from France opened a branch in Croatia. The share of these banks in Croatian market is relatively small, but their presence is important at least in terms of contestability if not in terms of effective competition yet. This conclusion holds in the light of announcements and visits from some major European banks, mainly German ones, who are developing their strategy to penetrate Croatian financial market.

[12] Recall that NBC bills are used as collaterals for lombard credit from the NBC.

Privatization

Technique

The legal framework for privatization in Croatia has been set up in 1991[13]. It was changed later on, but its essence did not change significantly.

Initial privatization was a large management and employee buyout controlled by the State Agency for Privatization, later transformed into the Croatian Privatization Fund (CPF). Some 2800 enterprises from all sectors entered the process, while the largest infrastructural companies (oil, railways, telecom etc.) were declared public companies, meaning entirely state-owned and not subject to privatization at the beginning of the process.

In a first step, the agency had to approve the estimated values of enterprises to be privatized (estimation of value was conducted by independent private auditors, not necessarily foreign ones), and the management and employees were the privileged buyers in the first step. They could buy up to 20000 DM in nominal terms per worker at a discount, and any additional amount without a discount. The rest of the estimated equity which was not bought out was transfered to three state funds: 2/3 to the CPF and 1/3 to two state pension funds. Later it appeared that pension funds in general did not take any advantage of having these shares in their portfolio. The capital market environment was underdeveloped, pension funds' portfolio management divisions were understaffed, and the demand for minor parts of equity of individual enterprises held by funds was small because strategic investors acquired majority stakes during the buyout procedure and by (over the counter) secondary market trading.

The CPF later drew upon several approaches for an additional privatization of the acquired portfolio. First, part of the portfolio was held as a reservation for expected denationalization compensations in a few old enterprises that were nationalised after the Second World War. Second, smaller parts of the portfolio were distributed freely to the people who suffered most from war. Third, larger sums were used as swaps for public debt. Two techniques were used: a discretionary one, that was intended to clear non-marketable public debt of the state health fund, and an open market one, that was used for specific offers of shares that could be bought out by public debt instruments. Whereas the first approach was missconcieved (because if claims on the state health fund were held by a state-owned company then the transaction was just a clearing within the state sector), the second approach proved to be rather succesful. It helped to reduce the amount of public debt outstanding. Direct auctions conducted exclusively for buyers with public debt instruments diminished public debt to GDP ratio by 2%. It also helped to develop the secondary market for otherwise non-marketable public debt instrument (frozen foreign exchange savings, see section 2). Fourth, the CPF used direct offers with free access for foreigners (there are no limits on foreigners' participation on the secondary capital market)[14].

Different techniques were aplied. The most common technique was a simple announcement of the offer, i.e. the company was auctioned off. The bidder could propose a payment technique on his own, including payments in cash, on credit or with public debt instruments, which had additional positive impact on public debt reduction and development of secondary market trading. This technique was used for controlling packages in larger enterprises. The second technique was employed for marginal stakes - offers at the Zagreb Stock Exchange (ZSE). These shares had to be payed immediately in cash. Not surprisingly, the technique proved to be the least succesful one. From 1993 to mid 1996, the volume of trading at these auctions reached only 7% of total trading volume at ZSE. The largest transactions occured in 1993, and the market vanished thereafter. For example, since 1994 the volume of trading at auctions for cash reached only 6% of the volume of trading at auctions conducted exclusively for swaps with public debt instruments. The third technique was successfully applied in the case of Pliva, large and successful farmaceutical company from Zagreb. A public offering was conducted by Zagrebacka banka and Union Bank of Switzerland, and the company was listed on the London Stock Exchange. Due to tremendous public interest the price rose far above the nominal value (simultaneously in London and in Zagreb), and the company has been majority privatized successfully. Shares are traded freely both in Zagreb and in London at a high, and for the time being, stable price (see the next secton on exchanges).

Results of Privatization

The overall result of the process based on a sample of 2557 enterprises that have finished the process through the end of December 1995 is presented in table 4. When looking at the numbers of enterprises, the results are impressive. When looking at equity values, the results are less impressive, although the majority of the equity capital is anyway controlled by private agents.

However, the results should be judged in light of the fact that large infrastructural companies (which are large conglomerates that have not been downsized to their core activities), were not subject to privatization. According to estimates by Rohatinski et. al. (1996: 33), 54% of the equity in the enterprise sector remained state-owned at the outset of 1996. However, these are nominal figures.

