

LIBERALIZATION OF FINANCIAL SYSTEM IN CROATIA AND IN TURKEY

Ayse Yuce
University of Northern British Columbia
Faculty of Management
3333 University Way, Prince George, B.C.,
V2N 4Z9 Canada
Phone: 250—960-6462
Fax: 250-960-5544
E-Mail: yucea@unbc.ca

Ljiljana Viducic
Faculty of Economics Administration
University of Split
21 000 Split, Croatia
E-Mail: lviducic@efst.hr

ABSTRACT

This paper examines the liberalization processes in two Mediterranean countries: Turkey and Croatia. Both countries have experienced delayed institutionalisation of EU relations. Focus of the analysis will be Turkish and Croatian financial sector liberalization, and prospect of their integration into EU and world economy. Their performances in these respects are going to be evaluated by comparison with other Central and Eastern European Countries (CEEC) .

INTRODUCTION

Successful internationalization of a national economy requires microeconomic and macroeconomic reforms based on national government competence and commitment, and aimed at financial sector deepening and sophistication, business sector restructuring and privatization, and integration into the world economy.

It is widely accepted that countries with developed financial institutions and markets grow faster while those having poor structure of financial sector are more likely to experience financial crisis with adverse growth consequences. Moreover, unstable and vulnerable financial systems can severely jeopardize macroeconomic performances.

Starting in late 1970s several countries started programs to liberalize their economies. In the 1980s and early 1990s more than 2000 state owned enterprises have been privatized in developing countries, and 6800 enterprises worldwide (Kikeri et.al, 1992).

After the collapse of the Soviet Union, privatization process started in the newly independent states, and other socialist economies. In mixed economies privatization is a tool for increasing the efficiency of the state owned enterprises, where as in the former socialist economies it is essential to transform to a market system. In Central and Eastern Europe and in the former Soviet Union to achieve a speedy means of transferring ownership and thereby ensuring the reliance on market forces, mass privatization programs have emerged.

The object of our paper is the analysis of two Mediterranean countries: Turkey and Croatia, which have adopted outward orientation and gradual liberalization of their economies. Furthermore, both countries have experienced delayed institutionalisation of EU relations. Focus of the analysis will be Turkish and Croatian financial sector liberalization, and prospect of their integration into EU and world economy. Their performances in these respects are going to be evaluated by comparison with other Central and Eastern European Countries (CEEC), especially with most advanced ones, determined by inclusion in the first wavers enlargement group in Agenda 2000 (Czech Republic, Estonia, Hungary, Poland, and Slovenia).

The rest of the paper is organized as follows. The first part examines the liberalization process and its results in Turkey. While the second part investigates the privatization process and its effects in Croatia, the third part discusses the status of Turkish and

Croatian candidacy in European Union. The fourth part compares the Turkish and Croatian financial markets.

I. I. LIBERALIZATION AND OUTWARD ORIENTED MARKET DEVELOPMENT IN TURKEY

On January 24 1980, the newly elected Turkish administration announced an economic package to liberalize the economy and the financial markets that also started the impetus for privatization of the state owned enterprises. The primary objectives of this decree can be summarized as follows: 1. The administration will take measures to promote export trading, 2. The administration will take measures to privatize the state owned enterprises, its subsidiaries and investments, 3. The exchange rate system will be floating rather than the fixed rate system that was used in the past, and 4. The administration will reduce its intervention in the markets, and interest rates will be determined by market forces.

Following, Istanbul Stock Exchange started its operations on January 1, 1986 with fifty listed companies. The administration decided to privatize the state owned enterprises and passed the privatization law . First state owned enterprises were established in 1938 in Turkey as state holding companies. The main duties of such enterprises were to produce basic consumer goods, or basic material. Most of the state economic enterprises operated in monopolistic or oligopolistic markets. At the same time they were highly protected under the import substitution strategy prevailing at the time. They became the support establishments for the governments through the decades via employment expansion for political reasons. As a result of these opposing developments, the efficiency and performance of state owned enterprises deteriorated over the years. Consequently, they started to draw from the government central budget and finally became a burden. The productivity and efficiency of these companies decreased more, and due to their effect on the economy their price increases accelerated the inflation in the 1970s and into the 1980s.

