

FINANCIAL INTERMEDIATION IN A SMALL (TRANSITIONAL) ECONOMY

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We can look upon transitional economies from various traditional viewpoints, such as how many businesses have already been privatized, whether macroeconomic stabilization has already been achieved, if genuine restructuring of the economy is already under way, and whether sustainable long-term growth is already taking place.... But instead, we will examine the neglected problems of financial intermediation or rather misconceptions concerning financial intermediation in a small (transitional) economy. Emphasis will be on the small economy, but since many important things concerning the financial system of a country are forgotten and the less important are put at the top, if it is the case of a transitional economy, the adjective >transitional< may be necessary as well.

Well-functioning financial intermediation is important for economic performance of a country. Households, as the most important savers, and others, need it on the one hand, and business enterprises (and the Government), and others, as the most important spenders or deficit economic units, on the other hand, need it as well. But if there are misconceptions or illusions, and upon them financial institutional arrangements are based, economic policies pursued, and general opinion of what is right and what is wrong promoted, these misconceptions and illusions may affect economic performance of the country.

One of the very important characteristics or states of a country should be its openness and/or liberalization of its capital account transactions. And international financial institutions and foreign experts have generally in mind and/or are concerned with the inflow of capital in the form of direct and portfolio investment when they evaluate how far a country has already liberalized its capital account of the balance of payments. They

think that capital account transactions are important for the sole reason of enabling a country to import foreign capital. They do not have in mind problems of financial intermediation in a small economy. They have in mind, consciously or unconsciously, their own country – for instance, the United States. But they are not alone. The majority of domestic economists with superficial knowledge of economics and/or groups within the country with special interests think in the same manner. They are somehow happy that they have rediscovered stock exchange and capital markets in a community where they cannot exist.

We can say that these groups are somehow waiting for something to happen, although this something will never happen. We can talk about three kinds of waiting. First, for financial intermediation through banks to increase at the same time so that financial deepening will take place. Maturity of bank deposits would become longer and longer. Second, for the capital market to expand, i.e., the number of securities, their volume and turnover or transactions would be increasing. And third, for foreign portfolio investors, who are crucial for the liquidity, as they say, of the domestic capital market, to play a role in the local capital market.

The three kinds of waiting are just illusions or wishful thinking. Financial intermediation through banks will not be increasing very much and maturity of bank deposits will not change substantially, at least in the near future, before the country abandons its currency. The number and volume of securities on the capital market will not be increasing but decreasing and finally almost disappear. And foreign portfolio investors should not be looked upon as important players or any players at all on the domestic or local capital market because there will be no local or domestic capital market. There will be perhaps some quasi capital market of negligible importance.

Through international capital transactions in both directions of more or less the same volume, financial intermediation between domestic savers (or financial investors) and domestic spenders (households, business enterprises, and the Government) will be taking place. In the first part of the paper, importance of gross and unimportance of net

international capital flows will be presented. In the second part of the paper, the role of banks is discussed; and in the third part, the genesis and the temporary role of the domestic capital market are presented. In the fourth part of the paper, we analyze in what way domestic and foreign institutional investors will be important, what kind of domestic securities will there be, and who will be buying them. The final part of the paper will discuss [financial intermediation and capital markets in a small economy and] why a country like Slovenia must be a mirror image of a country like the United States, if looked upon through its balance of payments.

1. Gross and Net International Capital Flows

Contrary to the current account of the balance of payments, where one is usually interested in the volume of exports and imports, and the openness of an economy is determined by the ratio of exports and/or imports (of goods and services) to GDP, capital account is generally not looked upon in such a way. What matters in the first place is the balance, i. e., net export or import of capital and changes in the international (monetary) reserves of a country. But for a country like Slovenia, gross international capital transactions should be important. The ratio between the sum of export (including increases in international monetary reserves) and import of capital, on the one hand, and GDP on the other hand, should somehow be treated as an important indicator of the financial openness of the country – and its financial maturity or development. Banks and other financial intermediaries abroad should be namely financial intermediaries for domestic savers and spenders (deficit economic units), and capital markets abroad should be a substitute for the domestic capital market.

If we look at the balance of payments of Slovenia for the last fifty, sixty, or even more years, we can see that it generally did not have a deficit in the current account. This general characteristic continued after 1991, when Slovenia became independent. The exception, however, was in 1999, when a deficit in the amount of 2,9 percent of GDP appeared. But even if this exception lasts a few more years, it does not undermine our thesis that capital flows in both directions are important. So, there has been almost no net

import of capital, if increases in international monetary reserves are treated as exports of (liquid) capital. According to conventional wisdom, such a country is closed and must open up – it must begin importing capital.

