“Financial system development progress in Western Balkans”

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Financial system development progress in Western Balkans

Abstract

Financial system supports economic growth, while its regulatory framework provides stability for investors. Developing countries with bank-oriented financial systems are not attractive to investors, so prolonged status quo leads to economic deterioration. This is particularly the case with some of the most underdeveloped areas in Europe: Western Balkans. It is essential the developing countries in this region consider steps towards financial liberalization, which will help open the borders for capital flows and attract new investments. The main goal of this paper is to review and present the available information related to the banking system development in Western Balkans in terms of ownership structure, capital adequacy, loan and asset performance, return on investment and liquidity. These indicators should provide a clearer picture of the current financial systems in Western Balkans economies and their development progress – useful for comparison with other developing regions and financial transformation and liberalization efforts.

Keywords: economic development, developing countries, Western Balkans, financial system transformation, banking system development.
JEL Classification: G18, G21, G28.
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Introduction

A well-functioning financial system plays a crucial role in the transformation process from a centrally-planned economy towards one that is market-oriented. It is essential that developing countries consider steps towards financial liberalization or deregulation, which will help open the borders for capital flows and attract new investments and ideas. While financial liberalization does not guarantee quick economic growth for developing countries, it helps increase the chances for progress and creation of opportunities for financial development.

Empirical research conducted for this paper reflects on selective history and current state of relatively young financial systems of some of the most underdeveloped countries in Europe, namely Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro, and Serbia. In addition to their struggle for economic growth, these countries are also trying to qualify for the EU membership (Croatia achieved this goal in 2013). The research focuses mainly on the banking sector, as the capital markets in these countries are still lacking sufficient depth for a proper investigation.

The paper focuses on the empirical analysis of financial liberalization in the Western Balkans region in the light of the latest global financial crisis. It is the aim of this paper that other developing countries would benefit from the experience and lessons learned from these countries, while taking into account any relevant similarities and differences. Ultimately, all developing countries thrive to become more attractive to investors, which requires stable economic conditions and clear regulatory framework, delicately balanced with expected flexibility, reliability and transparency.

1. Banking system transformation and liberalization

Developing countries have learned through their own history and the evidence from around the world that, in order to start liberalization processes, it is essential to first ensure adequate regulation of their financial systems in line with country-specific requirements and circumstances. It is often wrongly assumed that economies with greater connection and dependencies on international trade require stronger liberalization. It is important to recognize that, when it comes to financial systems and economy, each developing country follows their own practices, processes and traditions and should also find the most appropriate liberalization model that suits their circumstances.

The most recent financial crisis experience has contributed to an interest in the issue of the financial liberalization not only in the developed part of the world, but also in the developing countries, such as the Western Balkans region. Developing countries in this region are keen on moving towards economic liberalization and catching up with the rest of the Western Europe in their efforts to become equal partners in the European integration process. While the developing countries of Western Balkans are considered to have the geographic advantage in comparison to some more remote regions of the world, it is important to understand each country's specific history, culture, customs, events and situations that impacted on their progress towards global integration and liberalization.

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The effects of financial freedom and ownership structure on economic growth have been popular topics among economic researchers. Some researchers attempted to perform calculations to predict the effects of openness on growth (Bremus and Buch, 2016, p. 16), or evaluate fragility during financial crisis (Ashraf, Ramady et al., 2016, p. 65), while some focused on the effects of leverage and liquidity on earnings and capital management (Gombola, Ho et al., 2016, pp. 35-58) or researching equilibrium calculations for competitive conditions (Dal Colle, 2016, pp. 2-9).

Turkey went through major liberalization efforts in 1990s, resulting in continuous changes in the financial sector over the next two decades, namely related to competition structure, involvement of foreign banks and response to the global financial crisis. The empirical study conducted on data covering 1990–2014 period not only showed the positive relationship between competition and economic growth, but also highlighted some negative effects associated with liberalization. For example, the share of consumer loans within total loans granted by banks rose from 2% in 2001 to around 40% in 2014, but these loans were mainly used for consumption rather than real investments, thus, affecting the economic growth (Celik and Citak, 2016, p. 1754).

The study conducted by Lin, Doan et al. (2016, p. 32) focused on the analysis of liberalization in Asia and determined that foreign presence improves bank efficiency, primarily in countries with high financial freedom. They also found that assessing the effects of financial freedom and the changes in bank ownership structure on the efficiency of financial institutions is particularly interesting in the context of the latest global financial crisis due to increase of the prominence of systemic risk. This study further emphasized the importance of designing an appropriate bank regulatory and supervisory framework in the design of privatization and liberalization programs to help maintain the efficiency and stability of banks.

Analysis of Pakistan liberalization experience (Bonaccorsi di Patti and Hardy, 2005, pp. 2402-2403) showed that sometimes immediate impact of liberalization reforms fails to produce results, especially when there is a time lag between regulations and the practical applications of those regulations to banking and financial processes, for example, in loan assessment and provisioning. Garriga (2016, pp. 19-20) agrees that the longer the time elapsed since the last prudential regulation reform, the more vulnerable the country is to banking crises; and adds that the countries at lower levels of liberalization of the financial system are even more vulnerable to banking crises than those that have progressed further in their liberalization efforts. Understanding this vulnerability helps with the efforts of achieving positive growth effects of liberalization without increasing the risk of a banking fragility (Hamdaoui, Zouari et al., 2016, p. 644).

The latest global financial crisis experience also highlighted the effects of risk-taking behavior, especially with regards to the impact that ownership concentration and income diversification have on the financial stability of banks. The study conducted by Ashraf, Ramady et al. (2016, p. 65) into experience in the GCC[1] region found that the fragility of the financial system and elevated risk-taking behavior of banks became more pronounced especially for banks located in the more financially open and globally integrated economies.

Developing countries find themselves in various stages of the transformation process from socialist banking (characterized by state ownership) to a market-oriented system. Privatization of state-owned banks, establishment of new private banks and the arrival of foreign banks are common characteristics for all countries under this transition.

Kapor (2005, p. 356) compared the change in participation of state-owned banks in total banking sector for some European countries during the period 1999-2001:

- Bulgaria from 50.5% to 19.9%;
- Croatia from 39.8% to 5%;
- Bosnia and Herzegovina from 75.9% to 8.9%;
- Serbia and Montenegro from 89% to 68%;
- Lithuania from 68.9% to 29.7%;
- Czech Republic from 23.1% to 3.8%;
- Slovakia from 50.7% to 4.9%.

The first socialist country to develop a financial system in the 1990s was former Yugoslavia, through separation between commercial and central banking. After the dissolution of Yugoslavia, with hyperinflation and decline of economy due to war devastation, the financial system was completely destroyed. Introduction of effective banking supervision, application of regulations with international standards and practices, state capital privatization, and introduction of foreign capital were very important elements of the transition process for all Western Balkans countries.

