FINANCIAL CRISES IN SOUTH EAST EUROPE CAUSES, FEATURES AND LESSONS LEARNED

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Abstract:

This paper analyzes systemic financial crises in three Southeast European countries, Albania, Bosnia and Herzegovina and Croatia (ABC). Albania's crisis involved the informal financial sector (pyramid schemes). Bosnia's crisis did not have a defining set of events, but instead involved "permanent stress" and an eternally unfinished reform agenda. Croatia's crises included a first crisis resulting from transition and war, and a smaller second crisis resulting from liberalization without an adequate institutional and legal framework.

We argue that there were common features of these disparate episodes. The crises were very costly, politics was involved in each case, the legal system was partly inadequate and there was a lack of coordination between the supervisory authorities and other institutions. The positive common feature is that none of the ABC countries inflated its way out of the crisis.

We argue that several lessons may be learned: political consensus is essential for speedy resolution, early design of a crisis resolution plan and strong crisis management are crucial, there is no "one size fits all" policy for crises and strong fiscal position is a plus. Finally we should be glad to have financial crisis, as it is only after a crisis that additional effort is made to improve the stability of the financial system.

1. INTRODUCTION[1]

The main aim of this paper is to analyze systemic financial crises in three Southeast European countries and attempt to draw some conclusions and general lessons based on those cases. The paper examines Albania, Bosnia and Herzegovina (BiH) and Croatia (or the "ABC countries").

The recent experience in financial problems of these three countries has not been widely studied. Their experiences are quite disparate: Albania experienced a financial crisis due to the advent and collapse of pyramid schemes. This crisis had little to do with the banking system, except perhaps that the growth of the informal financial sector was a result of the lack of development and flexibility of the formal banking sector. In addition, crisis prevention and resolution were not primarily in the hands of the central bank, for that institution did not have clear authority over the informal financial sector.

Bosnia and Herzegovina experienced sustained distress of the formal financial system without a single event or set of events that could be characterized as a crisis. Banking supervision functioned separately in each of the two entities established by the Dayton Accords, creating significant differences in the pace of change and the extent of banking problems. Nonetheless, the problems in the two entities and the overall legal and macroeconomic framework were similar enough to merit the term "Bosnian."

Croatia, substantially the most economically developed of the three countries, experienced two banking crises. The first was the result of the transition from communism, and essentially was the result of stocks of bad loans inherited from the old system. The first crisis was drawn out and amplified by the 1991-95 war. Shortly after the first crisis was resolved in 1996, a new crisis broke out, this time a classic crisis of liberalization and excessive risk taking.

Despite these rather disparate histories, we argue that there are important similarities between the three cases, in particular the difficulties caused by weak legal systems, political interference in financial sector supervision, and inadequate coordination among supervisory institutions and governments.

The paper has three main parts. Following this introduction in the first part we give a comparative analysis of the main economic, financial and banking indicators for the ABC countries. In the second part, we analyze banking sector (financial sector) problems in each of them separately, with an assessment of crisis management in each country. In the last part, we try to draw some conclusions and lessons learned from these experiences.

2. MAIN INDICATORS FOR ABC COUNTRIES.

Albania, Bosnia-Herzegovina and Croatia are not well known. The latter two only emerged as independent states a decade ago. Until the transition started, Albania was arguably among the closest countries in the world. So, it seems useful to provide some background information before moving on to their financial problems.

The three countries are all geographically part of Southeast Europe. As can be seen from Table 2.1. all have relatively low GDP per capita. Albania's and Bosnia Herzegovina's GDP per capita are estimated to be barely higher than 1000 USD (or less than 3 USD per day). Croatia's is substantially higher. Measured by total GDP, their economies are very small. But all of them grew

[1] The initial draft of this paper was presented at the International Seminar on Comparative Experience in Confronting Banking Sector Problems in Central/Eastern Europe an Central Asia, April 22-24, 2002, Warsaw, Poland, organized by: the World Bank, the International Monetary Fund, the European Bank for Reconstruction and Development and the National Bank of Poland. The authors would like to thank in particular the WB and the participants for their useful comments. Needless to say, the views expressed in the paper are only the author's, and should not be linked with institutions where they work.

relatively rapidly in the 90's. All showed a very high degree of monetary discipline, as manifested by low inflation. Bosnia and Herzegovina achieved this with a "rules based" monetary policy i.e. a currency board (since 1997), while Albania and Croatia employed managed floating exchange rate regimes and independent monetary policies.

Table 2.1. Economic indicators for 2001

	Total GDP in bill. US $	**GDP/p.c. in US $**	**GDP/p.c. in PPP US $**	**GDP growth in %**	**Inflation in % (eop)**
Albania	4.1	1 108	3 488	6.5	3.5
Bosnia- Herzegovina	4.6	1 068	N/A	5.6	0.9*
Croatia	20.3	4 625	7 892	4.1	2.8

Source: IMF Article IV reports for Albania, Bosnia and Herzegovina and Croatia (www.imf.org) and Borish (2002)
Note: * Estimate (weighted average of two entities). There is no data for inflation for BIH.

As Table 2.2 demonstrates, their current account deficits are relatively high (Croatia's was double digit in 1997) and all have fiscal deficits. Albania's deficit is very high indeed (four years ago it was in the double digit zone). None has a particularly deep financial market (as measured by the share of broad money in GDP), but all have experienced high rates of money growth[2]. Albania and Bosnia and Herzegovina have very high shares of currency in circulation in GDP. If, on top of easily measurable domestic currency outside banks, foreign currency banknotes (which circulate widely in all three countries) were to be added, they could easily be labeled "cash societies".[3]

Table 2.2. Financial indicators for 2001.

	Current account as % of GDP	**Fiscal balance as % of GDP**	**Broad Money as % GDP**	**Broad Money Growth %**	**COB** as % of GDP**
Albania	-6.3	-8.5	66.7	19.9	20.2
Bosnia- Herzegovina	-18.0	-0.9*	43.6	79	16.3
Croatia	-3.1	-5.3	62.8	45.2	5.0

Source: IMF Article IV reports for Albania , Bosnia and Herzegovina and Croatia (www.imf.org)
Note:
* Consolidated central government on commitment basis.
** Currency outside banks

In short, if rapid GDP growth continues in the future, there is ample scope for further deepening of financial markets. At the same time, financial deepening, if combined with inadequate financial institutions (weak regulatory frameworks and especially weak enforcement) and rapid deregulation may be a recipe for financial problems in the future[4].

After taking a macroeconomic view of the countries we now turn their banking industries in particular.

Table 2.3. Banking indicators for 2000.

	No. of	**o/w**	**Banks per**	**Assets/bank**	**Assets/**	**EBRD**

[2] It has to be noted that due to changeover to Euro from DM end 2001 is an outlier for countries with strong currency substitution and high official and unofficial dollarization. Nevertheless, rapid growth of broad money is characteristic.
[3] For estimates of unofficial dollarization in Croatia see: Feige et al (2002) and CNB (2002a). In Croatia, more than 2.1 billion euros of foreign exchange cash were exchanged in the last months of 2001, indicating that the foreign currency in circulation was roughly twice the local currency in circulation.
[4] For example Eichengreen and Arteta (2002) identify rapid growth of banking credits linked with financial liberalization as major causes of banking crises in emerging market economies. See also Caprio and Klingebiel (1996) and Gavin and Hausmann (1996).

	banks	foreign	100 000	(mil US $)	GDP	Indicator*
Albania	13	12	0.38	155	52%	2+
Bosnia- Herzegovina	56	14	1.30	52	65%	2+
Croatia	44	20	0.96	312	70%	3+

Source: EBRD Transition report (2002) and own calculations
Note: * The EBRD Banking reform indicator has a range from 1 to 4 + (the latter being the highest score). A score of 2 means that there is significant liberalization of interest rates and credit allocation. A score of 3 means that there is substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation. For more details see: EBRD Transition report (2001) p. 16.

