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INTERNATIONAL CAPITAL FLOWS AND FINANCIAL MARKETS IN TRANSITION ECONOMIES: THE CASE OF CROATIA

Abstract: Following the economic and political reforms international private capital started flowing into the emerging market economies of Central and Eastern Europe reducing the official capital flows to the region. The composition of private capital flows showed continuous dominance of direct equity investment but, with the perceptions of risk changing, portfolio capital also made its way into the transition economies. Both types of flows caused significant changes in the domestic financial markets. In this paper, after reviewing the composition and direction of international private capital flows, we focus on the effects that the international private capital flows had on the Croatian banking industry as well as how they helped shape its stock market. We conclude with some insights and dilemmas regarding the desirable degree of openness of the capital accounts with regard to the trade-off between growth and stability in the long run.

1. Introduction

The opening up of capital accounts to international capital flows became an essential aspect of economic reforms following macroeconomic stabilization in the countries of Central and Eastern Europe. In the period preceding the reforms, during the 1980s, Western official lending in the form of commercial bank loans and trade finance to state-owned foreign trade banks was the predominant form of net capital flows to the region. Private capital was initially hesitant and it started flowing in only after the programs of liberalization, privatization, and institutional change started happening on the ground.

From the point of view of the reforming economies, private capital flows provided for an increasingly important source of their external finance throughout the 1990s and well into the 2000s. Especially important in this process was direct equity investment, which helped the recipient countries cross the investment-savings gap and overcome the transitional recessions

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that caused GDP growth rates to be negative for a couple of years following the onset of reforms. During the past decade, all transition economies displayed relatively high rates of direct equity investment inflows happening simultaneously with the relatively high rates of growth of their GDP. An important aspect of this process has been the development of the domestic financial system, which forms a crucial link between capital inflows and economic growth.

The financial sector of the transition economies in Central and Eastern Europe underwent significant transformations as a consequence of international private capital inflows. Together with the processes of "Europeanization" and the accession driven reforms, foreign direct equity and portfolio investment speeded up and played an influential role in transforming domestic banking and in creating stock markets in all transition economies. Both also led to changes in the corporate governance structures and to the exposure of domestic firms to the scrutiny of international capital markets.

In this paper, after reviewing the composition and direction of international private capital flows, we will focus on the effects that international private capital flows had on the Croatian banking industry as well as how they helped shape its stock market. We will conclude with some insights and dilemmas regarding the desirable degree of openness of the capital accounts with regard to the trade-off between growth and stability in the long run.

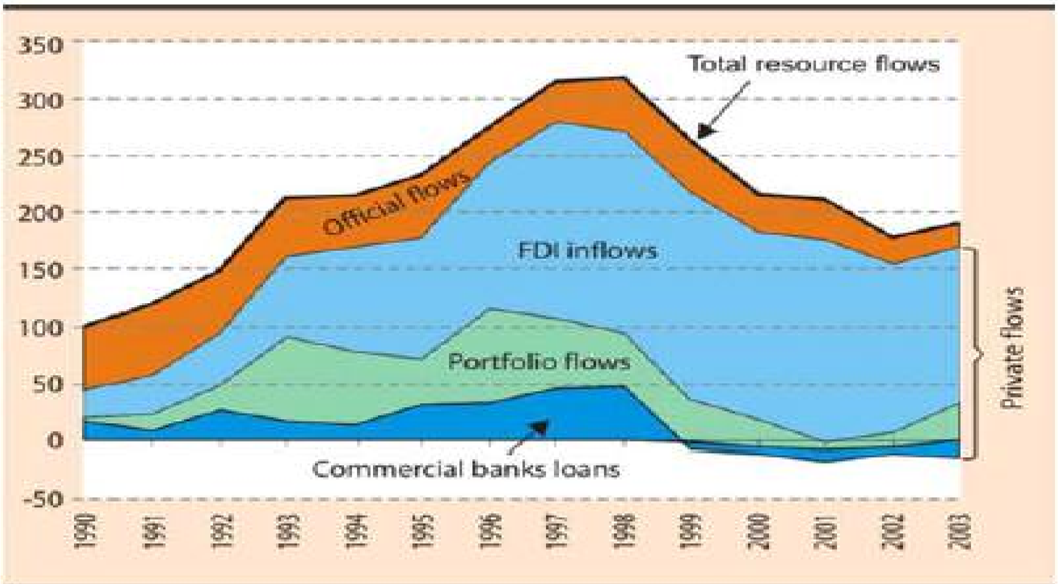
2. The Composition of International Capital Flows

International equity capital flows consisting of direct and portfolio investment are balance of payments categories and they are recorded in the financial account of a country. Direct investment covers all transactions between direct investors and direct investment enterprises, so it includes direct equity investment and reinvested profits. Portfolio investment implies transactions in equity securities and debt securities, which are further classified into bonds and notes and money market instruments. Both international trade in financial assets in the various forms of cross-border portfolio holdings and the internationalization of production via foreign direct investment suggest an ever increasing international economic interdependence worldwide.

In the pretransition period, Western official lending to Central and Eastern European countries mainly took the form of commercial bank loans and trade finance to state-owned foreign trade banks and it was the predominant form of net capital flows to the region. Neither equity nor bond finance were in accordance with the socialist ideology and market practice. Net medium to long-term capital flows to the region averaged US$1.2 billion per year in 1976-80, $1.8 billion in 1981-85, and $5 billion in 1986-90.[1]

During the 1990s international capital flows to developing countries, with transition economies included, marked the tendency to replace official capital flows with a greater share of private capital flows. In the period 1990-2003 private capital flows were continuously the largest component of all capital flows, six times higher than official flows. This contrasts with the latter half of the 1980s and the early 1990s, when official flows and foreign direct investment flows were almost the same. The period 1990-2003 is shown in Figure 1.

Figure 1: Total Resource Flows to Developing Countries (by type of flow) in 1990-2003 (in Bil US$)



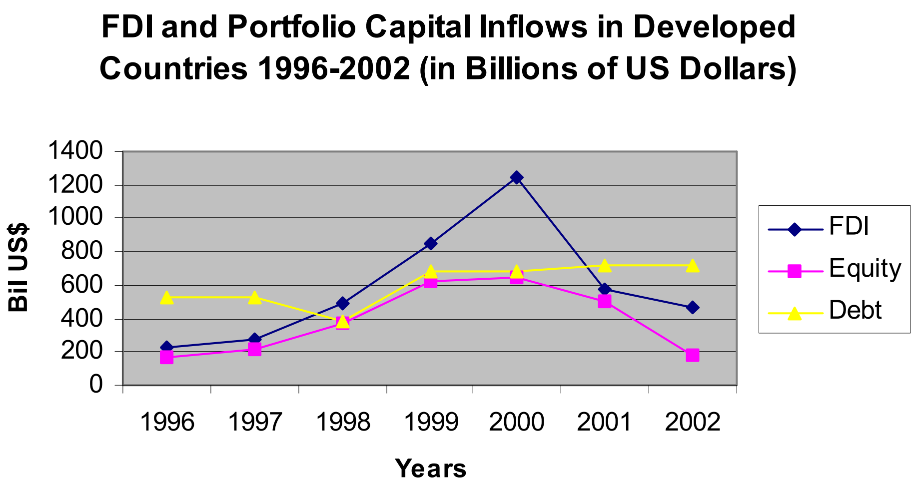
Source: UNCTAD, World Investment Report 2004

