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Predrag Četković

The Role of Banks in Economic Development in the Former SFR Yugoslavia

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The Role of Banks in Economic Development in the Former SFR Yugoslavia

Predrag Ćetković[1]

Abstract – The economic model of the former SFR Yugoslavia was subject to frequent institutional changes which were oriented towards the real economy as well as the banking sector. The country experimented with a wide range of institutions in the financial sector which had different implications for the autonomy of banks. The industrialization period from the end of the second world war until the end of the 1970s was marked by a sharp expansion of bank credits to enterprises. However, the Yugoslav banks relied strongly on foreign capital inflows for funding their credit activities which contributed to the massive increase in foreign debt of Yugoslavia during the 1970s. The dependence of the Yugoslav economy on foreign funds is a feature which is still very much present in the Yugoslav successor countries.

[1]Vienna University of Economics and Business, predrag.cetkovic@wu.ac.at

1 Introduction

In a market-based economic system banks could be important actors for promoting economic growth and development due to their power to create the necessary funds for productive investment by enterprises. A dynamic real economy is to some extent dependent on the elasticity of the supply of credits. Finance is thus in general treated to have a positive influence on economic growth. However, as the recent financial and economic crisis has shown, too much of finance can also have negative implications for financial stability. This is particularly the case if loans for unproductive purposes, like for example consumption loans, increase on a fast pace. Such rising household debt can result in an unsustainable growth model and therefore the instability of the financial sector may eventually affect the real sector in a negative way.

The situation in the former state socialist countries was somewhat different. Although banks could play an important role also in such an economic system, they did not act autonomously but generally carried out the policies set by the authorities. Loans were subject to strict planning and stood in relationship to the necessities defined by the economic plans. Yugoslavia was a special case since it experienced frequent economic reforms which resulted in a decentralization and increasing market orientation of the economy. The same was true for the Yugoslav banking system which was reorganized many times between the end of the second world war and the breakup of the Yugoslav federation. The institutional setting of the banking sector ranged from a monobank system in the early post-war years to a system of commercial banks accompanied by a system of national banks.

The aim of the present paper is to take a historical perspective on the role which Yugoslav banks had in crediting the economy. The 1960s and the 1970s are of special interest because that was the period when Yugoslavia showed significant signs of transformation to an industrial economy. The industrialization process went along with a sharp rise in loans granted by Yugoslav banks. The main target of these loans was the enterprise sector although there was also a rise in household indebtedness. However, the strong growth of loans went along with a fast increase in the external debt of Yugoslavia. The rising foreign indebtedness was influenced by the reliance of Yugoslav banks on foreign funds in order to expand loans to the domestic non-financial sector.

The paper is structured as follows. The next section provides an overview of the structure as well as the reforms of the Yugoslav banking sector. Section 3 deals with the evolution of credits in Yugoslavia with a particular focus on loans to enterprises. The question about the reliance on foreign funds is discussed in section 4. Section 5 shows a brief overview of the behaviour of banks during transition and examines the parallels to the pre-transition period. The final section concludes.

2 Structure and reforms of the Yugoslav banking system

The first Yugoslavia was formed after the first world war as the Kingdom of Serbs, Croats and Slovenes. The new created country consisted of parts from the former independent Kingdoms of Serbia and Montenegro as well as of parts from the Austro-Hungarian Empire and the Ottoman Empire. The economic differences between the regions were significant from the beginning, with the former Austro-Hungarian regions on top of the development ladder and the southern parts on the bottom. Additionally, the pace of economic and industrial development was much higher in the north than in the south, leading to a widening gap between the regions (Madžar 1992: 72-74). Economic development was then interrupted by the second world war.

After 1945, Yugoslavia was still a predominantly agricultural country, although with regional differences. The new political administration adopted a soviet style administrative socialism already during the last years of the second world war. The major aim of this strategy was the transformation of the agricultural to an industrial state (Mencinger 2000: 120). The first years after the second world war were marked by a fast recovery from the heavy war damages and by 1947, Yugoslavia reached its pre-war output level (Horvat 1971: 73). However, the initial successful years were interrupted by the slow growth performance during the period 1949-1952, which led to the first reform of the economic system in post-war Yugoslavia. This should not be the last reform since Yugoslavia changed its economic and institutional setting several times until the breakup of the country.

The Yugoslav financial sector was also subject to frequent reforms, which went along with the institutional reorganizations of the country. Prior to the second world war, Yugoslavia had a financial system, which consisted of private as well as state banks. The National Bank of Serbia, which was created in 1883, was transformed into the National Bank of Yugoslavia. After the war, private banks were abolished and the state banks were reorganized. Among these reorganizations was the establishment of regional banks on a republican level, which actually occurred already during the last years of the war. In the end of 1946, a consolidation process started where the existing banks were merged into the National Bank and the State Investment Bank. The former was responsible for the issue of currency, conducting banking and agency services for the government and clearing activities while the latter dealt with investments and foreign loans (Horvat 1971). For the purpose of servicing local budgets or the control of plan fulfillment of local enterprises, 89 communal banks were introduced in 1948. At the same time there was also the formation of 6 regional State Banks for Lending to Agricultural Co-operatives (Horvat 1971). In the years of administrative planning (1947-1952), the potential of the banking sector to influence the growth of credit was limited since the system functioned on the basis of credit planning, which was one major instrument of monetary policy along with the cash distribution plan and the automatic collection of invoices (Vučković 1963).

The system of administrative planning was abandoned with the reform in 1952 which was the first round of introducing measures with the aim of decentralizing the economy. However, the decentralization of the real sphere of the economy was accompanied by a centralization of the financial sphere. Thus, communal banks where abolished while the other banks were merged with the National Bank leading to a monobank system (Horvat 1971). The bank had its offices over the whole territory and was responsible for all types of banking operations (Vučković 1963). The monobank system lasted only until 1955 when communal banks were re-established. They had similar functions to those they had before their elimination. Additionally, a foreign trade bank, an investment bank and an agricultural bank were established in the following years (Horvat 1971).[2]

The next big reform of the banking system occurred in 1961, when regional banks were re-established.[3] Their function was to serve as a mediator between the National bank and communal banks. The latter were also targeted by the reform as they became basic and universal credit institutions. The banking system now consisted of the Yugoslav National Bank, the Bank for Foreign Trade, the Investment Bank and the Bank for Agriculture on a federal level, the regional banks on a republican/regional level and the communal banks belonging to municipalities (Vučković 1963). One problem of this structure was that the credit market was disintegrated into regional markets (Horvat 1971). The communal banks had a special role in the banking system since they were the only banks which were directly in contact with territorial economic and non-economic entities. Communal banks could also be jointly established by more municipalities who were also the guarantors of the liabilities of the banks (Vučković 1963).