It is worth noting that both in BIH and Croatia the number of banks has significantly decreased since 1997 (in Albania it has actually increased). It is expected that in the future consolidation will continue and especially that the market share of foreign banks will continue to increase rapidly. But, as Table 2.3. reveals, average bank size in these countries is still very small. This is a typical feature of a relatively lax entry policies and licensing at the early stages of transition. Besides it shows that those countries are not immune from global trends that affect not only developed economies, but emerging markets banking industry as well.[5]

Deregulation, opening up to foreign competition and privatization will continue in the future, as they are world-wide trends that will affect the ABC countries (see Hawkings and Mihaljek, 2001). In short, there is no doubt that all countries (including the ABC ones) are more and more involved in globalization and would be well advised to study them well and prepare for them..

Table 2.4. International obligations (end of Q1 2002)

	WTO	**EU-SAA**	**IMF/WB/ EBRD**	**Sovereign rating**	**External debt**
Albania	Yes	No	Yes	None	Not fully
Bosnia- Herzegovina	No*	No	Yes	None	Not fully
Croatia	Yes	Yes	Yes	BBB-	Fully

Source: own information
Note:
WTO World Trade Organization membership EU-SAA, European Union Stabilization and Association Agreement signed or not.
IMF/WB/EBRD. Does a country lend (i.e. it active) from multilateral financial institutions. Both Albania and Bosnia and Herzegovina lend under concessional terms.
Sovereign rating by any of major agencies (S&P, Moody's and Fitch IBCA).
External Debt: Whether external debt is fully regularized or not.
* BiH is presently negotiating its accession to WTO. It is expected that BiH could become a member in 2004.

Croatia is by far the most advanced of the three countries as far as international obligations are concerned. Since all three are part of the "periphery" of the huge EU market (which will come even closer when the 10 new applicant countries becoming full fledged members, perhaps as soon as two years from now), it is no surprise that the EU is their main trading partner. So, institutional relations with the EU (presently in the form of Stabilization and Association Agreements) as well as trade developments are key to their further integration into the world market.

One could argue that proximity to the EU determines (broadly speaking) the legal framework for banking industry. Our three countries embrace universal banks and have independent central banks with modern laws that grant independence (*de iure* if not d*e facto*). What is not easily

[5] For more detail on trends in emerging markets banking see the excellent work by Hawkings and Mihaljek (2001)

measurable is the question of enforcement of laws (especially in the area of banking). One could argue that the ABC countries are not enforcing their laws vigorously enough. Indeed, this is the assessment of the EBRD, as shown in table 2.5.

Table 2.5. Legal framework for banking operations

	L,R and S in central bank*	Banking law	Bank closure	Deposit insurance	EBRD legal indicator**
Albania	Yes	July 1988 (amended)	***	April 2002	2-
Bosnia- Herzegovina	No (two entities)	Oct 1998 April 1999	Relatively Easy	Feb 2001 (only FBIH)	1+
Croatia	Yes	Dec 1998 (new draft)	Easy	June 1997	3

Source: EBRD Transition report and own assessment
Note:
* Licensing, regulation and supervision
** EBRD legal transition indicator is a classification system for financial regulation. The highest grade is 4+. An indicator of 1 indicate that legal rules on banking are very limited in scope, 2 means that they are limited and 3 means that they are comprehensive, but further refinement is possible. For more details see: EBRD Transition report (2001) p. 38-39.
*** Through mid-2002, no banks had been closed, so it is not possible to assess the ease of bank closure.

After this brief comparative analysis, we will now examine systemic financial crisis in each of countries more closely.

3. Financial Crises: ABC Countries

3.1. Albania

3.1.1. Crisis background, the crisis and crisis management

It has to be mentioned that so far Albania has not been confronted with a typical banking crisis. But, it had very serious financial sector problems. Its financial problems were much more related to the growth and spectacular collapse of pyramid schemes and especially to the negative social and political consequences this collapse had on Albanian society as a whole. So, the fact that the non-regulated part of the financial system grew and caused such havoc is what makes the Albania case interesting.

There is no doubt that, at the beginning of transition, Albania faced the worst initial conditions. Indeed Albania's initial conditions were not only the worst of the three countries we are comparing, but of all European postsocialist countries. Before 1991 it was among the least known and poorest countries in Europe[6].

At the beginning of transition its financial system was similar to that of other former socialist countries. Its banking system was composed of the State Bank of Albania (which, typically, performed some central banking and commercial banking functions), the State Agricultural Bank and the Albanian Commercial Bank. The State Agricultural Bank's main function was to lend to cooperatives and state farms. The Albanian Commercial Bank, which was developed from a foreign relations department of the State Bank of Albania, was in charge of foreign exchange reserves, foreign exchange operations etc. The State Bank of Albania collected deposits as well.

[6] For a very good view on Albanian economy before 1992 see Blejer at al. (1992).

At the same time, there were about 40 thousand local offices of the state bank scattered throughout the country. These representatives collected deposits that were redeposited at the State Bank of Albania.

The payment system was very rudimentary, consisting only of cash and clearing of banking invoices.

But major reforms in the financial system started relatively early in the transition. In April 1992 the new central bank and banking law created a two tier banking system. The Agricultural bank was later closed, leaving the National Commercial Bank (the new name for the Albanian Commercial Bank) and the Savings Bank as the main second tier banks in Albania. The central bank was separated from commercial banking activities. In July 1993, the first foreign bank started to operate in Albania. Soon, some other private banks started. But, they were all dwarfed by the National Commercial Bank and especially by the Savings Bank with its dominant position on the domestic market.

Regardless of all the institutional changes and the emergence of *de novo* banks in that period, financial intermediation remained in very poor condition. In other words, financial sector did not play the role it was supposed to play. And this inadequacy of formal intermediation, combined with lack of adequate regulation and lack of knowledge about finances, was fertile ground for the development of pyramid schemes[7].

Due to deeply rooted mistrust of the financial institutions and the inefficiency of the payment system, households kept large portions of their financial assets in cash (see chart 1). With inflation in double digits (30% in 1993 and 16% in 1994) the opportunity cost of holding cash was high.

At the same time, the lending market was very small and underdeveloped. Three state banks and the new emerging private banks were unwilling to lend to households and small private businesses. So, an informal market both for deposit taking and making loans was developing rapidly.

At the beginning of the development of the informal financial market, neither the regulators nor international financial institutions viewed those activities as illegal. On the contrary, they were viewed as a welcome complement to (inefficient) official financial intermediation. So, both the lending and deposit taking markets were developing in the shadow of the inefficient formal financial intermediation. During 1995 interest rates on deposits were 4-5% monthly[8].

Since the companies claimed to operate under the Civil Code, it was difficult to regulate and control them. But, according to Jarvis (1999) "…the problem was not just a legal one, and (that) members of the government themselves benefited from and supported the pyramid schemes companies." (p. 10). This is an important element as obviously this capture of the state by interested parties contributed to the growth (and later the collapse) of the schemes in Albania.

Unfortunately, the central bank did not attempt to close the pyramid schemes under its authority to close unlicensed banks. But the Chief Prosecutor ruled that the pyramid schemes did not fall under the banking law. Given this and the refusal of the Ministry of Justice to handle the issue at all, it seems likely that the central bank would not have had any allies if it had moved against the schemes by itself. In addition, the IFI's also warned the authorities about the schemes, but at a relatively late stage (mainly during 1996) and again without much effect until rather late in the game.

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[7] Our description of the rise and fall of pyramid schemes in Albania is based on Jarvis (1999) and Korovalis (1999).

[8] A 4% monthly rate is about 60% per year. Compared with 6-7% annual interest rates in banks, the differential was huge.

It should also be mentioned that it was not always easy for the public to understand that the pyramid schemes were not legitimate enterprises. Many did make a show of investing in real assets that probably brought some profits. Also, some undoubtedly “invested” in high-yield criminal activities.

Two main events contributed to the collapse of pyramid schemes in late 1996 and early 1997. The first was the lifting of sanctions on FR Yugoslavia at the end of 1995. This meant that profitable smuggling activities financed by money from the pyramid schemes began to dry up. Second, the upcoming parliamentary elections created uncertainty whether the ruling Democratic Party (which actively supported the schemes) would win. On top of this came the “normal” dynamics of pyramid schemes: they always collapse sooner or later. Further, increased competition (new entry) led to the increase of monthly interest rates to 6-10% per month in the first half of 1996. Finally by November of that year, some schemes were offering more than 40% monthly deposit rates. In autumn 1996 international warnings (IMF/WB annual meetings in October) became much stronger, and the pyramid schemes started to collapse in a couple of months.