[1] Lankes and Stern (1997), pp.59

The approach to capital flows changed dramatically in the period after the fall of the Berlin Wall in 1989. The comprehensive package of economic reforms comprising overall liberalization of markets and prices, privatization and institutional change in those economies changed perceptions and created palpable incentives for private capital to make its way into the region. In addition to the shift in paradigm in economic policies, which now became much friendlier to foreign investors, there was an abundance of physical and human capital which had been used inefficiently and, in the case of physical capital, which was largely obsolete. All this looked promising in the eyes of foreign investors in the sense that marginal productivity and profitability of capital invested in the region would be higher than average.

As regards the composition of private capital flows, it differs between developed and developing countries. Among the industrialized countries, portfolio equity investment and investment in debt securities generally represent the largest channels of capital inflows. For them portfolio investment consisting of equity and debt flows exceeds direct investment. Such tendencies are perfectly natural since high costs of production in developed countries generally make FDI expensive. On the other hand, the level of development and transparency of their financial markets make portfolio investment efficient. Although the share of equity in portfolio investment is rising, the bulk of foreign portfolio investment in developed countries takes place through debt securities. The latter part reflects the high level of development of financial markets in the industrialized countries. Figure 2 llustrates these relationships.

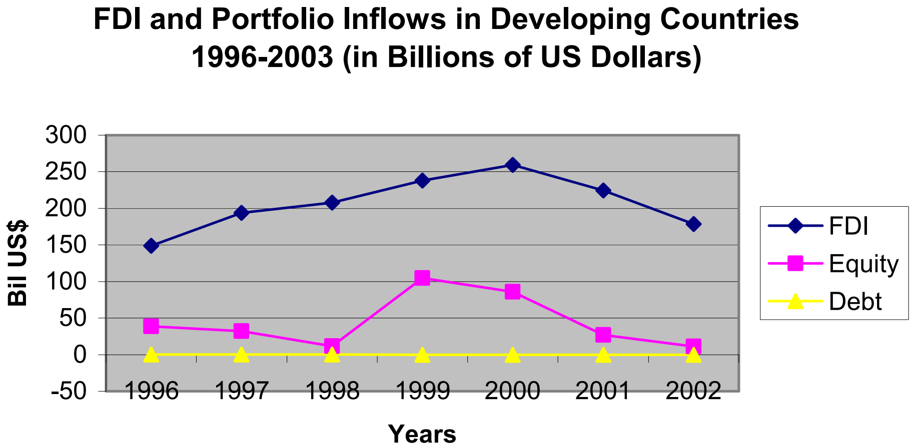
Figure 2.



Source: IMF Balance of Payments Statistics Yearbook, 2003

Developing countries reveal a pattern where it is direct investment that dominates private capital flows and portfolio investment, especially in its debt financing component, is far less significant. This is shown on Figure 3.

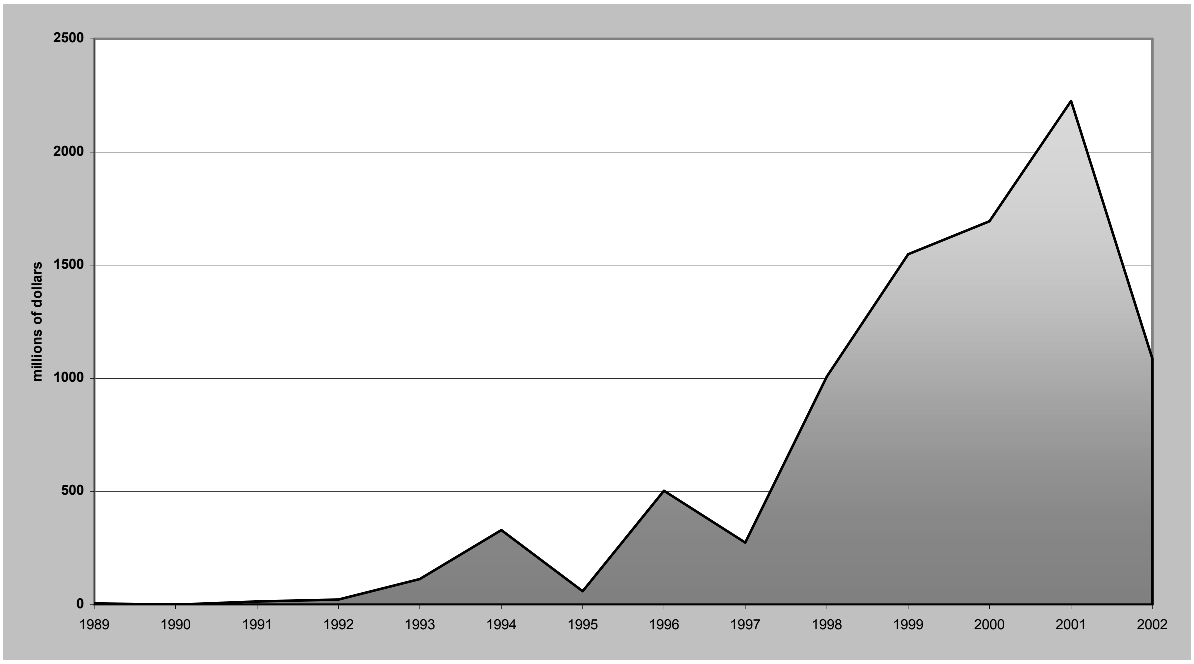
Figure 3.



Source: IMF Balance of Payments Statistics Yearbook, 2003

Like other developing countries, the European transition economies exhibit the tendency to attract relatively more equity capital, in particular direct investment. Foreign direct investment normally includes greenfield investment as well as cross-border mergers and acquisitions (M&As). In fact, as a result of a large-scale wave of liberalization and de-regulation processes around the world in the past two decades, as well as the political and economic reforms in Central and Eastern Europe in the 1990s, cross-border M&A was the main mode of FDI entry. In fact, in the transforming economies privatization through FDI has been an integral part of the transition to a market economy. Cross-border M&A purchases in the transition economies are shown in Figure 4

Figure 4. Cross-border M&A Purchases in Central Eastern Europe
(in Mil US$)

