MONETARY AND BANKING SYSTEMS TO HELP (OR HINDER) ECONOMIC DEVELOPMENT OF TRANSITIONAL ECONOMIES

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Abstract
In this article we analyse how different monetary arrangements, i.e. money, central bank, exchange-rate regime, monetary policy and banks, have been influencing economic performance in the countries of former Yugoslavia. The countries for various reasons opted for different monetary arrangements and we were interested predominantly in whether the central banks have had enough monetary autonomy to prevent damaging overvaluation of their domestic currencies due to inflow of capital originating from sale of business enterprises to foreign investors. The connection between changes in international monetary reserves and monetary circulation is investigated. Further we discuss the capability and willingness of the central banks to purchase foreign exchanges in sterilized way, what impact have had monetary arrangements on the banking systems, how the countries have got used to 'live above their means', and how to change it.
Key words*: monetary regime, exchange-rate policy, central bank, banks, sterilised interventions on the foreign exchange market.*

JEL Classification: D 23;
Preliminary Communication
Received: Mart 02, 2012 / Accepted: May 10, 2012

1. Introduction

Besides changes in the ownership of business enterprises, the most important changes in economic institutions that had to be made during transition were changes in monetary arrangements and banks. In addition, financial market had to be introduced. Changes in ownership of non-financial business enterprises were predominantly done so that they were unfair and socially unacceptable or they caused decrease in saving and capital formation (Ribnikar, 1993). Their consequences are still present and economic problems the countries have been facing so far can be at least partly attributed to them. Financial markets, although necessary for market economy, have been erroneously praised as a panacea that would be a centre of economic happening. We should add, together with funded pension system.

Monetary arrangements, i. e. money, the central bank, exchange-rate regime, monetary policy, and banks have been crucial for economic performance of countries if we take changes in the ownership of business enterprises as given. Those changes started at the beginning of transition andone cannot change something ex-post, changes have been namely happening since the beginning of transition. Therefore in the paper we will concentrate on monetary arrangements and banks, where changes can be made ex-ante and they are taking place according to changing circumstances. Countries approaching EU and later euro area would be, for instance, obliged to adapt their monetary and banking systems to the systems existing in the EU and/or euro area. As all countries have been running huge current account and budget deficit, and their public and external debt have become quite substantial, we cannot ignore them. They importantly determine both monetary and banking systems and are influenced by them.

2. Monetary arrangements and central banks

We will put aside history, namely how several separate monetary systems were established within former Yugoslavia, and concentrate on monetary systems or standards. Nowadays, when there are no commodity standards, monetary systems or standards are characterized or differ among themselves at first by the manner in which national monetary system is connected with international monetary system. Is there free movement or flow of money, capital or fundsbetween individual countries and the world is the first important question? As it is known all transitional countries of the former Yugoslavia sooner or later abandoned all or almost all barriers and opened up to cross border flow of money or funds. Sometimes they did it too soon.