The market value of the equity would probably give a very different picture because the state enterprise sector employs 32% of the total number of employees, but produces only 24.2% of total turnover[15].

Table 4: **Results of privatization by the end of 1995**

	Share in number	Share in equity
Entirely privatised	44.8%	8.4%
Majority privatised	44.7%	55.3%
Controlled by the state funds	10.5%	36.3%

Source: Authors calculations based on "Privatizacija", no. 15, t.3, p.68.

Therefore it is hardly a wonder that this sector produces net losses. But interestingly enough, the average net wage in this sector was only 1.6% below the average wage in the economy. This indicates that this is still the overemployed sector where wages are far above the value of the marginal product of labor. There is a clear pressure for a reallocation of factors of production away from this sector which makes it necessary for the state to control a large part of the equity in the enterprise sector: The number of unemployed persons rose to 13%-14% of the active population during war times, and from the social and political point of view, it was not sustainable to speed up the reallocation of labor in times when there were no fast growing sectors that could absorb the free labor. The size of the required reallocation is still a heavy burden for the economy which started to grow only since 1994 and which operated in a war-time environment that was not supportive of the required supply-side restructuring.

Peace and growth prospects have risen considerably after the signining of the Dayton Agreement in December 1995. The government feels that it can ease its control over the "social pain of restructuring", i.e. over equity in the enterprise sector. But still there are a lot of political doubts and battles over the speed and scope of the process. The new Law on Privatization was enacted by the Parliament in March 1996, but the process of privatisation itself will not be affected dramaticaly by the new legislation. Although the law allows a wider distribution of shares, the privatization of large infrastructural companies is left aside to be regulated by additional legislation. Obviously, political consensus over privatisation of these state owned monopolies could not be reached, at least not up to this point of the privatization process.

Despite that, the overall picture looks optimistic. Regardless of the war times, the economy underwent a deep restructuring process in the last few years. Although owning only 46% of total equity in the enterprise sector by the end of 1995, the private sector comprises 69% of total employment, 75,8% of total turnover and 80,3% of total profits before taxation (Rohatinski et. al., 1996, p. 33).

[13] It was called the Law on Transformation of Social Enterprises. The name of the Law is important because the word privatisation is missing in it. This is due to the starting point which was different than in other transition countries, where equity capital was owned by the state. Former Yugoslavia established so-called "social ownership", often popularly labeled as "no-one's ownership", and the purpose of the Law was to transform " social ownership" partly into private and partly into state ownership.

[14] Generally, foreigners' participation in Croatian enterprises is liberal. There are no obstacles for establishing an enterprise, enhancing the equity stake, repatriation of capital, there are no tax discriminatory measures or any similar type of legislation. Foreign enterpreneurs entered the Croatian market either directly, by founding their own enterprises or joint ventures, or through the process of privatization. According to Rohatinski, Vojnic et. al. (1996: 75), till the end of 1995 there have been 460 mln DM worth direct foreign investment through the privatisation process. Since the overall data are not reliable, it is hard to conclude if this has been more or less important than green field FDI.

[15] The latest release of preliminary data for 1995 indicate that the relative importance of the state enterprise sector continues to dimnish rapidly: the share of employed persons fell to 23% and the share in total turnover to 18%.