From 1985 till 1998 , 112 companies have been privatized. Besides these completely privatized companies, some partial sales of shares have taken place. As of the end of 1998, there are thirty-five companies traded on the Istanbul Stock Exchange that are partially or completely privatized by the Privatization Administration. As of today some companies are still in the

privatization portfolio. These companies are the most important companies for the Turkish economy.

Turkish administrations have only achieved partial progress in the privatization of the State Owned Economic Enterprises. On the other hand in 1980s Turkish economy has revealed faster economic growth, increased international competitiveness and volume of foreign trade due to implementation of liberal policies and outward-oriented market economy. The exports grew at 22% annual rate between 1980-1985 and this rate has quadrupled in 1990s. At the same time percentage of exports in GNP has doubled during the period of 1980-1990.

Previously negative real interest rates were abandoned through deregulation of interest rates. Capital flows were liberalized. Entry of foreign banks boosted competition, product quality and product diversification in Turkey. Furthermore, financial infrastructure was completed by establishment of the fundamental financial markets: Istanbul stock exchange (ISE), Turkish lira and forex interbank money markets, and Istanbul gold exchange. Moreover, new financial institutions such as leasing and factoring companies, mutual funds and life insurance companies enriched Turkish financial sector.

Beginning in the mid 1970s, both developed and developing countries removed foreign investment barriers in order to encourage foreign investors to invest in their country. The Istanbul Stock Exchange removed all the barriers to foreign investment with Decree No 32 (August 11, 1989), giving (1) foreign investors the right to invest in Turkish stocks and mutual funds without getting the permission of the government and (2) domestic investors the right to invest in foreign markets. Removing restrictions on foreign investors has increased the volatility of the stocks. It is concluded that the opening of the market to international investors caused a structural change in price distributions (Yuce 1997) .

During the 1989 European Union meeting in Helsinki, Finland, the European Union decided to accept Turkey as a candidate for full time member and asked Turkey to start procedures. After that the Turkish administration started a new package to reduce inflation in Turkey.

II. LIBERALIZATION IN CROATIA

Liberalization process in Croatia, which begun in late 80s, have intensified at beginning of 90s when Republic of Croatia become independent and when country stepped into transition process. Market type of economy has become a final aim accompanied by reintegration into world economy. Real and financial sector of the economy has undergone crucial changes encompassing privatization, and efforts on imposing hard budget constraints on both enterprises and banks.

Privatization process in Croatia by the 1999 has resulted in 1364 completely privatized firms, with 904 ending up with minority state ownership and 596 with majority state ownership. New government that comes into force this year intends to privatize 1 800 firms from its portfolio by 2000.

Liberalization of banking industry in Croatia includes enacting of the new Law on Banks and Saving Banks in 1993, which was followed by government actions to clean banks bad debt portfolio and subsequent rehabilitation of four large banks in 1996 and 1997. These led to establishment of private and foreign banks and initiated the process of restructuring and privatization in the local banking industry. Market share of small and medium sized banks, which comprise most of the newly established banks, has risen in the 1995-97 period. Proportion of bad loans decreased in 1994-97 period. This can partly be contributed to rehabilitation of large banks and debt equity swaps which in the same cases involved substitution of bad debt for bad equity.

Unfortunately privatization in Croatia has not led to increased share listing and market capitalization of Croatian securities markets. Croatian security markets include Zagreb Stock Exchange (ZSE), the principal official security market, and VTV-over-the-counter market. First quotation of main securities market-Zagreb stock exchange includes 5 shares.

The main features of Croatian security markets include insufficient transparency of transactions and financial reports of company listed, high reliance on foreign investors, undeveloped institutional environment, and high macroeconomic risk. As far as ZSE prospect is concerned, one can expect that market will benefit from transformation of privatization investment funds into traditional investment funds, accomplishment of pension reform and completion of privatization (including utilities, banks and tourism industry).