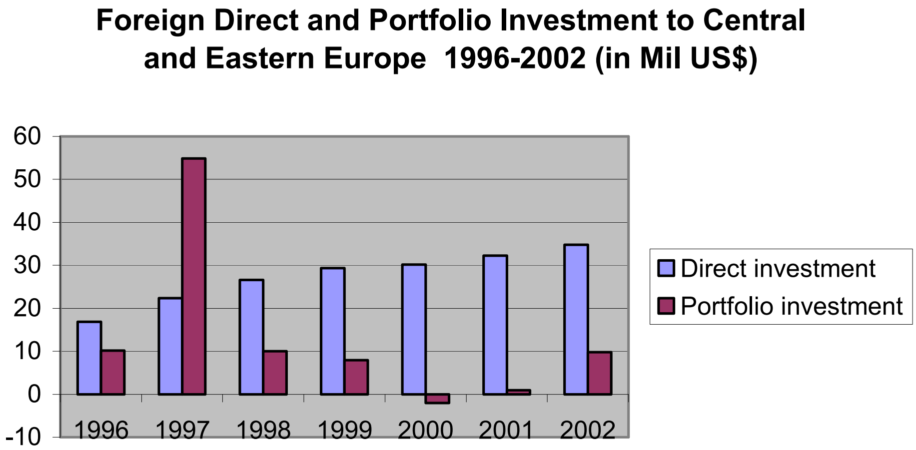


Source: World Investment Report, 2003.

Foreign acquisitions of domestic, mainly state owned firms in transition economies, as well as opening utilities to FDI privatization, brought foreign capital largely into the service sectors, such as trade and financial related activities, or telecommunications and power generation and distribution. However, due to the decline of the value of stocks traded on the world stock markets, cross-border M&As worldwide fell by 38 percent in 2002. Reflecting the winding down of privatization in some transition economies, the region also recorded a significant drop in M&As. They declined to one half of the 2001 value. With greenfield investment on the decline as well, what kept total FDI increasing in the transition economies was mostly the reinvested profits.

The first flows of foreign capital into transition economies consisted of foreign direct investment. However, the transition process changed radically the volume and composition of external capital flows into the region. As the perception of risk on the side of foreign portfolio investors changed, so did the inflows of portfolio capital. The composition of international private capital flows to transition economies in 1996-2002 is shown in Figure 5.

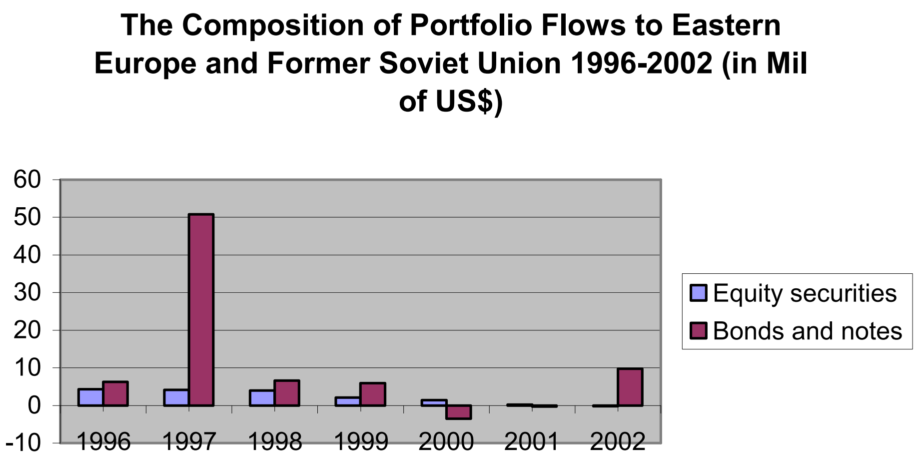
Figure 5.



Source: IMF Balance of Payments Statistics Yearbook, 2003

The domination of direct investment relative to portfolio inflows in the transition economies of Central and Eastern Europe reflected the still low level of financial sector development. What stands out is the steadiness of inflow of FDI *vs.* the unpredictability and volatility of portfolio investment.

Figure 6.



Source: IMF Balance of Payments Statistics Yearbook, 2003

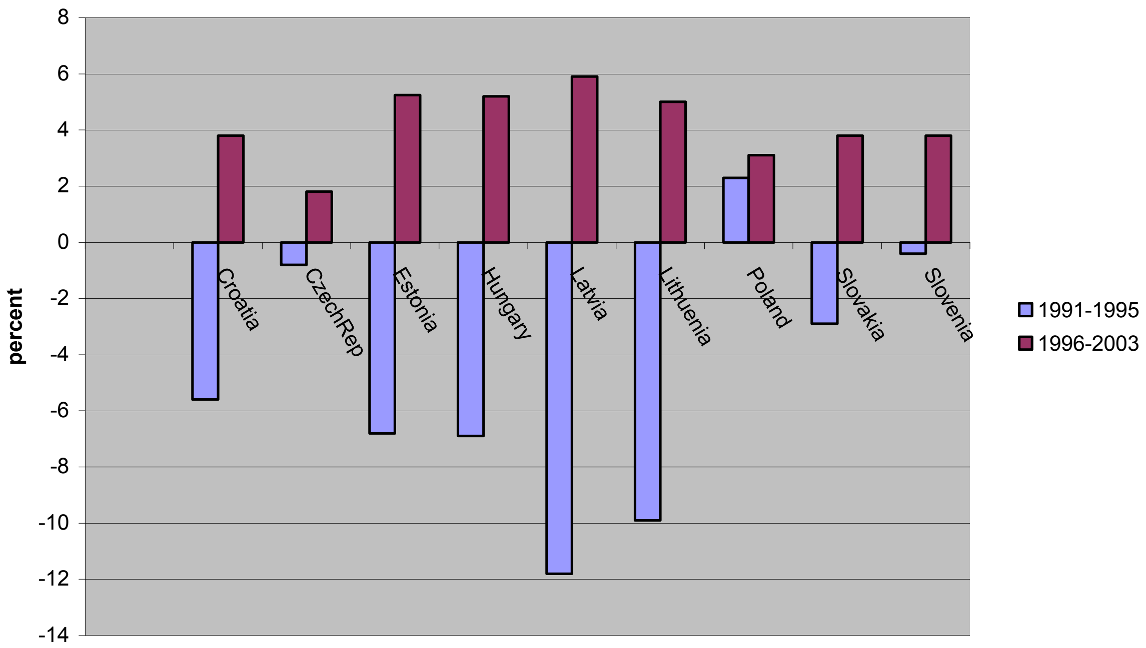
When the composition of portfolio flows to Central and Eastern Europe is examined, it shows a relatively steady representation of equity securities, and their gradual diminution in

2001 and 2002, while bonds and notes provide for most of portfolio investment volatility. The high surge in 1997 represents huge investments into Russian securities.

To evaluate the impact of financial liberalization on the financial sector and on the economy as a whole, an important piece of information is to observe the behavior of GDP. All transition economies experienced some form of recession shortly after the reforms started getting implemented. By 1995 they all returned to positive territory in terms of their growth of GDP. Consequently, the rising private capital flows during the past decade and a half are happening simultaneously with high rates of growth in the region. Figure 7 illustrates individual average growth rates over two five-year periods in the European transition economies.

