2. BANKING SYSTEM IN CROATIA: EVOLUTION, STRUCTURE AND PERFORMANCE

1. INTRODUCTION

Seven years ago, there have been 20 commercial banks in Croatia. They were owned by big state-owned enterprises, the same enterprises being the biggest clients of these banks. Lending to related parties and related moral hazards were not considered to be a systemic problem. On the contrary; it was a substitute for Soviet-type central planning mechanism, so that the scope of banks' business was determined by the ruling communist party. Structure of the system was dependant on the structure of political power which was segmented along regional lines. Hence 18 banks were regional banks and 2 of them were nationwide banks.

Instead of relying on highly complex national economic plan, ruling party controlled economy through control of banks and their owners and clients - largest enterprises. So-called "self-management" socialism was, in fact, economizing on transaction costs (costs of information processing and monitoring) in a centralist model which was in essence not a lot different from other forms of socialism. However, a system was "softer" than the Soviet-type system, so that two tier banking system was put in place early, in the fifties.

Since the banking system acted as a main remedy for control over the economic system, the organization of the economy generated permanent banking failure. There were no prudential constraints, banks were systematically and cheaply bailed out through the soft budget constraint thanks to the generous federal central banking system. Risk was not considered as a factor of the credit decisions, so banks' portfolios were highly concentrated and illiquid (financial markets were not allowed to develop). Incentive of banks' managers was designed in favor of ruling party's investment plans, so that banks ranked expansion higher than prudency and soundness.

Now, seven years later, Croatia has a record of three years of low inflation, far the lowest among the CEU countries. That was not achieved *by chance. Standard prudential measures were put in place, there are no* guarantees for cheap bailouts. Financial discipline improved, markets developed and monetary instruments have been adjusted comparable to developed countries. Central bank, the National Bank of Croatia, conducts monetary policy mainly by indirect monetary instruments. Rehabilitation of bad banks is conducted in a credible way which implies punishments for owners and managers of insolvent banks. Finally, there were 60 banks operating in Croatia in September 1996, and the large part of the banking system is controlled by the private sector. Although share of the private sector is still about 50% in terms of total capital or assets, it is over 70% measured by newly extended credits. However, this is a picture of the system in 1996. Till the end of 1995, as bank rehabilitation lagged behind macroeconomic stabilization, the system was heavily influenced by problems of the banking sector and interest rates were increasing.

Croatian experience is interesting in at least three aspects. First, changes occurred more in evolutionary than in revolutionary way. For example, some older banks became privatized during the course of time, as enterprises that owned them became privately owned; many banks managed to maintain proper capital adequacy in hard times. Second, Croatian experience shows that ownership concentration matters regarding banks' performance in the new competitive environment. Namely, the older and larger banks with lower degrees of ownership concentration are ready to do business with lower interest spreads, while newly founded, smaller privately owned banks typically charge higher interest rates (Šonje, Kraft and Dorsey, 1996) and have more concentrated ownership structure. This fact is extensively elaborated in the paper, because it explains why greater number of banks does not necessarily lead to greater competition in the short-run. And third, credible rehabilitation of problem banks in Croatia proved to be a sufficient condition to improve the banking system performance in the short-run, while new entry of domestic or foreign financial institutions proves to be the necessary condition for the long-run improvement.

Croatian experience now allows direct comparison of banking system's structure and performance prior and after the credible bank rehabilitation begun, both period being marked with firm macroeconomic stability.

The first section contains basic empirical findings regarding interbank differences in interest rates policy, impact of bank rehabilitation, impact of monetary policy and feedback impact of the structure and behavior of the banking system on monetary policy. The basic finding is that structural factors such as bank rehabilitation determine the choice of monetary instruments as well as the scope of monetary management. The second section provides details on bank rehabilitation, and the third section provides more details on aggregate banking system behavior regarding relations among sectors of the national economy.