However, Croatia, like other small and open economies in the region, should be aware of fact that its economy will hardly be able to sustain autonomous local security market. Better solution may be to be open for regional association of security markets, which is more in line with the global trend in security trading, too. Furthermore, it may be expected that EU eastern enlargement will probably lead to convergence of both interest rates and stock markets valuation resulting in higher market capitalization and hopefully more substantial equity raising by local companies coping to create and sustain competitive advantages in global markets.

Positive effects of liberalization may be observed in the field of foreign capital entry and business entities, establishment of foreign banks in Croatia. However in the field of banking and security trading reciprocity is required. Foreign residents are not allowed to invest in central bank short term instruments on the primary market. Furthermore, capital restrictions for resident transactions are imposed (depositing money abroad, investing in foreign securities etc.)

Currently, Croatian economy is not fully liberalized, which stands for both current and capital account transactions, and for products at both real and financial markets. Restrictions in financial sphere include restrictions at insurance market such as restrictions of establishment of foreign insurance companies' branches. Furthermore, in securities markets trading sphere, which is the sphere most fastly liberalized in the world due to globalization of securities markets, foreigners are forbidden to invest in short term securities of Croatian National Bank. Finally, residents are forbidden to invest in foreign securities and to open accounts abroad. Therefore, Croatia has to proceede with two step progressive liberalization (Radošević, 1998.). First step will include measures needed for WTO membership, which is expected to be gained in next years, while second phase will be realised in medium term resulting with full reintegration in global financial markets.

When measured by overall transition progress Croatia is very close to first accession group countries performances (for example Slovenia and Estonia), and among leading ones when compared with transition and economic progress of "second wavers": Republic of Slovakia, Bulgaria, Romania, Latvia, and Lithuania (see table 1).

Table 1.
Transition progress of CEE countries in 1998

(in %)

Country/ Criteria	Overall progress	Market and trade liberaliz.	Privat. and restructur.	Financial institutions	Legal reform	Private sector(% of GDP)
Hungary	86	885	89	83	89	80
Poland	82	85	81	78	89	65
Czech Rep.	80	78	85	67	89	75
Estonia	77	70	85	72	78	70
Slovenia	71	70	78	67	67	55
Lithuania	70	70	70	61	78	70
Slovakia	70	78	81	56	56	75
Croatia	69	67	74	56	78	55
Bulgaria	68	67	63	56	89	50
Latvia	66	70	70	56	61	60
Romania	66	67	59	50	89	60

Source: EBRD Transition Report, 1998, The Banker, April 1999.

When restoration of pre-transition GDP level, inflation rate and current account balance is taken into account Croatia has better performances than Estonia (see Table 1). Croatia also fared better than Slovenia when budget balance and legal reform are considered, and it is just behind Slovenia when measured by overall transition progress. It may be stated that privatization method, management knowledge, workers skills, presence of local companies on foreign product and financial markets in Croatia are very close to those of Slovenia.

III . CANDIDATE STATUS OF TURKEY AND CROATIA IN EUROPEAN UNION

European eastern enlargement principle was adopted at Copenhagen European Council in June 1993. Enlargement process was launched at the Luxembourg European Council in December 1997. One month later the commission has prepared opinion on criteria fulfilment by candidate countries (so called- Agenda 2000) and key areas of adjustments for the first CEEC wavers: Czech Republic, Hungary, Poland, Slovenia, and Estonia, enlarged by one Mediterranean country - Cyprus. Furthermore, Agenda has established a timetable for full membership: for the first five countries (Czech, Estonia, Hungary, Poland and Slovenia by

year 2001, and followed by CEEC: Bulgaria, Latvia, Lithuania, Slovakia and Romania, and five years latter.

Although Croatia has neither signed an European Agreement nor joined CEFTA, it has “inherited” benefits of preferential trade agreement. In other words, EU has granted Croatia Autonomous Trade Preferential Regime (APTR) which is subject to annual review.

Turkey’s relationship with EU is several decades long. Association Agreement between EU and Turkey came into force on November 1, 1964, while Customs Union Agreement came into force on 31 December 1995. Turkey’s application for EU membership in 1987 was not approved. In July 1997 European Commission have issued a communication to the council proposing increased Turkish participation in certain areas and programs as well as further liberalization of trade in agricultural products and services. Furthermore, the commission has supported the conclusion of trade agreements between Turkey and CEECs and other Mediterranean countries (Temprano-Arroyo, 1998).