Figure 7.

Average Real GDP Growth Rates in European Transition Economies 1991-1995 and 1997-2003

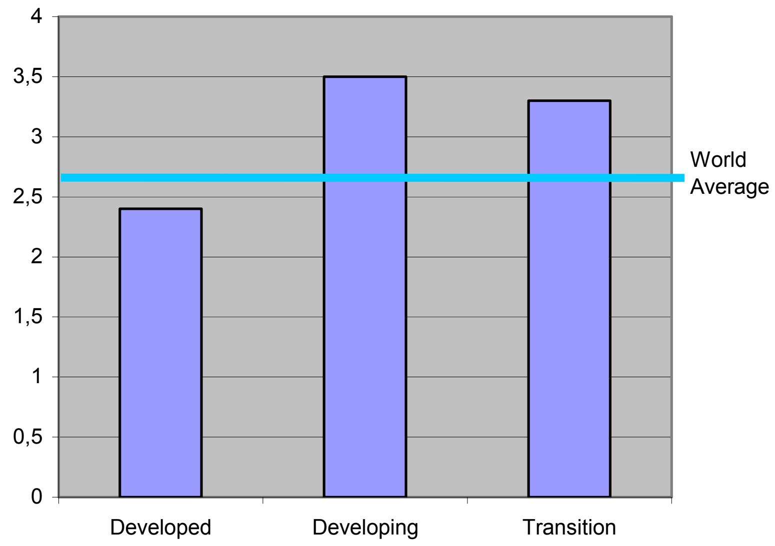


Sources: UNCTAD Handbook of Statistics, 2004.

The average growth rates recorded in transition economies in relation to the world average are shown in Figure 8.

Figure 8.

Average World Output Growth Rates 1997-2002



Source: UNCTAD Trade and Development Report, 2003.

As Figure 8 shows, average growth rates in transition economies exceeded the average world output growth rate by almost 1 percent. Developing and strengthening the weak and immature domestic financial systems was a necessary prerequisite for such growth as foreign capital needs financial institutions to move in a certain space and to allocate capital efficiently.

3. The Banking Sector in European Transition Economies

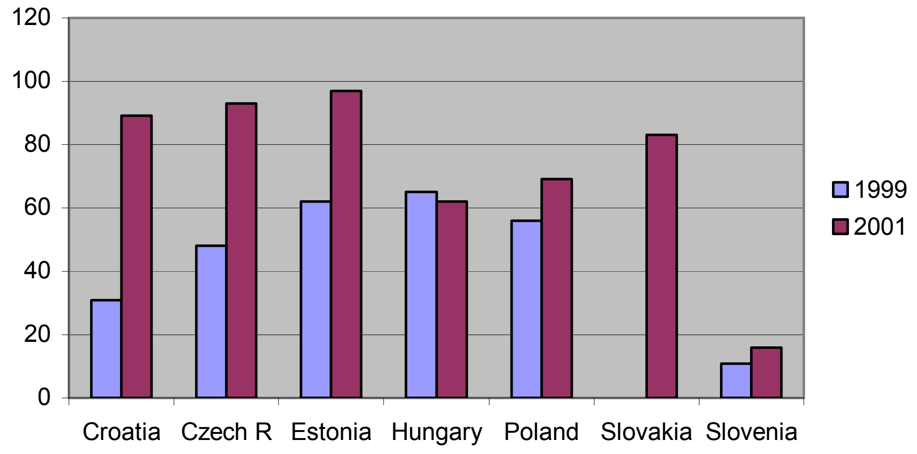
The extent to which capital flows can affect growth is largely determined by the level of development of the domestic financial system. The existing level of development of the financial system is reflected in its ability to exercise functions such as mobilizing savings, helping to allocate capital, and facilitating risk management. Domestic financial development is one of the most important links between capital inflows and economic growth. By allocating investment funds to those projects where the marginal productivity of capital is the highest, efficient financial intermediation improves the allocation of capital and it increases the overall or total factor productivity. Such developments are usually translated into higher economic growth.

The financial systems in the European transition economies have traditionally been "bank-centric". In other words, stock markets did not exist prior to reforms. Consequently, the first reforms of the financial systems in transition economies started happening in their banking system. First the introduction of a two-tier banking system lifted sectoral restrictions on special banks, permitting private ownership of banks, and allowing foreign banks to enter the market. Then came the liberalization of the licensing policy, and the implementation of a legal framework and a supervisory system.

These early banking sector reforms often resulted in a liberal licensing policy coupled with weak supervision and shortcomings in the legal framework. Adequate bankruptcy laws either did not exist or simply were not enforced. A large number of newly founded banks often engaged in unsound practices, while the state-owned commercial banks, which emanated from the specialized financial institutions under the old monobank system, suffered from an inherited burden of bad loans and an insufficient initial capital base. The banking systems generally lacked capital and banking skills, and political intervention, coupled with the uncertain economic and institutional environment in the state-owned banks, lead to a quick accumulation of bad loans and a number of banking crises. During the ensuing large-scale bank recapitalization programs, substantial public funds had to be put up to prepare the state-owned banks for privatization.

The process of foreign bank entry in all transition economies intensified in the late 1990s and continued in the 2000s. This is partly due to the "Europeanization" process, which aims to unify the European banking markets. Figure 9 illustrates how intense the foreign bank penetration into the transition economies' banking sector has been.

Figure 9: Foreign Bank Share of Total Bank Assets in Transition Countries (in percent)



Source: Kraft, 2002.

With the exception of Slovenia, foreign bank shares of total assets in local banks in transition economies are exceptionally high. Studies on the effects of such structure, however, have shown that it resulted in increased competition, bank efficiency, and the quality of banking products and services. The consequence of large foreign bank entry has been significantly better asset quality as well as an increase in overall lending under more favourable conditions than domestic banks.[2] The more general effects on the economies are transmitted through lowering the transaction costs of doing business. Such developments exert a positive impact on economic activity and the possibility of growth.