A very important factor for an economy is clear and established exchange rate policy. For Montenegro, it meant introducing "euroization", and for Bosnia and Herzegovina, it was the establishment of a currency board. Croatia and Macedonia implemented a quasi-fixed exchange rate policy, while Serbia and Alba-

[1]GCC member countries include Bahrain, Kuwait, Oman, Qatar, United Arab Emirates and Saudi Arabia.

nia introduced a policy of controlled floating exchange rate of their respective national currencies. These steps helped eliminate the biggest economic problem of the past – inflation.

Now, several years after the global financial crisis (GFC), it is interesting to review some of the economic indicators such as ownership structure, capital adequacy, loan and asset performance, return on investment and liquidity, especially their change over the years before, during and immediately after the GFC. The insight in the status of the respective financial systems through these indicators might provide some valuable lessons and terms of comparison for some other developing economies and regions around the world.

2. Empirical evidence from the Western Balkans countries

2.1. Banking sector structure of the Western Balkans countries. The common element for the countries of the Western Balkans is the existence of a central or national bank, the institution that plays a key role in their financial systems. Central or national bank is often called "bank of the banks", it acts as the main pillar of stability and enjoys a high degree of political independence. The most important activities and tasks associated with the role of the central or national bank are (Kapor, 2010):

- right to issue money and provide credit;
- implementation of the monetary and credit policy;
- creation and implementation of external liquidity;
- additional financial tasks on state's behalf.

Central banks have the right to issue currency that acts as legal tender in their respective countries. By providing loans to banks, central banks create money reserves that are used to provide loans to customers, creating money in the process.

The next part of the text will briefly focus on some specifics associated with banking sectors of Western Balkans countries, including Croatia.

2.1.1. Banking sector of Albania. The Bank of Albania is the central bank of the country and was founded in 1913 as the Central Bank of Albania. It has changed the name couple of times since establishment, with the current name being set in 1992. Most banks are under foreign ownership (Figure 1).

The banking sector of Albania saw a significant growth in 2004, which can be related to an increase in the number of banks in the market and the fact that two state-owned banks were privatized. In 2005, another private bank was added to the banking sector, while in 2008, the Italian Albanian Bank merged with the American Bank of Albania. There were no further changes in the ownership structure and the number of banks (16) until 2012.

2.1.2. Banking sector of Bosnia and Herzegovina. The financial institutions in Bosnia and Herzegovina are: the Central Bank, commercial banks, other banking and non-banking institutions (insurance companies, micro-credit organizations, investment funds, etc.).

The Central Bank of Bosnia and Herzegovina was established in June 1997 in accordance with the law adopted by the Parliament of Bosnia and Herzegovina and became active in August 1997.

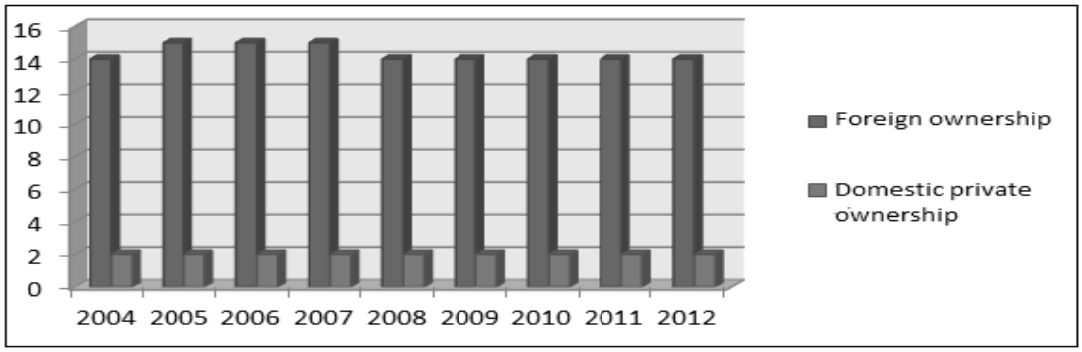


Fig. 1. The ownership structure of banks in Albania

Commercial banks are institutions that have a license to perform banking operations in accordance with banking laws established by the relevant administrative entity. Commercial banks in Bosnia and Herzegovina are divided according to administrative entities: commercial banks of Federation of Bosnia and Herzegovina, commercial banks in Serb Republic, and commercial bank branches in Brčko District.

The banking sector in Bosnia and Herzegovina is regulated by not only banking laws governing the activities of commercial banks (at commercial entity level), but also the laws on the banking agencies that define their goals, independence, competence, and responsibility (also at commercial entity level), Deposit Insurance Act (at the state level), and the Law on the Central Bank defining the coordination role with regards to banking supervision. The legal framework for banking in Federation of Bosnia and Herzegovina and Serb Republic, together with Brčko District, is largely harmonized (the Central Bank of Bosnia and Herzegovina, 2005, 45).

The banking sector of Bosnia and Herzegovina went through rapid development in 2004 and 2005, which included consolidation. There were 33 licensed banks in 2004, while by the end of 2012, the number went down to 28[1]. During the observed period, the banking sector was marked by numerous status changes, as well as the introduction of new banks. The upward trend was stopped in 2009 due to the multiple effects brought on by the global financial crisis.

Figure 2 provides an overview of the ownership structure changes in the period 2004–2012[2], covering foreign, domestic, and state participation in the total assets of the banking system in Bosnia and Herzegovina.

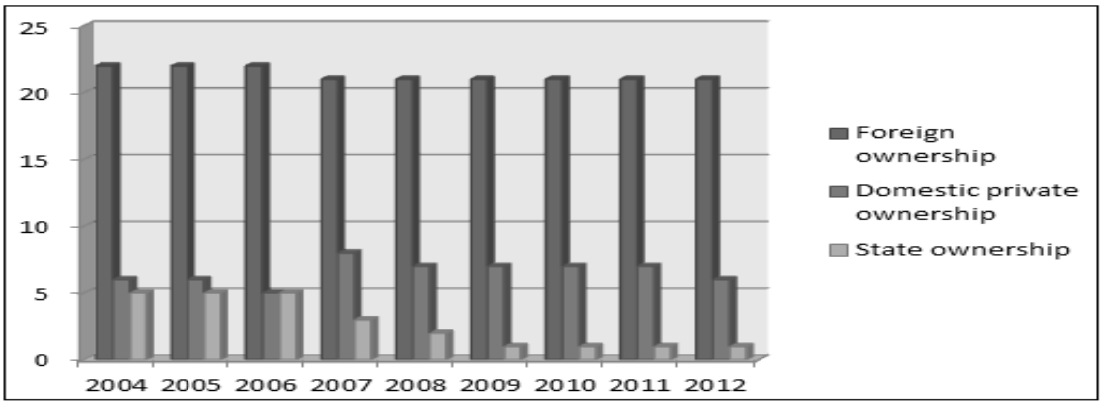


Fig. 2. The ownership structure of banks in Bosnia and Herzegovina

It is evident that the foreign ownership has the largest share in the total assets of the banking system due to large inflow of foreign capital. Domestic private and state banks control only a very small part of the ownership and have little or no impact on the capital market. It is important to note that from 2006, the commercial banks have included custodial activities as part of their services, including custody of securities. At the end of 2007, the total number of custodian banks was twelve (nine in Federation of Bosnia and Herzegovina and three in the Serb Republic).