Exchanges

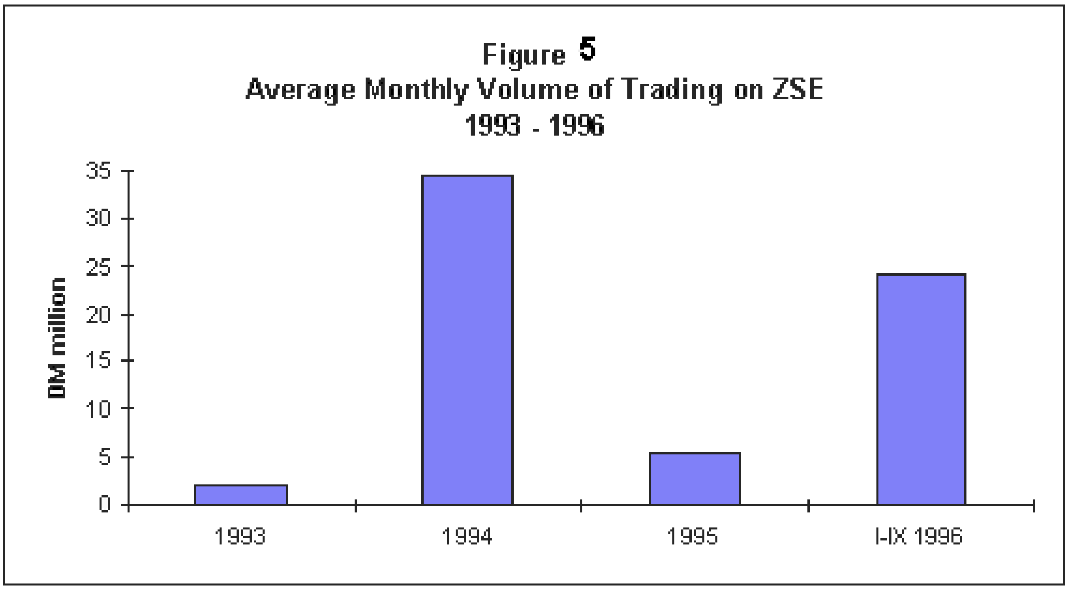
Although Croatia has completed the set of legislation related to capital markets [16], the official markets remained thin. While money markets, including both the Kuna and the foreign exchange interbank market work in a transparent way, equity and bond markets are still segmented.

The interbank Kuna money market works both as OTC market and through a formalized institution called the Zagreb Money Market (ZMM). Overnight trading is mainly conducted through ZMM, while daily trading occurs mainly as OTC. Majority of Croatian banks are members of the on-line electronic money trading system, but on-line trading is used only occasionaly because financial institutions are still adapting to its use. The interbank foreign exchange market is an on-line market, but interventions of the central bank are carried out by occasional direct foreign exchange auctions.

An important money market instrument in Croatia is the NBC bill - short run paper issued by the central bank. This paper is auctioned every Wednesday at the primary market, and is freely traded at the secondary market created by commercial banks. The government started to issue T-bills at the end of July 1996 at auctions conducted by the Ministry of Finance (MF). The MF and the NBC have set up a joint committee which coordinates auctions and liquidity projections, so that NBC bills and T-bills do not compete at the market. Besides, potential buyers at the primary market are different. Although banks can participate in auctions for both instruments, enterprise and households' sectors agents have direct access only to T-bills auctions, while they can participate in NBC bills trading only on the secondary market.

The Zagreb Stock Exchange (ZSE) is the most important official exchange in Croatia. There are also two important regional exchanges in Varazdin and Osijek. Stocks and bonds are traded in these markets. The number of listed companies in all exchanges together is about 40, and the trading volume is growing rapidly. While the average monthly volume of trading at ZSE in 1995 was below 10 mln DM, in the period from January to September 1996 the average monthly volume of trading has increased to about 24 mln DM mainly due to the above mentioned companies Pliva, Zagrebacka banka, and Podravka (food processing industry). Several types of government bonds are also traded, and investors showed particular interest recently when the Ministry of Finance issued 3-year refinancing bonds with 12% annual interest rate in the first issue and 8.5% in the second issue.

Average Monthly Volume of Trading on ZSE 1993-1996



The exchanges shared all the difficulties with the economy in general and capital markets in particular. However, since early 1996 a clear and strong upward trend is obvious regarding the number of traded instruments, volume of trading, and prices. In fact, market optimism is so obvious that the rise in prices of the most traded instruments from January to May is ranging from approximately 100% for shares of Zagrebacka banka to 400% for Pliva shares. After good development in 1994, pessimistic expectations driven by war-time and regional security risk prevailed till the end of 1995 and they have pushed the market prices down far below nominal values. Now the market shows clear signs of optimisim which is well founded in the development of the real sector.

[16] Securities Law, Law on Trading with Securities, Law on Investment Funds, Banking Law.

Sources of External Finance

Foreign Direct Investment

According to balance of payments statistics, in the 1993 - 1995 period 252,3 mln USD FDI flew into Croatia. In relative terms, the official volume of FDI in 1995 amounts to 0.6% of GDP (the same ratio as for 1994). This figure is probably somewhat underestimated due to statistical deficiencies. The Ministry of Economic Affairs published a number that exceede 1 bln DM, because it used the contracted, not the realized amounts, that is the privatization contracts signed by foreign investors mainly contained planned investments for the period of a few years. So, the large discrepancy between BOP data and other data reflects expected FDI which will come later.