At the time of the collapse of the schemes, they had more than 2 million depositors (out of a total population of 3,5 million). Accrued fund liabilities were more than 50% of GDP. So, it came as no surprise that when the schemes stopped paying back their depositors, civil disturbances started.

Slowly, Albania descended into anarchy. The government took some measures to seize the remaining assets of the schemes, but it was obviously too little and too late. By March 1997, Albania was in chaos. The police and army deserted, foreigners were evacuated. As a consequence of widespread rioting some 2000 people were killed and more than a million weapons looted from military barracks and police stations.

By mid-1997 things started to calm down. With the help of international forces, the interim government managed to organize new elections in July of 1997 and gradually peace returned to the country.

But, the problem of the pyramid schemes was still there. A new law was needed to provide a basis for seizing and winding up the pyramid schemes. To make things worse, then president Berisha refused to sign the decree on the law of pyramid schemes. It was only in July 1997, when a new president took office, that the new law was signed.

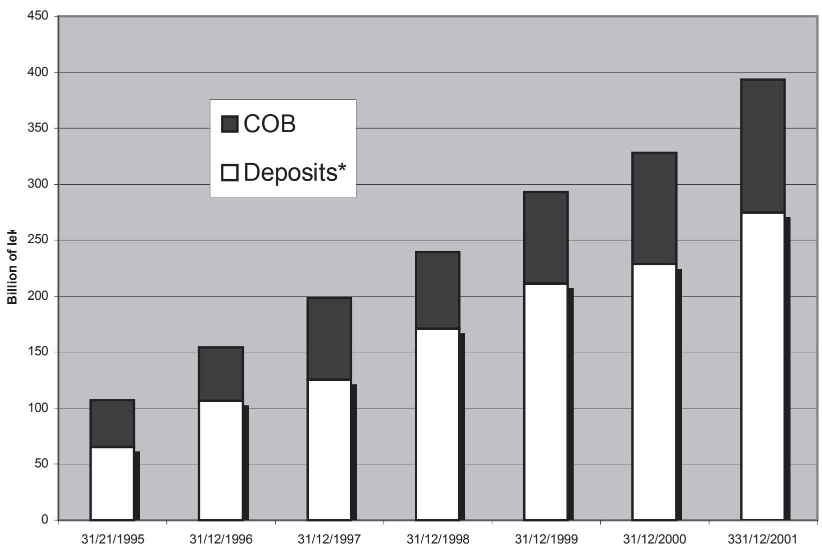
The new law stated that all pyramid schemes were subject to control by administrators. The administrators were given wide powers. The administrators were foreigners and faced formidable difficulties (from physical threats to legal challenges). So, it took several more months, roughly to March 1998, to gain complete control of the schemes.

3.1.2. Crisis management: assessment

The Albanian pyramid scheme experience reveals some interesting lessons:
Problems in the financial sector need not be linked with banks or the regulated financial system. Informal financial markets can easily get out of control. Albania is not the first country to be faced with pyramid schemes (MMM in Russia, cases in Romania, Croatia etc.) but the size and especially consequences of the Albanian schemes make them unique.

Financial sector problems can have devastating consequences on civil society and can provoke major social unrest. Argentina in 2002 is another example of how huge problems in the financial sector (and losses of the household sector) can spill into social and political trouble.[9]
The late reaction of the authorities was not only caused by an inadequate legal framework but broadly speaking was a problem of governance i.e. of crisis management. The authorities reacted slowly and weakly. Linkages with highest levels of the government and corruption postponed adequate reaction for some time. This delay not only allowed the schemes to grow but also delayed the seizure of remaining assets, which facilitated asset stripping.
It is interesting to note that in spite of the devastating political and social consequences the economic impact was relatively modest. The formal sector (i.e. banks) did not suffer. Looking at yearly data, one can hardly see any impact on deposits in banks, as can be seen from the following chart.

Chart 3.1. Total deposits and currency outside banks in Albania



Source: Bank of Albania
* all deposits (demand and time deposits, lek and foreign exchange)

Broad Money (deposits plus currency) grew at a steady, rapid pace in the period from 1995 to end 2001, without interruption even during the crisis period. The currency to deposit ratio increased from 0.44 at end 1996 to 0.58 at end-1997, but quickly fell back to 0.40 by end 1998 and stayed at that level through the end of 2001.

This does not meant that the collapse of the schemes did not have any economic consequences. Inflation went up and GDP growth fell from 9.1% in 1996 to -7.0% in 1997 (although it has to be noted that data on Albanian GDP are very unreliable). But it seems that most of the GDP decrease has to be ascribed to the social unrest, which brought normal life to a standstill in much of the country for several months. In short, the economic consequences of the collapse of the pyramid schemes per se were less than expected (as documented in Jarvis, 1999).

[9] To be completely clear, the problems in the financial sector were not the cause of Argentina's macroeconomic problems in late 2001. Instead, it would be fairer to say that banks became the victims of the breakdown of the currency board, and of popular anger.

As a consequence of the collapse of the pyramid schemes, the public remained extremely sensitive to financial sector problems. An episode in March 2002 with the largest bank in Albania clearly demonstrates this. The bank had a clean balance sheet. All bad loans had been carved out and the bank had been recapitalized with government money. The bank was forbidden to make loans, so that all its assets were either in government bills, foreign assets or claims on the central bank. The bank was awaiting privatization (relatively soon, one hopes). In spite of its clean balance sheet and high quality of assets, in March 2002 rumors started that the bank was insolvent and that people should withdraw their deposits, referring to the collapse of the pyramid schemes. The cause for those rumors is not clear, but as a consequence the bank lost 12% of its deposits in a single month. After that, the situation returned to normal (withdrawals ceased), but the deposits did not return to the bank. At the peak, the net outflow was 1% of total deposits per day. This is a textbook case of how a run on bank can be produced out of nothing more than rumors based on a recent history of financial distress. Confidence is easily lost, but takes a long time to regain.

Finally, in the meantime the Albanian banking system has continued to develop in the right direction. There are presently 13 banks, out of which only one is state owned (but with a dominant position of roughly 2/3 of the deposit market). There are no major risks in the system at the moment, but caution is warranted for the future. On top of privatization of the largest bank, further strengthening of supervision is needed[10].

3.2. Bosnia and Herzegovina.
Banking development background and banking crisis[11].

Describing the history of BIH banking is equivalent to describing the prolonged crisis/distress of the financial system. From the beginning of transition, until recently the system was in a state of "permanent stress." Bosnia and Herzegovina (BIH) did not have a classical banking crisis but serious difficulties during a decade (and it is still not completely over). So, BIH definitely can be classified it in a group of countries with systemic financial crisis.

Bosnia and Herzegovina became a sovereign country in March 1992, when it declared independence from SFR Yugoslavia. This declaration was followed by a prolonged war that ended only in December 1995 with the signing of Dayton peace agreement.

So, during four long years, while some other transition economies were vigorously reforming their financial systems, the people of BIH were fighting a war that ended with more than 250,000 fatalities (or about 6% of the pre-war population). Needless to say, the conflict resulted not only in enormous human losses, but physical destruction (housing, infrastructure, factories) as well, which continues to impede speedy recovery.

But, to start with, at that time the war broke out, Bosnia's financial system was far from orderly. Not only was it coming out of a socialist system (more liberal than most other former socialist countries, but socialist nevertheless[12]), but disruption of the common Yugoslav market together with a pile of bad debt made the need for serious structural adjustment very urgent.

Numbers on the banking system of that time are scarce. But, according to the last comprehensive analysis of the banking sector carried out by Coopers & Lybrand in 1989, identified cumulative potential losses in the banks of the former Socialist Federal Republic of Yugoslavia (SFRY)

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[10] We will not pursue the analysis of the Albanian banking system any further. For more details see: Siegelbaum et al. 2002, Cani et al (2000), Banking Supervision Annual Report (2000) or Muco et al. (2001).
[11] It has to be noted that not only there is very little work written on Bosnia and Herzegovina's financial system, but available statistical data are of very poor quality. Without going into detail about the causes of this, the reader would be well advised to keep this in mind.
[12] For more detail on banking is socialism see Coats and Skreb (2002).

amounted to almost USD 10 billion.[13] No data for BIH alone are available, but is safe to say that, when BIH became independent, banking system capital was deeply negative.