The next step in reforming the banking sector occurred in 1965. Banks were now classified according to the type of credit they provide. Investment banks dealt with funding fixed and constant working capital, commercial banks with short-term loans and savings banks with consumer loans (Horvat 1971). The role of banks for financing investment gained importance with the transfer of social investment funds to banks from 1964 onwards. The reform included the possibility for working organisations to found banks themselves or jointly with other working organisations or political entities (Sirc 1979). Banks now had their own capital , called the credit fund, and were managed by the funding entities according to the invested capital. To limit political pressures from local and republican authorities, banks should spread their activities over the whole territory of the federal state (Horvat 1971). However, this was achieved only in exceptional cases, since banks in general restricted their operations within republics (Singleton & Carter 1982). Banks now had a strong market orientation, which resulted in a concentration

[2]The Yugoslav Bank for Foreign Trade started its credit operations in 1955, the Yugoslav Investment Bank in 1956 and the Yugoslav Bank for Agriculture in 1958.

[3]The Serbian republican bank was the first to be founded in late 1961, the establishment of the other republican banks followed in early 1962.

process and a reduction of the number of banks from 217 in 1964 to 111 in mid-1967 (Horvat 1971). This concentration was strongly intensified during the following years.

A further reform was conducted in 1971/1972 when autonomous National banks for the republics and autonomous provinces were established.[4] Along with the National bank of Yugoslavia (NBY) there existed now 8 other national banks which meant a new big step in decentralization (Singleton & Carter 1982). The National Bank of Yugoslavia represented the unified monetary and currency area. It was responsible for the issue of currency, regulating the money supply and foreign exchange operations. The Board of Governors of the National Bank of Yugoslavia consisted of its own governor and those of the national banks of the republics and autonomous provinces. The board was thus the institution, which integrated the nine national banks. The national banks of the republics and autonomous provinces were not branches of the National Bank of Yugoslavia but autonomous institutions within the system of national banks. They conducted their operations either together with the NBY or on their own behalf in accordance with republican laws. The republican national banks had a significant role since they performed a great part of the operational work with commercial banks. (Golijanin 1978).

A further reorganization of the banking and financial system was conducted in 1976/1977. The commercial banks were reorganized into basic and united banks. Additionally, they were accompanied by new institutions, the internal banks (Ribnikar 1981). Basic banks were established by enterprises and generally took over the operations which the former commercial banks had (OECD 1978: 22). United banks were only aggregations of basic banks. (Ribnikar 1981). Internal banks stood in relationship with a number of basic organizations of associated labor (BOALs) and in general performed financing operations (OECD 1978: 22). The BOALs held their money within internal accounts at their internal bank. These sources were used for the payments between BOALs, which were part of the same internal bank. For payments between BOALs, which were not members of the same internal bank, sources from basic banks were required. For this purpose, internal banks had to hold reserves at basic banks (Ribnikar 1981).

In the late 1970s, other financial organizations[5] were also established (OECD 1978: 21–22). One of these financial organizations, was the Yugoslav Bank for International Economic Cooperation, which was established in 1978 by a decision of the Federal Assembly. The role of this bank was to finance joint ventures with foreign firms, to deal with export credits, to raise foreign credits and to establish joint Yugoslav-foreign banking institutions (Singleton & Carter 1982).

[4]The National banks for the six republics were established in 1971, those for Kosovo and Vojvodina in 1972.

[5]After the reforms in the 1970s, the Yugoslav financial system consisted of Monetary Institutions and Other Financial Organizations. The system of national banks, the basic and united banks and the savings bank were part of the former, while the latter consisted of the Yugoslav Bank for International Economic Cooperation, the Credit funds for financing investment in the less developed republics and provinces and the Funds of Associated Labor.

Instruments of monetary policy were also subject to changes, which went along with the reforms of the banking sector. With the reform in the early 1960s, a network of commercial banks appeared. The effect was that the Yugoslav central bank reduced its activity of crediting enterprises (Horvat 1971: 136). The National Bank of Yugoslavia continued to operate as a traditional national bank and socio-political communities remained the only important borrowers of credits from it. In regulating the money supply, the national bank had a set of instruments available, for example, foreign exchange operations, reserve requirements or special credits to banks. The latter acted as some kind of substitution for open market operations, since these were not possible due to the lack of treasury bills. The special credits were frozen in the late 1960s and other new measures emerged like rediscount credits or quantitative restrictions of credits. There was also the establishment of a daily market for the exchange of short-term capital between banks (Horvat 1971: 137). In 1977 the National Bank of Yugoslavia started to purchase short-term securities as an instrument for creating reserve money. This instrument should emerge as one of the basic monetary policy instruments (Golijanin 1978: 107).

3 Credit dynamics

Credit dynamics in Yugoslavia experienced significant changes with the reforms of the financial and banking system.[6] The role of the National bank of Yugoslavia (from 1972 onwards the system of National banks) in granting loans to the non-financial sector[7] decreased steadily (Figure 1). Specialized banks had a more or less stable share during their existence from the mid-1950s to the mid-1960s.[8] Republican banks had an increasing role until they were merged with other banks. From the 1960s onwards, the major part of credit funding was provided by local banks, which were later reorganized into commercial banks, and in a further step into basic and universal banks. Internal banks showed an increasing trend from the late 1970s to the mid-1980s.

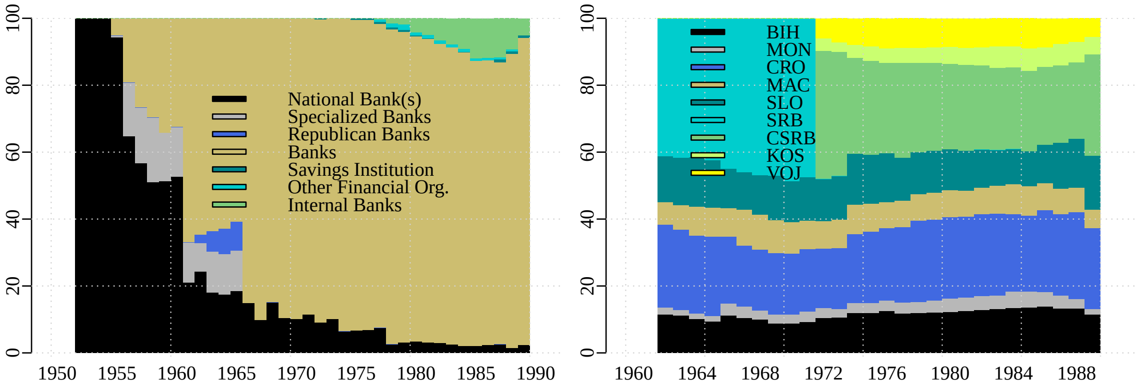
The share of local (commercial) banks in loans by republic is shown on the right hand side of Figure 1. With about 40%, Serbian banks had the highest share during the whole period, followed by Croatian banks. The rise in credits by Serbian banks in the mid-1960s was due to integration of the former specialized banks, which had their headquarters in

[6] The data used in this paper are from the monthly bulletins of the Social Accounting Service and the National Bank of Yugoslavia. Due to limitations in data availability, the series do not always refer to end-of-year data but in some cases to data from October or November. For some variables there are no data available for single years so they had to be interpolated.

[7] Credits include Dinar-loans to the non-financial sector, loans for housing and foreign exchange loans to companies.

[8] Of the three specialized banks, the foreign trade bank had by far the highest share in loan funding. The Yugoslav Investment Bank had a similar share from its establishment until 1958. From 1959 onwards„ this bank played a minor role in terms of financing credits. The same is true for the bank for agriculture.