According to the banking agencies across the administrative entities, the share capital of the banks in Bosnia and Herzegovina during the observed period was mainly privately owned. The details are provided in Table 1.

Table 1. The ownership structure of the share capital of banks in Bosnia and Herzegovina

	2005	2006	2007	2008	2009	2010	2011	2012
Bank equity capital (billions BAM)	1.20	1.33	1.66	1.95	2.01	2.26	2.42	2.56
State equity %	13.40%	12.40%	8.70%	2.20%	2.10%	12.70%	13.00%	12.70%
Private equity %	86.60%	87.60%	91.30%	97.80%	97.90%	87.30%	87.00%	87.30%
Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

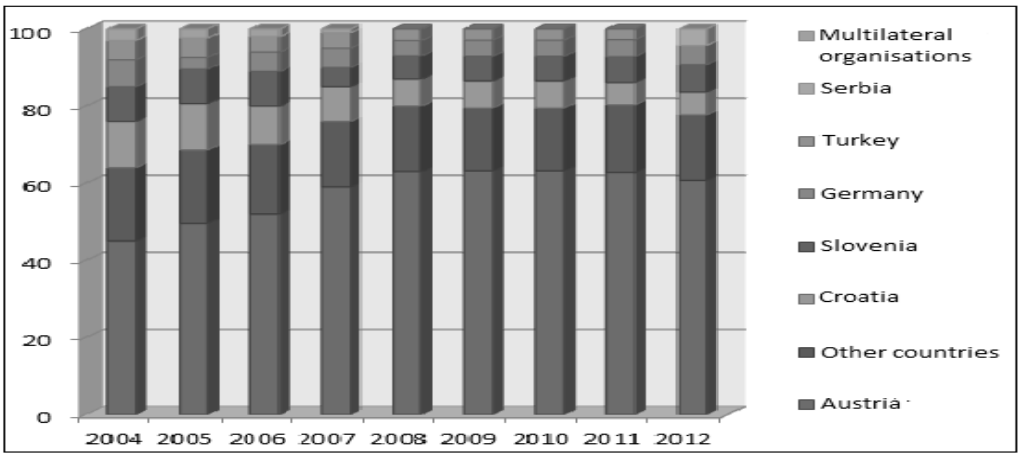


Fig. 3. The ownership structure of non-residents' share capital

[1] Up-to-date, in late June 2013, the licence was revoked for Post Bank Inc. Sarajevo, and in late November 2014, the Bobar Banka ad Bijeljina went under the receivership.

[2] The period 2004–2012 was covered by the research, because it covered four years before and four years after the crisis.

Private equity consists of the private domestic and private foreign banks. The share capital owned by non-residents makes well over half of the overall private equity capital. Figure 3 presents the ownership structure of the capital of non-residents in commercial banks in Bosnia and Herzegovina.

By analyzing the ownership structure of the banks it can be noted that Austrian investors have dominant role when it comes to non-residents ownership. The lowest participation in the ownership have multilateral organizations, which were not even present 2012.

2.1.3. Banking sector of Montenegro. The Central Bank of Montenegro is the top institution of the Montenegro monetary system. It was established in November 2000 and became active in March 2001, making it one of the youngest central banks in the world. The Constitution of Montenegro defines the Central Bank of Montenegro as "independent organization, responsible for monetary and financial stability and the banking system" (http://www.cb-mn.org/index.php?mn1=o_nama, accessed: 2/9/2013).

Montenegro's economy is dollarized (euroized), since the monetary system of Montenegro is based on the euro as the legal tender (as of March 2002). Before that, Montenegro adopted two-currency regime in 1999 with German and local currency (dinars), with German Mark being the only accepted means of payment since January 2001, until euroization in March 2002. One of the strategic objectives of the Central Bank of Montenegro is joining the euro system, bringing Montenegro closer to officially becoming part of the economic and monetary union (http://www.cb-mn.org/index.php?mn1=o_nama, accessed: 2/9/2013).

The structure of the banking system in Montenegro consists of commercial banks under foreign and domestic private ownership.

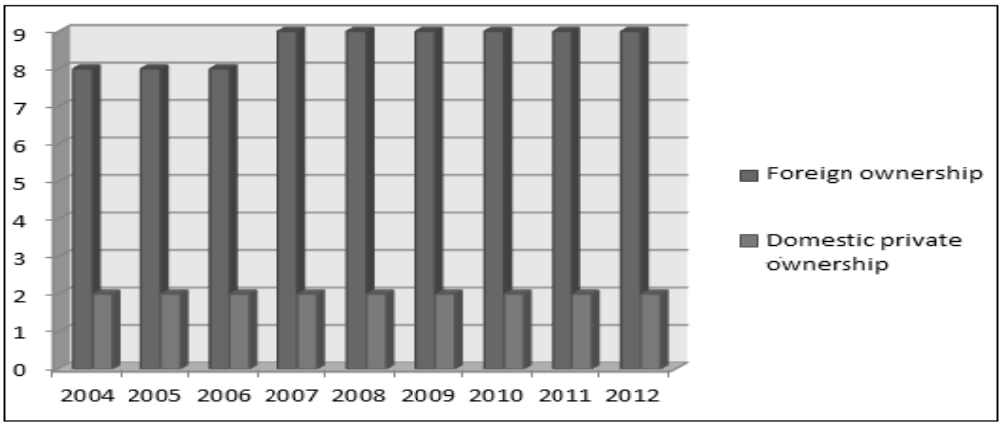


Fig. 4. The ownership structure of banks in Montenegro

The number of banks in the observed period (2004–2012) remained about the same (11), with one bank closing in 2005 and a new bank opening in 2006 and another one in 2007.

2.1.4. Croatian banking sector. Croatian National Bank (as specified in the Croatian Constitution) is the Central Bank of Croatia. Croatian banking sector at the end of 2004 included 34 banks, mostly owned by private domestic owners. As of 2007, the ownership structure shifted in favor of the foreign investors. Figure 5 shows the ownership structure in the period 2004–2012.

The number of banks in state ownership remained unchanged in the reporting period. The chart clearly shows the shift from the domestic ownership that was dominant in 2004 towards foreign ownership in 2012.