In February 2000 EU have started negotiations with six “second wavers”: five CEECs and one Mediterranean (Malta), meaning that both of these countries remain in anteroom for EU enlargement. In the case of Turkey, EU has recognised it at Helsinki December 1999 ministerial meeting as a candidate. On the other hand, while Croatia is not yet recognised as a candidate, after recent election that replaced autocratic with democratic rule, hopefully she will start negotiations with EU soon.

IV . COMPARISON OF TURKISH AND CROATIAN FINANCIAL MARKETS

Croatia and Turkey are facing certain constraints, which are to be dealt by complex programs and set of consistent economic policy measures. Both economies are encountering task of accomplishment of privatization programs aimed at increased efficiency of state owned enterprises and sounder public finances. Furthermore, sound monetary and public finance, securing favorable macroeconomic environment with restored confidence in national stock exchanges makes fertile ground for more intensive foreign capital inflow in developing countries.

In the sphere of finance, Croatian government has to promote and regulate the process of recapitalization and privatization of banks, diversification of financial institutions and to demonstrate serious results in normalizing public budget relative size and structure - in the favor of private sector and infrastructure expenditures (Viducic, 1998). In the case of Turkey, stabilization results need to be revealed as well as better results should be obtained in the public sector efficiency.

In Croatia, although the process of rehabilitation of banking sector is in its final phase, recapitalization of banks is yet to be dealt with. Operations of banks are mainly based in the field of traditional functions such as collection of (mainly foreign exchange) deposits and short term lending which resemble Turkish experience prior to financial and overall economic liberalization. Brokerage activities, fund management, international and internet banking, leasing and factoring arrangements offered by leading Turkish banks unfortunately represent a thin share of Croatian banks income. Croatian banking sector is coping with confidence building. Furthermore, it is faced with existence of at one hand two big banks which account for 59% of the market and at the other hand several dozens of small under-capitalized banks totaling around 60 commercial banks, and local saving banks.

As far as Croatian financial sector is concerned, foreign banks have begun to operate in the country, although, as opposed to Turkish one, Croatian banks have not started to open their branches abroad.

Croatia has attained investment grade rating in January 1997, which was followed by the successful Croatian government and corporate sector access to international capital markets. Croatian financial markets (Zagreb Stock Exchange, Varazdin-Osijek O-T-C market, interbank money and foreign exchange markets) have been under great dominantly psychological constraints due to frozen old foreign exchange deposits, war and high political risk in the broader region. Zagreb Stock Exchange (ZSE) has revealed good results in 1996, but recently it started to decline due to withdrawal of foreign institutional investor and weak financial strength of local retail and institutional investor (later one being rare and underdeveloped).

Certain problems are stemming from incomplete legal and regulatory infrastructure of the main security market including delayed establishment of central depository agency

and unsatisfactory transaction transparency resulting in anemic trade and few (around 15) company shares actively traded. Istanbul stock exchange, on the contrary, is one of the major emerging markets in the world. More than 240 company shares are traded on the exchange while the market capitalization is around \$40 billion.

In both countries, in the view of EU enlargement preparation, market oriented economic policy measures in financial sector are expected to result in much higher standards of transparency of operation and financial strength of financial institutions. Central banks have to provide prudent regulation and supervision. Moreover, banks will have to increase efficiency in mobilizing and allocating domestic savings resulting in stronger deposit base, and easier/ cheaper access of small and medium sized enterprises to banks credit.

CONCLUSION

Liberalization and market oriented economic development have brought diversification and sophistication in Turkish and to a lesser extent in Croatian financial sector. There is still a great necessity to undertake a set of interrelated and complex programs aimed at business restructuring and privatization aimed at increased competition, increase of portfolio and foreign direct investment, restoring external balance and, in case of Turkey, curbing the inflation rate.