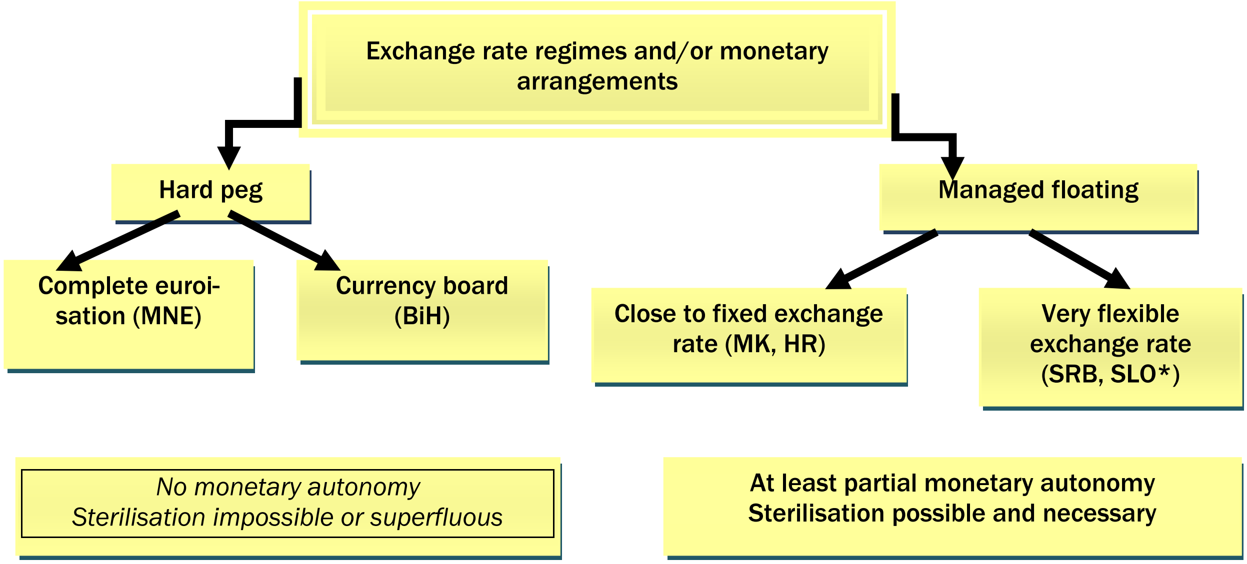
But the countries may be, as concerns money, connected with the world in various ways as can be found in literature (Yeager, 1976; Viser, 1993; Mundell, 2001). In one case, the countries may be not only completely opened, but the cross border flow of money may directly and to the whole amount affect domestic monetary circulation. Domestic monetary system is an integral part of the international monetary system. The balance of payments and domestic monetary circulation are connected according to the so-called monetary approach to the balance of payments (Johnson, 1977). Such is the case of some varieties of hard peg exchange rate regimes, for instance if there is a genuine currency board where money, 'created' by the currency board, is almost only currency. Bank deposits were negligible (Walters & Hanke, 1992). Relation is one for one, it, means for one unit of foreign money just one unit of domestic money is 'created'. There is, of course, no creation, just exchange of domestic for foreign money. Currency boards existing to-day are in that sense not genuine currency boards, they also 'create' reserves for banks, and there is not such a straightforward connection between balance of payments, i. e. changes in international monetary reserves and changes in monetary circulation. The same is true for countries that do not have their money and therefore use some other country's money (complete dollarization). Besides currency in circulation, that is some other country's money in the case of complete dollarization, there is also deposit money.

Deposit money, that is much important in to-day's currency board system, created by domestic banks, prevents straightforward connection, if, as usually is the case, bank reserves are not 100 per cent (in foreign money), and, in addition,reserve ratio may change either by the central bank decision or by banks themselves. They, for instance, simply want to have more or lesssurplus reserves. Direct connection between changes in international monetary reserves and monetary circulation is further loosened. Not only that there is not one for one relation, in the case of complete dollarization domestic circulation of coin and note is even not known, but there even does not need to be proportionality. But, nevertheless, there is a rather limited autonomy for the central bank

In other exchange rate regimes, for instance managed floating regimes (Ribnikar, 2004 & 2011), the impact of cross border flow of money on domestic monetary circulation is partly or substantially loosened or disrupted by central bank intervention on foreign-exchange.The central bank may create base money also by buying domestic assets, it means by buying government bonds or giving loans to banks, although for small and very open economies there would be little space for such purchases. Secondly, it may insulate influences of its interventions on the foreign exchange market; it means changes in international monetary reserves, on base money creation by sterilised interventions on the foreign exchange market. We will see that this capacity of the central bank is crucial for its de facto relative independence or its autonomy from the balance of payments or changes in international monetary reserves.

In exchange rate regimes that do not belong to hard peg regimes, the central banks have this capacity. In Fig 1, where one cannot find pure or free floating, are for instance regimes that are relevant for small transitional economies. It, of course, does not mean that if there is not hard peg regime, the central banks can do whatever they want. The central banks especially in small and therefore very open economies are pretty much constrained by the balance of payments or changes in international monetary reserves disregarding exchange rate regime.

Figure 1: Exchange-rate regimes or monetary arrangements and monetary autonomy



* until December 31st 2006

It is well known that for small and therefore much more open economies that depend so much on foreign trade, international liquidity is crucial. In addition we may add that there should be as little as possible of exchange-rate volatility. To achieve these two goals the central banks must be prepared to intervene daily on the foreign exchange markets and to be able to do that they should have substantial international monetary reserves. The base money should be created predominantly by purchases of foreign exchanges on the foreign exchange market. There should be usually no place for purchases of Government bonds, bills or notes and very little room for loans to banks. Usually a little room for loans to banks should be created somehow artificially by, for instance, absorbing some reserve money or creating less of it – for instance by purchasing a bit more of foreign exchanges in sterilised instead of straight way.Without such loans central bank would not be able to perform its lender of last resort function and this function is peculiar to it. Currency board, for instance, differs from central bank, that it cannot do that.