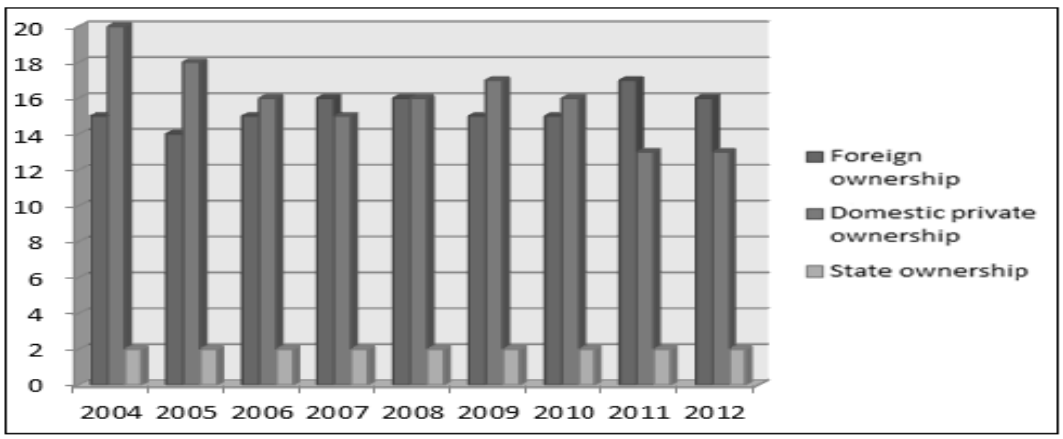


Fig. 5. The ownership structure of banks in Croatia

2.1.5. Banking sector of Macedonia. The National Bank of the Republic of Macedonia is the Central Bank of Macedonia. According to the National Bank of the Republic of Macedonia, the primary objective of the National Bank is to achieve and maintain a stable financial system, as well as ensuring pricing stability (http://www.nbrm.mk/default-en.asp?ItemID=7B388C2967979A4CA95D7EFBEB3F05D1, accessed: 2/9/2013).

On average, there were 19 banks operating in the Republic of Macedonia during the observed period (2004–2012). The chart clearly shows the dominance of the foreign ownership over Macedonian banks.

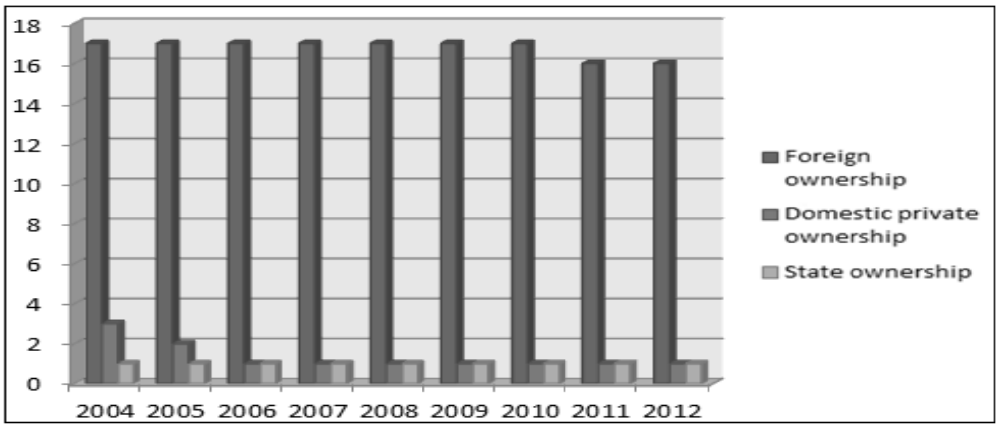


Fig. 6. The ownership structure of banks in Macedonia

2.1.6. Serbian banking sector. The National Bank of Serbia is independent and autonomous in the execution of functions established by the National Bank of Serbia and other laws. It is accountable for its performance to the National Assembly of the Republic of Serbia. The main objective of the National Bank of Serbia is to achieve and preserve price stability. In addition to the primary objective, the National Bank of Serbia contributes to the preservation and strengthening of the financial system stability (http://www.nbs.rs/internet/latinica/10/index.html, accessed: 2/9/2013).

The main characteristic of the Serbian financial system is the banking sector dominance. Serbian banking sector consists of the banks that are foreign, private and state-owned. At the beginning of 2004, there were 18 banks (out of 43) that were privately owned. With the development of the banking sector and the increase in the foreign capital flow, we can observe significant decline of the domestic and state ownership in favor of the foreign investors. There is also a consolidation trend where smaller and less capitalized banks merged or joined larger institutions, resulting in overall reduction in number of banks by 10 in the observed period (2004–2012).

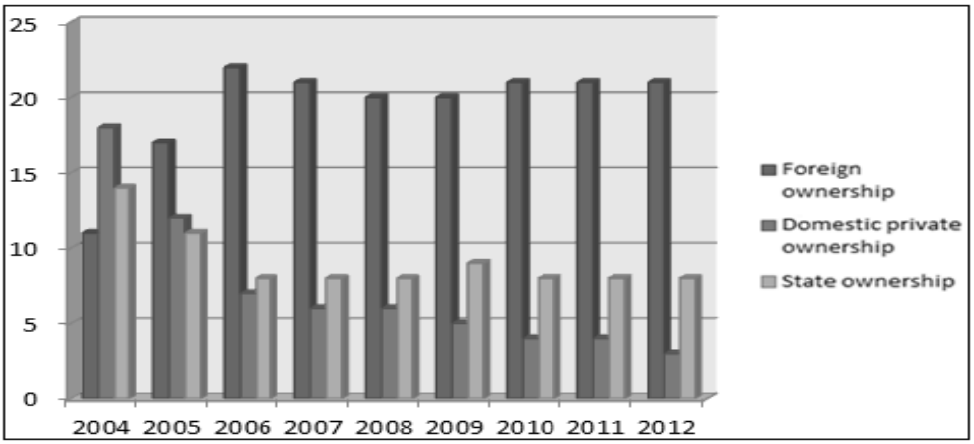


Fig. 7. The ownership structure of banks in Serbia

The banking sector of the Republic of Serbia began important reforms in 2001. Compared to the situation at the start of the reforms, the banking sector has undergone significant changes, which included revoking licenses for insolvent and illiquid banks. According to the reports issued by the National Bank of Serbia for 2005, there were 86 banks with the licences to operate in early 2001, but only 50 were in operation by the end of 2002.

2.2. An overview of the effectiveness of the banking sectors in Western Balkans countries. Banking sectors try to maintain the sufficient amount of capital to

absorb unexpected losses incurred due to large credit expansion. The increase in the rate of growth of loans should be followed by the increase of the capital adequacy ratio, which was not the case with the countries of the Western Balkans. This was particularly evident at the end of 2007, when the average annual growth rate of loans was 52.24% and the capital adequacy ratio was only 18.36%. Also, in 2008, the average annual growth rate of loans was 23.74%, with the capital adequacy ratio of 16.44%. Nevertheless, the capital adequacy of banks in the region still showed satisfactory results. Before the first impact of the global financial crisis, capital adequacy of banks ranged from 14% in Macedonia to 21.9% in Serbia. With the increase in credit risk in 2008 and 2009, there was a significant reduction in the rate, but still above the required level.