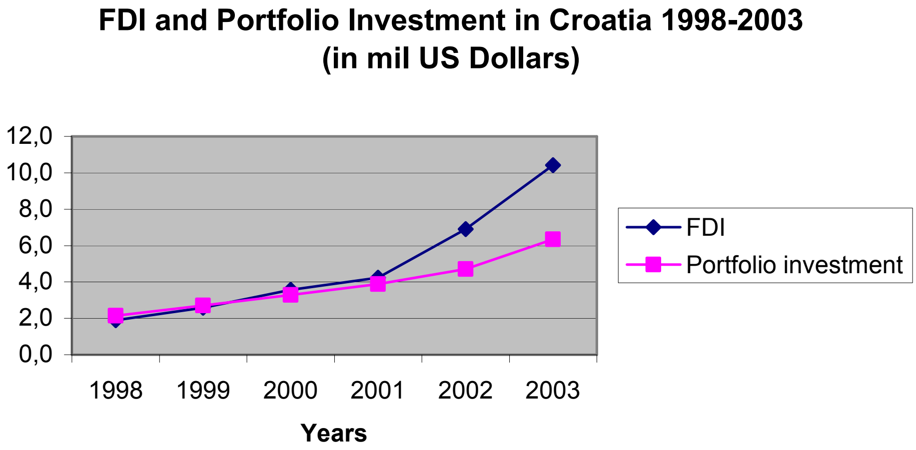
However, the most dynamic field of banking in CEE over the last few years has been consumer loans. That led to concerns about macroeconomic stability in a number of countries in the region, triggering restrictive measures by some of the central banks. With loans often being used to buy imported consumer goods, the deficit of the trade and current account balance have markedly increased. High current account deficits are especially troublesome if they cannot be financed by non-debt creating inflows (i.e. foreign direct investment), and can seriously threaten a currency stability. The central banks of Croatia, Bulgaria and Romania all have introduced a number of different measures to restrict credit growth. If anything, the economies need more corporate lending, particularly to small and medium sized enterprises, in order to raise productivity and improve quality.

[2] Kraft, 2002.

4. Global Capital Flows and the Croatian Financial Sector

International capital started flowing into Croatia in considerable amounts only after the war hostilities ended in 1995. As in other transition economies, foreign direct investment took a clear lead and it dominated portfolio investment in both equity and debt securities in the years to come. Figure 10 shows the composition of FDI and portfolio investment in Croatia during 1996-2003.

Figure 10.



Source: IMF Balance of Payments Statistics Yearbook, 2003

Like its counterparts in the transition world, the Croatian financial system prior to reforms was also immature and underdeveloped. The degree of overall financial development as measured by the ratio of private credit to GDP of 40 percent remains relatively low by European standards. Although it has faced substantial changes since then, it is still dominated by banks. The inflows of foreign direct investment had the most direct impact on changing the scene in the Croatian banking industry.

4.1. Foreign Direct Investment and Banking in Croatia

Since 1995, when Croatia implemented its first privatization program and opened its market to foreign investors, the Croatian banking sector has attracted more than two 2 billion USD in FDI. The main mode of entry was cross-border mergers and acquisitions and the main motivation for FDI was higher interest rate spreads and lower competition than in home markets. In 2005, 92 percent of the banking sector is in foreign ownership. The chronology of acquisitions of Croatian banks is presented in Table 1.

Table 1.

Acquisitions of Croatian Banks

Year	Bank	Buyer	Share %	PBV ratio	EUR mil.	Market share %
2004	Nova banka	OTP	96	2,7	236	2,53
2002	Riječka banka	Erste bank	85	1,82	55	6,6
2002	Dubrovačka banka	Charlem. Cap.	100	1,4	24	1,86
2002	Splitska banka	BACA	88	1,8	132	6,41
2002	Zagrebačka banka	UniCredito	82	1,7	626	26,45
2000	Varaždindnska banka	Zagrebačka bank.	94	1,22	56,9	2,8
2000	Splitska banka	UniCredito	63	1,74	58	7,64
2000	Riječka banka	Bayer LB	60	1,3	76	7,2
2000	Privredna banka	IntesaBCI	66	1,72	302	16,9
2000	Dalmatinska banka	Regent	65	1,4	33	2,33

Source: RBA Research (2005)

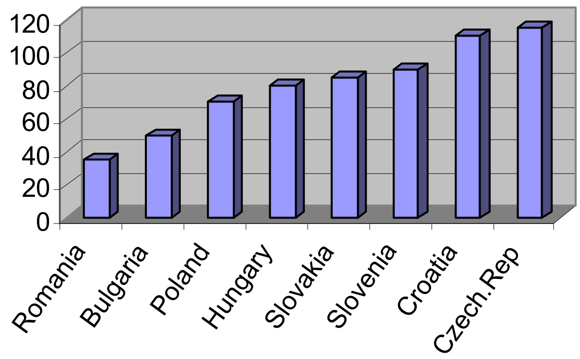
The biggest wave of acquisitions happened during 2000, when five banks that represented 36,87% of the Croatian banking market came under foreign ownership. The average PBV ratio was 1,47 and the average price for one percent of the market amounted to 14,10 million euros. Four banks were taken over in 2002, among them were Zagrebačka banka - the biggest local bank with 26,45% market share. Within two years, banks became more expensive. The average PBV ratio rose to 1,68. The trend was followed by average price of market share – one percent valued at 16,37 million euro. For one percent of market share UniCredito has paid the highest price – 23,67 million euro. After that foreign banks controlled over 90 percent of banking assets in Croatia. Space for new foreign entrants was limited with two state banks (that are still waiting on privatization) and a few small private regional banks with very small market share. When the investment fund Charlemagne Capital announced the sale of Nova Banka, that was the last chance for international banks to acquire a local bank with significant market share. There was strong interest among big international banks (IntesaBCI, Erste Bank, Société Générale and OTP). The Hungarian OTP was very eager to finally step into Croatia and ready to pay the highest price. The real value of the highest PBV ratio of 2,7 paid for one Croatian bank becomes clear when we are reminded that for one percent of the banking market OTP paid 93,28 million Euros. This proves that the Croatian banking sector still has big potential for growth in the coming period. In the next few years Croatia's GDP is expected to grow at a rate of 4,5% annually, which is higher than in Western Europe, where the origins of foreign owners of the Croatian banks are. This means that, like other banks before it, OTP will soon repay its investment and make a profit.

Amidst such intense FDI activities, the Croatian banking sector saw a lot of restructuring and consolidation with several major banks collapsing under the pressures of the new tides on the market during its 1998-99 banking crisis. Their weaknesses in risk management, substantial related party lending and single client exposure, inadequate provisioning and political interference in lending decisions in a system dominated by public sector banks made the Croatian banks vulnerable to the new macroeconomic realities. In 2003, only the top six banks accounted for almost 82% of total banking assets in Croatia. Despite restrictive measures by the Croatian Central Bank, total assets still grew by 14,4% in EUR.

The overall size of the Croatian banking system (in terms of total assets) surpassed GDP for the first time in 2003. The comparison with other transition economies is shown in Figure 11. Its assets amount to 100 percent of domestic GDP, which puts it among leading transitional countries, but it is still far from the EU average of 250 percent of GDP.

Figure 11.

Banking Assets in Relation to GDP in 2003 (in percent GDP)



Source: Croatian National Bank (2005)

Bank assets in Croatia have two major characteristics. Almost 70% of liabilities are denominated in foreign currency or indexed to foreign currency (predominantly EUR), which results in loan portfolios also largely indexed to foreign currency. The second characteristic is the high share of retail loans (around 48% of all loans). Credit to households increased to almost 30% of GDP, growing significantly faster than credits to private enterprises. Croatia has the highest ratio of retail loans in % of GDP among all CEE countries, but still well below the EU average.

Table 2.