The most important FDI individual projects occured in telecommunications and electronic industries (Ericsson, Siemens), in breweries and in the construction material industries. Investors hesitated to enter the tourist industry which as an industry has the best prospects in Croatia, and it is expected that the change in the political and security situation in the region will speed up FDI largely due to investments in tourism. The most important foreign investors in Croatia come from Austria, Belgium, Germany, Sweden, Switzerland and the USA. It is also expected that direct investment into the financial industry will play an important role from 1996 onwards.

There is no doubt that the unfavorable war and political situation influenced the relatively low level of FDI in Croatia compared to other transition countries. And there is no doubt that FDI will speed up after good prospects for peace have been achieved. Indeed, BOP data for I-VI 1996 show a strong upsurge in FDI of 186% compared to the same period in 1995. Upsurge in foreign aid is also expected, but it has not occured yet because Croatia was cut off from EU aid programs, such as PHARE, from the beginning of the war. The foreign aid mainly consisted of different forms of humanitarian aid that largely helped the people, but this type of aid is getting less important. During the same period other forms of aid, such as US AID, and aid connected with international financial projects, mainly from IMF and the World Bank, were still available to Croatia. However, Croatia became a full member of the Council of Europe in November 1996, so that inflows from EU funds can be expected from 1997 and onwards.

Relations to International Creditors

At present, Croatia is strenghtening its relations with international financial institutions, mainly the IMF, the World Bank and the EBRD. Serious negotiations started in 1993, the first projects were realized in 1994, and cooperation speeded up in 1995. As of September 30 1996, the EBRD had invested 74.1 mil USD and the World Bank 53.1 mil USD in Croatia (net outstanding amounts). However, the largest creditor is the IMF with 209.5 mil USD debt outstanding, because from autumn 1994 till the end of 1995 Croatia conducted a successful stand-by arrangement with the IMF. The signing of an Extended Fund Facility arangement ranging from 1996 to 1998 is expected by the end of the year.

1996 is a turning point for Croatian relations with external financial sources. After the successfull rescheduling of the foreign debt with the Paris Club in 1995, an arrangement with the London Club has been concluded in spring 1996, so that the burden of the past debt accumulated in the period of former Yugoslavia has been successfully rescheduled. As a result, debt was converted into tradable Croatian government bonds (exchange date was end July) listed on the Luxembourg Stock Exchange.

Balance of Payments Position

The low overall foreign indebtness of the Croatian economy opens room for running a BOP current account deficit that is needed in the period of post-war reconstruction of the economy. The expected and sustainable current account deficit to GDP ratio for 1996 and 1997 is about 5-6% (see the appendix), and a large part of it will be financed by international financial institutions. The largest individual creditor in 1996 will be the World Bank with an amount of approximately 300 mln USD that comprises loans for road and post-war reconstruction, as well as public and financial sector adjustment loans [17].The government is planning a Eurobond issue, but the amount and the conditions have not been settled yet. The Ministry of Finance will probably wait for rating (credit raiting agencies are coming to Croatia in late November) because the country will most likely get an investment grade, so that an issue can be expected in early 1997. In addition, the private sector is expected to be an important channel for funds flowing into the Croatian economy. The private banking sector, which holds 2 bln USD of reserves abroad, built up international credibility and is capable of getting loans at interest rates far below those prevailing on the Croatian market. It is expected that some additional 300 - 350 mil USD will flow in during 1996, mainly in the form of loans syndicated by private banks.

[17] Source: State Budget for 1996.

Concluding Remarks

The war severely affected Croatian economic performance. Despite hardships, Croatia managed to achieve remarkable success regarding macroeconomic stabilization and the development of the institutional framework for a market economy. By far the lowest inflation among all transition economies has been achieved by the liberalization of the price system, opening of the economy, fiscal discipline, and full independence of the monetary authority. However, political uncertainty, banks burdened by bad loans in their portfolio, depressed expectations and high interest rates did not allow greater success in terms of higher rates of real growth.

In end 1995 and early 1996 the situation changed comprehensively. Political prospects for a lasting peace became firmly established. The bank rehabilitation process started on a large scale which immediately lead to a decline in interest rates. Privatization was speeded up and foreign direct investments soared, and expectations became more optimistic, leading to a deepening of capital markets and a rise in asset prices. Both theory and experience suggest that the simultaneous development of credits and equity markets is a basic precondition for sustainable growth in the long run (Kletzer and Roldos, 1996). On the one hand, there seem to be enough causes for optimism in this respect. On the other hand, the status-quo regarding the scope and the speed of privatization of large infrastructural monopolies appears to be the main obstacle for further progress. This is the main problem that Croatia will have to resolve in the near future.