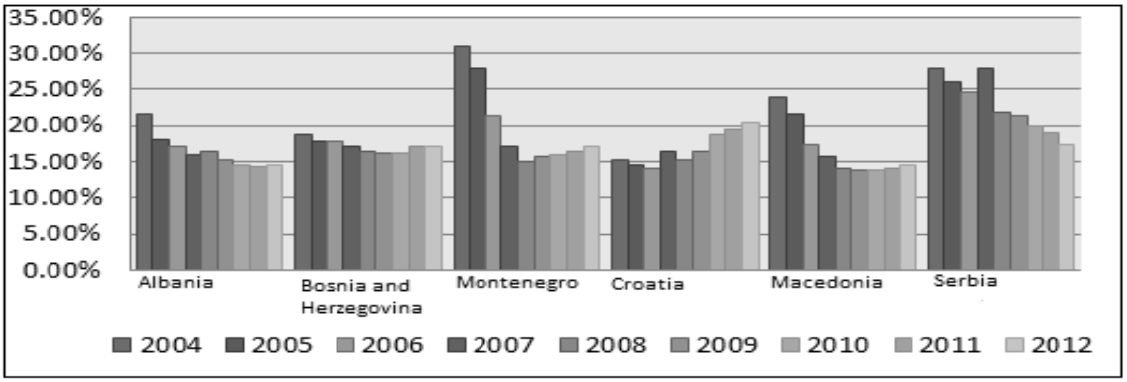


Fig. 8. Capital adequacy indicator of the banking sector of the Western Balkan countries

Except for Bosnia and Herzegovina, most countries experienced relatively sharp falls in capital adequacy ratio since the beginning of the observed period until the end of the crisis. The reasons for the stability of banking sector of Bosnia and Herzegovina can be found in the conservative core business banking policy. Among the countries taken into consideration in this analysis, the highest average capital adequacy ratio for the period 2004–2012 was recorded in Serbia with a rate of 22.89%, followed by Montenegro with 19.72%. Bosnia and Herzegovina was in the third place with a rate of 17.11%, followed by Croatia, Macedonia, and Albania with the rates below 17%.

Until the escalation of the global financial crisis, the banking sectors of the Western Balkans experienced rapid growth in credit supply. The consequences associated with the credit growth became evident later. Due to the high credit debt, the banks were forced to reduce interest rates in order to remain competitive in their national markets. Motivated by their desire to achieve higher profits, banks expanded their customer base and lowered the criteria for obtaining credit, leading to the overestimation of borrowing power of the overall creditworthiness of their customers. Before the crisis started, the participation of non-performing loans to total loans was the lowest in Albania, Bosnia and Herzegovina, and Croatia. The crisis slowed down the growth of loans and led to the growth of debt of private sector within the observed countries. Bank lending in the region also slowed down. The main effect of the first wave of the crisis the banks had to face was the increase in non-performing loans. Montenegro and Serbia showed the worst indicators of credit quality, while Bosnia and Herzegovina and Croatia had the best among the observed countries. Bosnia and Herzegovina had the lowest share of non-performing loans in 2008, at the level of 3.1%.

Some of the main characteristics associated with loans during a crisis are: loan repayments falling behind the due dates, discrepancy between liabilities and claims, minimal lending activity, higher risk adversity, and caution among banks, etc. The higher risk adversity by banks was particularly strong when dealing with enterprises, because it became increasingly obvious that the crisis transferred to the retail sector, causing major problems in the economy's liquidity.

Figure 9 shows the participation of non-performing loans in the banks, comparing to the period before the crisis. With significant reduction in the number of profitable projects and creditworthy clients, some lines of credit for small and medium enterprises obtained with the state's guarantee remained unused. The creditworthiness of customers (both legal entities and individuals) significantly declined in 2010, so the number of bank-approved loans was also lower, as banks became more selective and risk averse. The increase in the percentage of loans with overdue payments continued in 2011–2012. Looking at each of the observed countries, Serbia and Montenegro had the biggest share of the non-performing loans. From 2011, they were joined by Macedonia.

The share in the non-performing loans to total loans for each of the observed countries can be seen from Figure 10.

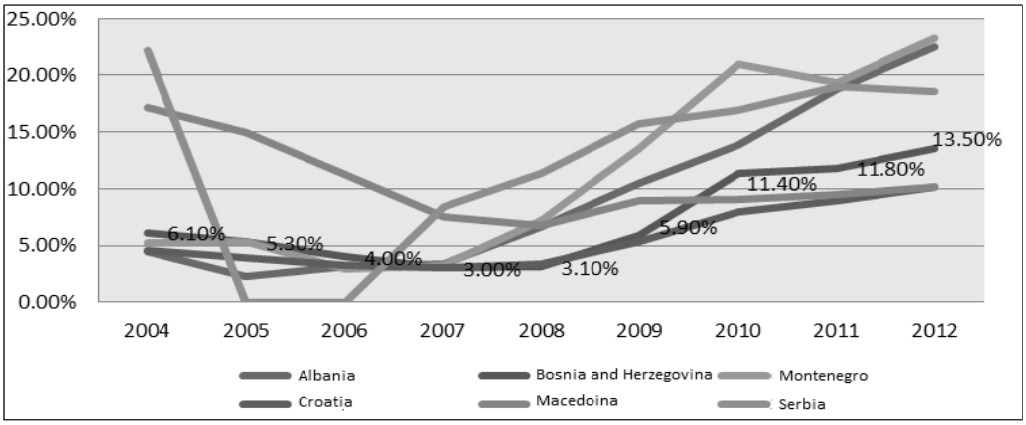


Fig. 9. Non-performing loans to total loans contribution trend of the Western Balkan countries

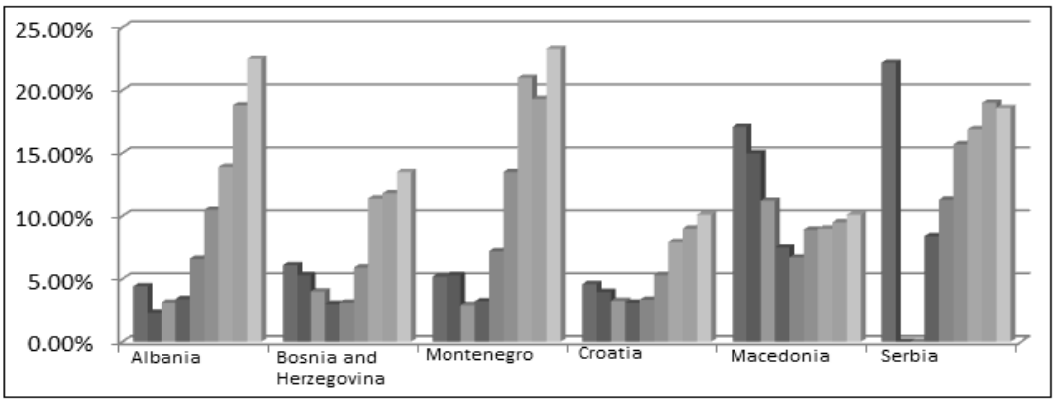


Fig. 10. Non-performing loans contribution to total loans of the Western Balkan countries

If we sum up the indicators associated with credit and participation of non-performing loans, we come to the following conclusions:

- up until year 2007, the region experienced a high credit expansion;
- prior to the crisis, the banks introduced the new banking products that meet the needs of more customers;
- the decrease in lending activity started in late 2008 and early 2009, coinciding with the financial crisis;
- the worst indicators can be attributed to the loans granted to individuals and the industry (trade sector);
- long-term loans have higher participation in non-performing loans than the short-term.