Table 1: Central banks' foreign assets and reserve or base money

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Croatia	2.21	1.83	1.64	1.46	1.36	1.38	1.31	1.34	1.35	1.40	1.35
BIH	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Macedonia			2.06	1.98	2.45	2.59	2.29	1.91	1.88	1.96	2.41
Serbia	7.29	1.39	1.70	1.66	1.70	1.80	1.74	1.41	1.92	1.98	2.09

Source: International Financial Statistics (IMF), national central banks

But there is something more. Taking into account sales of business enterprises to foreigners, and it has been a very important or even dominant way how socially owned businesses have been changing into privately owned ones,the purchases of foreign exchanges on the foreign exchange markets by the central bank have had to be even greater than the required increase in base moneywould have permitted. So there has been usually even not enough space for the central banks, if they are to stay within required increases of base money, to purchase all surplus foreign exchanges on the foreign exchange market. By surplus foreign exchanges we mean foreign money that would cause not only unnecessary but also damagingappreciation of domestic currency. Therefore some of those purchases of foreign exchanges had to be done in a sterilised way to neutralise or annihilate the effect of foreign exchanges, coming on the foreign exchange market from sales of businesses to foreigners, on exchange-rate and supply of money.

Domestic money should not appreciate because of such a temporarily inflow and supply of foreign money that would sooner or later disappear. We should not take such transactions as transactions that determine equilibrium exchange rate. Preventing appreciation of domestic currency is so important, at least we think so and experience of Slovenia confirms it, that we can even roughly evaluate whether the monetary arrangement has been appropriate or not and/or whether monetary policy has been exercised properly or nor by looking at two balance sheet items of the central bank – foreign assets among assets and base money among liabilities (table 1). The greater is the ratio between foreign assets and base money, the better marks should be given to monetary system and/or monetary policy. In all countries foreign assets have been greater than base money, although not that much. In Slovenia, for instance in 2003, the last year before exchange rate had been fixed, net foreign assets were 3,66 times greater than base money.

The same may be said also for ratio between foreign assets kept by banks and central bank and narrow money (M1) in table 2. In this case foreign assets in the portfolio of banks, their foreign exchange reserves, are included in foreign assets and instead of base money there is narrow money (M1) that is for deposit money greater and for bank reserves smaller than base money.But in this case the ratio has been less than one – even in Bosnia and Herzegovina. In Slovenia in 2003 that ratio was 1,59.

As can be seen from Fig. 1 hard peg exchange-rate regime, i. e. complete euroisation in the case of Montenegro and currency board arrangement in the case of Bosnia and Herzegovina, is not appropriate arrangement, or at least quite appropriate arrangement, because under such an exchange rate regime sterilisation is impossible. But if we look at thehuge current account deficits of Montnegro and Bosnia and Herzegovina we can say that sterilisation would be superfluous or unreasonable luxury. It would have meant to keep foreign money that is so needed idle.This has not been happening. Proceeds from sales of businesses abroad have been simply used for partly financing big current account deficits.

Table 2: Narrow money (M1) and foreign assets in portfolios of central banksand banks

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Croatia	0.33	0.45	0.40	0.37	0.43	0.47	0.50	0.47	0.38	0.39	0.43
BIH							0.56	0.60	0.59	0.63	0.67
Macedonia			0.61	0.35	0.28	0.28	0.35	0.47	0.41	0.41	0.34
Serbia	0.12	0.48	0.39	0.36	0.30	0.26	0.28	0.29	0.22	0.20	0.21

Source: International Financial Statistics (IMF), national central banks

We must add that because under the hard peg exchange rate regime the exchange rate once determined remains unchangeable, the very important variable to balance the balance of payments has been given up. There is another way how to achieve the same goal, although much more complicated, and it is so-called internal devaluation or depreciation, that has been used and will be used in countries within the euro area.And there are expectations that the Germans would in the future internally, by increasing wages, appreciate their currency. It is one of the ways how to abolish problems among the countries within the euro area (Cohen, 2012). If the wages are already very low, it is almost impossible to further decrease them nominally. Some decrease in real wages can be probably achieved via devaluation or depreciation of domestic currency, but only under the managed floating exchange-rate regime.