***Figure 1:** Structure of loans by type of bank (left, in %, 1952-1989) and structure of loans of communal/commercial banks by republic/autonomous region (right, in %, 1962-1989)*



Source: Social Accounting Service, National Bank of Yugoslavia.

Belgrade. The data for Serbia is divided into Central Serbia and the two autonomous provinces from the early 1970s.

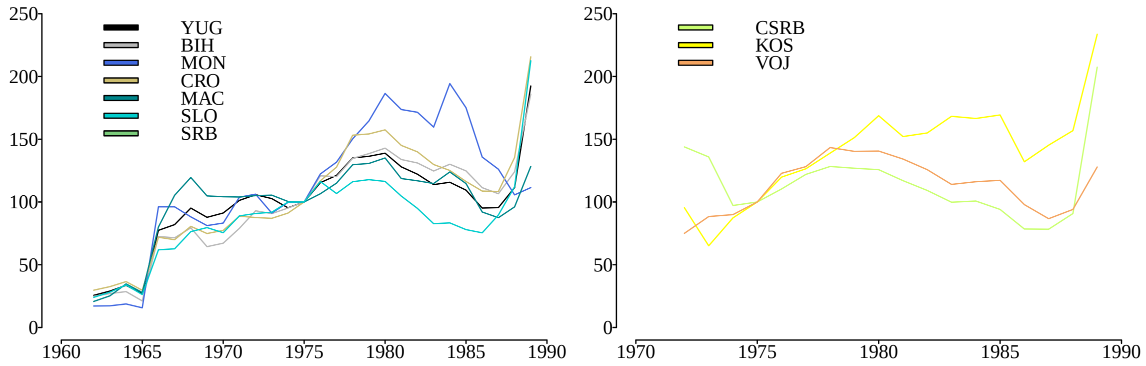
The value of outstanding credits show an increasing trend during the whole period. Particularly in the 1980s, the nominal value of loans increased massively. However, this was mainly the effect of the massive inflation during that period. But also the 1960s and 1970s were marked by relatively high inflation rates. In order to correct for the significant inflationary effects, the evolution of credits is shown in real terms in figure 2.[9] It can be seen that the level of outstanding credits increased during the 1960s and the 1970s. The increase in loans was to a significant extent the result of negative real interest rates, which prevailed most of the time due to relatively high inflation and relatively moderate nominal interest rates. Real credit growth was negative from the early t o the mid 1980s. However, there occurred a steep increase in credits in the last years of that decade.

Loans to enterprises had the highest share in total loans, but household loans showed an increasing tendency, particularly in the richer republics Slovenia and Croatia (Figure 3). The figure shows a fall in the share of household loans in the mid-1960s. This is due to the fact, that for the period 1962-1965 the data refer to only local banks, which played the major role in granting loans to households. From 1965 onwards, the data include also the former specialized and republican banks, which had a focus on other sectors than households. The level of household loans was also different between the regions, with the lowest share in Kosovo.

The role of bank funds as a source of investment financing for enterprises experienced significant changes. Investment itself was also affected by the economic reforms. The decentralization process resulted in a higher autonomy of enterprises concerning investment

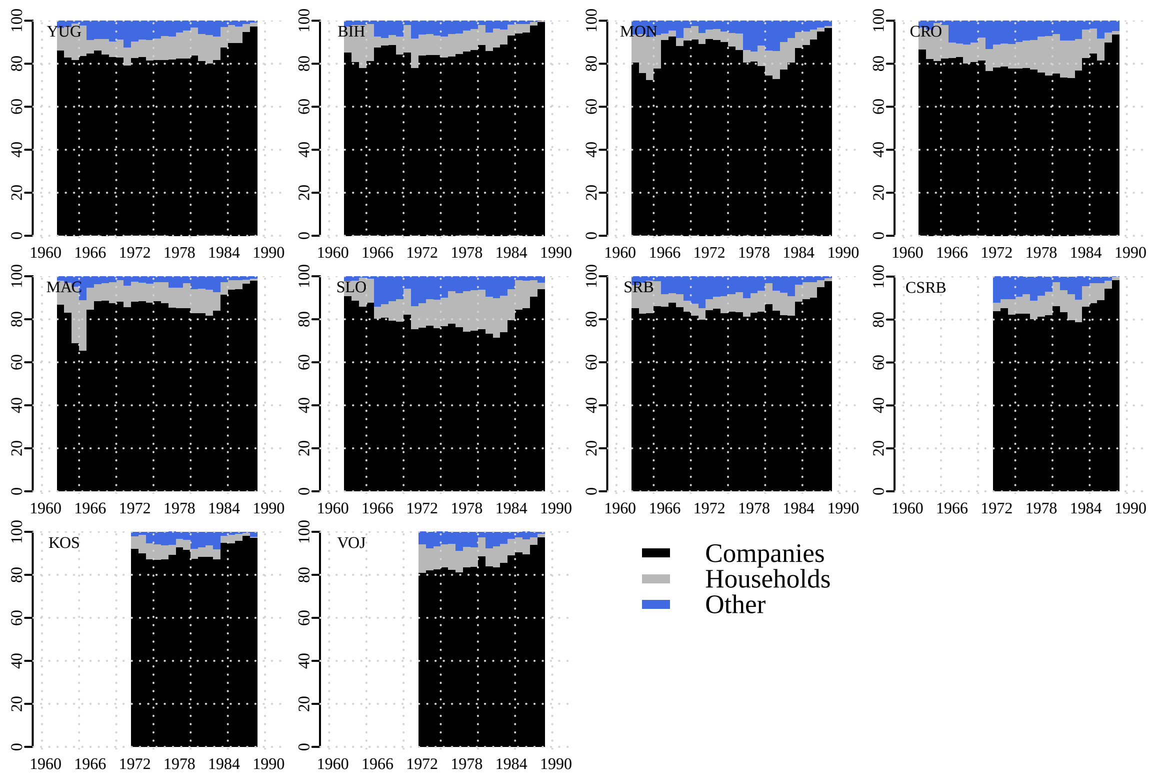
[9]The value of outstanding loans was deflated by the index of cost of living.

Figure 2: Evolution of loans in real terms (1975=100, 1962-1989)



Source: Social Accounting Service, National Bank of Yugoslavia.

Figure 3: Bank loans by sector (in %, 1962-1988)



Source: Social Accounting Service, National Bank of Yugoslavia.