1. BASIC EMPIRICAL FINDINGS

1.1. Interbank Differences in Interest Rate Policy

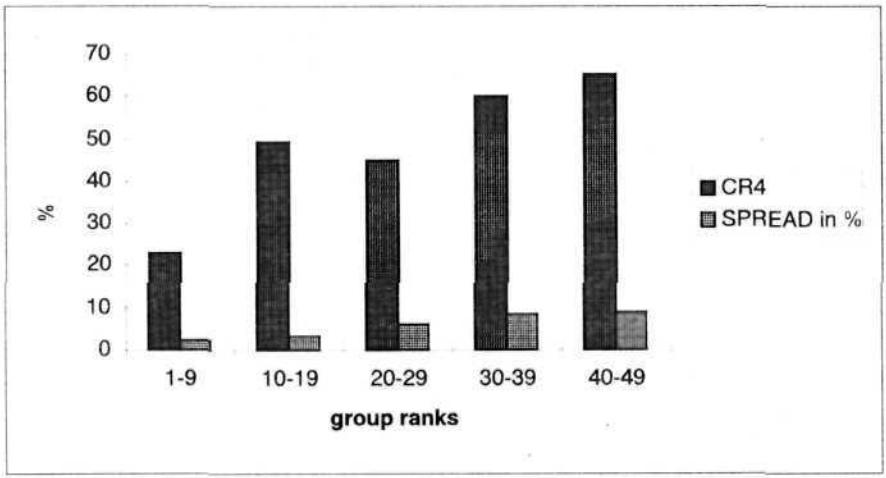
Research Department of the National Bank of Croatia submitted a Report on Interest Rates to the Council of the National Bank of Croatia at the beginning of 1996 where it states that:

> ***"There is a widespread belief that problem banks have higher costs, interest spreads and lending interest rates. Generally it is assumed that problem banks do business with worse clients in financial distress who are ready to pay any interest in order to survive in the short-run, without taking care about long-run repayment of the principal. Our research proved that this belief is wrong." (p.8).***

The same argument is repeated in a recent article by Šonje, Kraft and Dorsey (1996). Their cross-section regression on individual banks proved that smaller, newly founded private banks charge higher interest rates and have larger interest spread. A graphical presentation in support of that argument is displayed here. Figure 1 is constructed in a following way: 49 banks are ranked in five groups according to the size of assets. The first group contains nine largest banks in Croatia and makes the bulk of

the banking system. Two indicators per group are displayed. The first one is the simple average of ownership concentration (CR4) for banks within the group. CR4 is the share of four largest individual owners in total equity capital of the bank. The second indicator is an average of net interest earnings over total assets for banks within each group.

Figure 1
CR4 AND NET INTEREST EARNINGS OVER ASSETS FOR FIVE GROUPS OF BANKS RANKED ACCORDING TO THE SIZE OF TOTAL ASSETS AS OF END 1995



Concentration ratio and net interest earnings over assets are the lowest in the largest group. Both indicators grow as the average size of the bank in the group becomes smaller. This is not a surprising result. Average size of the bank in the first group is 6,1 billion Kuna i.e. about 1,7 billion German marks worth of assets, which is roughly 100 times more than the average size of the bank in the smallest group. It is 7 times more than the average size of the banks in the second group (10-19) and 17 times more than the average size in the third group (20-29). Large banks are generally old banks with more dispersed ownership structure and greater burden of non-performing assets from the past (there are significant intra-group differences which will be analyzed below) which tend to influence

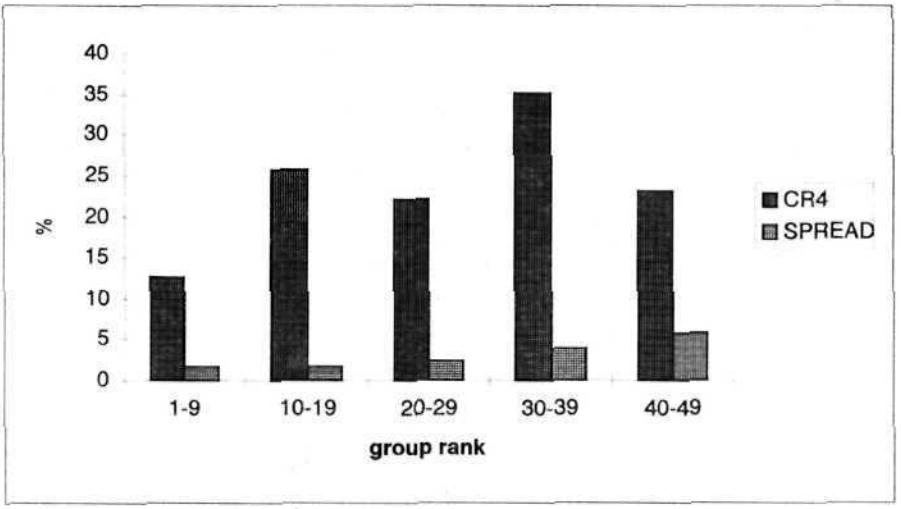
their net interest earnings over assets downwards. Hence average net interest earnings over total assets are 2,5% in the largest group and 8,7% in the group of the smallest. Generally, these are newly founded private banks with much more concentrated ownership structure.