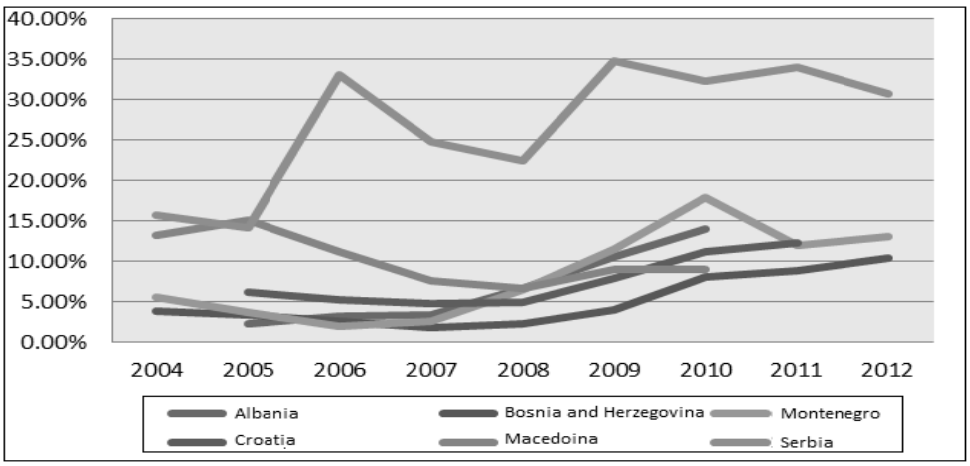


Fig. 11. Non-performing assets to total assets contribution trend of the Western Balkan countries

Looking at the quality of assets in the period before 2008, we can see Serbian banking system measuring a very high level of non-performing assets in comparison to other countries. Sudden worsening of asset quality started in 2008 for the entire region, as a result of high growth of new loans in previous years, when banks seeking high profits did not put an objective assessment of the

financial capability of their borrowers. This underestimation of the credit risks led to a steep deterioration in asset quality for all countries, with Serbia still maintaining the lowest asset quality ratio in the region (Figure 11).

The share of non-performing assets in total assets of the Western Balkans can be seen in Figure 12.

The return on average assets in the banking sectors of the Western Balkan countries in the reporting period was positive, with the exception of Montenegro. Looking at each country separately, the banking sector of Montenegro was the least profitable. The biggest return on assets was achieved in the banking sectors of Croatia and Albania. This is followed by the banking sectors of Serbia, Macedonia, and Bosnia and Herzegovina. Banks of Albania, Croatia, and Macedonia had no negative results in the observed period, while Serbia and Bosnia and Herzegovina each reported one negative annual result.

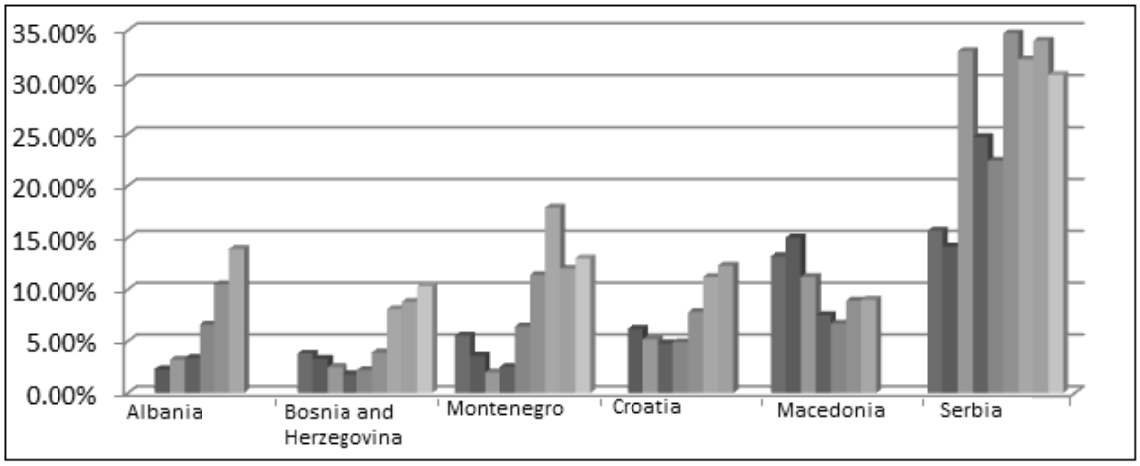


Fig. 12. Non-performing assets contribution to total assets of the Western Balkan countries

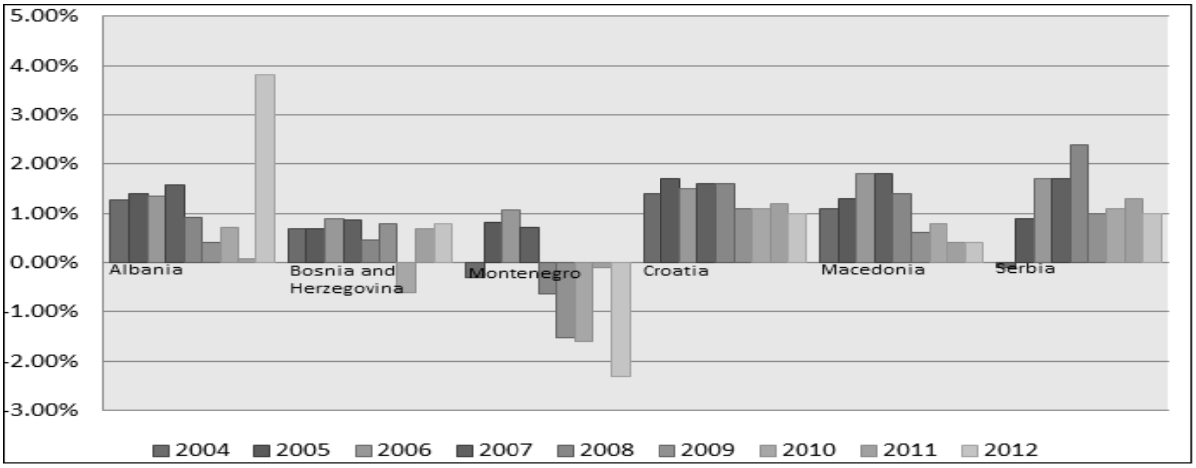


Fig. 13. Return on average assets of the Western Balkan countries

If we look at the profitability movement of banks year by year, we can observe the expected trend of the return on average assets: rising until 2008, then, falling in 2008, 2009 and 2010, followed by the revival in 2011 and 2012. Bank profitability by 2007 was significantly increased due to favorable economic and financial conditions, which was reflected in return on assets at 1.3% for the Western Balkans countries. During the crisis period the profitability trend deteriorated and the average rate of return on assets was 0.51%. The decline in profitability of the banking sector in the Western Balkans was caused by the deterioration of asset quality, increased exposure of banks to credit risk, as well as increase in the distribution of the reserves to cover loan losses. The recovery of the banking sector performance started in 2011 and 2012, with profitability ratios improving by 0.7%.