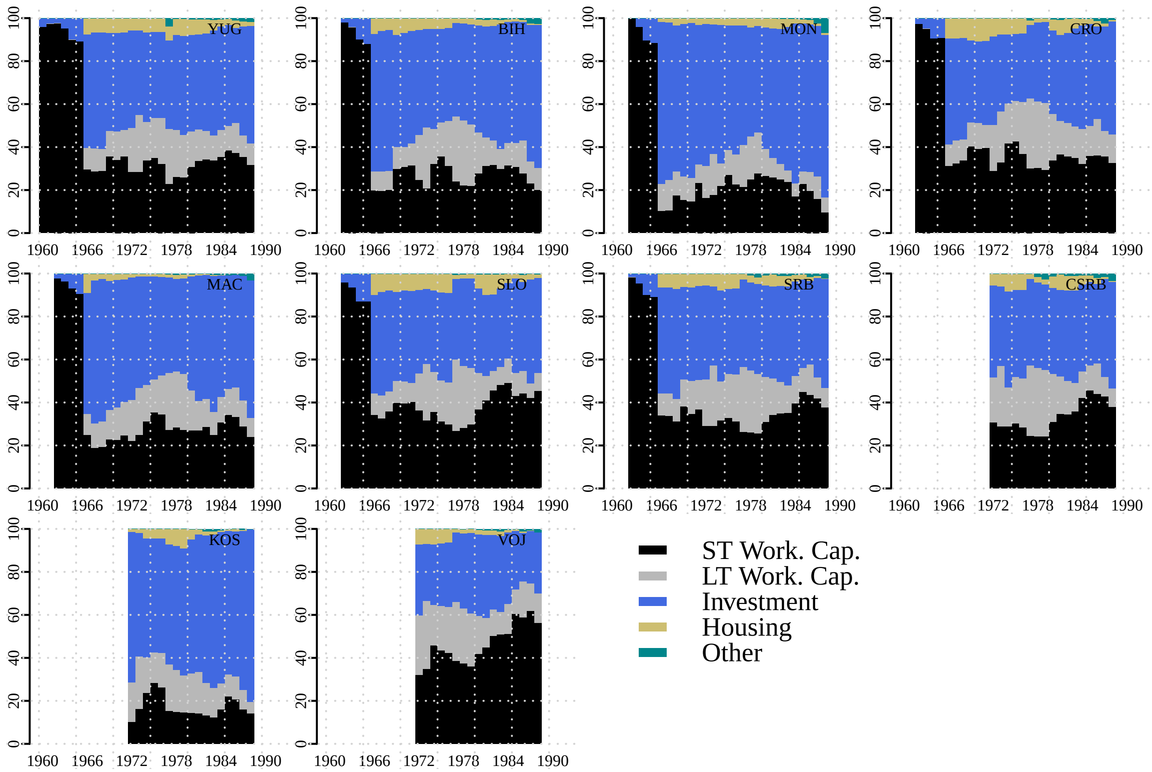
decisions. The Yugoslav economy was marked by high investment rates until the early 1980s (Uvalić 1992). In the initial years after the world war, investment was financed out of budgetary sources. However, they were replaced by the Fund for Basic Capital Development in 1952. From 1952 onwards, funds of enterprises, which consisted of retained profits, started to play an increasing role. Their share increased from 2% in 1952 to close to 40% in 1960. At the same time, the share of the investment funds decreased (Horvat 1971). These funds were transferred to banks from 1964 onwards, which resulted in an increasing role of banks in investment financing. Banks, which had a share of about 1% before 1960, increased their share to about 45% until the end of the 1960s. This share remained more or less stable until the end of the 1970s. Thus, from the mid 1960s to the end of the 1970s, investment was more or less completely financed out of own funds of enterprises and bank credits. The role of banks in financing investment decreased steadily during the 1980s due to quantitative limits imposed on credit financing. This was accompanied by a rise of the role of enterprise funds, which stood for about 75% of investment finance in 1988, while banks had only a share of about 20% (Uvalić 1992).

A closer look on enterprise loans shows that they consisted mainly of short-term loans for working capital until the early 1960s (Figure 4). With the transfer of funds from the state investment fund to banks from 1964 onwards, the share of long-term loans for working capital and particularly that of investment loans increased significantly. The separation between short-term and long-term working capital was due to the reason that the former was treated as a fluctuating part, while the latter has rather the character of fixed capital and was thus financed mainly out of enterprise funds prior to the mid-1960s (Horvat 1971). Loans for housing included funds for expanding the supply of municipal housing as well as for building dwellings for market purposes. Until the early-1970s, housing loans to all sectors were mainly financed out of specific funds, which the banks held for that purpose. However, these funds did not held pace with the dynamics of housing loans, which resulted in an increasing reliance of banks on other sources for financing housing loans.

Concerning the sectoral composition of enterprise loans for working capital, it can be seen from Figure 5 that the share of industry increased significantly in Yugoslavia as well as most of the republics and autonomous provinces until the end of the 1970s. On the other side, trade and catering activities got a steadily decreasing share of working capital-funds from banks. Funds were also decreasingly provided to the agricultural sector between the early 1960s and the late 1970s. The relative increase in bank funds for industry was halted by 1980 and during the 1980s the share of loans to industry remained stable. During the same period, financial and other services increased their share remarkably.

The strong increase of working capital-loans to industrial enterprises goes along with the industrialization process of Yugoslavia after the war. From the early 1950s until the end of the 1970s, the industrial sector had very strong growth rates in terms of Gross Material Product (Flaherty 1982: 107). The share of industry in total GMP increased steadily, leading to a transformation of the former predominantly agricultural into an industrial economy. The initially less developed regions like Macedonia or Montenegro had growth rates of real industrial production which were higher than those of the more

Figure 4: Structure of bank loans to companies (in %, 1960-1988)



Source: Social Accounting Service, National Bank of Yugoslavia.

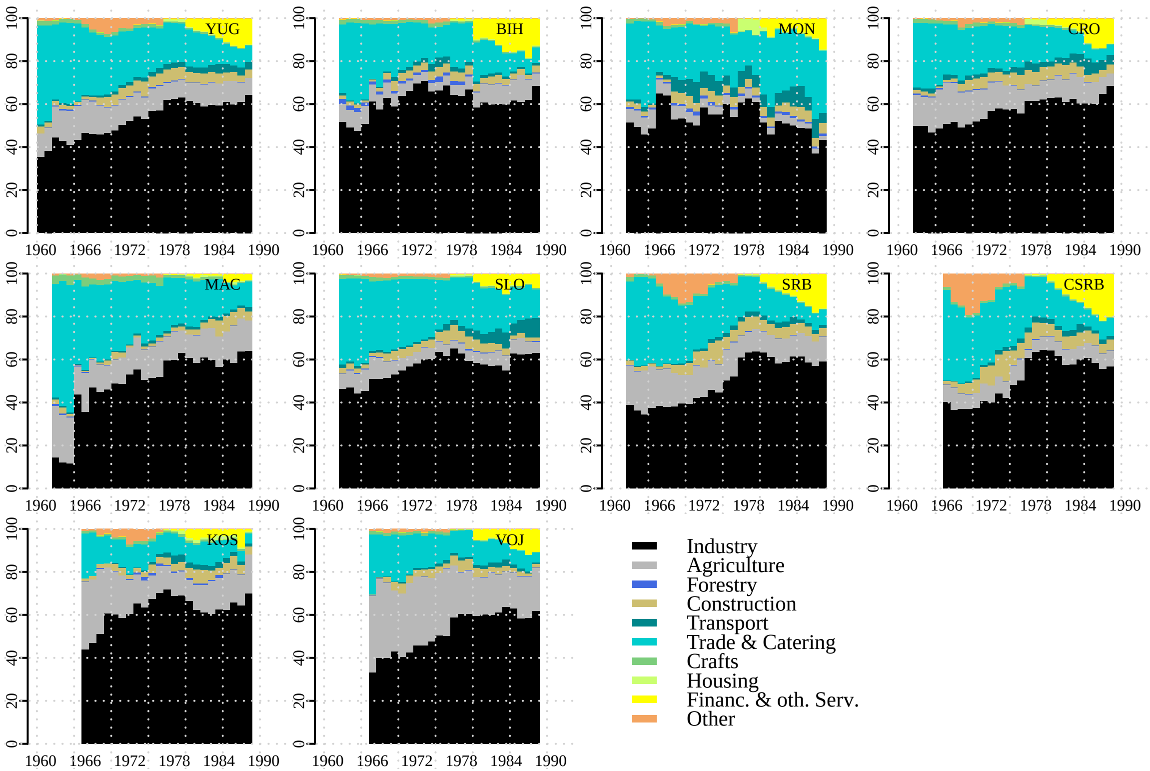
developed republics (Krasulja 1979).