Existing literature offers several explanations for high net interest earnings over assets in the smallest banks. First, these banks do not have non-performing loans. Second, a few owners can easily coordinate their influence over managers' preferences, so that these banks prefer short term profits over expansion. Third, these are liquid banks which earned high interest rates on the interbank market (see bellow) by covering illiquid problem banks. Fourth, these banks are so small that they are able to position themselves in a specific market environment where willingness to pay on the demand side is extremely high. Fifth, these banks do not evaluate risks properly because they are still learning banking business. Sixth, net interest earnings are high because interest costs are negligible; loans are financed out of capital. Seventh, risk component of the interest rate is influential because of imperfect instruments of collecting claims (slow legal procedures), and it influences small banks more, because they have less bargaining power and less experienced lawyers than greater banks.

All explanations are valid since none can be ruled out as impossible. Indeed, Šonje, Kraft and Dorsey (1996) showed that the sixth explanation is valid because they calculated capital asset ratio for new private banks as high as of 42%, and loans over deposits ratio as high as of 242%. Hence, these banks did not develop retail banking business and a great number of banks has no real life influence on competition for households' sector deposits. They lend out of capital, and their role in the banking system as a whole is still very small. Indeed, banks ranked from number 1 to number 9 (group 1) comprise 80% of total assets, while the first two groups (ranks from 1 to 19) comprise 91.5% of total assets. Hence, number of banks is misleading if used for evaluating competitive pressures and luckily, any future banking failure that can occur in the sector of small banks will probably have no negative systemic impact, at least presently and in the short-run.

Now we take a look at intragroup characteristics in order to asses intragroup homogeneity. Figure 2 shows intragroup standard deviations for indicators presented in Figure 1.

Figure 2
INTRAGROUP STANDARD DEVIATIONS OF OWNERSHIP CONCENTRATION AND NET INTEREST EARNINGS OVER ASSETS



Again, intragroup homogeneity gets lower as the size of the banks gets smaller. The smaller the banks are, the more different their ownership and performance is. Smaller banks are less capable to respond to idiosyncratic shocks, so that negative shocks in small individual markets influence higher intragroup variability of performance. Hence, vast majority of banking institutions (30 - 40 in number) belong to smaller groups which presently record high earnings. They are subject to strong influence of concentrated owners who are probably myopic in a sense that they strongly prefer short term profits over reinvestment of profits, expansion and survival in the long-run.

This conclusion is confirmed by the cross section regression estimates of net interest earnings over assets (NIEA) as dependent variable on

ownership concentration and size of assets as independent variables for a sample of 49 banks (t-statistics in parenthesis):

$$NIEA = 3.7132 + 0.0513CR4 - 0.0231A$$
$$(3.026) \quad (2.481) \quad (-1.516)$$

Ownership concentration is a significant explanation of interbank variability of net interest earnings over assets, while size of the bank is only a marginally significant explanation. Higher ownership concentration leads to higher net interest earnings over assets.

1.2. IMPACT OF (LATE) BANK REHABILITATION

As already notified, differences in groups' net interest earnings may also be due to strong negative impact of non-performing assets in older and larger banks, as well as due to high earnings of smaller liquid banks who extended interbank loans at high rates to illiquid, on average older and bigger banks. Test of this hypothesis is presented in this subsection.

Four large banks are considered to be the problem banks in Croatia. During 1994 and 1995 these banks systematically recorded negative cash flow and generated demand at the interbank money market. Moreover, they generated interest rate inelastic demand for money market funds because they were ready to pay high interest rate in order to maintain daily operations. The central bank was not bailing them out directly, because these banks could draw only interventive loans from the National Bank of Croatia with high penalty interest rate (above market rates). While using the loan, the bank's account is blocked, as well as accounts of its clients, so that problem banks tended to avoid this window. Other banks were ready to cover problem banks' daily minuses because they were considered to be to big to fail, and obligatory reserves deposits at the central bank were used as collateral for interbank loans (the collateral was abolished in September 1996). Hence, the system was avoiding cheap bailout either directly from the government or indirectly via central bank, so that there was no direct monetization of losses that

could jeopardize stability of exchange rates and prices. However, liquid commercial banks were ready to support problem banks because they could earn high interest with low risk. Hence interest rates were persistently high, and restructuring of problem banks and problem clients slow till spring 1996, when credible rehabilitation begun.