Is it true that a country like Slovenia has not had as good an economy as other transitional economies because it has not been a net importer of capital? Is it maybe because it has no net import of capital, which has isolated it from the international economy? Is a deficit in the current account of the balance of payments the only virtue? Are international financial transactions of no importance for a country like Slovenia? None of these questions is true. Slovenia needs financial intermediaries and financial markets abroad more than other (bigger) transitional or non-transitional economies, but it needs them for other reasons and in a different way.

If we look, from the beginning, at the so-called structural position of the money market, which shows us the balance of autonomous transactions of the central bank and items in its balance sheet, we see that it has had a surplus so far. A deficit is a usual or normal structural position of the money market, as in the Eurosystem (Monthly Bulletin, 1999).

A surplus of the structural position of the money market means that the amount of base money created by the autonomous transactions of the central bank, i. e., transactions that are not connected with monetary policy instruments or operations, is greater than is required as currency and central bank deposits, excluding bank reserves. The main reason for such a structural position of the money market are net foreign assets, i. e., the difference between foreign exchange reserves and outstanding short-term central bank foreign currency papers that banks are required to have against their short-term foreign currency deposits. Because of such a structural position of the money market, the central bank's main preoccupation has been to absorb surplus liquidity created autonomously. Its dominant monetary policy instrument has been the absorption of surplus liquidity through sales of its short-term domestic currency papers.

Figure 1: Bank of Slovenia (BS) Balance Sheet

(December 31, 1999)

Assets	Liabilities
Domestic Assets – 7%	Base Money – 29%
Foreign Assets – 93%	Short-term Papers – 50%
	Other – 21%

Source: *Bank of Slovenia Monthly Bulletin*, March 2000.

A substantial part of financial intermediation via banks and capital markets abroad has already been taking place with financial intermediation of the central bank. Claims on the central bank in the form of base money and its short-term foreign and domestic currency papers have been de facto short-term claims on banks and money market instruments abroad. As can be seen from Figure 1, all base money (H) and all Bank of Slovenia (BS) short-term papers are de facto claims on banks and money market instruments (FA). These foreign liquid assets have been increasing more or less parallel to the inflow of foreign longer-term or long-term capital – partly in the form of foreign direct investments. Unusual or neglected importance of the capital account for a country like Slovenia can be seen already in the balance sheet of its central bank: import of long-term capital on the one hand (this, of course, cannot be seen in the balance sheet of the central

bank), and export of liquid capital (this can be seen in the central bank balance sheet), on the other hand.

As a consequence to the neglected importance of gross international financial transactions, foreign liabilities and foreign assets have appeared. They have not been based on deliberate policy, according to acknowledgement that financial intermediaries and capital markets abroad should help us in financial intermediation. They appeared, of course, partly because of the central bank's sterilization policy. And sterilization has been treated as something transitional, as is always the case. Already, it has almost come to its end.

2. Domestic Banks as Financial Intermediaries and the Basis for a Banking Economy

One of the fallacies or illusions that has been in circulation for years is based on the right conclusion, which is that the economy of a country like Slovenia would be a banking economy (Allen, 1993). What is wrong is thinking that domestic banks, without help from banks and financial markets abroad, would be able to intermediate and provide enough funds, especially long-term, required by business enterprises. Therefore, this means permanent waiting for further bank financial intermediation and financial deepening – a lengthening of the maturity structure of bank deposits.

Unfortunately, that which the economy has been waiting for will not arrive, at least not in such a form that domestic banks would be self-sufficient for the functioning of the banking economy. Various investment funds will start to compete for savings of households – they will not wait as long as they waited in Western Europe, and there will be no substantial change in the maturity of bank deposits. Propensity for liquid financial assets will not subside. Therefore, the banking economy, which has been and will be the only viable type of connection between savers and spenders, would not be possible without the help of banks and financial markets abroad.

The kind of financial intermediation via banks abroad that we are talking about has already been taking place. This can be seen from Figure 2, which shows that for the

major part of their foreign currency deposits, for instance 100 percent for demand deposits, banks have already been required to have foreign assets directly with banks abroad or via the central bank, i. e., its foreign currency papers. But, it is financial intermediation that intermediates domestic funds abroad. If we are talking about financial intermediation, we are thinking about how to enable banks to channel adequate funds to business enterprises. Therefore, let us put aside foreign currency bank deposits for the moment, which we will come back to when we will discuss domestic investment funds, and let us concentrate on domestic currency bank deposits.