Loans and Interest Rate Spread in the Croatian Banking Sector 1999-2002

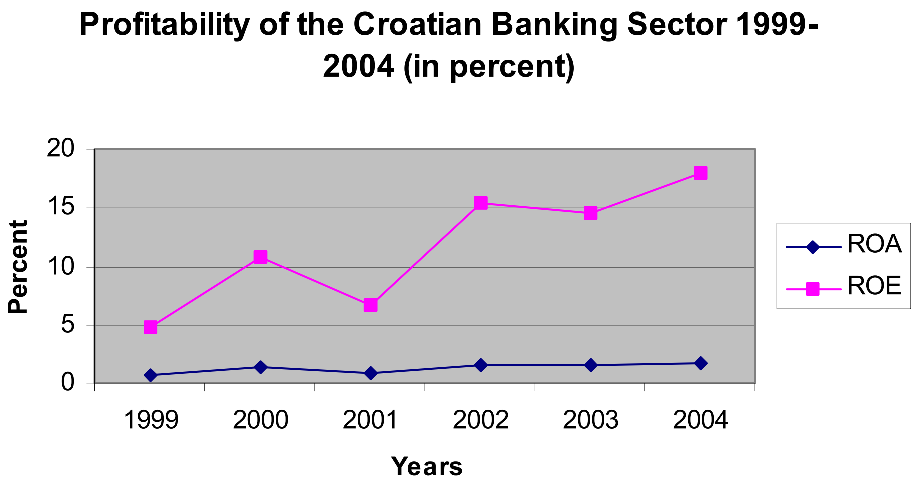
	1999	**2000**	**2001**	**2002**	**2003**
Loans to private enterprises (mil Eur)	n.a.	2.983	3.968	5.094	5.395
Loans to households (mil Eur)	n.a.	3.066	4.087	5.787	7.193
Average interest rate spread (percent)	9,3	7,1	6,8	9,4	9,8

Source: Croatian National Bank (2005)

It is not surprising that those banks granted more loans to households. That market segment still has tremendous potential for growth as people have needs in buying cars and real estate. In addition, the interest margins are high, around five percent. That is higher than the EU average, which is slightly under 3 percent. The problem for the host economy is that companies, which are the main drivers of development, are getting fewer loans. In the long run that is not sustainable as people somehow have to earn the money needed for loan repayment. Without new investments in the near future it will not be possible for such a trend to continue.

One of the most visible results of changes in the Croatian banking sector is the subsequent fall in interest rates. The interest rate on loans fell from 18 percent in 1997, to 8 percent in 2004. But with the interest margins sill being so high, Croatia is still an attractive region for foreign banks. The Croatian banking sector's potential in retail business increases its profitability still further. The returns on assets and on equity are summarized in Figure 12.

Figure 12.



Source: Croatian National Bank (2005)

Following the banking crisis of 1998-99, and given the subsequent improvements in the underlying business environment, the profitability and health of the Croatian banking system improved. This is illustrated by the improved capital adequacy ratio with non-performing assets declining from 10 percent at the end of 2000 to 7 percent at the end of 2001. Also, an average risk-weighted capital adequacy ratio rose to 18 percent compared to the statutory ratio of 10 percent, indicating that the banking system is relatively well capitalized.[3]

[3] World Bank (2002)

Currently only two banks remain state-owned but the Croatian government plans to privatize them as well. Also, some small privately-held banks still play a role in certain regions within the country. However, with continuing consolidation, many of the smaller banks are likely to become niche players, merge, or exit. In terms of international standards, Croatian banks are small in general. In 2005 the number of banks has been reduced from 46 to 37, which is still a lot given the population of the country of only 4.5 million inhabitants.

4.2. New Institutions in the Croatian Financial Sector

In the overall structure of the financial system in Croatia commercial banks still account for around 82% , although the competition of other institutions is slowly growing. Such institutions represent a healthy balance to the exclusively bank-based finance as they can increase the resilience of the entire financial system by preventing excessive reliance on banking. In addition, they increase the diversity of financing instruments allowing for ventures that, for political or other reasons, would not be able to obtain finance from banks. They also introduce an additional element of competition into the financial system, at least where the firms in the nonbank financial sector are not largely owned by the banks. Thus, a strong nonbank financial sector is important from the development point of view.

In Croatia, banks turned out to be the main generators of financial system development. They have established leasing companies, fund management companies and housing savings banks, which became important constituent parts of the financial system. They are presented in Table 3. In 2003 exceptional growth was recorded in the leasing industry as an alternative to ordinary credit.

Table 3.

Croatian Financial Institutions in 2004

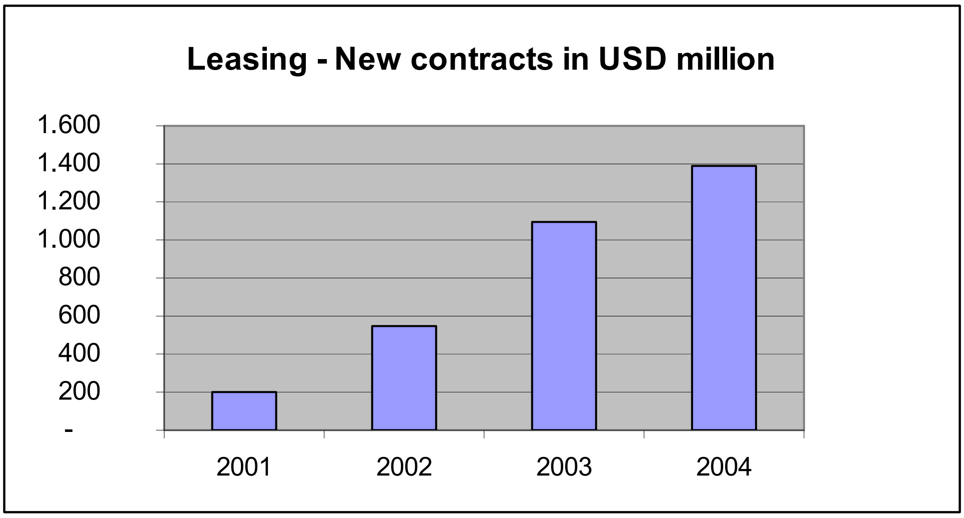
Institution	number of institutions	Total assets in USD million	%
Banks	46	35.106	82,0
Leasing companies	36	2.507	5,9
Insurance companies	26	2.302	5,4
Pension funds	8	1.146	2,7
Housing savings banks	4	690	1,6
Open-end investment funds	35	675	1,6
Savings & loans coop.	109	226	0,5
Closed-end & privatization inv. Funds	4	172	0,4
TOTAL		**42.824**	**100,0**

Source: Croatian National Bank (2005)

Leasing is a relatively new model of financing in Croatia. The first leasing company was established in 1995. After banks, leasing in Croatia is the biggest segment of the financial system. At the end of September 2004, assets under management of the leasing companies amounted to more than US$2 million. Remarkable growth was recorded in the last three years, when leasing became the fastest growing segment of the financial sector.