The position of central bank is different if there is managed floating exchange-rate regime. The central bank has substantial monetary autonomy. Central bank can, for instance, purchase or sell foreign exchanges in a sterilised way. If we say that monetary autonomy is important we have just that in mind that the central bank can intervene on the foreign exchange market in as sterilised way. Domestic monetary system is at least partly insulated from changes in international monetary reserves or from the balance of payments development. But for the countries of former Yugoslavia that have had managed floating exchange-rate regime, there are questions whether this autonomy has been exercised at all, it means whether these purchases have been done at all and if they have been done have they been done in the required or proper amount to prevent damaging appreciation of domestic currency.

As one can see from current account deficits and foreign indebtedness, the countries have been living beyond their means and an appreciated domestic currency has been enabling it or goes with it. But foreign indebtedness is not the whole measure of living beyond one's means. One must add to it proceeds from sales of existing businesses, assets or wealth to foreigners. Substantial part of accumulated wealth has been namely eaten up as well. Not only future wealth has been eaten up but also wealth created in the past.

3. Banks

The developments in the banking sectors in the region have followed a very similar pattern in the recent two decades. After banking crises that hit some of the countries in the initial stages of transition, banking sectors have gradually recovered and in the period before the recent global financial crises also experienced strong growth in financial intermediation and profitability. So, in years preceding the outburst of the global financial crisis the annual credit growth amounted to 19,4% in Croatia (in 2007), 40,3% in Macedonia (in 2008), 28,4% in Bosnia and Herzegovina (in 2008), 34.2% in Serbia (in 2008) and to exorbitant 165% in Montenegro (in 2007). Even the prospects for further growth were very optimistic at that time and there were estimates in some studies that banking sector assets in the region could continue to grow on average by 17% p.a. until 2011 (Deutsche Bank Research, 2007). However, due to the overwhelming global financial crisis commenced in mid-year 2007 in the USA and Western Europe, a sharp slowdown in credit growth rates has followed also in Western Balkans. In Montenegro a credit contraction by -14.3% followed in 2009 and growth rates have not recovered yet. Similarly credit growth rates plummeted also in other countries although they didn't sink below zero percent mark, meaning a modest credit growth not exciding 10% p.a. has been maintained (see Table 3).

Table 3: Annual credit growt in banking sectors of selected countries (in % of GDP)

Annual Credit Growth in %	2005	2006	2007	2008	2009	2010	2011
Croatia	14.9	22.0	19.4	11.6	5.0	2.9	6.5
Macedonia	46.7	25.0	35.0	40.3	14.2	5.4	8.1
Montenegro	33.6	125.3	165.1	24.6	-14.3	-8.2	-11.1
Bosna & Herzeg.	21.5	24.5	27.4	28.4	5.4	-0.9	5.6
Serbia	45.4	32.3	32.5	34.2	24.4	29.9	7.4

Source: EC, EU Candidate and Pre-Accession Countries Economic Quarterly

Accelerated credit growth rates have been reflected in the increased proportion of credit to private sector to GDP. This proportion only in Croatia (51,8%) exceeded the 50% mark at the end of 2004 while in some of the countries like Macedonia, Montenegro and Serbia it used to be well below 30% mark (see Table 4) which was a clear indication of low level of financial intermediation and at the same time also a low level of indebtedness of the corporate sector and households. In only four to five years the credit to GDP ratio has been elevated to 80.4% in Montenegro, about 70% in Croatia and almost 93% in Slovenia, while the rest of the countries in the region still did not exceed the 50% mark. If compared to most of the economies in the economically more advanced countries it is obvious that there exists a significant gap as concerns the credit-to-GDP ratio, but at the same time it is also clear that for the closure of the existing gap much more time will be needed in the future as it was expected just couple of years ago. It is not only because of the slowdown in the economic activity of the countries but also because of the way how the credit growth has been generated in the booming years.