**Figure 2: Foreign Currency Assets and Liabilities of Banks
in Slovenia at the End of 1999**

Assets	Liabilities
Foreign Currency BS Papers – 12% Foreign Assets – 13%	Foreign Currency Deposits – 18% Foreign Liabilities – 10%
Domestic Currency Assets – 75%	Domestic Currency Liabilities – 72%

Source: *Bank of Slovenia Monthly Bulletin*, March 2000.

As domestic currency bank deposits will remain predominantly short term, banks of such a small banking system will not be able to transform them into long-term loans (five to seven years) according to the demand for such loans. It is not a solution for banks to give only short-term loans. If business enterprises and others did not get required funds from

domestic banks, they would get them from banks abroad. If they would want to stay in business, banks would be obliged to get long-term funds from abroad, on the one hand, and export surplus liquid funds abroad, on the other hand.

There may be chances for banks to survive if they would invest funds, collected in the form of short-term domestic currency deposits, partly into liquid foreign assets (deposits with banks abroad and foreign money market instruments). They should invest in liquid assets abroad that part of funds which they would not be able to transform into longer-term loans or which are not required as short-term loans. In the amount of liquid assets invested abroad, they would be able to collect long-term deposits abroad or get long-term loans from banks abroad. These long-term deposits and/or loans would enable domestic banks to give their customers long-term loans within their constraints, not exposing themselves to illiquidity and/or currency risk. Therefore, banks would have on the liabilities side of their balance sheet short or shorter-term domestic currency deposits and long or longer-term foreign deposits and/or loans; and on the assets side of their balance sheet, short-term or shorter-term foreign assets and long or longer-term domestic loans. Without such help from banks abroad, domestic banks would not be able to intermediate between domestic savers, who prefer liquidity, and domestic business enterprises, which need long-term funds. The United States played a similar role for Europe, at least according to Kindleberger (1965) and Kindleberger and others (1966). Domestic banks should perform, of course, as a financial intermediation at least as cheap as banks abroad. And we must still add one thing. This will only happen if both domestic savers and domestic borrowers want domestic currency to be used. If foreign currency is used and both lenders and borrowers prefer foreign currency, it would be much more simpler, but at the same time, there would be much less space for domestic banks.

Expectations or waiting for domestic banks alone without financial intermediation of banks abroad, as just described, to enable the only viable so-called banking system is without any basis. If provisions, as described, are not made very soon for such financial intermediation of domestic banks, one should not expect the so-called market economy to appear and develop for the benefit and happiness of people around the Ljubljana stock

exchange. Domestic banks would simply be wiped out. It does not mean, of course, that they would not be wiped out if they would nevertheless try proper financial intermediation.

3. Domestic Capital Market

A domestic secondary capital market, i. e., trading with shares, appeared soon after shares were created when non-financial business enterprises in social ownership changed into stock companies and shares were given either to citizens directly and indirectly through closed-end investment companies, which were created by law at the same time that the abolishment of social ownership started; or shares were given to the two public funds and to the Government agency responsible for privatization or ownership transformation of previously socially owned business enterprises, which changed names and [partly] function several times. As in other transitional economies, the capital market appeared at first as a secondary capital market. It is logical that the emergence of a secondary capital market, contrary to the historical development of capital markets in countries without revolutions and counter-revolutions, preceded the primary capital market. But only to some extent, it is something logical and/or inevitable. What followed, and the ill-founded expectations, illusions, and basis for fraudulent behavior that were created around and/or upon a capital market is something that cannot be accepted namely as a necessity.

What was wrong and why, and what should have been done quickly to help genuine owners of previously socially owned business enterprises without negative macroeconomic and social consequences, and how normal development of financial institutions had to be ensured has been explained several times (for instance, Ribnikar, 1997). We will not elaborate further on these points, but will concentrate on »waiting« for the capital market to develop, i. e., why the capital market in a country like Slovenia cannot even exist and even less so, can develop.

If capital markets in the United States and other countries are properly analyzed and understood, there cannot be a separate capital market in a country like Slovenia for two

simple reasons. First, there are only few business enterprises that may find financing via the capital market cheaper than via banks. The problem is not the quality of their securities, but their volume. Second, even if there were domestic institutional investors, they would have invested primarily in foreign securities. We can say that only those business enterprises that can issue so-called investment grade securities for institutional investors abroad will decide for financing via the capital market, but it will not be taking place in the domestic capital market. Domestic institutional investors, once they appear, will be active in capital markets abroad, unless, for patriotic reasons, they will be prevented from managing their portfolios to benefit their clients. But in this case, there would be no domestic portfolio investors. This business would be handled by foreign institutional investors.