Figure 13 illustrates the speed and the momentum that leasing contracting has gained in Croatia in the past four years.

Figure 13.

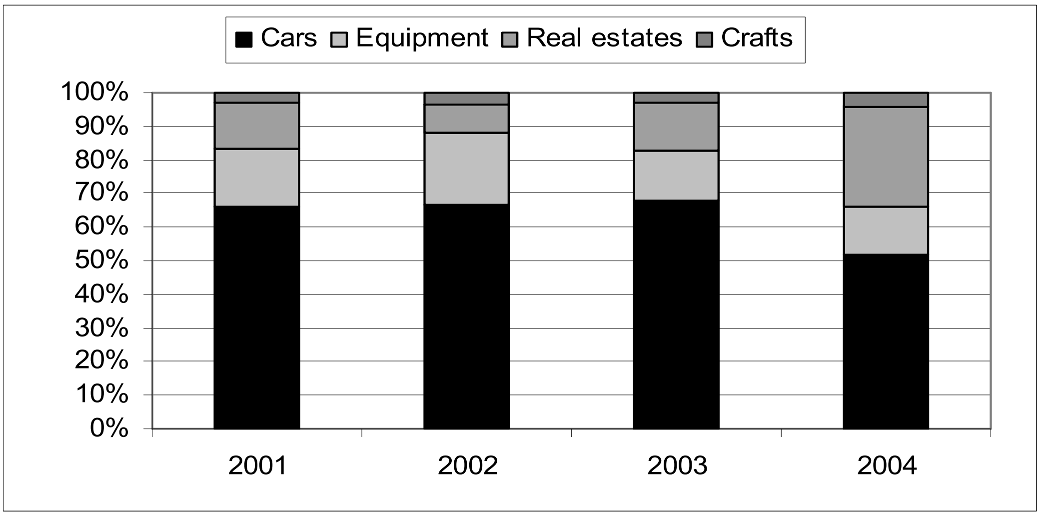


Source: Horvatin (2005)

As figure 13 shows, on the average 60 percent of leasing contracts is represented by cars, followed by real estate. Only in 2004, the car share fell below 50 percent because of the saturation on the car market. Clearly leasing is a new product on the market with a bright future when Croatian entrepreneurs find out how good a tool for improving cash flow it is.

Figure 14.

The Structure of Leasing in Croatia 2001-2004 (in percent)



Source: Privredni vjesnik (2005)

The insurance sector is small and concentrated. Premiums collected are about three percent of GDP, compared to a range of six percent to eight percent in Western Europe. The market structure is somewhat distorted, with the state-owned Croatia Osiguranje capturing almost 50 percent of market share, and the balance of the market is divided among other 25 privately owned companies. Non-life insurance still dominates, but life insurance is becoming more important, as it is being increasingly sold by foreign insurers that have long traditions in dealing with it. The legislation applicable to insurance companies and regulations issued by the Insurance Companies Supervisory Agency has been updated several times in recent years and it now conforms in many respects to the system prescribed for companies in the European Union.

The pension system reform started on January 1, 2002 and it is based on three pillars. The first pillar is based on “generation solidarity” and every employed person pays 15 percent of his or her gross salary into that fund. The second pillar comprises mandatory funds that capitalize five percent of gross salary that must be paid into such fund. The last pillar is voluntary and it is still undeveloped because the low living standards cause the savings to be generally low. There are four mandatory funds and four voluntary funds with 7 billion HRK under management. According to projections, private pension fund assets are expected to grow to be 17 percent of GDP in the next 20 years. Namely, during that period they will mostly be collecting payments and they will start to pay out significant amounts of money when the period of 20 years is up.

Investment funds are another new institution on the Croatian financial market. These products are not a real competition to traditional bank deposits, which Croatian people still prefer. Assets of open-end funds amount to less than two percent of banking assets. There two main reasons: small and underdeveloped local capital market, and, generally speaking, low knowledge about this product. Closed-end funds are mostly the results of the privatization process and there is no real future for them. Some of them will be liquidated and a greater part will be transformed into holding companies.

4.3. Portfolio Investment in Croatia

While foreign direct investment, mostly in the form of cross-border mergers and acquisitions, had a considerable impact on the banking sector, portfolio capital made a change in the corporate world and it stimulated the creation of domestic financial markets and the Zagreb Stock Exchange. Total portfolio investment into Croatian securities, in the three quarters of 2004 alone, amounted to 14,9 billion of USD, which is more than the three prior years combined. That was the consequence of an increased number of foreign investors (mostly investment funds from Slovenia, Sweden and USA), which entered into the Croatian capital market when Croatia started negotiations related to its accession to the European Union. Table 4 shows the detailed structure of portfolio capital inflows to Croatia 1998-2004.

Table 4.

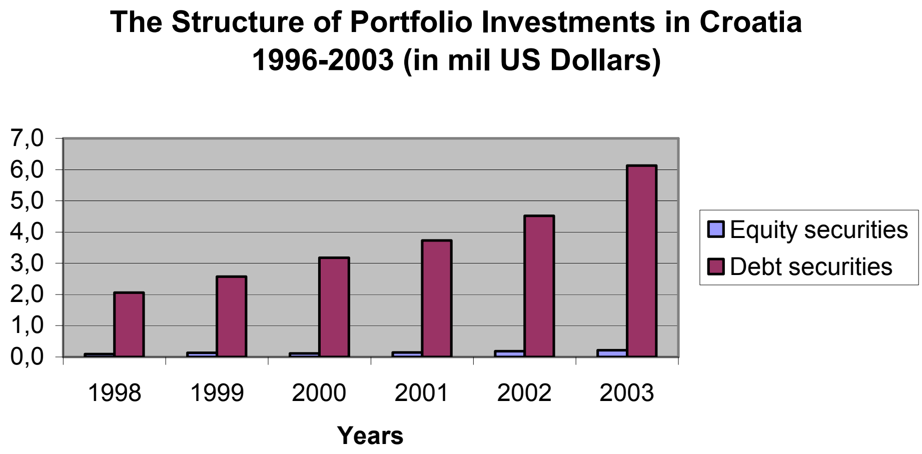
Portfolio Investment in Croatia 1998-2003 (in Mil US$)

	1998	1999	2000	2001	2002	2003	
1. Equity securities	*87,3*	*128,3*	*108,8*	*145,4*	*180,8*	*213,1*	
1.1. Banks	36,5	61,5	36,5	36,2	37,7	48,2	
1.2. Other sectors	50,8	66,8	72,3	109,2	143,0	165,0	
2. Debt securities	*2.058,0*	*2.571,8*	*3.179,6*	*3.731,8*	*4.524,8*	*6.124,5*	
2.1. Bonds	2.049,3	2.554,4	3.170,1	3.704,4	4.524,8	6.082,7	
2.1.1. General government	2.049,3	2.523,2	3.141,2	3.677,1	4.357,1	5.646,5	
2.1.3. Other sectors	0,0	31,2	28,9	27,3	167,7	436,2	
2.2. Money market instruments	8,7	17,4	9,5	27,4	0,0	41,8	
TOTAL	2.145,3	2.700,0	3.288,4	3.877,2	4.705,6	6.337,6	

Source: Croatian National Bank (2005)

The comparison between equity and debt securities reveals a surprising ratio in Croatia when compared to other transition economies, and developing economies in general. While as a general rule equity investment dominates debt securities in countries with weak and underdeveloped financial markets, in Croatia it was the debt securities that clearly dominated equity. As Figure 15 shows, the inflow of portfolio capital in the form of debt securities was high and steady.