Table 4: Domestic credit to private sector in % of GDP

Domestic credit to private sector in % of GDP	2004	2005	2006	2007	2008	2009	2010
Croatia	51.8	56.4	64.0	67.1	68.1	69.6	na
Macedonia	22.1	25.1	30.2	36.8	43.9	42.9	na
Montenegro	16.8	20.7	39.4	83.0	90.7	80.4	na
Bosna & Herzeg.	32.3	36.5	39.5	44.4	50.9	50.2	na
Serbia	24.8	30.7	30.8	35.3	41.4	45.0	na
Slovenia	48.1	56.3	65.8	78.8	85.2	92.7	na

Source: EBRD Structural change indicators

Namely, if we observe the loan to deposit (LTD) ratio it took values greater than 100% in 2011 for all the countries in the region, except for Macedonia, where it was at the level of 93.2% (see Table 5; the data for Serbia is missing). Such LTD ratios indicate that credit activity of banks was not funded only by collected domestic deposits but also by funds borrowed in the wholesale markets. In most cases it means that especially banks in foreign ownership quite heavily borrowed from their parent banks and increased that way their credit potential significantly. They had relatively easy access to additional funding in many cases at cost lower than normally available in the wholesale markets. On the other side parent banks were motivated for the investment of available funds in the region because of the usually greater profitability than achievable in their home markets.

Table 5: Statistics on Loan-to-deposit (LTD) ratio and volume of foreign currency denominated loans (statistics refer to year 2011)

Statistics refer to year 2011	LTD in % (private sector)	FX loans to private sector in % of GDP	Share of FX loans in total loan stock
Croatia	120.2	70.8	72.4
Macedonia	93.2	24.2	52.4
Montenegro	116.7	---	---
Bosna & Herzeg.	155.0	2.7	72.3
Serbia	---	35.5	71.5
Slovenia	153.6	4.1	4.9

Source: EBRD, Regional Economic Prospects, May 2012

To some extent a heavy reliance on foreign funding was reflected in relatively high proportion of foreign currency denominated loans, which were intensively advertised by banks in the region and used to be attractive for the customers due to more convenient interest rates. The data for 2011 reveal that proportion of foreign currency loans in total loan stock took more that 70% in Croatia, Bosna and Herzegovina and Serbia and 52.4% in Macedonia. In all these countries foreign currency loans were denominated in Euros and Swiss Francs, while in Slovenia (4.9%) the share refers to the Swiss Francs denominated loans only.

4. Balance of payments and budget deficits

Two deficits, and two debts – external and public, often exist at the same time and are often but not always connected. But there need not to be one if there is another and if there are both there is the question which one is more important and dangerous. Countries with huge public debt, like for instance Japan, need not have problem with balance of payments deficit and external debt. Japan is the case that country may have very high public debt, about 200 per cent of GDP, without any "sovereign debt" problem. Explanation is that Japan has been running balance of payments surplus and its net international financial position is in surplus, and not, what one can hear, that public debt is in domestic hands.Especially for transitional countries of former Yugoslavia balance of payments deficits, and foreign debt, are of primordial importance and budget deficits and public debts are problems in the first place because the countries have balance of payments deficits and external debt at the same time. Budget deficits and/or sovereign debts are also in the case of EU or euro area wrongly treated as the main problems, although the countries with huge public debt problems, like Greece, Portugal and so on, have problems because of permanent balance of payments deficits and huge external debts. Living permanently and extensively beyond one's own means does not mean that there is a huge budget deficit and public debt, although at least it looks like to be prevailing official opinion in the EU and euro area, but 'living beyond one's means' manifests itself in huge and permanent balance of payments deficits and external debts.

So let us look at first at the balance of payments deficits and external debts. All countries of former Yugoslavia have been running huge current account deficits (Table 6) that have decreased after 2008 due to economic crisis and substantial decrease in economic activity abroad and in the first place at home. Although all countries started as new states at the beginning of nineties with a rather small external debt, in about twenty years it has become for majority of them menacing. And it is the major problem the countries are facing.

But current account deficit cannot be explained only or maybe even predominantly by non-competitive business enterprises. In this case solution would be rather easy.One can make business enterprises more competitive by decreasing their prices in foreign money by depreciating domestic currency. But there are some technical obstacles. One isextensively dollarized economies. Large part of bank deposits and loans is denominated in foreign currencies – in the first place in euros. Any substantial appreciation of euro would expose banks to huge credit risk. Banks may not be exposed to currency risk, but it does not mean much. If euros appreciate banks borrowers would not be able to service their debts. Other obstacles are less technical.