Therefore, it could have been great fun if it would have been without cost for all of us to hear and/or read about concerns of the liquidity or illiquidity of the Slovenian capital market; about financial deepening that is going to happen; about foreigners, for instance foreign institutional investors, who are eagerly expected to provide liquidity to the Slovenian capital market; about beta coefficients and required rates of return for various domestic securities; about capital structure of business enterprises, when long-term debts are non-existent; about how domestic securities have been underpriced, although anyone can, at least since February 1, 1999, get as many loans abroad as one wishes; and about how traders on the stock exchange have been controlled, and trading on the basis of inside information and the manipulations of stock prices prevented in the country, where most intimately connected are people who are formally completely unconnected. Nothing enumerated has anything to do with specific characters of people living in, for instance, Slovenia, but it is only the consequence of the smallness of the community in which the capital market or trading in shares suddenly appeared. It happened in a community for which we can say is »Gemeinschaft«, and that will probably never develop into »Gesellschaft«.

At the basis of all those funny things about capital markets is, of course, the ill-designed way of the abolishment of social ownership of business enterprises, which was ill-

designed on purpose to enable the quick enrichment of the right people – i. e., people without any prejudices and scruples and who belonged to or joined the old and/or the new establishment or nomenclature. But, at the same time, the mainstream economic profession with its textbooks, articles, and advises is not without reproach. Members of the economic profession should have prevented the inappropriate use of ideas, concepts, and institutions developed in a quite different milieu. Like pills and medicine that must be labeled “Keep out of reach of children”, a similar warning should have been required for economic textbooks etc. with ideas, concepts, and institutions, once transition started, so that they would not have been uncritically or without proper understanding used in countries like Slovenia.

4. Institutional Investors

A capital market almost could not have existed in a country like the United States, where institutional investors are buyers of almost all bonds - 95 percent (Mishkin, 1995, p. 208), without institutional investors. It is more or less the same concerning shares, but new issues are negligible. There are almost no institutional investors in countries like Slovenia, but their nonexistence is not the cause of what has been happening in capital markets.

As has already been mentioned, domestic institutional investors will, once they have been established, invest mostly in foreign securities. It will be the only way for them to be able to diversify their portfolios properly. One type of institutional investor with almost exclusively foreign assets has already been de facto there. It must now formally change into proper legal form – into foreign assets mutual funds (open-end investment funds) or unit trusts.

What we have in mind is for banks to be obliged to invest predominantly into liquid foreign assets those funds that have been collected from foreign currency deposits. They have a major part of these foreign assets indirectly via the central bank in short-term foreign currency papers. Foreign currency deposits are a hangover of the old practices in Yugoslavia and, at the same time, a reminder of how the long-term process is to make the

new domestic currency credible. But the desire of people and business enterprises to have foreign currency deposits will probably not disappear before our domestic currency disappears once Slovenia joins the EMU.

In the meantime, no one is satisfied with this arrangement. Banks are almost prohibited to intermediate those funds collected on the basis of foreign currency deposits to business enterprises as loans. A major part of these assets must be in liquid foreign assets and, therefore, banks are not making any profit from these activities. Depositors are not satisfied because they are getting low interest rates on their foreign currency deposits. They are getting more or less the same interest rate as for comparable deposits abroad, for instance in Germany, but these predominantly liquid deposits are de facto genuine long-term savings of households. The problem is that they want to keep them in liquid form and as foreign currency deposits with banks in a very small economy. The central bank must take care that there would be no cause for runs on these deposits and, therefore, require that banks generally not perform the function of ordinary intermediary for thus collected funds. Therefore the central bank requires that banks should keep enough (for demand deposits, 100 percent) liquid foreign assets for these deposits.

Once the laws on securities market, investment funds, insurance companies, etc., change, it will mean that they are no longer written under the assumption that Slovenia is like the United States, but that it is almost the opposite, that banks should start from the beginning to establish and run foreign assets mutual funds that will allow bank foreign currency depositors to switch from foreign currency deposits into shares of foreign assets mutual funds.

If or until foreign assets mutual funds increase on the basis of foreign currency bank deposits that decrease, there would be no change in the foreign claims and liabilities of the country. What will happen is that banks will get rid of that part of their balance sheet from which they have not been performing the function – in the usual meaning – of financial intermediary. On the other hand, former bank depositors will stay with liquid

foreign assets indirectly as before, but now via claims to mutual funds and not via bank deposits. Earnings on these assets will be appropriate to their liquidity and risk.