If this is correct, than a binary variable which equals one for problem banks and zero otherwise (PROBLEM) should be a significant explanation of variability of net interest earnings over assets. Its expected sign is negative, because problem banks are expected to have low NIEA due to high interest costs for interbank loans.

Binary variable PROBLEM equals one six times. Besides four banks that are publicly announced to be subject to rehabilitation, two more banks that often recorded minuses in 1994 and 1995 are included. One additional bank is from the group of top nine, and another one is from the second group (10-19).The result is (t-statistics in parenthesis):

$$\underset{(3.469)}{NIEA = 4.1534} + \underset{(2.405)}{0.0479CR4} - \underset{(-0.559)}{0.0001A} - \underset{(-2.177)}{3.8659PROBLEM}$$

Sign and significance of the parameter with binary variable expectedly show that problem banks on average have 3.9% lower net interest earnings over assets than the entire population of banks. The hypothesis is confirmed. Moreover, it shows that it is exactly these problem banks, overburdened with non-performing assets, that influenced significance of assets parameter in equation presented in section I.1. When variable PROBLEM is included, it appears that larger banks in terms of assets, on average, do not have lower spreads.

However, conclusion holds only ceteris paribus. The method applied does not allow for assessment of dynamic effects such as effects of credible bank rehabilitation on stronger competition. As documented bellow, the dynamic effects have been at work since the end of 1995, when credible rehabilitation begun. The next section shows how bank rehabilitation opened room for big changes in monetary instruments, which induced sharp drop in money market interest rate.

1.3. IMPACT OF MONETARY POLICY AND FEEDBACK IMPACTS OF THE BANKING SYSTEM ON MONETARY POLICY

National Bank of Croatia increased money supply mainly by foreign exchange interventions since 1993. Presently, international reserves comprise more than 95% of its assets, and gross international reserves of the central bank increased roughly 400% since the beginning of stabilization in October 1993. Since foreign exchange inflows were strong, as in other advanced transition economies, the central bank used several sterilization techniques in order to maintain price stability. Choice of instruments was limited by the structure and performance of the banking system.

High and rigid money market interest rates complicated the sterilization problem. Growth of money supply did not influence money market interest rate downwards because problem banks absorbed free excess reserves of good banks, no matter the high interest rates. However, any indirect instrument of sterilization had to take into account the height of money market rates. Market mechanism did not work if interest offered for the indirect sterilization instrument was significantly below money market rate. On the other hand, high interest offered on T-bills or NBC-bills[1] implied high fiscal costs of sterilization. Hence the National Bank of Croatia relied heavily on raising obligatory reserves requirements (Figure 3). It tried to offset opportunity costs for good banks by raising the rate of remuneration on reserves.

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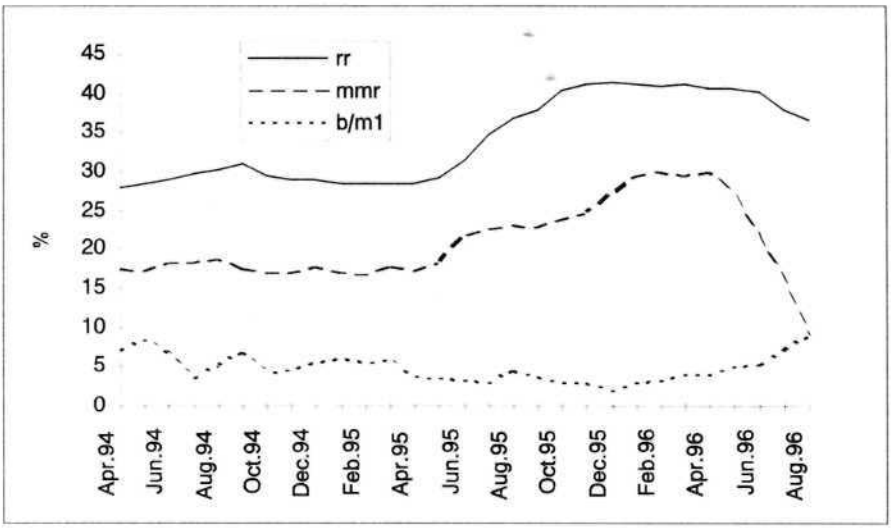
[1] These are two main indirect instruments of domestic monetary policy. T-bills are not effective yet, because the market started to develop only in 1996 and comprises 30% of the NBC bills market, measured by the volume of outstanding papers. NBC bill is a short term central bank paper denominated in domestic currency with maturities of 35 and 91 day. Bills are regularly auctioned on Wednesday, they are freely traded at the secondary market, and commercial banks can use them as a collateral for getting the central bank's lombard loan. National Bank of Croatia enjoys discretion in choosing both the volume and the interest rate at each auction, so that it can easily achieve targeted level of sterilization. On the other hand, by choosing interest rate, it can influence the market interest rate. This is a flexible way to control money supply in periods when sterilization is of primary importance, but it also allows to influence interest rates when sterilization becomes of secondary importance.