Table 6: Current account deficits and net international financial position
Current account deficit in % of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Croatia	-8.7	-7.3	-5.3	-6.4	-7.8	-7.2	-8.8	-5.0	-1.0	-1.2
Macedonia	-9.5	-3.4	-7.7	-1.3	-0.4	-7.1	-12.8	-6.7	-2.2	-2.8
Montenegro	-12.6	-7.3	-7.2	-8.9	-26.0	-39.5	-50.6	-29.6	-24.7	-19.9
Slovenia				-1.7	-2.5	-4.8	-6.9	-1.3	-0.8	-1.1
Bosna & Herzeg.	-19.1	-19.4	-17.9	-19.8	-10.7	-10.7	-14.0	-6.3	-5.7	-8.7
Serbia	-8.7	-7.5	-11.7	-8.4	-11.5	-16.1	-20.6	-7.4	-7.5	-9.5

Source: International Financial Statistics, IMF, national statistics

Net International Investment Position in % of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Croatia	-28.6	-57.6	-89.1	-78.5	-135.5	-203.0	-143.8	-178.3	-168.7
Macedonia		-60.5	-77.1	-57.4	-62.6	-87.3	-94.4	-111.7	-96.4
Slovenia	-0.7	-11.4	-18.2	-15.3	-29.6	-46.2	-65.4	-75.8	-64.1
Bosna & Herzeg.			-55.6	-44.3	-46.6	-62.9	-79.9	-102.9	-102.8
Serbia							-145.5	-168.1	

Source: International Financial Statistics, IMF, national statistics

It would be probably a different story had the central banks from the very beginning by sterilised purchases of foreign money, coming into the countries as payments for business enterprises sold to foreigners, prevented appreciation of domestic currency. In that case step by step destruction of domestic manufacturing and other sectors would not happen. It is not only or dollarized economies that prevent depreciation of domestic currency, but much more that its effects are dubious. We namely cannot simply look at textbooks for the consequences of depreciation of currency. Efficiency and competitiveness of economy is the "product of the intersection of economic environment with social, political and cultural institutions" (Kay, 2003). And these institutions, compatible with economic environment and adequate economic environment, do not exist at all or are at least not developed enough.In all countries quite some individuals have become rich without taking risk and this has been taken as something a norm. One should not rely very much on changes in instruments,measures, laws; it is on more or less formal changes. The same can be said for simple solution, it means by depreciating the currency. Consequences are namely not predictable.

For each borrower there must be a lender. Highly indebted countries did not come into this position alone and they did not steal money from anybody but lenders from the developed world gave them loans or bought their bonds. Situation in which they are now is not only of their-making, although they were the major players. It is interesting why they have been able to run current account deficits and for so long time.

Philosophy of free movement of capital and openness of the economies probably played some role (Ribnikar, 2011a). Besides, it has been in the interests of more developed countries of the EU that especially transitional economies should be opened and should allow their capital and goods to enter freely. Therefore balance of payment, it means its deficit, should not be taken as something very bad or bad at all. In Maastricht criteria one cannot find that balance of payments should be in equilibrium – whatever it may mean. Countries with huge current account deficit, financed, for instance, by sale of business enterprises and/or accumulation of foreign loans, might qualified for the euro area. There is the same approach to the current account deficit when financial and economic crisis escalated in Europe. The problem is supposed not to be balance of payments but budget deficit and public debt and countries should recover by fiscal restrictions.

Table 7: Budget deficit and public debt Budged deficit in % of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Croatia	-4.1	-5.5	-4.1	-3.8	-2.2	-2.5	-1.4	-4.1	-4.9	-5.5
Macedonia	-5.6	-1.1	0.0	0.3	-0.6	0.6	-1.0	-2.7	-2.5	-2.5
Montenegro		-1.9	-2.4	-2.7	1.1	6.2	-0.4	-5.7	-4.9	-4.0
Slovenia							-1.8	-6.0	-5.6	-5.8
Bosna & Herzeg.	-0.1	0.7	1.6	2.4	2.9	1.2	-2.2	-4.4	-2.5	-1.3
Serbia	-3.1	-1.1	0.9	1.9	1.6	-2.0	-2.6	-4.5	-4.6	-4.7

Source: European Commission, EU Candidate and Pre-accession Countries Economic Quarterly