Another important element is that in April 1991 all household deposits in foreign exchange in BIH banks were frozen (as in the rest of SFR Yugoslavia). The problem was much deeper than a mere deposit freeze, for the National Bank of Yugoslav had control of the foreign exchange assets of the former country. Bosnia, along with Croatia, Slovenia and Macedonia, was left without counterpart assets to the deposits when it became independent. This problem was in a sense created by the requirement under the monetary system of the former SFRY that the proceeds of foreign exchange deposits be surrendered to the NBY.

The estimated amount of frozen deposits for BIH at that time was DEM 2,7 billion. Without any accrued interest, this is more than 25% of estimated GDP for BIH in 2001. It is worth noting that this problem is still not resolved in Bosnia and Herzegovina (unlike Croatia and Slovenia, for example). So, state banks still have (part of) this debt on their balance sheets and households have claims on banks that they cannot realize.

During the war, the banking system did not function normally. There were four monies circulating in BIH: the Bosnian dinar, the Yugoslav dinar, the Croatian Kuna and the German Mark (DEM). Combined with the fact that there were no governmental authorities with control over the entire territory of BIH, it is understandable that the banking system could not efficiently intermediate funds in the economy.

In the meantime, the real sector (and its very limited capacity to pay back the loans in the first place), has only deteriorated further. Combined with war damages (international donor pledges for reconstruction amount to more than US $8 billion according to Tesche (2000)), it is obvious that the overall financial system in Bosnia and Herzegovina was in serous trouble and in need of deep reform.

On top of all the domestic troubles, non-regularized external debt was an impediment to international help. So, immediately after the signing of the Dayton peace agreement, BIH became an IMF member (Dec 20, 1995).

It is only in 1998, after the formation of the central bank, that a single currency (convertible marka) was introduced into the whole of BIH. The establishment of a single monetary authority for the country as a whole (with ample help from the IFIs – for more details see Coats (1999)), and the formation of two licensing, regulating and supervising agencies for the two entities made it possible to start building up and restructuring the financial system in Bosnia. At that time BIH had old, debt ridden, non-restructured state owned banks, whose loan portfolio was almost completely non-performing, and a handful of small, private banks that played no significant role in financial intermediation.

As a result of Dayton, BIH was a decentralized state with two entities, the Federation of Bosnia Herzegovina (FBIH) and the Republika Srpska (RS). It has to be mentioned immediately that reforms did not proceed equally rapidly in each entity. Banking sector reforms were faster (though not very fast) in FBIH than in RS.

In both entities, banking industry reform was two-pronged. First, the banking system itself had to be restructured and second, the payment system had to be reformed. The payment system was a special problem due to its manner of organization in the former Yugoslavia. Before reform there were actually three payment bureaus (one in RS with direct links to FR Yugoslavia and two in FBIH,). The biggest problem was the monopoly position of each of them for all payment transactions in their respective geographical areas. In addition, the payment bureaus performed

[13] from www.nbj.yu http://www.nbj.yu/english/banks/index.htm

numerous other functions (tax collection, audit, clearing house for banks, distribution of government revenues and statistical functions).
To create a normal, marked based financial infrastructure, the payment system had to be reformed. The legal framework for this reform was put in place, both the RTGS and clearinghouse were set up and on January 5, 2001 the new payment system started operating successfully. With this reform, banks got control of payments. Fees for payment services decreased, and now form part of bank revenues, instead of going to state-owned payments agencies. The Central Bank of Bosnia and Herzegovina provided all the necessary preconditions for the proper functioning of the RTGS and Giro Clearing systems, for medium risk transactions. It is worth noting that only banks with special licensed to provide payment services have access to the payment system. The payment services license is issued by the banking agencies in each entity. By end 2001, 42 banks in BIH had licenses for payment system operations, 30 in FBIH and 12 in RS[14].

Another big problem for banks is the external debt generated in former Yugoslavia. The state of BIH has only taken over the liabilities that were guaranteed by the Yugoslav federation or by the former National Bank of Yugoslavia (including London and Paris club debts and so-called frozen foreign exchange household deposits).

Since Dayton, it is not possible to speak about a unified financial system as each entity within BIH has its own banking supervision agency. For that reason, we will treat each one separately.

Federation of BIH.

Reforming the banking sector itself was done in three ways. First, old state banks had to be dealt with. Second, an adequate legal framework for banking had to be constructed. Third, institutions had to be built up and strengthened to ensure adequate regulation and enforcement of laws and regulations.

First, old banks. The authorities were wise to decide not to get involved in bank restructuring. The state did not recapitalize banks with fiscal sources, nor did it help with liquidity injections. It has to be remembered that the currency board system in BIH does not have a lender of the last resort facility, in the same that other currency boards in Europe such as Bulgaria and Estonia also do not have lender of last resort facilities.

Since 1998 consolidation of banking in FBIH has proceeded relatively fast. It should be noted that the negative net capital at the beginning of reform was estimated at KM 4,5 billion (Banking Agency FBIH, 2002 p. 6). This can be seen from the following table.

Table 3.2.1. Consolidation of banking in FBIH

Date	Number of banks (of which state owned)	Provisional administrator	Liquidation	Bankruptcy
31. Dec 1998	55 (11)	-	-	-
31. Dec 1999	44 (10)	13	-	2
31. Dec 2000	38 (10)	2	4	4
31. Dec 2001	33 (6)	5	3	-
Total	N/A	20	7	6

Source: Banking Agency FBIH (2002)

The strategy of reform in the banking sector aimed at letting the new private banks develop and allowing the debt-ridden, old state owned banks to either be merged, sold to a strategic investor or be liquidated. Since these banks were plagued with nonrecoverable loans, and with very weak financial conditions, this was a wise strategy.

[14] For more details on the payment system in BIH visit http://platni.cbbh.ba/engl.htm

Another pillar of banking system reform was the adoption of the new legal framework for banks, especially for the liquidation of insolvent banks. What is less commendable is that the deadline to close down state owned banks that have not been privatized or merged has been postponed several times already. This does not create good incentives for disciplined behavior, as at the moment the remaining state banks do not fully satisfy legal capital requirements.

The last pillar was institutional build-up and strengthening. This included implementation of banking supervision and establishment of a deposit insurance system. The banking agency of FBIH was formed by end-1996 and has since grown into a well respected independent institution in FBIH[15]. The deposit insurance agency has recently started working as well. In FBIH, deposit insurance is in place and by the beginning of 2002, 8 banks had licenses for deposit insurance (up to KM 5000 per deposit is insured). In the second part of 2002 deposit insurance agency has been formed at the level of Bosnia and Herzegovina.

In short, banking reform did make substantial progress, but has been slower than warranted (especially the resolution of state banks through merger or liquidation) with strong political influence on the process. The most rewarding fact is that private, foreign owned banks have made significant progress in the last two years, gaining market share and positioning themselves for serious competition in the future.

Republika Srpska[16]

In the RS, a banking agency was formed only in mid-1998, and state banks still dominate the system. The economic space of RS is very small (in 2000 total GDP was estimated to be US $1,2 billion), so a total of 18 banks seems like a relatively large number (with average assets per bank of only about KM 60 million at end-2001). An additional problem is that 10 of 18 banks were predominantly state owned[17] as of mid-201, and they represented more than 80% of total assets. But the main feature is that banks are not significant financial intermediators. The share of total banking assets in GDP was 43% at the end of 2000. But total household savings (new ones, excluding the accounts frozen in 1991) amounted to no more than KM 50 million or less than 2% of estimated GDP for the RS. This is a very clear indicator of the extremely low trust placed in the banking system.

Some features of the banks in the RS can be seen from the following table.

Table 3.2.2. Balance sheet of deposit money banks in RS
- in mil KM

	Dec 1997	**Nov 2001**
Total assets	748	1 106
- o/w foreign assets	63	101
- o/w claims on private sector	683	946
Foreign liabilities	532	526

Source: Bosnia and Herzegovina, Statistical Appendix (2002) p. 17.

It is obvious that a large portion of the claims on the private sector is old non-performing and non-recoverable loans. By the same token, the most important element in bank liabilities is foreign liabilities that to a large degree cannot be serviced (frozen foreign exchange deposits).