The focus on the development of specific industrial sectors changed with time. In 1945, the expansion of energy and raw material as well as mechanical engineering was promoted. Later on the consumption goods industry was stressed which went in line with the rise of the income of Yugoslav households. The change in the structure of the material product by industry was significant. The metalworking industry increased its share from about 20% in 1952 to 28.5% in 1977. On the other side, the textile and leather industry experienced a drop from 22.7% to 14.2 % during the same time-span (Krasulja 1979). The generation of electrical energy was also promoted in line with the requirements of the economy. Overall the Yugoslav industry was marked with a significant transformation although differences were present between the republics and regions.

A deeper look into loans for working capital to industry can be seen in figure 6.[10] The metal industry (machinery, transport equipment) had the highest share in Yugoslavia as well as in Serbia, Slovenia or Bosnia and Herzegovina. While the textile industry

[10]The data covers total bank funds until 1965, short-term bank funds from 1966 to 1971 and total funds from 1972 onwards. Thus, from 1972, other sources like social funds are also included. However, the share of the latter is relatively low, since these funds did not play an important role for financing working capital of industry.

Figure 5: Bank loans for working capital of companies by sector (in %, 1960-1988)

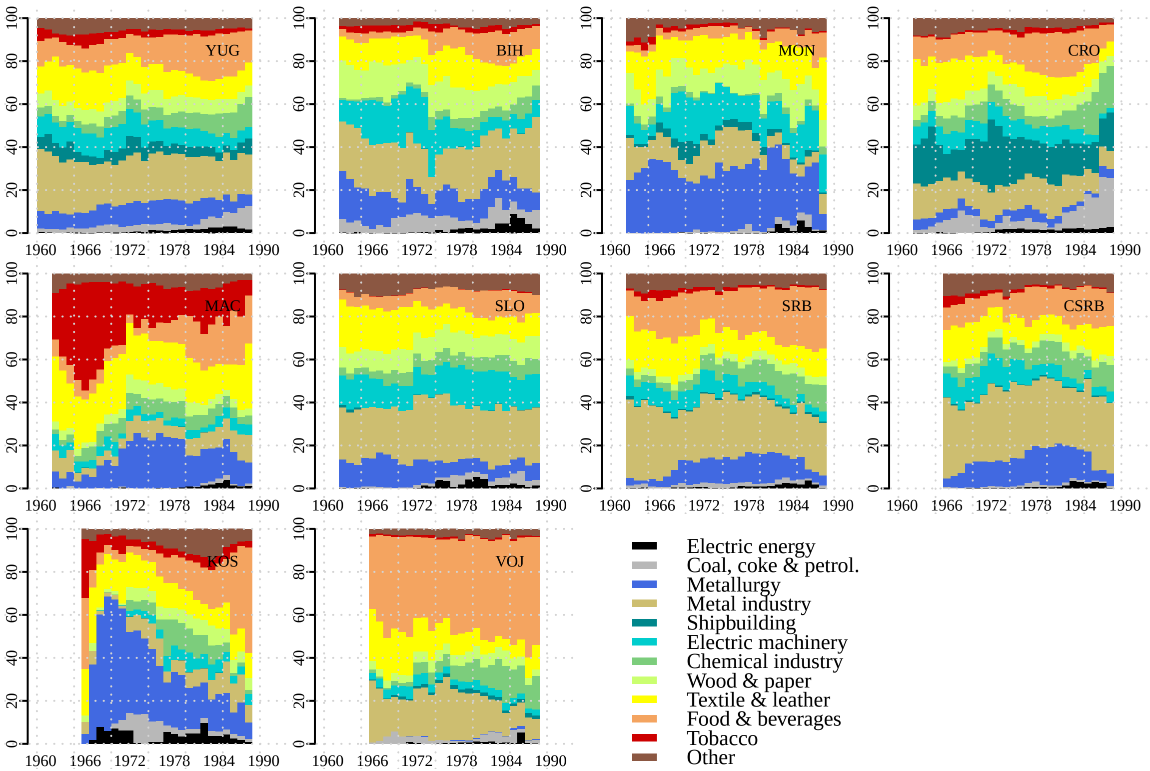


Source: Social Accounting Service.

reduced its share, that of the chemical industry increased. In the lesser developed regions (Kosovo, Montenegro), the metallurgy industry absorbed a high share of loans. Croatia is the only republic, where the shipbuilding industry shows a significant dependence on loans. Another sector with a high share is food and beverages, which is particularly true for the Vojvodina. In Macedonia the tobacco industry shows a high though decreasing dependence on loans for working capital. The amount of loans for working capital seems to be in accordance with the relative importance of the industrial sectors in the Yugoslav regions.

In Figure 3 it was shown that household loans played a more or less negligible role in relation to loans to enterprises. The role of household loans was limited before the reforms in the early 1950s. Such loans consisted of consumer loans which were granted only for specific purposes. (Vučković 1963). With the reforms, consumption loans started to play an increasing role. The share of consumption loans in total household loans can be seen from figure 7. Consumption loans consisted partly of direct loans from banks and partly of bank loans which are covered by enterprises but are not funded out of enterprise funds. The emergence of loans for housing in the late 1950s underlined the trend in the rise of household loans further. The share of loans for consumption increased during the 1970s

Figure 6: *Loans for working capital of industrial companies by sector (in %, 1960-1988)*



Source: Social Accounting Service.