Public debt in % of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Croatia	40.0	41.0	43.2	44.2	42.1	32.9	28.9	35.2	41.2	45.8
Macedonia	48.7	45.0	43.8	48.5	41.5	27.3	28.8	32.1	35.1	29.0
Montenegro	88.3	51.1	44.9	40.4	35.6	27.5	29.0	38.2	40.9	45.3
Slovenia					26.7	23.1	21.9	35.2	38.0	42.8
Bosna & Herzeg.		27.7	25.5	25.6	21.3	18.1	17.1	21.8	25.6	25.8
Serbia	80.6	70.9	56.7	52.9	34.9	29.4	25.6	31.3	37.0	

Source: European Commission, EU Candidate and Pre-accession Countries Economic Quarterly

Huge budget deficits and public debts are, of course, not sustainable in the longer run, but 'living beyond one's means' tells us that there is huge current account deficit and external debt. Transitional economies of former Yugoslavia have been running budget deficits and have been increasing their public debt.They have those familiar problems as well, and therefore they are, due to the current account deficits and external debts, much more serious.

At the beginning of the nineties, when the countries of former Yugoslavia established themselves, they had very small external public debt. Yugoslav internal debt was hidden in the balance sheet of the National Bank of Yugoslavia and when it was (provisionally) distributed among individual states and added to the external debt that was allocated to individual states, it was still small.

Although it is still, if we compare it to the countries of the EU or euro area, small, we must take into account that it is increasing and that there is a rather huge external debt. It does not mean very much if it is still below 60 per cent of GDP.

5. Conclusions

Different monetary arrangements, i. e. exchange rate regimes, chosen at the beginning of independence, and at the beginning of transition, by countries of former Yugoslavia have had generally not contributed at all or at least not enough to their economic development or performance. If we take that it has been crucial for central banks to be able to neutralise, i. e. sterilise, impact of sales of business enterprises to foreigners, that has been taken as the only genuine privatisation both at home and abroad, on exchange rate. Hard peg exchange rate regimes (Montenegro and Bosnia and Herzegovina) or almost fixed exchange-rate regimes (Croatia and Macedonia) have not been suitable for this, although they have enabled the countries to achieve monetary stability. But for the most of time appreciated domestic currency destroyed much of domestic industries and the countries have got used to live 'beyond their means'. Permanent current account deficit that cannot be explained by import of capital for new investments cannot last for ever. As an approximate estimate, whether monetary arrangement has been good or appropriate, ratio between foreign assets in portfolio of the central bank and base money may be used. The higher this ratio, the better mark should be given to the monetary arrangement. It has been above one, but it would have been much higher, had the central banksused sterilised interventions on the foreign exchange market extensively enough.

Countries with hard peg and (almost) fixed exchange rate regime are in similar position as the countries of the euro area. There are good sides, but also not that good. Concerning foreign trade, the countries have been most of the time uncompetitive with current account deficits and increasing foreign debts. They cannot make their goods more attractive to foreigners as concerns their prices. They may have their money, and that has been the case for all countries with the exception of Montenegro and Bosnia and Herzegovina, and depreciates their currencies, but for overwhelming concern for monetary stability they have not done it at all or very rarely. They may improve their price competitiveness only via internal depreciation. They are in the same position as the countries of euro area that have problems with the current account and foreign indebtedness. But when the wages are already rather very low, as has been the case for almost all countries of the region, but the prices of their goods, nevertheless, too high, it is not an easy task to make internal depreciation of domestic currency.

The monetary arrangements of individual countries were also reflected in the behaviour of commercial banks. The opening of the national financial sectors in the individual countries to the international markets was associated with the intensified credit activity in banks. Credit growth rates accelerated significantly in years prior to the beginning of the global financial crisis. So credit growth was as high as 40% in Macedonia, where credit increase was funded completely by domestic bank deposits, or with 165% in 2007 even higher in Montenegro, where domestic deposits did not suffice for credit expansion in banking sector. Consequently the share of domestic credit to private sector in GDP was raised significantly in all countries and loan to deposit ratios went over 100%, in some countries exceeding even 150%. The only exception was Macedonia. The elevated loan to deposit ratio can be taken as an indicator of the increased dependency on foreign funding. Financial markets have not, for two simple reasons, played any positive role. All those economies have been and will remain almost exclusively banking economies, since in such small communities genuine financial markets cannot develop at all. If needed they should rely on the services of financial markets abroad. All those economies are anyhow very open.

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