When other financial intermediaries appear, they will be obliged as well to invest mostly in foreign securities. The number of domestic securities available will be decreasing for two reasons. First, the majority of previously socially owned business enterprises, which were changed by law into stock companies, will disappear because they will be merged with other business enterprises, will be taken over by foreign companies, or will stop being stock companies or at least public stock companies. Second, very few business enterprises that will remain alive will find it profitable to be financed via the capital market, and will go on to capital markets abroad.

We can expect only two kinds of domestic securities, besides securities of few business enterprises, that will be quoted and traded on foreign stock exchanges, to be available in great enough volume. The first are Government bonds and the second are pass-through securities on the basis of residential mortgages (Saunders, 1997, pp. 600-633), if they happen to be issued by one institution and if they will be of just one kind. Otherwise, their volume will not be great enough.

It is logical for institutional investors, if or when they appear in such a small country, to be obliged to invest predominantly in foreign securities. Domestic securities – first, Government bonds, and then pass-through securities and securities of a few domestic companies – will be kept predominantly by foreign institutional investors. Capital markets abroad will be a market place for domestic securities.

5. Financial Intermediation and Capital Markets in a Small Economy

It is much more important for a small transitional and/or emerging economy than for big economies to be open as concerns international capital transactions. But this openness has

nothing to do with the necessity of net import of capital. Openness is necessary also in the case when a country has a balanced current account and does not need funds from abroad. Small countries must be open and allow the flow of capital in both directions because domestic financial intermediaries cannot intermediate properly. They cannot transform funds obtained on the basis of predominantly short-term deposits into long-term loans without financial intermediation of banks abroad.

The general pattern that we can expect from small economies is the import of long-term funds and the export of liquid funds. Its foreign assets will be liquid and its liabilities long term. And this transformation of liquid assets into long-term liabilities must be allowed by liberalization of capital account transactions. From the data in Figure 3, we can see that something like this has been happening. The volume of foreign assets and liabilities outstanding is important, and not the balance.

Domestic financial intermediaries, such as banks, would be able to survive if financial intermediation through capital account transactions were allowed. But it is not quite the same as concerns capital markets and institutional investors. There will be no domestic capital markets once securities that are created artificially (when all business enterprises are transformed into stock companies) disappear. There will be few domestic securities, but there will be a kind of swap between domestic and foreign securities. Domestic institutional investors will invest mostly in foreign securities and domestic securities will be predominantly in the portfolios of institutional investors abroad.

Figure 3: Foreign Assets and Liabilities of Slovenia at the End of 1998 (in million of USD), without Unrecorded Foreign Assets that Households May Have Abroad

Assets		Liabilities	
FDI	563	FDI	2907
Portfolio Investments	50	Portfolio Investments	1512
Other Assets		Other Liabilities	
(Loans, Trade Credits, etc.)	4395	(Loans, Trade Credits, etc.)	5255
International Monetary Reserves	3339		
	8347		9674

Source: *Bank of Slovenia Monthly Bulletin*, March 2000.

We have seen that the capital account of the balance of payments is much more important for the small economy although, in general, its current account will be in balance. A small economy cannot afford a substantial and prolonged current account deficit. A small country must behave like a small bank within the banking system where there are also big banks. It must be a net supplier of funds via the money market and it must keep substantial liquid assets with bigger banks – if it wants to survive.

Therefore, it is just nonsense when liquidity of the domestic capital market in Slovenia is being analyzed, when one hears how foreigners should provide adequate liquidity to the domestic capital market, when securities are being analyzed in the same way as on Wall Street, when banks are not allowed to intermediate via banks abroad, when institutional investors are required to invest predominantly in domestic securities, and when other small countries (like Bosnia and Herzegovina) are being advised by domestic "experts" on how to build up domestic capital markets. If a country is politically independent and has its own money, it does not mean that it can have a capital market and financial intermediaries without the help of financial intermediation abroad. If international money

is the international public good (McKinnon, 1979, p. 3) or international collective good (De Grauwe, 1989, pp. 7-8) that can be used by residents of countries that do not have international money, then we can say something similar for products of financial intermediaries and capital markets of big countries or currency areas, such as the Eurosystem. Of course, these financial intermediaries and capital markets or their products must be used as international public goods with care and prudence. And, in this way, residents of a small country may find that living in a small country, where financial intermediaries cannot perform their function and where there may be no capital market if the financial system of the country is isolated, may be quite good – economically. Within this framework or constraint, residents may have whatever kind of market economic system they want.

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