It is interesting to compare the average rate of return on assets in the region, with Montenegro experiencing low returns ever since the financial crisis and Bosnia and Herzegovina feeling the impact of the crisis on banks profitability around year 2010. The remaining countries maintained mostly positive position during the observed period, with Croatia making strong improvements in 2011.

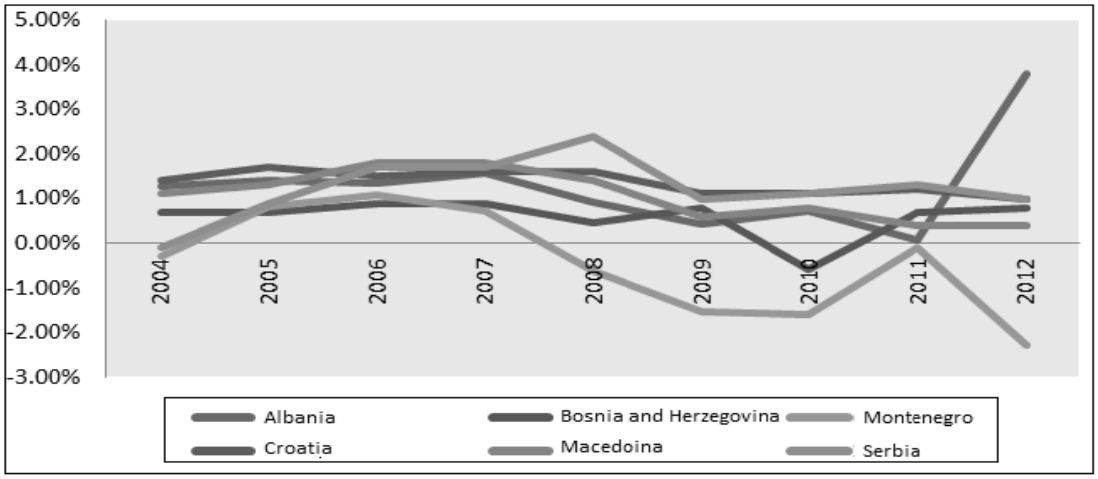


Fig. 14. The return on average assets of the Western Balkan countries

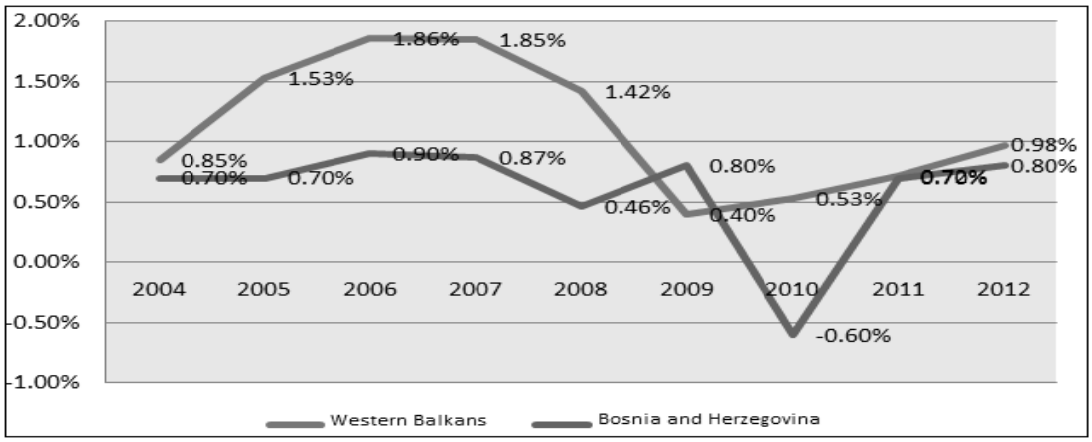


Fig. 15. Comparison of indicators of return on average assets of the banking sector of Bosnia and Herzegovina and the banking sectors of other Western Balkans countries

The countries with the highest rate of return on capital of the Western Balkans region are Albania, Croatia, and Macedonia. These countries also have a high capitalization rate. They are, then, followed by Serbia, Bosnia and Herzegovina, and Montenegro, which had the worst rate of return on equity, the lowest which was at the level of -27% in 2010.

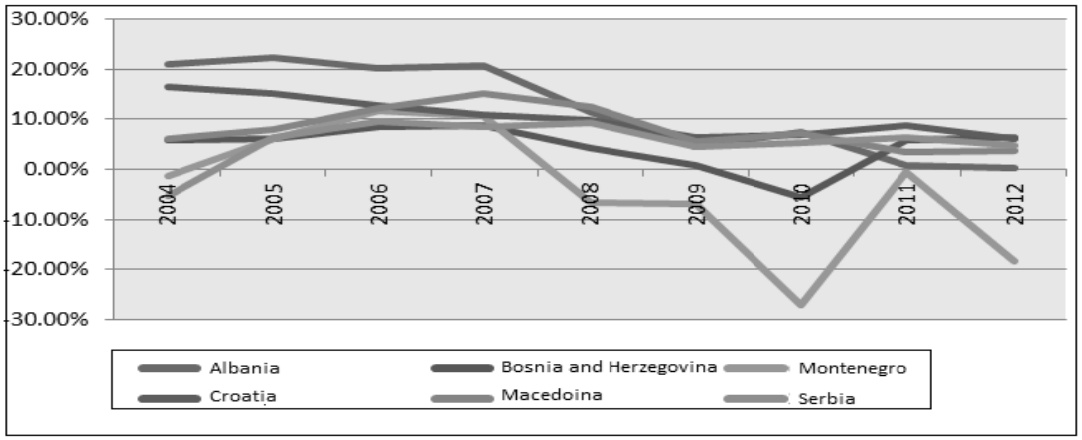


Fig. 16. Indicators of return on average equity of the Western Balkan countries

The liquidity indicators demonstrate the effects of the first signs of the financial crisis. Liquidity is an important indicator of the stability of the banking system. Figure 17 shows the participation of liquid assets in total assets of the banking sector in the Western Balkans. In the period before the crisis, Albania, Bosnia and Herzegovina, Croatia, and Macedonia had the lowest share of liquid assets in total assets. The crisis has not had a negative impact on the banking sector of Bosnia and Herzegovina and Serbia, who remained highly liquid, with the liquidity figures in 2009 of 30.9% and 41.5%, respectively.