[15] From Banking Agency FBIH (2002).
[16] Data for Republika Srpska, unless otherwise stated are taken from Banking Agency RS 2001.
[17] In late April 2002 one of them, Kristal banka, Banja Luka was sold to an Austrian bank, Hypo-Alpe Adria Bank.

The banking industry in the RS is very inefficient. The main problem with the state banks (and the banking system as a whole) in the RS is excessive employment. As of mid-2001, average assets per employee amounted to only 234 thousands KM (or less than US $100,000 per employee). This compares rather unfavorably to Croatian banks' average of US $1,100,000 in the same period. (Croatian National Bank 2002b) State banks still have bad loans and frozen foreign exchange deposits on their books and without resolution of these problems, the balance sheet of banks do not reflect the true magnitude of financial intermediation.

During the first quarter of 2002, there was strong international pressure on the authorities to either close down or privatize the three main state banks

Banking problem and crisis management in BIH: assessment

Banking in BIH has been faced with a difficult socialist legacy, very much like Croatia. The initial negative capital of the banking system, and the fact that banks had played functions incompatible with a market economy meant that restructuring would be a huge task. On top of this, war and political divisions of a highly decentralized country have slowed down reforms and destroyed the real sector of the economy (human resources, infrastructure, productive capacity etc). *De facto* financial sector reform started only five years ago (1997).

The banking sector strategy had two main pillars: reform of the banking sector (which comprises reform of state banks, creation of a new legal framework and creation and strengthening of institutions) and the reform of the payment system.

Today, the legal framework for banking is (more or less) in place. So are the institutions (one central bank, banking agencies in both entities). It has to be noted that deposit insurance is present in FBIH, but not in RS. The problem today is not so much with the banking laws but with their enforcement for all deposit taking institutions. Reform of state banks is underway, at a slower pace than warranted, so the same capital adequacy criteria do not apply to all banks.

An important lesson to be learned is the need for a comprehensive approach to financial system restructuring. It is difficult to reform the banking system without adequate reform of other parts of the system, especially financial infrastructure. So, a very positive element is the change in the payment system in BIH[18].

Nevertheless, problems remain in the financial sector. First, the small economic space is divided into even smaller entities. It would be helpful to increase coordination, especially on bank supervision and harmonize regulation. The initiative that supervision should be under the “umbrella” of the central bank seems like a positive one. But, strong political obstacles are still present, and any initiative that “diminishes” the powers of entities is vehemently opposed.

Foreign bank penetration is much more important in FBIH than RS. Foreign banks are entering BIH in spite of relatively high sovereign risk (BIH has no formal rating, but by all standards sovereign risk is high).

In both entities the main problem seems to be inadequate and very slow court procedures. Creditors are not sufficiently protected, as under socialism.[19] This is a good example of how reform of the financial sector alone, without adequate legal reforms in other areas and a coherent and well-enforced overall financial legal framework, is not enough. An adequate legal framework is a comprehensive concept in finance. Not much is achieved by addressing only the question of banking law without clearly defined and well-protected property rights.

Banking crisis management by the authorities can be labeled as inadequate, especially in the early phases. The biggest problem was politics. The politicians were reluctant to make the bold moves necessary to transform the old banking system, especially to curtail local powers. With strong pressure from the international community, reform is proceeding, but as mentioned slower than warranted.

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[18] The policy of a dual approach to transform banks and payment system in post-conflict countries from the IMF is a very positive one. See Lonnberg (2002).

[19] This problem is universally recognized as one of the main problem for speedier development in banking. See for example Governor’s Nicholl speech on banking system reform (Nicholl, 2001).

Finally, people lost trust in banks due to frozen deposits and wartime. But, it is coming back. In addition to the stability provided by the currency board, some positive external shocks have helped the process. With the "Euro-changeover" process, more money come to banks than was expected. This is a clear indication of strong currency substitution, even with a currency board and little trust in the domestic banking system. But, problems remain.

Croatia
Crisis Background

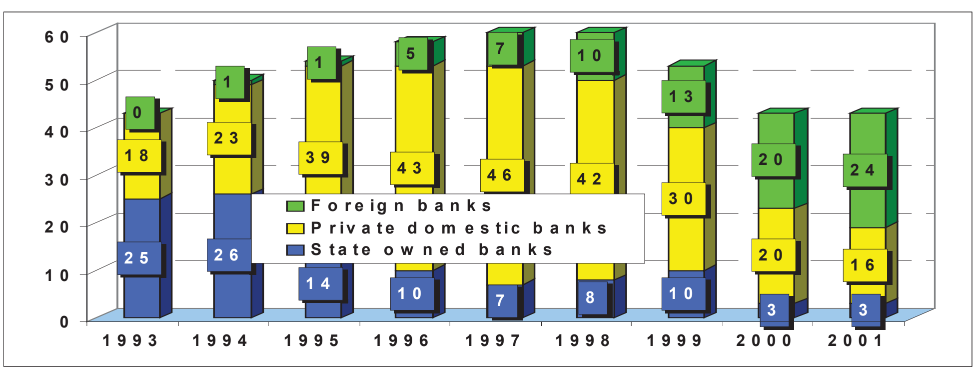
Liberalization and regulation

The Croatian banking market was substantially liberalized in the early 1990's. Even before the break-up of the country, Socialist Yugoslavia introduced a relatively liberal banking law in 1989. Importantly, bank supervision was established, and the Basle capital standards were adopted.
After Croatia received independence, its parliament passed its own Law on Banks and Savings Banks in 1993. This Law continued the liberalization process. The minimum capital requirement for a bank was set at the local currency equivalent of 5 million DEM, and the minimum capital requirement for a savings bank was set at only 1 million DEM.[20]

Unfortunately, the law gave very little discretion to the central bank regarding licensing. The wording of the law made it difficult to deny licenses in marginal cases where there was simply a strong impression that the candidate was not fit and proper, and no “smoking gun” that could hold up in court. The rationale for such a liberal law, as in many other transition countries, was a desire to increase competition, and also a desire to give local entrepreneurs a chance to enter the banking business.

Under these relatively liberal laws and less than exacting licensing practices, the number of banks increased rapidly from an initial 22 in 1990 to some 61 in 1997. Not all of the new entrants were private: some government-owned entities set up banks as well. In the late 1990’s, large numbers of these banks—both private and state-owned—would run into problems. Efficiency analyses actually suggests that the new banks were often *less* cost efficient than the old banks (Kraft and Tirtiroglu 1998). In retrospect, it seems that the benefits of entry created via increased competition and increased learning were balanced or even outweighed by the costs of dealing with the failure of so many of these institutions. That is, the entry regulations were simply too liberal.

Figure 3.3.1 Number of banks in Croatia



[20] Savings banks originally did not have the right to deal in foreign currency, nor could they make commercial loans. They were given the right to accept foreign currency deposits and limited rights to deal in foreign currency later, and were eliminated as a category separate from banks under the new banking law adopted at the end of 1998.

Source: Croatian National Bank

Initial crisis and resolution efforts

Croatia's initial banking crisis occurred in two phases. First, in 1991, the authorities recognized that bank claims on many socially-owned enterprises were uncollectible, and issued bonds (called "Big Bonds") to cover these claims. The bonds totaled $1 billion or roughly 5% of GDP. The timing was unfortunate, however, for it came just before the beginning of hostilities in the summer of 1991. In addition, the "Big Bond" scheme did not include adequate provisions to force banks or enterprises to change their behavior.

The banking system suffered another shock in 1991 when the National Bank of Yugoslavia froze household foreign exchange deposits (see the discussion above for Bosnia). When Croatia was excluded from the Yugoslav monetary system in the summer of 1991, the Croatian banking system was left virtually without any foreign exchange reserves at all.

Although the government guaranteed the frozen deposits immediately, it did not begin unfreezing them until 1995. It is very important to note that this incident had strong effects on depositor confidence that would be felt throughout the whole decade.

The second phase of the crisis came after the successful macroeconomic stabilization program of October 1993, which succeeded in lowing monthly inflation from above 35% per month to zero or even negative rates in the ensuing months.[21] With the advent of low inflation, banks' accounts became more transparent. It became obvious that the country's largest bank and three large regional banks (ranked third, fourth and fifth by total assets) had failed. The causes of these troubles were a mixture of war-related problems, inherited burdens from the old system, and new problems.

