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The Croatian financial system has come under consideration only very recently. However, at this moment focus is on the commercial banking sector. That the quality of services provided by the financial system affects the performance of the economy as a whole, is a well-known fact. In addition, how well the financial system of a country satisfies the needs of its users is a matter of public concern and democracy and is particularly important in new democracies such as the Republic of Croatia. Efforts to reach the standards of a market-driven economy and the privatization process itself, make it necessary to look not only into the commercial banking sector but into a large number of subjects, instruments and procedures that are emerging in the financial system. The object of any inquiry today is to ascertain whether the organization of the financial system and the practices of its institutions are in accordance with the current needs of society, and make recommendations for improvements.

Brief historic overview

As a newly independent state (1991), Croatia does not have much experience and expertise in setting up and running a sovereign financial system. From its central role of monetary authority the National Bank of Croatia founded as an independent central bank at the end of 1991, has been the engine of the development of the financial system. The evaluation of the current financial system should take into consideration the major economic imbalances, mainly caused by the war and Serbian aggression, but also by poor management of the economic system during the Communist regime. In 1993, prompted by extremely high inflation, which in the first ten months of 1993, reached an average 28% per month, the Croatian Government launched a stabilization programme in October 1993, whose primary objective was to bring inflation down to an acceptable level. In the next steps of the programme, the government will deal with a whole variety of problems starting with structural changes in the economy to measures aimed at creating an economy ready to fully accept the norms of a market economy and enter a period of sustained economic growth. The situation has not been very helpful for the programme. With estimated war damage at about 15 billion US$, a steep decline in the GDP, high unemployment and real wages more than halved, these represent a very unfriendly ground for building up a modern financial system.

A banking sector legacy

The analysis of the asset side of the banking sector shows a relatively good performance of the assets management function. However, an independent analysis could come to quite a different conclusion. Some serious doubts could be expressed in banks rating or risk classification of loans given. Inside that category one should be careful when assessing emerging securities risks and less liquid capital markets, as in Croatia (is), fairly higher than in fully functioning markets and therefore require a higher risk premium. Consequently, special reserves for potential losses should be higher in the whole sector. The fact that long-term financing of the banking sector amounts to 61.2% of the assets gives rise to concern. What is more worrying is that more than 50% of it has been invested in long-term securities at the moment when the market in Croatia is illiquid, with default risk in all cases fairly high. Furthermore, a large part was placed in equities of various companies. This vast amount of banking sector assets, practically immobilized and non-performing alongside with various other frozen funds, amount to 75.2% of the overall assets. The big four banks amount to 2/3 of the sectorial balance sheet, which shows strong banking concentration. Very early on, the Croatian government recognized the danger of major crisis in the financial sector and launched a programme in order to rehabilitate the financial sector through a case-by-case approach. This will put additional pressure on an already overworked state. The expected help from the EBRD and the World Bank is therefore badly needed. The underdeveloped financial sector and poor performance of the supply side compound the problem. As a legacy, savings in financial assets have almost become a forgotten category, with the bulk of savings kept under matrasses or abroad. Official data, however, show the ratio of savings at deposits with banks to GDP of about 17%. Most of the savings are in foreign currencies (almost 84% of total savings). Critics have been pointing their finger at poor assets management of bank savings, which is partly responsible for the supply problem affecting the prevailing high interest rates. In the following text we shall try to discuss the efficiency of the Croatian financial system and to point out what should be done in order to benefit from a fully functioning system.

Putting aside the facilitation of payment within the economy, we shall concentrate on the function of the financial system to raise saving and investment levels and the provision of incentives for the allocation of the available resources to those uses where they are likely to give the highest returns.

One of the factors that influences saving and investments is the psychological element, whose roots go back to the former Communist regime. Confidence in the banking sector has been even more undermined after independence. The reason is the fact the Central Bank of ex-Yugoslavia still controls a big chunk of the foreign currency reserves which belong to all the former member states. This has created a problem for Croatian banks, which have been unable to service withdrawals from individual foreign currency deposits kept inside them. Such deposits are now called "frozen-foreign currency" and are being used as a means of payment for the privatization of state assets. The past experience of high inflation and from time to time, hyper-inflation, still influences saving. On the micro-economic level, the availability of financial instruments is far from satisfactory. At the moment, potential investors are offered two instruments, with nothing between them in terms of risk, shares from privatization, and bank deposits, as a basic banking function.