Until spring 1996 rehabilitation of three out of four problem banks started. These three banks generated more than half of the demand for money market funds in 1994 and 1995, and suddenly the demand disappeared as rehabilitation begun. Sharp drop of money market interest rate started too (mmr in Figure 3). Monetary policy makers found themselves in a position to influence the money market rates and use indirect instruments of monetary policy. Figure 3 clearly shows the shift from direct to indirect instruments by comparing the rate of reserve requirements (rr) with the share of NBC bills in M1 (b/m1). The biggest increase in the rate of reserve requirements was recorded during 1995, while a significant drop of share of NBC bills outstanding in M1 was recorded in the same period. In the post-rehabilitation period of 1996 the *dynamics is inverted: rate of reserve requirements is decreasing, while* the share of NBC bills in M1 is increasing. Hence, money market interest rate does not seem to be sensitive to monetary policy stance itself (i.e. on the scope and size of sterilization) which did not change significantly since late 1993. It appears to be sensitive to the combination of the sterilization instruments. Since the combination of direct and indirect instruments depends on structural factors, i.e. on a pace of bank rehabilitation, interest rates in general are predominantly influenced by structural factors at work in the banking system.

The following regression confirms the verbal argument, although it calls for further econometric refinement. Money market rate is dependent variable, and an artificial variable constructed as a ratio of rr over b/m1 is independent variable. When monetary authorities rely more on direct instrument, it goes up and vice versa. Hence the expected sign of that variable labeled R is positive, and it reflects the room left for monetary instruments reforms, given the pace and scope of bank rehabilitation. Any decrease in value of R (relying more on indirect instrument) pulls the money market interest rate down and vice versa.

Figure 3

RATE OF RESERVE REQUIREMENTS (RR), MONEY MARKET INTEREST RATE (MMR) AND SHARE OF NBC BILLS OUTSTANDING IN M1 (B/M1) 1994:1 - 1996:8



Results are estimated from May 1994 to August 1996. Direct impact of R is 0.46 in two periods, but it also has a prolonged dynamic impact via lagged effect of money market rate. Hence this equation helps to explain events in 1996 in Croatia (t-statistics in parenthesis):

$$mmr_t = \underset{(5.274)}{0.76001 mmr_{t-1}} + \underset{(1.703)}{0.19672 R_t} + \underset{(2.285)}{0.270189 R_{t-1}}$$

$$R^2adj = 0.925 \qquad Dh = 6.7$$

2. BANK REHABILITATION AND COMPETITION: SHORT-RUN VS. LONG-RUN

Bank rehabilitation is a key to understanding events in 1996. Its lagging behind macroeconomic stabilization in 1994 and 1995 is also a key to understanding financial developments in these years. Why does it play a key role?

2.1. BANK REHABILITATION IN THE SHORT-RUN

First, rehabilitation starts with a liquidity injection from the government. At the very beginning of the process, when old managers leave and new ones are appointed by the state Agency, the bank gets a cash injection so that new management has only to maintain liquidity and devote their scarce organizational resources and time to solving deeper problems of soundness and solvency. So, any immediate short term systemic danger *coming from the problem bank is eliminated at the beginning.*

Up to now, cash injections have been given to three big banks which are, or have been, in the process of rehabilitation. Their illiquidity had strong adverse systemic effects as pointed out in section I.3., because these banks comprise 17.4% of total assets of the banking system. After *elimination of their illiquidity, which pushed the money market rates up* and influenced their rigidity downwards, the central bank properly adjusted instruments and improved financial performance of the system. Hence the beginning of rehabilitation had a strong impact in the short-run due to liquidity improvements.