The banking crisis of 1994-1996 expressed itself most strikingly in the behavior of interbank interest rates. Three of the failed banks were chronically illiquid, and borrowed heavily on the interbank markets. Since market participants expected that these banks would eventually be rescued, the banks were able to borrow. But the enormous distress borrowing of these illiquid banks pushed interest rates up to 30%. In addition, in 1994, the banking system as a whole showed net losses.

There was great political resistance to rehabilitating these banks. The incumbent managers argued strenuously that they were not at fault. They were supported by advocates of loose lending policies and government direction of credit. In one case, the incumbents did manage to keep their jobs and receive a bailout. But in the other three, eventually, old management was removed, bad assets (not all, but most) were carved out, cash was injected, and the Bank Rehabilitation Agency became the banks' owner.[22] Subsequently, the banks' performance improved substantially. Ultimately, the government was able to sell majority stakes in all four banks to foreign partners during 1999 and early 2000.

These measures effectively resolved what Kawalec (2002) calls the stock problem: the existence of a large stock of bad debt on the banks' books. Rehabilitation also resolved the flow problem in these particular banks, as they no longer made large amounts of new bad loans. But, as we will see below, there were substantial flow problems elsewhere in the banking system.

THE MACROECONOMIC BACKGROUND

In many ways, the macroeconomic background in Croatia in the second half of the 1990's should have been favorable for the development of the banking system. Inflation was low, reaching a

[21] For more on the stabilization, see Anušić et al (1995).
[22] For more on the rehabilitation process, see Lovegrove (1998).

maximum of 5.3% in 1998 thanks to one-off effects of the introduction of the value-added tax. GDP growth was rapid, thanks to wartime reconstruction and the recovery of consumer demand and credit.

Table 3.3.1 Inflation And GDP Growth In Croatia, 1994-2001

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
GDP*	5.9	6.8	6	6.5	2.5	-0.3	3.7	4.1
RPI**	-3	3.8	3.4	3.8	5.4	4.4	7.4	2.6

*real rate of growth of GDP
**retail price inflation, eop

There were, however, substantial external imbalances developing. The rapid growth of consumption helped swell the current account deficit from a 5.8% of GDP in 1996 to 11.6% of GDP in 1997. The consumption boom was fueled by rapid growth in consumer credit, which rose by no less than 93% in 1997. At the same time, strong capital inflows began, helping underpin nominal stability of the main kuna-deutschmark exchange rate. The capital inflows had four components: the repatriation of deposits held by Croatian citizens abroad; government foreign borrowing in the form of bonds; humanitarian aid and other foreign assistance; and, starting in early 1997, when Croatia for the first time received an investment grade credit rating, private capital flows, mainly bank borrowing.

Monetary policy was tightened in mid-1997, with the National Bank decreasing its foreign exchange purchases (the main channel of money creation). Unfortunately, fiscal policy was not tightened correspondingly, and the current account deficit reached threatening proportions.

Seeing that conventional monetary tightening was not slowing the credit boom, the National Bank reacted in April 1998 but imposing Chilean-style capital controls. (Šonje 1998) These controls raised the cost of foreign borrowing and helped slow the credit expansion. It seems clear that these measures led to funding problems for some aggressive banks who had relied on foreign borrowing to fuel their expansion.

The impact of the capital controls was strengthened by unfavorable developments in the international environment. Croatian banks continued to borrow despite the Asian crisis, but they felt the Russian crisis much more. Furthermore, in the fall of 1998, several large German banks began a boycott of Croatia to protest the central bank's refusal to rehabilitate Glumina Banka, a failed private bank to which they had substantial exposures. These elements on the supply-side of international borrowing were also important in slowing down capital inflows.

The slow down in capital inflows and in credit certainly played a part in the onset of recession in the fourth quarter of 1998. Numerous large firms, particularly those associated with the so-called "tycoons" who had put together large corporate groups, had significant difficulties. The recession was to last through the third quarter of 1999.

POLITICAL ECONOMY PROBLEMS

As Caprio and Klingebiel (1996), Gavin and Hausman (1996) and Eichengreen and Artesta (2002) point out, credit booms usually lead to banking crises. During 1997, it was clear to the management of the central bank that several banks could be expected to run into problems. However, there were several political economy problems standing in the way of a vigorous effort to resolve these problems proactively.

First, a great deal of political capital had just been spent on convincing the government to deal with the stock problems. The rehabilitation of the four banks had been quite expensive (approximately 4% of GDP), although it is true that much of this expenditure was in the form of bonds and not cash. It was not an easy moment to go the politicians again.

Second, on the surface, everything seemed well. Banks profits were high, credit availability was improving, consumers were finally getting access to goods they had been unable to purchase during the period of war and transition depression. This did not create a good background for warnings of imminent banking problems.

Third, the banking lobby itself had become quite powerful and well-connected. Political influence over bank lending was widely believed to be substantial, and this provided the bankers with political cover. They certainly were prepared to contest any attempts to strengthen banking supervision.

These political economy problems were especially important because it had become clear that the legal framework was inadequate. The 1993 Law on Banks and Savings Banks simply did not provide adequate prompt corrective action measures. Nor did it provide a realistic mechanism for bank bankruptcy. In practice, the only exit mechanism available was rehabilitation, certainly not appropriate for dealing with problems in larger numbers of small to medium sized banks.

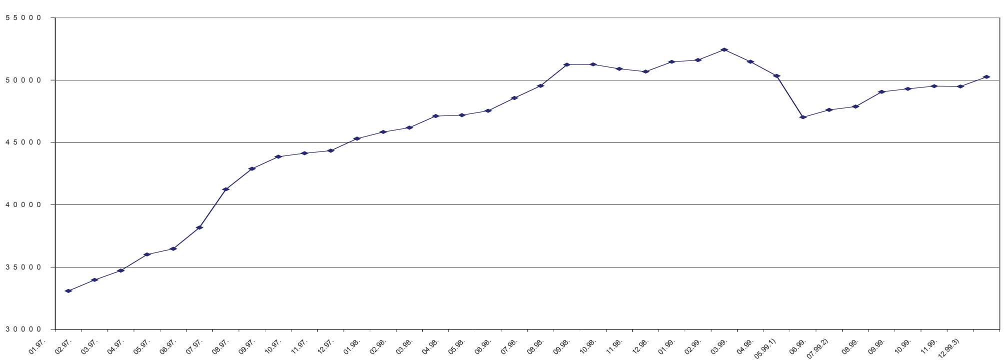
For all these reasons, when the banks did begin to fail, the central bank was severely limited in its ability to respond. Perhaps, given the delays in dealing with the stock problems and other political economy obstacles, that was inevitable.

The Crisis

Croatia's "Second Banking Crisis" (Kraft 1999) can be dated from March 1998 when a run on Dubrovacka Banka, then the country's fifth largest bank by total assets, occurred. It quickly became clear that the bank was deeply insolvent, and there were strong indications of criminal activity. The bank was rehabilitated by the government in view of its dominant position in the Dubrovnik regions.

The crisis continued with a slow stream of failures throughout 1998. Matters came to a head in early 1999, as failures came more frequently and overall depositor confidence was shaken. Total deposits fell from February to May 1999, as can be seen from the figure below.

Figure 3.3.2.1. Total Deposits in Croatian Banks, 1997-1999



Source: Croatian National Bank

Overall, some 14 banks failed outright in 1998 and 1999, and another 6 received lender of last resort support. The failed banks had accounted for 17.3% of total banking system assets at the end of 1997. Clean-up costs, including the rehabilitation of two banks and deposit insurance payments for the other 12, amounted to 4.8% of GDP.

The failed banks were all privately owned. Some were new banks formed since 1990, while others were older banks formed as regional banks during the communist period. Even in the case of the latter banks, however, it does not seem that the main reason for failure was a stock of bad loans from previous times, but rather imprudent lending in the post-war period. Connected lending was a very significant part of the problem in many banks.

Crisis Management

The failure of Dubrovacka banka at the outset of the crisis was a major watershed. The strong evidence of improprieties put the bank's owners and managers on the defensive, and strengthened the hand of the central bank. The decision not to bail out the bank and to dismiss the management board and supervisory board was an important rebuff to those who insisted that the bank had been soundly managed and was merely the passive victim of political machinations.