Figure 15.



Source: IMF, 2003.

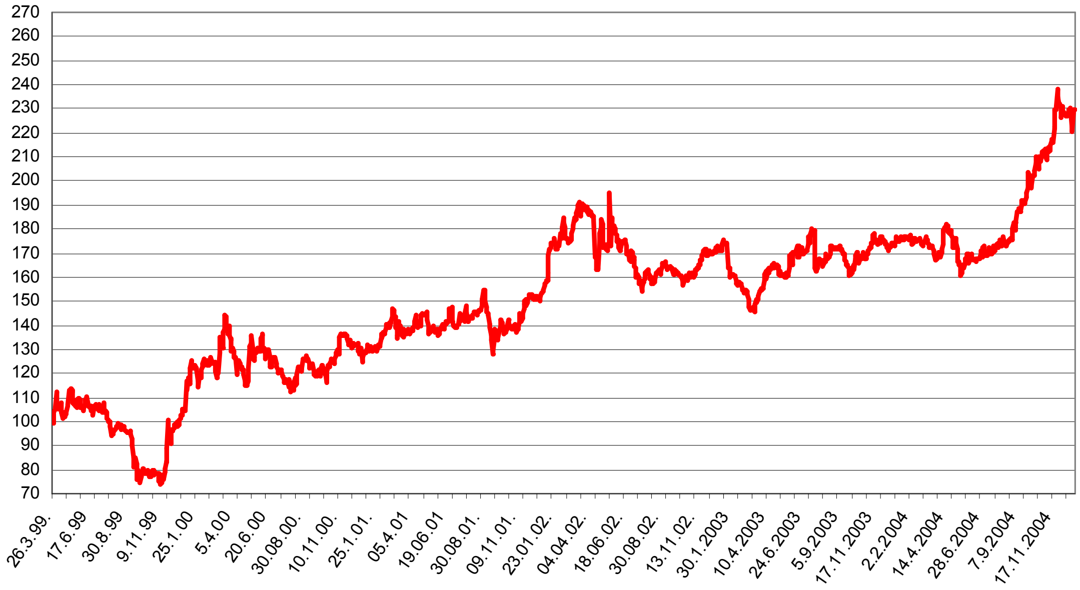
Such a structure leaves Croatia relatively vulnerable to possible sudden reversals of such inflows. In general it is safer if the countries opening up to international financial transactions first strengthen their markets and institutions. This includes upgrading prudential supervision, limiting the moral hazard created by excessively generous financial safety net, strengthening corporate governance as well as adopting transparent auditing and accounting standards and equitable bankruptcy and insolvency procedures.[4]

On the positive side, the result of an increased interest of foreign investors, annual turnover on the Zagreb Stock Exchange increased by more than 50 percent compared to 2003. Market capitalization rose by 70 percent, while the number of transactions increased by 43 percent. CROBEX, the Zagreb Stock Exchange index rose 30 percent.

Figure 16.

[4] Eichengreen, B. (2002), pp. 360.

Performance of CROBEX - the Zagreb Stock Exchnage Index 1999 - 2004



Source: The Zagreb Stock Exchange (2005).

Further development of the Croatian capital market and investments in local shares and bonds will depend on factors such as the privatization of the rest of the public companies through IPOs on the stock exchange as well as on the progress in integration with the European Union. Naturally, the decisions of local companies to raise capital on the capital market will be important determinants as well.

Conclusions

Following the economic and political reforms, and attracted by the potential of growth, international private capital started flowing into the emerging market economies of Central and Eastern Europe reducing the official capital flows to the region. The transition process affected the volume and the composition of external capital flows as investment and lending risk are closely associated not only with investment opportunities but also with improvements in the structural and institutional fundamentals. The shift from bank lending to foreign direct investment and portfolio capital inflows occurred after foreign investors became more confident at the prospects of economic reforms in transition economies. The composition of private capital flows showed continuous dominance of direct equity investment but, with the perceptions of risk changing, portfolio capital also made its way into the transition economies. Both types of flows caused significant changes in the domestic financial markets. In fact, the most significant efficiency gains from financial market liberalization often result from improvements in domestic markets and this was the case in transition economies as well.

Both foreign direct investment and portfolio investment mean more for a host economy than just additions to the physical stock of capital. Foreign direct investment, in particular, gives an impetus to growth to a receiving economy, proportionally to its absorptive capacity, by bringing with it more advanced technology, management skills, and expanded access to global markets. Portfolio investment, on the other hand, opens up domestic companies and financial markets to the scrutiny of the world financial markets and imposes on them the rules of financial discipline. International capital flows promote growth in transition economies, among other ways, through transforming their financial systems and increasing their financial intermediation. Moreover, capital inflows foster higher economic growth above and beyond any effects on the investment rate provided the banking sector has reached a certain level of development. Using the example of Croatia, it was possible to illustrate how international capital flows spurred a major banking reform as well as the development of securities markets and non-bank financial institutions. In spite of some adverse effects of this transformation, the overall banking system in all transition economies and in Croatia has achieved remarkable stability.

It is important to stress, however, that positive properties of international capital flows should be weighted against their inherent volatility and the dangers that it can present to countries with weak financial markets. That is particularly true of portfolio capital, whose nature is that it is short-term and highly susceptible to the foreign investors' perception of risk and liquidity shock. While foreign direct investment is a more stable source of external finance that becomes a long term companion of the host country, portfolio capital, in both its equity and debt components, is subject to sudden reversals and it can cause spectacular short-term declines in output and even full-blown financial crises. That can be particularly dangerous for countries that are liberalizing their financial sectors while simultaneously opening up their economies to external capital.

It is, therefore, advisable that the host countries put in place a well designed financial liberalization scheme that will introduce into their capital accounts the right kind of buffers to constrain the undesirable volatility of portfolio capital flows, while actively encouraging productive direct investment. Taxing two kinds of capital differently might be one way of achieving that objective until domestic financial markets and institutional infrastructure do not reach the necessary level of development. Partial liberalization of capital accounts, with proper safeguards in place, can ensure that transforming the financial systems in the transition economies, international capital flows are indeed helping set the stage for an even higher economic growth in transition economies in the future. As stated by Eichengreen and Leblang (2002), the implications of capital account liberalization for economic growth indeed remains one of the most pressing economic issues of our age.[5]

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[5] Eichengreen, B. - D. Leblang (2002)

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