Second, rehabilitation implies a change in the ownership structure. It is a threat to owners who may resume huge capital losses if the bank is not properly run. Namely, new management and the government's Agency (with a help from the Supervision Department of the National Bank of Croatia) estimate bad claims and write them off against guarantee capital (tier 1 + tier 2). Then, a bank is recapitalized if needed, by government bonds. Solvency improves on the assets side, and ownership structure

changes on the liabilities side in favor of the government Agency proportionally to its cash and bond injections.

It is important to note that presently it does not mean transfer of ownership from the private to the state sector. In other words, it is not a typical state intervention in functioning of private markets in order to correct private banking failure. More precisely, Croatian type of bank rehabilitation means consolidation of financial relations and political powers within the state sector as a first step towards privatization of the bank. As big old banks were owned mainly by large state owned companies[2], rehabilitation implies a shift of ownership from state owned enterprises and agencies towards the Agency for rehabilitation which has a legal obligation to privatize the bank in the second step. This model is well designed for Croatian institutional environment because it recognizes the legacy of the past in the form of tight links between banks and enterprises that have been established in the period of so-called "self-management". It offers an "exit" mechanism for banks that are not able to evolve normally in the period of rise of private markets and institutions. Other old banks, which are able to privatize themselves indirectly through privatization of owners or issues of new or treasurers' shares, and which remain liquid and sound, evolve without external institutional shocks possibly coming from the state intervention. Indeed, Croatian banking system offers some success stories in this respect.[3] So, only if old bank fails to adjust to the new environment, rehabilitation provides the exit by breaking links between old management and old state owned enterprises. It is done fast, so that it also works in the short-run, while effects of privatization of rehabilitated bank occur in the long-run.

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[2] Refer to introduction.

[3] The second Croatian bank by size of capital and assets (which is the first by deposit base, newly extended loans and share in the foreign exchange market) is considered to be 2/3ds in private hands, including foreign owners. This bank is listed among top five emerging markets banks. At least half of equity is held by privatized enterprises, and the remaining part of private ownership is in hands of US portfolio investors. Moreover, the *strongest medium size bank in Croatia managed to attract one big European bank as a* strategic investor in its new equity.

Third, rehabilitation is a behavioral externality that imposes threat to all banks. It improves strength of self-enforcing prudential constraints. So, besides liquidity and solvency, rehabilitation influences prudence and soundness in general, which can also help to explain recent events in Croatian financial system, because it has very short term effects. Namely, every owner and banker who sees owners and managers in other old banks loosing their shares and positions, naturally thinks of how to improve bank's reserve position in order to avoid painful exit from the business. Since rehabilitation in Croatia occurred as a one-shoot shock in Spring this year, other bankers eagerly started to look for additional reserves in order to improve soundness of the business. One obvious way to improve soundness in the short-run is to accumulate risk free government papers, especially if they can be used as collateral in the interbank deals. The other way which is less obvious and pays off in the long-run is to invest in screening and monitoring of clients. According to Berglof and Roland (1996), the two can be viewed as substitutes. In other words, it is much easier to invest "a million" in government risk free papers which bear high interest and can be used as collateral, than to invest "a million" in staff, knowledge and equipment for screening and monitoring clients. The first strategy pays off in the short-run, the second in the long-run; since rehabilitation has a short- run impact as a behavioral externality, other bankers prefer government papers. This is exactly what has happened in Croatia and enabled central bank to drive the interest rates down.

Contrary to widespread opinions that emphasize the long-run impacts of bank rehabilitation, Croatian experience shows its short-run potential which can exhibit strong impact on interest rates comparable to an impact of a stabilization program on exchange rate and prices. Banks in rehabilitation are put in a position of shock, liquidity and solvency are reestablished fast, and negative externality of problem banks' illiquidity is been substituted by a positive behavioral externality. What will happen later, in the long-run, depends on numerous factors which only partly depend on rehabilitation.

2.2. *THE LONG-RUN*

Identity and structure of new owners i.e. the speed of privatization of rehabilitated banks, and personality and background of new managers undoubtedly are long-run determinants of behavior of individual banks. However, there are other determinants outside rehabilitation process itself which are probably more important in the long-run. The rest of the section is devoted to two such examples.