However, when the central bank tried to initiate bankruptcy procedures at another troubled bank in May, the weaknesses of the legal system became apparent. The courts refused to open the case, sending it back to the central bank to consider rehabilitation. Nearly six months would elapse between the first bankruptcy filing and CNB's refusal to rehabilitate the bank, which returned the case to the courts.

In addition, when another private bank failed in late June, further problems came to light. The management remained at the failed bank, engaging in asset stripping, helping individuals to split up deposits above the deposit insurance limit into smaller, fully-insured deposits in the names of friends or family, and bombarding the media with stories of how the bank would soon be saved by foreign investors. Even though the central bank rejected rehabilitation of the bank as economically unjustified in the fall, no resolution was found.

The new banking law was finally passed in late December, and came into force on January 1. Immediately, the national bank sent temporary administrators into the failed banks. The administrators were able to stop asset stripping and deposit splitting. Their reports all clearly recommended bankruptcy. After these recommendations were ratified by the Council of the Croatian National Bank, the CNB requested that bankruptcy procedures be opened for four banks in late March 1999. This time, the courts accepted the requests, and bankruptcy procedures were opened.

In addition to using the temporary administrator mechanism, the national bank also used its powers under the new banking law to provide so-called “liquidity loans” to solvent but illiquid banks in January 1999. These loans were intended to be secret, but were quickly uncovered by the press. The loans came with strong conditions such as limits on lending growth, cessation of dividend payments and improvements in risk management and organizational structure to limit moral hazard.

However, from a crisis management point of view, what is important is that these loans stabilized the situation in the six recipient banks, preventing a much wider crisis. To give an idea of the potential effects, note that the 6 banks constituted 5.8% of the banking system, and all had strong or dominant positions in certain local markets.

The other important step taken during the bank crisis was the decision to rehabilitate Croatia banka. The bank had been judged solvent by external auditors in spring 1998, but ran into liquidity problems in February 1999. A liquidity loan was granted, but a CNB supervision team soon found that the bank was deeply insolvent. The question then was whether to shut the bank, which did have a fairly extensive national retail network. It was decided that the effects on depositor confidence would be too great, and the bank was rehabilitated. Its reopening for business in March 1999 was an important psychological boost.

After the opening of the bankruptcies in late March, the situation remained tense. Total deposits continued to fall. The war in Kosovo raised the specter of a longer economic crisis. However, there were no more bank failures in April and May, and early June brought the end of the Kosovo war. Deposits began to grow again in June as tourism revived, and the crisis subsided.

3.3.4. Assessment of crisis management

Timeliness of response

One of the key problems in the Croatian crisis was the central bank's inability to respond to banking problems in a timely manner. Thanks to the weaknesses of the old banking law, the central bank was only able to stop a bank's activities when it became completely illiquid and came to the central bank for help. The bank would be granted the "interventive loan" facility, which was available to banks unable to meet their interbank commitments. This facility required the bank to submit a plan to restore its liquidity, and also led to the bank's accounts being blocked. Quite rightly, bankers perceived the interventive loan as a death sentence.

Experience shows that banks may remain liquid but insolvent for quite some time. Because of this, the central bank usually was only able to block the bank's accounts when it was already deeply insolvent. Furthermore, since it did not have the power to oust incumbent management under the old law, the central bank was unable to prevent asset stripping and deposit splitting in the failed banks.

The new law substantially addressed these problems. The temporary administrator did have the authority to oust management and stop objectionable activities. However, the temporary administrator mechanism could only be activated upon a supervisory finding that the bank was insolvent. This, too, does not fully meet the requirements of prompt corrective action.[23]

Depositors perceived the arrival of the temporary administrator as a sign that the bank would be sent to bankruptcy. However, this was a self-fulfilling prophecy, since depositor runs in some cases pushed the bank over the brink. This underscores the importance of earlier intervention and rapid resolution to allow the bank to be shut quickly and reopened only when viable owners have been found.

Exit mechanisms

As we mentioned earlier, of the 16 banks that failed in 1998 and 1999 14 were sent to bankruptcy, and only 2 were rehabilitated. The Croatian authorities did not resort to forced mergers, nor were they able to use market-oriented measures such as purchase and assumption, assisted mergers etc.

Given that the crisis was mainly one of excessive risk-taking, and not the result of *force majeure* (e.g. war and the legacy of communism), the bias towards bankruptcy was justified. The failed banks were generally deeply insolvent, had weak management, and often had failed to comply with regulations. There was simply no basis to create sound banking institutions out of most of these failed banks. Thus bankruptcy, although very painful, was probably the right solution.

It is also important to note that the two banks rehabilitated during the crisis had a much more difficult time recovering than the banks rehabilitated in 1995-96. Those latter banks actually had been the victims of *force majeure* to some extent. In addition, the authorities were much more

[23] In the banking law currently under parliamentary consideration in Croatia in mid-2002, the central bank is granted the power to remove management even in solvent banks if capital is impaired and the bank has failed to enact a recapitalization plan. In addition, under the proposed law, the central bank would be able to remove management if capital adequacy fell below 2.5 percent.

able to focus resources on the four big banks than they were on the two banks rehabilitated in the midst of a general crisis.

While we would like to be cautious about drawing general conclusions, we would suggest that the bias towards bankruptcy in a crisis of excessive risk-taking was appropriate. One can discuss whether to save a particular institution at the height of a panic, as was done with Croatia banka, but the general conclusion seems to be that, when market-oriented mechanisms fail, it is better to bankrupt a risk-loving bank than to try to fix it.

Policy coordination

In addition to weaknesses in the banking laws, difficulties in policy coordination were a major cause of slow response to banking problems in Croatia. As Škreb and Šonje (2001) note, there was no coherent plan agreed on to rescue the banking system. There was a clear mechanism for bank rehabilitation, since top officials of the government and central bank were on the board of the Bank Rehabilitation Agency, but there was no clear mechanism for providing funding for assisted mergers, purchase and assumption or other more market-driven transactions. This lack of support was certainly one reason why such solutions were not implemented in Croatia.

More generally, the lack of coordination led to substantial policy delays and great uncertainty about the direction of crisis resolution. Škreb and Šonje (2001) break down the delays into five lags: perception lag, action lag 1, persuasion lag, action lag 2 and legal lag. Without retelling the whole story here, we can simply recount the main point: fragmentation of responsibility exacerbates delays and makes the crisis more difficult and more expensive to resolve.

Deposit insurance

Deposit insurance was put in place in July 1997. Initially, deposits of households up to 30,000 HRK per person per bank were insured, with deposits between 30,000 and 50,000 HRK 75% insured. Faulend (2001) estimates that this level covered 80% of depositors, which seems to be quite an adequate figure.

However, in the summer of 1998, the Minister of Finance raised the insurance level to 100,000 HRK. This decision was clearly taken under pressure from large savers in some of the failed banks. This level puts Croatia's coverage maximum/GDP per capita at 3.3, higher than all countries in Europe except Norway and Italy, and even higher than the United States. (Garcia 1999) On the basis of cross-country regressions, Faulend estimates that that coverage level was 92% above the predicted value given the country's characteristics. (Faulend 2001)

Much discussion has revolved around the usefulness of a blanket guarantee for deposits during a banking crisis. However, in Croatia, there is little evidence that the deposit insurance guarantee affected small savers' behavior. Instead, runs occurred based on rumors in many cases, even though most of those running were insured.

Furthermore, the authorities were extremely slow in paying out deposit insurance. In the case of Glumina banka, the largest of the banks sent to bankruptcy, deposits were frozen in late June 1998, bankruptcy procedures opened in late March 1999 and most depositors only repaid in December 2000. Thus it is easy to understand why deposit insurance was not considered credible.

Our view is that a blanket guarantee would only have raised the cost of crisis resolution. It would have bailed out large depositors who in general should have known better than to put their money into banks offering suspiciously high interest rates. The overall effect on public confidence would probably have been minimal, and the costs large.

Lender of last resort

In the Croatian case, the lender of last resort facility worked well. A concentration of failures during a short period was avoided, safeguarding confidence and buying time for eventual resolution. Of the six banks granted such assistance, two have already been acquired by foreign investors. One was found insolvent in late 1999, but was rescued by a revaluation of big bonds in spring 2000.