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APPENDIX
Balance of Payments (mio USD) and Related Indicators 1993 - 1996
In USD millions

	1993	1994	1995	1996*
Balance of Payments				
Current Account Balance	*104.0*	*103.4*	*-1712.0*	*-1097.3*
Goods	-762.5	-968.9	-2877.2	-2780.0
Services	631.9	737.5	612.7	832.7
Income	-141.3	-124.5	-93.3	-100.0
Transfers	376.0	459.3	645.8	950.0
Financial Account	*269.8*	*583.6*	*901.7*	*910.0*
Direct & Portf. Invest.	74.3	97.6	80.5	150.0
Other Investment	195.4	486.1	821.2	760.0
Central Bank's Reserves	*-449.6*	*-788.8*	*-490.2*	*454,8*
Net Errors and Omissions	75.8	101.7	1300.5	642.1
Related Indicators				
Real GDP Growth, y.o.y.[1)]	-0.8%	0.6%	1.7%	5.1%
Manufacturing production, y.o.y	-5.9%	-2.7%	0.3%	3.5%
Central Bank's Int. Reserves, end y.	616.4	1405.0	1895.2	2350.0
Current Account / GDP	0.6%	0.6%	-9.7%	-5.7%
International Debt / GDP**	15.6%	18.5%	20.9%	25.5%
Total Debt Service / Exports***	10.8%	8.5%	10.1%	11.0%
Kuna vs. DEM, end period	3.8	3.6	3.7	3.6
Real Effective Exch. Rate****	-27.4%	7.1%	0.5%	0.0%
Annual Inflation, retail prices	1149.7%	-3.0%	3.7%	3.3%
Ann. Rate of Growth of Base Money	996.3%	109.6%	43.1%	18.6%

*Author's unofficial projection based upon data for the first six months.

**Jump in 1996 is due to inclusion of the part of non-allocated debt of former SFRY which Croatia recognized by the agreement with the London Club this year. Ratio refers to end year data.

***Exports of both goods and services included. Prinicipal and interest payments and arrears included.
****End-year rate of change of the trade weighted real effective exchange rate. Source: NBC Bulletin, various numbers; author's calculations.

Most Active Shares by Turnover for the Nine Months of 1996 Ended 30 September

In HRK thousands

Company	Core Business	Turnover	High (HRK)	Low (HRK)	Last(HRK)
PLIVA d.d. Zagreb	Pharmaceuticals	361.867	13.500.00	1.853.00	13.150.00
Zagrebacka banka d.d.					
Zagreb ordinary shares	Bank	118.762	1.010.00	140.81	1.010.00
Podravka d.d. Koprivnica	Food Proccesing	59.150	275.00	70.24	275.00
Kras d.d. Zagreb	Confectionery	5.329	550.00	110.95	550.00
Laguna d.d. Porec	Tourism	3.963	915.00	369.76	915.00
Jadran Turist d.d. Rovinj	Tourism	2.857	300.00	100.00	300.00
Ekla d.d. Zagreb	Cabels	985	195.00	125.00	195.00
Elcon d.d. Zlatar Bistrica	Car parts production	953	141.03	140.64	140.73
Arenaturist d.d. Pula	Tourism	925	110.00	73.784	100.00
Riviera Holding d.d.Porec	Tourism	541	115.00	55.35	115.00
Suncani Holding d.d. Hvar	Tourism	495	50.00	32.50	45.00
Karlovacka pivovara d.d.Karlovac	Brewery	487	190.00	144.00	180.00
Croatia banka d.d. Zagreb	Bank	259	326.60	118.21	135.00
Zitoproizvod d.d.Karlovac	Agriculture	229	144.00	133.00	143.00
Zagrebacka banka d.d.	Zagreb E series of shares Bank	184	400.00	174.08	400.00
Istraturist d.d. Umag	Tourism	181	185.00	44.29	185.00
Other		528	-	-	
Total		557.695			

Source: The Zagreb Stock Exchange, according to: "The Republic of Croatia: A Presentation on Credit Ratings" Ministry of Finance, Merril Linch and UBS: Zagreb, November 1996: p.96.