As regards Croatia, when measured by overall transition progress it is very close to first accession group countries performances (for example Slovenia and Estonia), and among leading ones when compared with transition and economic progress of “second wavers”: Republic of Slovakia, Bulgaria, Romania, Latvia, and Lithuania. It is worth stressing that such results in Croatia were achieved in the worst political circumstances (war in the country, and in Bosnia and Herzegovina as well as Kosovo conflict which wound down last year tourism receipts and hurt some important infrastructure objects). In the same time it was the only country isolated from regional integrations.

In the sphere of finance, Croatian government has to promote and regulate the process of recapitalization and privatization of banks, diversification of financial institutions and to demonstrate serious results in normalizing public budget relative size and structure (in the favor of private sector and infrastructure expenditures). In the case of Turkey,

stabilization results need to be revealed as well as better results should be obtained in the public sector efficiency and improvements in public finances.

As far as future development is regarded, as appropriate course of action graduate liberalization is recommended (Radošević, 1998). Restrictions for foreigners to establish, operate and expand trading activities should be removed, followed, in the second phase of liberalization, by enabling residents to purchase financial services abroad and, latter on, by allowing nonresident traders to sell its financial services in Croatia. These measures would enable Croatia to join WTO and consequently CEFTA, and hopefully to accomplish liberalization and sign association agreement with EU.

Furthermore, privatization of banks, restructuring and accomplishing of final -mass privatization phase are expected to boost establishing and operating of domestic institutional investors. In such way, not only supply of qualitative and various securities will be secured at the official stock exchange (Zagreb Stock Exchange-ZSE), but also strong and competitive demand form local institutional investors will emerge providing satisfactory market capitalization, liquidity and transparency on the ZSE.

One of the key tasks of respective governments is to secure prospective economic environment and to bring confidence to the financial markets. On the base of improved financial strength and competitiveness more intensive presence on the international market accompanied by the more intensive product and capital flows may be expected between Croatia and Turkey as well as between Mediterranean basin and European countries.

REFERENCES

- Aktan, Oktan, (1996), " Liberalization, Export incentives and exchange rate policy: Turkey's experience in the 1980s", *The Economy of Turkey since Liberalization*, MacMillan Press Ltd, 177-198
- Estrin, S., 1994, *Privatization in Central and Eastern Europe*, Longman Group U.K.Ltd., London
- Jones,C., (1999), All Change, *The Banker*, April 1999.
- Jones, C., (1999), Croatia on a tight rein, *The Banker*, April, 1999
- Kikeri, S., J. Nellis, and M. Shirley,1992, *The Lessons of Experience*, World Bank, Washington D.C.
- Lieberman,I. W., A. Ewing, M. Mejstrik, J. Mukherjee, and P. Fidler, 1995, *Mass Privatization in Central and Eastern Europe and the former Soviet Union: A Comparative Analysis*, The World Bank, Washington D.C.
- Onis,Z., 1991, The Evolution of Privatization in Turkey: The Institutional Context of Public-Enterprise Reform, *International Journal of Middle East Studies*, 23,163-176
- Perotti,E. and S.E.Guney,1993,The Structure of Privatization Plans, *Financial Management*, 22 (1), 84-98
- Perotti,E., 1995, Credible Privatization, *The American Economic Review*, 85(4), 847-859
- Radosevic, Dubravko, (1998), Liberalizacija hrvatskog finanicijskog trzista u postupku pristupanja u svjetsku trgovinsku organizaciju, *Racunovostvo i financije*, 4, 70-76
- Temprano-Arroyo, Fieldman, R.,(1998) Selected Transition and Mediterranean Countreis: An Institucional Primer on EMU and EU Relations, IMF Working Paper, June, No 82.
- Veselica, Vladimir, Vojnic, Dragomir, (1997),Quo vadis Croatia-kuda ide Hrvatska-komparativni pristup, *Ekonomski preglad* 12, 871-897
- Viducic, Ljiljana, (1997), Financial Environmnet of the Transition Economies Enterprises With Regard to Small and Medium Enterprises, *Ekonomski preglad* 11, 835-848
- Yuce, Ayse, (1997) , "Statistical Properties of the Turkish Stock Prices" , *Research in Middle East Economics* 2, 79-100