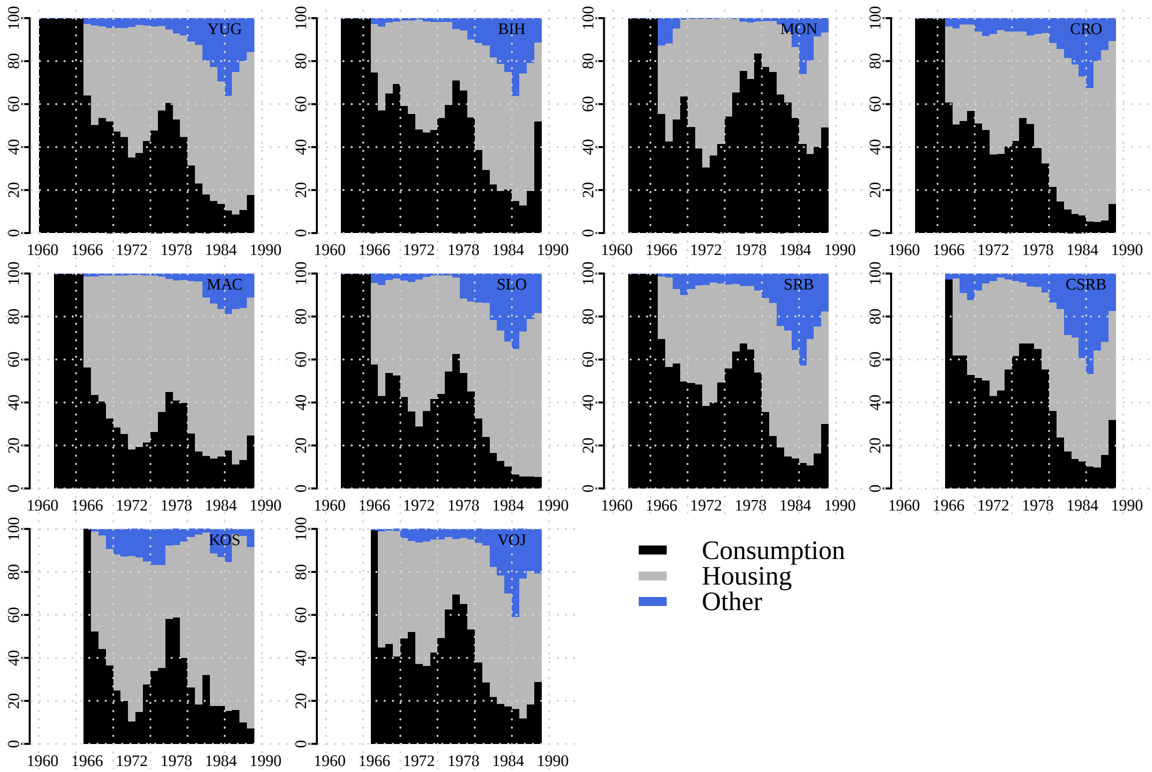
but decreased in the 1980s. On the other side, loans for housing show an opposite trend. The data shows an increase in other loans in the first half of the 1980s, which was the result of long-term loans classified neither as consumption nor as housing loans.

4 Funding and stability

The fast expansion of loans raises the question how they had been financed. A feature of the Yugoslav banking system was that total bank loans were generally higher than deposits held by domestic sectors. This was due to the fact that banks had also access to a set of funds like the fund for financing housing loans or the sources from the former social funds for the purpose of investment financing. However, the strong investment activities during the 1970s were well above the savings potential of the Yugoslav economy (Uvalić 1992). The high current account deficits during that period were an indicator for the reliance of the Yugoslav economy on funds from abroad.

Since domestic sources were not sufficient, Yugoslav banks relied to an increasing extent on funds from abroad in funding their credit operations. Figure 8 shows the evolution of

Figure 7: *Structure of bank loans to households (in %, 1960-1988)*



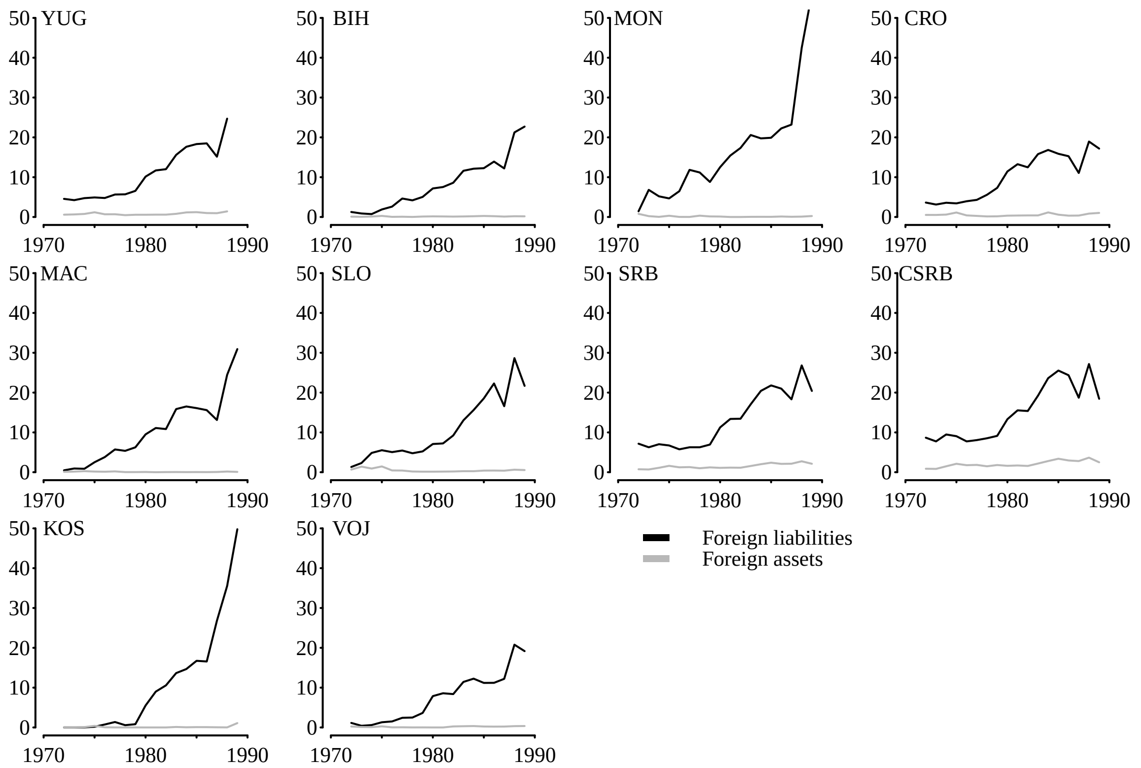
Source: Social Accounting Service, National Bank of Yugoslavia.

foreign assets and foreign liabilities. While the latter show a massive increase from the early 1970s onwards, the former were relatively stable. Yugoslav banks thus increased their net borrowing position steadily. Montenegrin banks had the highest value of foreign liabilities in relation to their total assets/liabilities, which reached about 50% in 1989. There may be different causes behind the developments in the 1970s compared to that in the 1980s. While in the former period foreign liabilities increased as a result of a rising inflow of foreign capital, the increase during the 1980s was heavily influenced by the depreciation of the Yugoslav currency, which increased the debt-burden in Dinar-terms.

The increasing indebtedness of Yugoslav banks went in line with the development of the foreign indebtedness of the total economy. Particularly during the 1970s, the Yugoslav economy experienced a sharp increase in its external debt. The bulk of that debt was attributed to credits for equipment and to financial loans. The latter showed much stronger growth rates than the former during that period. Foreign debt of Yugoslavia was concentrated mainly in a few Western European countries, which had a share of 67% in outstanding Yugoslav debt in 1978. (Marković 1979: 64-65).