In the first section we saw that ownership matters. Number of banks is misleading as a measure of competition, because 30-40 banks in Croatia are small banks with concentrated ownership structures that favor short term profits over long-run expansion. Competitive and contestable pressures are still weak. Hence there is no external enforcement, except ownership pressure, which can prevent rehabilitated bank to become problem bank again. Ownership pressure itself can prevent getting into problems again, but it does not provide a guarantee for achievement of social optimum in the banking sector. The present situation clearly points into this direction. New private owners of rehabilitated banks will act as any other private owners, and they may exploit market imperfections to extract rents. Competition is the only vehicle which can simultaneously ensure both internal efficiency and social optimum reflected in interest rates comparable to those in the developed countries. And it does not have a lot to do with rehabilitation in the long-run. Easy entry and openness to foreign competition are necessary conditions for the long-run success. Luckily, Croatian regulations stick to this rule.

The other example is related to the above mentioned decision between investment in government papers and screening & monitoring clients. It *is obviously crucial for the future of the bank regardless of its size,* ownership structure and manager's personality. However, this choice is influenced by long term macroeconomic considerations related to capital inflows and fiscal deficit. If net capital inflows is strong for a few years, monetary authorities will try to sterilize domestic monetary effects of interventions at the foreign exchange market. They will continuously offer short term risk free papers to the markets, and bankers will probably

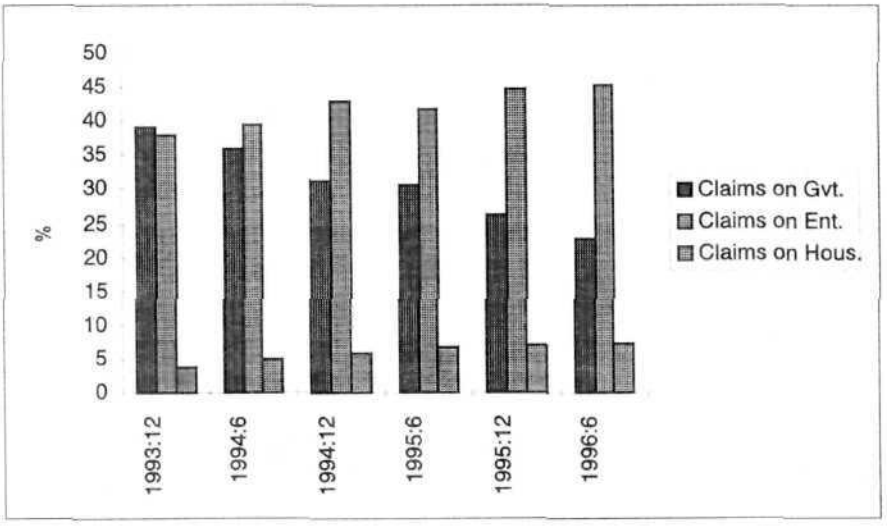
prefer these easy earnings as long as the interest earned is higher than the cost of collecting deposits. The same effect can be induced by persistently high fiscal deficit which is financed by domestic banks. Ministry of Finance would continuously offer T-bills at the market, and bankers can earn fair interest higher than the cost of collecting deposits. Hence there is the danger of renewing the old links between banking sector and the state sector in another form.

3. ORIENTATION OF THE BANKING SYSTEM

I conclude by examining relations among the banking system and other sectors of the economy. Changes in directions of inter-sectoral flows are expected in times when everything is changing, especially in financial sector. Stability of exchange rate and aggregate and relative prices, growing importance of newly extended loans by the private banking sector, introduction of sound fiscal principles and new financing instruments, rapidly changing ownership structures and rehabilitation of problem banks; all of this must have had some influence on decisions and flows. The question is: can we identify sectors that are attracting flows from the banking system; is there a danger of a new domination of the state sector? In order to answer these questions, half-year data on consolidated balance sheet of commercial banks starting in end 1993 is presented in the appendix.

Figure 4 depicts main changes. Share of the claims on government in total assets decreased sharply, from 39,3% to 22,7%. All other items benefitted: reserves at the central bank increased from 1,7% to 5,1%; foreign assets from 17,1% to 19,3%, claims on enterprises from 38,1% to 45,3% and claims on households from 3,8% to 7,4%. Growing share of reserves at the central bank is justifiable because of fast growth of the share of money in liabilities. In other words, liabilities are relatively more liquid than in end 1993. Growing share of foreign assets can also be justified. Although foreign liabilities are declining, the main reason for growth of share of money in total liabilities is to be found in the fast growth of foreign exchange deposits. Hence, having more foreign assets is a prudent behavior.