The allocational efficiency of the financial market sill struggles with the remnants of the past. The moment to stop opportune state interference in allocation was not used. A very doubtful mechanism of pricing in privatization did not emerge from the usual market elements of pricing thus creating a problem that will be augmented in the next privatization stage. The issue of competition that helps and encourages elasticity and choice should be dealt with, taking into consideration the strong forces that do not allow its functioning. Nevertheless, competition is functioning only in small segments of the financial system, and class not have the usual effect natural to transparent financial markets. Savings in the form of life insurance, private pension plans, investment in securities that would meet the needs of individual savers, are things for all of us to work on. On the other hand, borrowers not only can not obtain short-term bank financing, irrelevant of risk involved in lending; they know that to raise long-term finance from the bank is impossible. Banks are not able to finance long-term needs, for, as they point out, they are short of long-term funds. As is quite often the case with transitional economies, securities markets and securitisation itself, as an alternative financing mechanism, are still in the embryonic stage of development. Low financial system elasticity comes from sectorial lending (un)preferences of Croatian banks and partly form unsuitable financial instruments. In spite of their unwillingness to engage in long-term lending, banks are now obtaining substantial equity stakes which they hold in their (un)structured portfolios.

One of the aspects dealing with efficiency, states that the financial system should ensure prices, or interest rates, of securities to be equal after allowing for differences in risk and cost of transactions. The first difficulty here is that risk has not been fully recognized as a market category and that the general public first faced and equity risk category inside privatization - which is a rather unnatural way of being introduced to risk. A tight monetary policy alongside with an inadequate regulation of bankruptcy have created a parallel money market with big discrepancies in interest rates. It appears that high interest rates are to be attributed to several factors. As we already pointed out, the supply side of the system is by far weaker than demand for funds. The next reason lies in the state of affairs inside bank balance sheets as well as in administrative directives influencing foreign currency deposit management. Interest rates differ between the official and banking markets: the parallel market ranges, due to the aforementioned problems, from the average 22% per year to 7-10% a month. At this moment it is difficult to identify even the"bench-mark" interest rate. Obviously, high interest rates are the main obstacle for further development. On the security side of the financial system the way in which privatization was and still is conducted and particularly the method of pricing state assets, have totally distorted the prices of securities. The absence of market information with the exception of the information provided by the Zagreb Stock Exchange with virtually no corporate information, make an evaluation of the information impact on the prices of securities impossible for the moment.

In addition, economic controls performed by the government are not in accordance with competitive neutrality and are partly influencing the general level of interest rates. When it comes to taxes and subsidies, they are of minor importance at this moment. However, it is quite possible for the government to start introducing various investment tax incentives in the near future.

Instead of a conclusion

In our effort to identify the problems in the financial system, we have been tolerant because of the transitional problems of the Croatian economy. Judging the financial system quality, in the Croatian case a just excuse for the absence of necessary action can be found. At a time of war and aggression against it, Croatia is definitely not in a good position to start building the financial system from scratch. However, the indications of non-market practices and irrationality given here are things that should be dealt with first. The biggest part of distortions mentioned have their roots in the former communist regime. A general lack of confidence and Serbian aggression still play a role. A better promotion of the financial services and investment tax incentives would probably have some limited success in efforts to help savings and investment. Market stability criteria show a big discrepancy between short- and long-term availability of funds, in favour of the former. The amplitude of current interest rates fluctuations points to a continuous interest rates increase, particularly in the parallel market - which points towards an inappropriate functioning of the financial system. Problems on the supply side should be fought in parallel with banking sector rehabilitation and the raising of the level of savings. Action should by no means be concentrated on the banking sector alone. The privatization process is paving the way for fully functioning and transparent capital markets. The Croatian government saw this necessity and has already started implementation of a three-year project that will considerably enhance the level of capital markets. In our opinion, considering the big capital needs of a transitional economy, all actions should be accompanied by strong encouragement of foreign capital inflows. Signs of state interference in capital allocation persist in a generally unstable economic system. Due to the legacy from the past, the system of regulated interest rates and limitation of credit, the limited amount of credit is directed largely to politically popular companies, mostly big employers. In order to raise efficiency, the bank management should be given more independence and authority to effectively manage banks once they are rehabilitated. On the other hand, management should work harder on acquiring greater expertise and knowledge. Inflationary risk has for some time been fought eagerly by pegging-up or indexing the value of local currency to the German Mark. However, indexation has spread to all sectors of the economy and is there to stay, thus showing the general belief in the local currency and danger of inflationary expectations. The letter can be dealt with successfully only through a sound economic policy of sustained growth and an efficient financial system. ■