There were two keys to the success of the lender of last resort facility. First was the strong conditionality of the loans. This insured that the banks would make full efforts to improve themselves, minimizing the risk of eventual failure. Second was the relatively strong macroeconomic situation, including especially low inflation. The central bank's money creation via the lender of last resort did not have a significant inflationary impact thanks to the general low inflation environment (and the low level of economic activity in 1999). This is an important benefit of sound macroeconomic policies.

It is interesting to contrast the case of Croatia with that of Bulgaria in this respect. When the Bulgarian banking crisis began in late 1995, the fiscal situation was such that no public funds could be offered. In addition, the exit mechanism was not functioning, so that the only option was assistance from the Bulgarian National Bank. This, however, pushed the country into hyperinflation. (Balyozov 1999, Enoch, Gulde and Hardy 2002). Croatia was spared this fate by better macro policies and the existence of an exit mechanism that, although overly slow and expensive, did allow stock problems to be resolved before creating a macro crisis.

COMMON FEATURES OF SYSTEMIC CRISES AND LESSONS LEARNED

4.1. Common features of financial crises:

Systemic financial crises are very costly, regardless of their different causes. In Albania the crisis was caused by the emergence of non-regulated, informal financial institutions. In Bosnia and Herzegovina the problems were mainly the legacy of the socialist financial system and the devastating consequences of the war. In Croatia, the first banking crisis was the result of transition and war, and the second was mostly due to lax entry policies combined with a weak legal framework and deficient supervision. But in all three cases the economic costs of financial sector crisis are enormous and are probably higher than one-third of yearly GDP. Exact numbers are very difficult to assess. In Croatia, both banking crises together were estimated to have fiscal costs of about one-third of GDP (Skreb and Sonje 2001). In Albania, the total liabilities of collapsed pyramid schemes were more than half of GDP. Not all this turned out to be fiscal costs, but a very rough estimate of the costs as a third of GDP does not sound exaggerated. For Bosnia and Herzegovina the methodology of computing costs is even more difficult, but frozen (and still unresolved) foreign exchange deposits by themselves account for more than a quarter of 2000 GDP (without any accrued interest). So, total costs of these financial crises can roughly be estimated at one-third of GDP.

The systemic financial crises that we analyzed had a strong "political component." We cannot say that the crises themselves were caused by politics, but political response to the crisis was slow and reluctant to "get involved" in Croatia[24] or deliberately attempted to postpone resolution (in Albania during the pyramid scheme period and in BIH to this day).

Legal problems in preventing and resolving crisis were present in all countries. The lack of an adequate legal framework has delayed action in the cases of Albania and Croatia. In BIH, no action was taken to resolve the problem without strong pressure from the international community. The existing legal framework immediately after the signing of the Dayton peace agreement was inadequate to deal with financial problems. In all three countries, the crisis itself

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[24] In Croatia conventional wisdom was that as the crisis is "caused" by the central bank, the central bank alone should be blamed for it and consequently should resolve it alone. For more on political opposition to crisis resolution in Croatia see Skreb and Sonje (2001)

forced the adoption of new legislation and regulation of the financial system, which is a positive feature.
Policy coordination in crisis management and resolution between the supervisory authorities[25] and other institutions was relatively weak in all of the ABC countries. In Croatia, the Finance Ministry was very reluctant to even discuss the resolution of banking problems (see Skreb and Sonje, 2001). In Albania during the rise of the pyramid schemes, no one wanted to deal with them. For quite some time they were "no one's problem". In Bosnia and Herzegovina due to institutional constraints neither the government(s) nor the central bank can get directly involved, but speedier resolution of existing problems (frozen foreign exchange deposits) would increase credibility in the financial system and deepen financial markets.
A positive common feature of the crises is that none of the ABC countries tried to inflate its way out of the problems (see Table 2.1.). In BIH, no government funds have been explicitly used to resolve banking problems so far. In Albania, the government decided not to guarantee pyramid schemes deposits, which at that time was a very brave decision. In Croatia, the government did rehabilitate some banks with fiscal funds (increase in public debt) and paid out insured deposits in bankrupt banks. The newly created Deposit Insurance Fund itself was not adequate to pay all of the depositors. (In fact, it was not adequate to pay more than a small fraction of the depositors.) But in none of these resolutions was central bank money involved (unlike in the Czech Republic, for example, where the central bank's wholly owned subsidiary Česka finačni injected capital into banks during the Stabilization program of 1996-97[26]).

4.2. Lessons learned:

It is very important to have a political consensus to start crisis resolution as soon as possible. Once the crises erupts the losses are already there. They will only get bigger with time, so the main "game" is how to redistribute them. If the attempts to get as small a share of a loss as possible are not resolved soon, the resolution may be significantly denied, and the costs substantially increased.[27] And this redistribution game will not be resolved without political consensus. The sooner one realizes that losses will not go away by themselves, but that someone will have to bear them, the better. All countries would be well advised not to be in denial about the nature of the financial crisis and its costs.
One should have a plan to resolve the crisis or a framework for its resolution. None of the ABC countries had a plan *ex ante* on how to deal with financial problems. In the middle of the crisis, when decisions have to be taken in an environment of incomplete information, it is much more difficult to avoid big mistakes. In addition to having a plan, crisis management (or good governance as it is sometimes called) is very important. Here we agree with Fischer (2001) that effective leadership in a crisis is the "single most important factor in financial crisis management" (p. 6). Albania clearly demonstrates how the lack of leadership in the early stages can compound the initial problem.
In our view there is no single best policy for resolution of financial crises. Based on ABC countries, it is difficult to come up with a list of "best practices" for such cases. Our view is that crisis resolution is more an art than a science. Crisis resolution (especially for systemic crises) requires that the authorities take into account not only economic conditions, but the political and social environment as well. Resolution should not be based on ideological dogmas of whatever kind[28], but should be based on *realpolitik.* So, to repeat the previous lesson, countries would be well advised to think of possible solutions (within a broad framework) well in advance.

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[25] In Albania it was not clear for a long time who should deal with the pyramid schemes at all. In Bosnia since 1997 the Banking Agencies in the entities have been responsible for banking issues and in Croatia it is the Central Bank. See Table 2.5.
[26] See Czech National Bank (1999).
[27] Argentina is a good case in point, where the "battle" between depositors, banks and the government about the distribution of the losses was still going on at the end of May-2002 (6 months after the default) and has prevented any solution.
[28] In Croatia some economists were vehemently opposed to any bank closure as something "unthinkable" and in and of itself disastrous for financial intermediation. But, one should be aware that banks are special,

Countries should put away contingency funds in “good times” for crises years[29]. At least, they should get their fiscal accounts in order during expansionary phases of the business cycle. An initially strong fiscal position and low inflation (strong monetary control) definitely are positive elements in the resolution of a crisis. On the positive side, Croatia's low inflation environment allowed the central bank to undertake lender of last resort operations without having to be too worried about creating inflation. On the negative side, Bosnia’s reluctance to deal with frozen deposits is primarily related to its low fiscal capacity to pay the public debt. Croatia’s postponement of paying out insured deposits for two years is of the same nature. And such postponements undermine the credibility of the financial system as a whole. Furthermore, austere budgets inhibit countries and politicians from adopting more popular (vote gaining) solutions like socializing losses of the financial system. In that way they avoid (or at least decrease) moral hazard which is inevitable if generous bailouts are granted.

Finally there is no doubt that financial crises have some positive effects. After a crisis, every country makes additional efforts to stabilize the financial system. Therefore we could even be glad about financial crises . Besides, financial crises are a very common feature in a lot of economies. [30] According to Lindgren at al. (1996), since 1980 more than three-quarters of the IMF's members have had significant banking problems. Based on this one is apt to conclude that they are rather a regular characteristic and not an exception in market economies. So, one should not be surprised by a crisis, but instead should resolve the present one, draw some lessons and get ready for the next one. One may be lucky enough not to have the next crises too soon. But, as Louis Pasteur said: “ Le hasard favorise que les esprits prepares.” ("Luck favors the prepared").

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that contagion does exist and free market principles should not be fully applied to deposit taking institutions.

[29] More about this in Skreb and Sonje (2001).

[30] In Albania it was not clear for a long time who should deal with pyramid schemes at all. In Bosnia since 1997 the Banking Agencies in the entities have been responsible for banking issues and in Croatia it is the Central Bank. See Table 2.5.

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