Figure 4
SHARES OF MAIN ASSET ITEMS IN TOTAL ASSETS OF COMMERCIAL BANKS - HALF YEAR DATA -



Source: Author's calculations based on NBC Bulletin.

All of the above mentioned factors contributed to the shift from financing government towards financing enterprises and households. Besides, the quality of credits improved within all sectors.

Lending to households is still at a relatively low level, so that there is high quality demand at the market which still has not been satisfied. The rate of default is at minimum because banks are extending loans to households with multiple collateral. Typically, these are mortgage loans which are additionally collateralized by a deposit in an amount of one quarter to one third of the amount of the loan. Long term lending to households is expected to grow rapidly in the near future, as banks are now able to raise long-term funds from abroad to finance these loans. The domestic funds are the only limit to the development of lending to households, because there are no long-term savings.

Lending to enterprises grow at the highest rate, but quality of claims is improving because of limits on credits to the largest loss makers. These limits were imposed in mid 1994. Still, collection of claims remains a problem because credible bankruptcy law which will speed up slow judicial procedures will become effective in January 1997. Hence there is a danger that part of growth is due to capitalization of interest.

The structure of lending to government improved, because non-marketable instruments are replaced with marketable ones. Far the greatest share of it are bonds issued as a counterpart to blocked foreign exchange savings accumulated during the period of former Yugoslavia. This is still nonmarketable instrument with dubious debt service. Ministry *of Finance recently issued 3-year marketable bonds in order to refinance* part of principal and interest that became due, and it announced that starting from end 1996 it will service due debt in cash.

Therefore, both macroeconomic regulations (monetary policy reflected in stable exchange rate and prices, fiscal and foreign exchange policy) and microeconomic ones (reforms of monetary instruments, bank rehabilitation and prudential measures) significantly improved performance of the banking system and set the terrain for financial deepening.

LITERATURE

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APPENDIX

DMB'S CONSOLIDATED BALANCE SHEET IN MILLION OF KUNA

	Dec 93		Jun. 94		Dec. 94		Jun. 95		Dec. 95		Jun. 96	
ASSETS	50728,9	100	53469	100	57198	100	57213,5	100	65816,5	100	69603,2	100
Reserves at the Central Bank	866,1	1,7	1406,7	2,6	2036,2	3,6	2494,1	4,4	3303,8	5,1	3512,9	5,1
Foreign Assets	8596,5	17,1	8968,3	16,8	9117,5	15,9	9207,6	16,1	11185,2	16,9	13459,1	19,3
Claims on Government	19983,3	39,3	19278	36,1	17950	31,4	17575,2	30,7	17333,9	26,3	15792,9	22,7
Claims on Enterprises	19354,7	38,1	21133	39,5	24627	43,1	23980,2	41,9	29349,6	44,6	31544,5	45,3
Claims on Households	1902,4	3,8	2605,9	4,9	3375,1	5,9	3837,1	6,7	4512,6	6,9	5139,4	7,4
Claims on Other Banking and Fin. Instit.	25,9	0	77,8	0,1	91,8	0,1	119,4	0,2	131,4	0,2	154,4	0,2
LIABILITIES	50728,9	100	53469	100	57198	100	57213,5	100	65816,5	100	69603,2	100
Money (M4) Without Cash in Circulation	8700,4	17,2	11874	22,2	14809	25,9	16688,3	29,2	21128,4	32,1	25800,8	37,1
Foreign liabilities	12248,4	24,2	12015	22,5	13301	23,3	13215,7	23,1	15335,4	23,3	16345,7	23,5
Central Government's Deposits	1437,8	2,8	1920,7	3,6	1669,4	2,9	1820,8	3,2	2025,6	3,1	1661,2	2,4
Credits from the Central Bank	275,3	0,5	98,4	0,2	223,9	0,4	137,8	0,2	183,1	0,3	122,4	0,2
Restricted and Blocked Deposits	15592,5	30,7	14335	26,8	13281	23,2	12678,3	22,2	11865,7	18,1	10648,3	15,3
Capital Accounts	11756,2	23,2	12407	23,2	14185	24,8	13404,2	23,4	16228,1	24,6	16308,3	23,4
Other net	718,2	1,4	818,3	1,5	-271,6	-0,5	-731,7	-1,3	-950,1	-1,5	-1283,5	-1,9

Source: NBC Bulletin