Another problem in relation to foreign exchange positions emerged with FX-deposits held by domestic sectors. Figure 9 shows the banking sector's FX-claims on as well as

__Figure 8:__ Foreign assets and foreign liabilities of banks in % of total assets/liabilities (1972-1989)

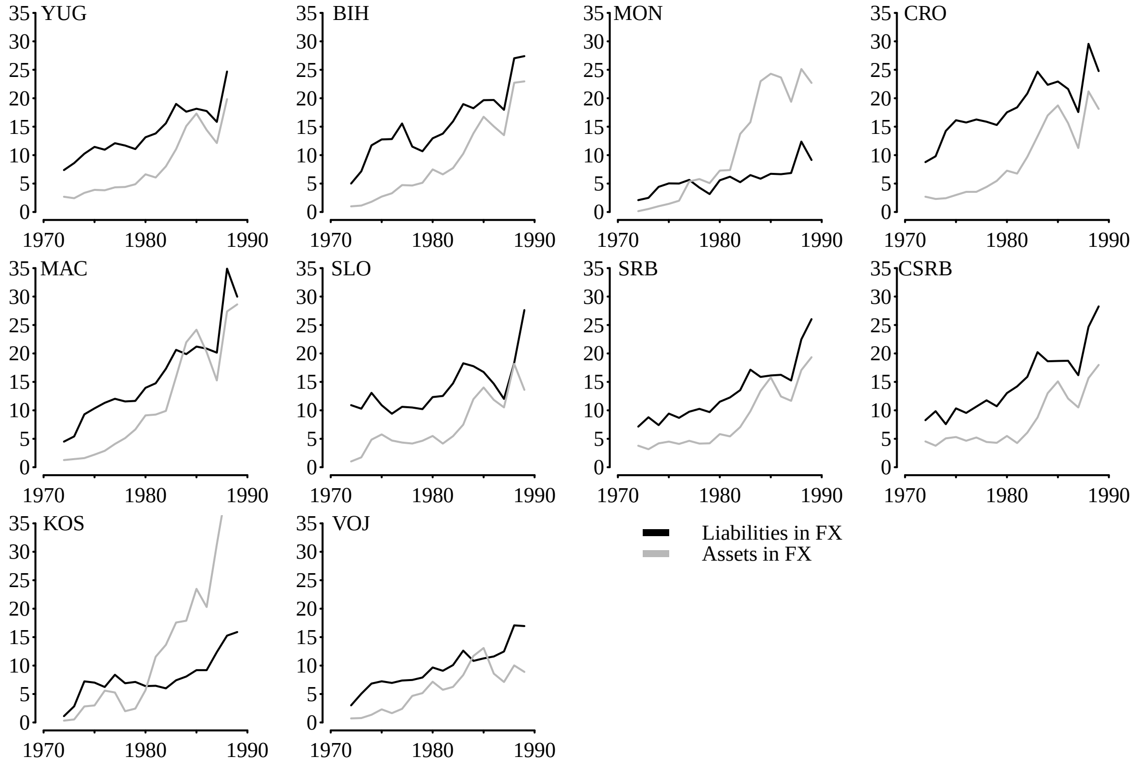


Source: Social Accounting Service, National Bank of Yugoslavia.

FX-liabilities to domestic non-financial sectors. Liabilities in foreign exchange increased during the whole period shown. The increasing role of these positions started already in the 1960s. The major driver of these liabilities were FX-deposits by Yugoslav households. There were also differences between the republics, with banks from the richer regions having a higher share of FX-liabilities in their total assets. In contrast to FX-liabilities, the level of claims in foreign currency was in general negligible until the mid 1970s. However, the Dinar-value of these assets showed a massive increase from the late 1970s/early 1980s. The major driving factor behind that development was the increase in the value of outstanding loans granted to enterprises.

The increase of the Yugoslav external debt had its effects on the real economy during the 1980s. The country applied to international financial institutions for loans and assistance in order to cope with its increasing inability to repay its foreign obligations. The 1980s were marked by structural adjustment programs and the Yugoslav economy entered a period of economic crisis which rested until the breakup of the federal state. The last years of the SFR Yugoslavia were characterized by policies oriented towards the transition to a merket economy and which should be continued in the Yugoslav successor states after

Figure 9: *FX-assets and FX-liabilities of banks to the domestic non-financial sector in % of total assets/liabilities (1972-1989)*



Source: Social Accounting Service, National Bank of Yugoslavia.

the breakup.

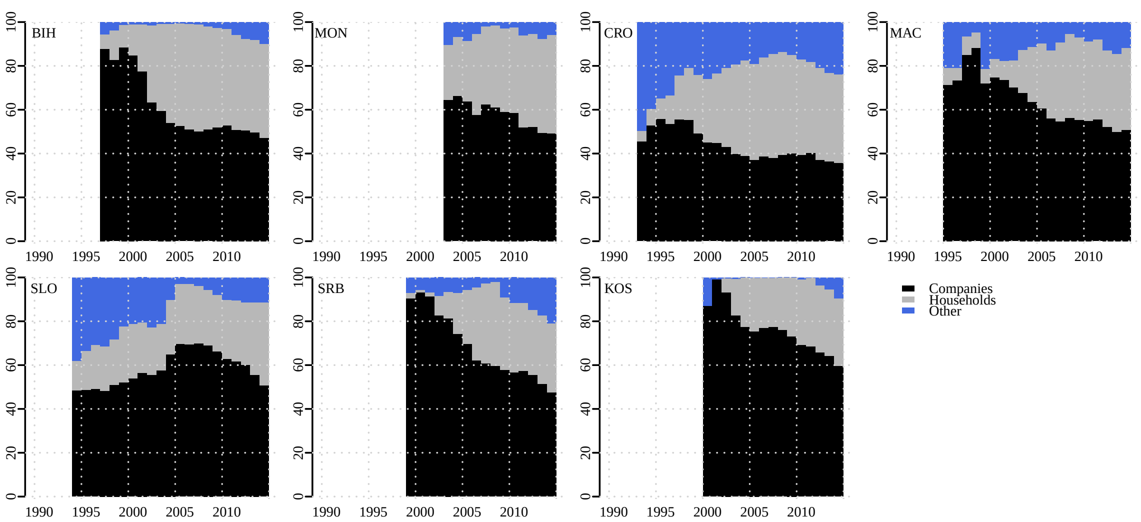
5 The banking sector during transition to market economies

The transition policies had some different outcomes for the real compared to the financial sector. The real sector showed a moderate performance since most of the Yugoslav successor countries suffered from a massive deindustrialization in the initial years of the transition to market economies. In 1995, the real volume of industrial production accounted for about 50% of its 1989-level in Croatia. The figures for Macedonia, Montenegro and Serbia are more dramatic since those countries lost more than 60% of industrial production until 1995 (Becker et al. 2010: 28). As a result of the transition policies and the war, industry in Bosnia and Herzegovina was more or less entirely destroyed in the first half of the 1990s (Bartlett 2009). There has been no significant recovery of the industrial sector in most of the former Yugoslav countries and industrial production, with the exception of Slovenia, is still well below its pre-transition level.

On the other side, the financial sector experienced a better recovery than the industrial sector and attracted a significant part of foreign direct investment. From the former Yugoslav republics, Croatia was the first country where foreign banks entered on a massive scale. The major sale of Croatian banks to foreigners occurred after the banking crisis at the end of the 1990s (Kraft 2004). The entry of foreign banks into the other Balkan countries followed a few years later and foreign banks now hold the major part of banking sector's assets in all countries except Slovenia.