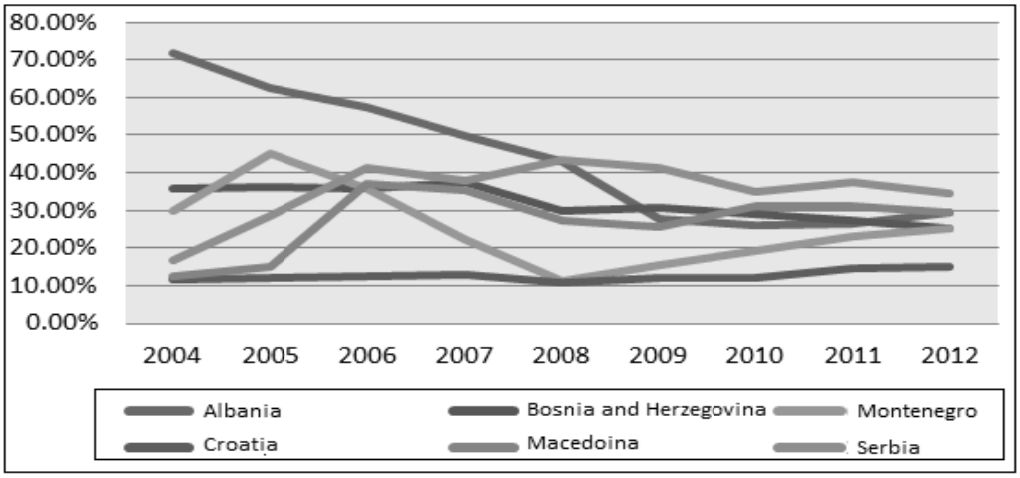


Fig. 17. Liquid assets to total assets trend of the Western Balkan countries

Looking at the liquidity trend of the Western Balkans, it can be concluded that the entire banking sector has had a reasonable liquidity. Average liquid assets before the crisis (until 2008) amounted to 33.10%, after 26% in 2008, all above the critical level. Most counties maintained relatively stable liquidity position, except for Albania and Montenegro, whose liquidity was more volatile during the crisis.

Similarly to the previous indicator, the positive trend can also be seen in the coverage of short-term liabilities by liquid assets within the banking sector of the region. The average value of this indicator in the reporting period for Montenegro and Macedonia amounted to 35.95% and 30.44%, respectively. The ratio of liquid assets to short-term liabilities of the banking sector of Montenegro was reduced by half in 2010 compared to the pre-crisis year 2007. From the presented data, it can be concluded that the banking sector of Montenegro and Macedonia is not liquid. Croatian banking sector had sufficient coverage of short-term liabilities with liquid assets, followed by banking sectors of Albania, Bosnia and Herzegovina, and Serbia.

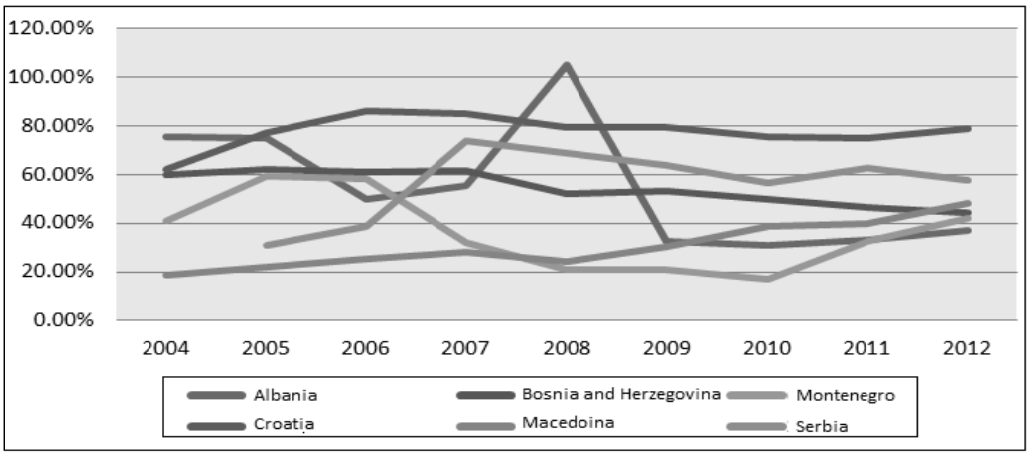


Fig. 18. Liquid assets to short-term financial obligations trend of the Western Balkan countries

Credit risk increase occurs due to unfavorable bank structural organization within financial sectors. The sectors impacted by the effects of the crisis show faster decline in credit capability with regards to exchange rates changes. In addition, the credit risk is higher, where national currency suffers depreciation. For example, during the crisis period, the Serbian banking sector experienced strong transition from the currency towards the credit risk, while other countries with the fixed exchange rates were spared and did not suffer with similar exposure.

In cases where there are significant deviations between the current exchange and the macroeconomic balancing factors, the depreciation pressures are expected to rise due to reduced capital inflows. The demand for foreign currency could prompt the foreign banks to apply a strategy of limiting and reducing their foreign currency assets in Southeast Europe as a basis for capital requirements. Such strategy would initiate conversion of all loans denominated in local currencies as the major balance sheet items to be converted

into foreign currency on the national foreign exchange markets. Reduction or further withdrawal of these assets abroad will further accelerate the depreciation. Available foreign exchange reserves in central banks are relatively small when compared to their value on banks' balance sheets (Živković, 2011, pp. 67-68).

Concluding remarks and future research

This paper examines the progress of financial systems development in Western Balkans as one of the least developed European regions, considering the impact of the latest financial crisis.

The paper presented a dataset from the Western Balkans region for the period before, during, and after the financial crisis, showing some common trends, as well as differences between the countries, which need to be taken into consideration when planning the next macroeconomic steps associated with liberalization or deregulation. Despite different organizational models across the Western Balkans countries, the data show strong similarities when it comes to trends associated with capital flows, return on equity, ownership structure, loans, etc.

It is recommended that further research is conducted by each developing country into how available lessons can be effectively utilized when making decision associated with liberalization, taking into consideration not onlycommon characteristics with economies that provided the lessons, but also the specific features unique to the developing countries and their respective cultures, financial and political setup, traditions, and development level. Developing countries should continuously research and apply available quantitative and qualitative methods in monitoring and managing their financial and banking system transformation progress.

And, finally, a practical recommendation for developing countries is to promote effective financial education for all subjects associated with liberalization process – policy makers, industry leaders, and public in general.

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