In market economies, finance is in general considered to have a positive link with economic growth and development. Schumpeter (1911) highlights that banks create purchasing power by granting loans to innovative entrepreneurs and are thus promoting economic development and growth. Gerschenkron (1962) stresses the close relationships between banks and industrial enterprises in the process of industrialization of countries like Germany, Austria or Italy. However, the role of banks in promoting an economic recovery in the Balkans was rather limited since a high fraction of loans were channelled to the private household sector. The fast rising indebtedness of the household sector led to increasing shares of household loans in total loans until 2008 (Figure 10). An outstanding exception to this trend is Slovenia, where companies increased their share in total loans until the outbreak of the recent financial and economic crisis.

Figure 10: *Bank loans by sector in %, 1990-2014*

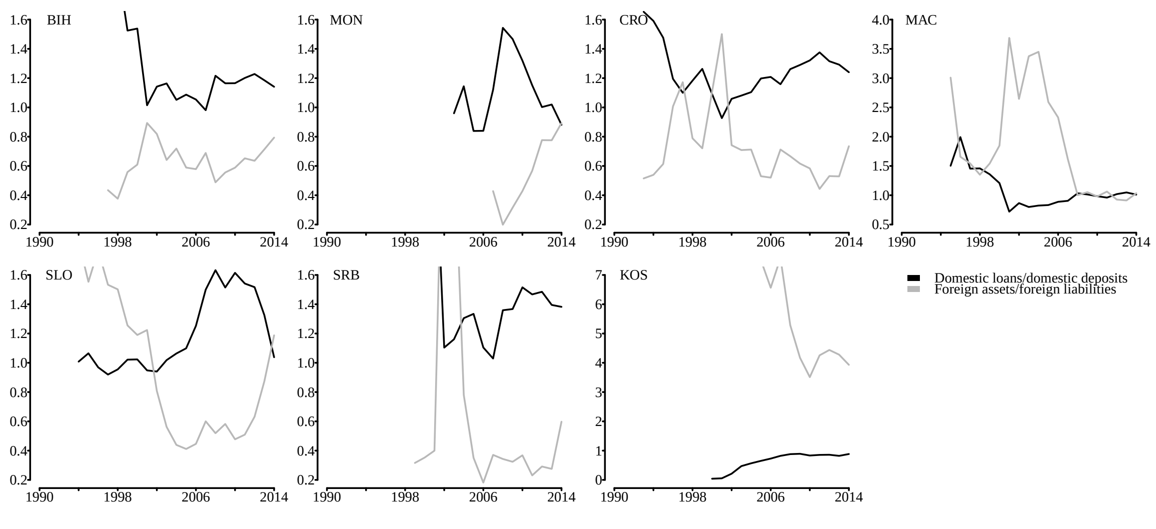


Source: Central banks.

There is a vast empirical literature dealing with the effects of finance on economic development (Levine 2005; Beck 2012). Many of the studies find a positive link between enterprise finance and economic growth (e.g. Beck et al. 2000; Demirguec-Kunt & Maksimović 1998; Rajan & Zingales 1998). However, these studies generally do not distinguish between loans to enterprises and credits to private households. There are only a few studies which take into account the composition of private credit when studying the effect of finance on economic growth (e.g. Beck et al. 2012; Sassi & Gasmi 2014). The results of these works indicate a positive link for enterprise loans and economic growth and no or even a negative link for household loans.

The problem with a fast rising household debt is that these loans are in many cases used for financing imported consumption goods. Thus, the economy becomes dependent on foreign funds in order to finance the increasing debt. Of the Yugoslav successor countries this was the case in Bosnia and Herzegovina, Croatia or Serbia. The result is that over time a gap arises between the outstanding amount of loans to domestic sectors and the deposits held by domestic sectors. Figure 11 shows that the ratio of domestic loans (excluding loans to the financial sector) exceeded domestic deposits (excluding deposits held by the financial sector) in all countries except Macedonia and Kosovo. On the other side, foreign assets did not hold pace with foreign liabilities. There is some kind of inverse relationship between the loan to deposit ratio and the ratio foreign assets to foreign liabilities, which depicts the reliance of banks on foreign funds as an important source for the financing of local credits in the Balkans. The trend of the indicators have been reversed during the crisis years. The case of Slovenia is different because the rising foreign indebtedness was not connected to household loans but to an increase in enterprise debt.

Figure 11: *Indicators for credit funding sources, 1990-2014*



Source: Central banks.

The reliance on foreign funding has also implications for the currency structure of the assets of the banking sector. Foreign liabilities are denominated in foreign currency and in case that these funds are used to cover the gap between domestic loans and domestic deposits, banks have to grant an increasing fraction of loans in foreign currency in order to avoid currency mismatches in their balance sheets. This will intensify the problem of Euroization which is very present in many Yugoslav successor countries partly as a result of the saving behaviour of households and partly due to the reliance on foreign funds. Both of these phenomena show strong similarities to the pre-transition period.

6 Conclusion

The banking sector in the former SFR Yugoslavia was subject to frequent and significant reforms from the early 1950s onwards. The aim of these reforms was mainly to adjust the functioning of the banking sector to the needs of the decentralized real sphere of the Yugoslav economy. The last steps of the reforms led to a system where the so-called basic and united banks emerged which had a strong relationship with the enterprises.

The credit activity of Yugoslav banks was very dynamic until the early 1980s. Banks gained access to former investment funds and acted as meaningful players in the industrialization process by granting loans for investment and also for working capital of enterprises. The latter depends very much on economic activity and the data indicate that throughout the Yugoslav republics and autonomous provinces, the amount of loans for working capital was related to the relative importance of the industrial sectors, like for example the shipbuilding industry in Croatia or the food industry in the Vojvodina. Loans to Yugoslav households played less a role than credits to enterprises but experienced also a sharp increase. This was particularly true for the richer republics as well as for loans for housing.

However, the domestic economy was not able to fund its expansion from exclusively domestic sources but relied heavily on the inflow of foreign capital. The net foreign debt of banks increased sharply during the 1970s. They thus contributed to the rising external debt of the Yugoslav economy. Currency mismatches in the balance sheets of banks occurred from the 1960s onwards due to the increase in FX-deposits of households. Assets of banks in foreign currency emerged mainly in the 1980s and were to a great extent composed of loans to enterprises. Credit activities in real terms eventually show a decline during the major part of the 1980s. This was due to the period of economic crisis which Yugoslavia entered in the early 1980s and which should remain until the breakup of the country.

Credit growth in the Yugoslav successor countries was also on a high level prior to the outbreak of the crisis in 2008. However, there have been differences in the credit development compared to the pre-transition time. During the 2000, credits were mainly granted to private households and not to enterprises. A comparison between the pre- and the post-transition periods in terms of the role of the banking sector for economic development is strongly limited due to the fact that in the former system banks acted in accordance with the development priorities while the privatized banks operated mainly on their own behalf and in strongly deindustrialized economies. But, the reliance of banks on foreign funds and the strong presence of Euroization shows continuity. Along with the objective to channel available funds to productive purposes, a major challenge for the financial systems in the Balkan countries for the future is to get rid of the dependence on foreign funds and to reduce the level of Euroization in order to get more space for an independent monetary policy.

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