VEZA KOJA NEDOSTAJE: KAKO POVEZATI RAZVOJ TRŽIŠTA KAPITALA I GOSPODARSKI RAST, Velimir Šonje (ed.), 2005, Arhivanalitika, Zagreb

Review*

This interesting and extremely informative book deals with the capital market in Croatia in the context of overall economic development. The book is published in Croatian and is a fairly comprehensive, analysing in detail as it does a multitude of factors that determine the development of the capital market. In addition to editor Velimir Šonje, eight associates worked on the book: Ivan Erdelez (on corporate governance), Petra Kalfmann (on Hungary), Ivo Nemjec (on the Czech Republic), Đurdica Ognjenović (on securitisation), Goran Pavlović (on the desired forms of saving, international capital flows and Chile), Leslaw Pietrewicz and Marcin Pietrzak (on Poland), Ivica Smiljan (on accounting and auditing) and Sandra Švaljek (on taxation).

The basic motivation for the writing of the book is the fact that in spite of positive trends between 2002 and 2005, the Croatian capital market is still much behind the advanced transitional countries in terms of liquidity. Since it is possible to kick-start the development of the financial market by economic policy measures, hence contributing to higher rates of economic growth, the topic certainly needs bringing into focus in the eyes of the general public.

The book is divided into three large units. The first provides a review of the relevant parts of the theoretical and empirical literature in the field, the development and structure of the Croatian capital market is analysed, and it is compared with the markets of other countries. In addition, due attention is paid to the analysis of various forms of saving and to the international capital flows that are particularly important for Croatia as a small and open economy. In the second major unit of the book the reader can find more information about the development of the financial markets in Hungary, Poland, Chile and the Czech Republic. In the third, most extensive part, there are accounts of the policies important for the development of financial markets, the relevant parts of taxation policy, measures and regulatory issues related to investment funds, corporate governance and privatisation and accounting and auditing. This part contains many concrete recommendations for those charged with creating economic policy. Because of the great scope of the book, this re-

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view can deal with only a few of the topics treated in the first and second parts, even then without being able to go into detail. For this reason it should be said that the other chapters too are extremely informative and excellently written.

The development of the financial sector, its structure, and the existence and intensity of the cause and effect relationship between financial and economic development depend to a large extent on the institutional environment. A comparison of the structures of financial sectors of different countries (the bankocentric systems in which banks dominate and the market system in which the financial markets for bonds and shares are primary) leads to the conclusion that developed countries at an equal level of economic development sometimes have very diverse financial structures, mainly determined by the legal heritage. On the other hand, comparison of countries with different levels of economic development reveals that the banking system is often extremely dominant in poorly developed countries. Some research suggests that the structure of the financial sector is not important and that it is not necessary particularly to stimulate the development of the capital market, because banks can equally well and effectively carry out the function of financial intermediaries. This book, however, puts forward several arguments that do not support such a claim. One of them, for example, is that banks often are unable to satisfy diverse investor preferences in the sense of risk to return ratio, liquidity and transparency of investment. This implies the need for inducing the development of financial markets, in which the banks and the financial markets develop complementarily.

According to the ratio of private sector loans and GDP, Croatia, as early as 2003 (i.e., before the strong credit expansion) was in what the World Bank classifies as "higher middle-income countries", to which it also belongs in terms of per capita income. On the other hand, in terms of ratio of stock market transactions and GDP, Croatia is in the group of least developed countries, and the market for financial asset instruments is assessed as markedly undeveloped. This conclusion is confirmed by the parallel ratio of banks and capital market development in other countries, according to which Croatia according to its current value of private sector loans should have a stock exchange turnover eight times greater than it really has. Although this calculation is at the "level of an educated guess", according to the authors (p. 53) it nevertheless tells of a big lag in the development of the equity market as against the banking sector. A similar conclusion goes, although in a somewhat smaller extent, for non-banking financial service provision in the country. At the same time it is concluded that the Croatian bond market is not behind that in other countries.

Croatia, it is claimed, has a relatively weak interest in shares and funds, which is capable of at least partially explaining the lower liquidity of the Croatian share market as compared with the markets of other countries. Today in Croatia it is mainly the younger and more educated part of the population that invests in shares, and in time, if their saving preferences do not change, and new generations with similar preferred forms of saving enter the market, a considerable growth in demand for shares can be expected. Since preferences depend on current trends in stock exchange indices (along with other external factors), the said expected rise in demand can be even stronger if there is a sudden rise in stock exchange indices. In such situations the inflow of foreign capital can also be expected, which will lead to a further growth and new changes of investor attitudes to saving in shares.

In a detailed analysis of the importance of international capital flows, most attention is devoted to arguments for and against capital controls. Theory predicts benefits from the liberalisation of international capital transactions. Reality is however somewhat different and in given conditions currency and financial crises can arise, because of which many call for circumspection during liberalisation. Croatia, it is said, should have stronger control on capital inflows than outflows, not vice versa, as is the case today, because of occasional appreciation pressures.

Various factors can have an important role in stimulating the development of financial markets and strengthening their possible positive impact on economic growth. Quite a lot of space is devoted to taxation in this volume. The reader is given an excellent review of the theoretical and empirical literature concerning taxation and savings, and concerning the taxation of capital gains. There are very informative surveys of the tax treatment of income from interest (and various connected tax reliefs) and capital gains (according to kind of asset) in the countries of the EU and in the transition countries. The current tax treatment in Croatia, in which neither capital gains nor interest is taxed, is considered desirable, particularly when it is considered that such taxation could in a small and open economy may induce a flight of capital. The part that deals with the taxation of investment in equity is particularly interesting. According to the methodology used in other countries, the aptness of the tax and statutory environment for the development of private equity and venture capital in Croatia is assessed. It is concluded that too little attention has been paid to the appropriateness of the tax and statutory environment in this context and that Croatia has a below average mark as compared with score of some European countries. Of the transition countries with which it is compared, Croatia is behind Hungary, the Czech Republic and Poland, and better only than Slovakia. This result shows that there are many areas in which improvement is possible.

A separate chapter discusses fund and asset management. After a review of the fund industry, quite a lot of attention is devoted to the relevant regulation in Croatia, and to a comparison with the laws in the EU. An important segment of the legislation relates to constraints in fund investment. Although the asset structures of the funds are not such that at the moment these constraints are effective, because the proportions of given asset categories of the funds have not yet come close to the limits, it is worth thinking of certain changes, because, e.g., the pensions funds have too high an exposure to bond market risk. Also stressed is the importance of the venture capital funds and the securitisation funds that need special regulation in Croatia. Securitisation is not well enough developed in the transition countries, including Croatia. A separate chapter is thus devoted to this in which there is a review of the basic concepts, and the legal and taxation framework for securitisation. It is said that in Croatia today the conditions exist for an enhanced development of securitisation business, and that hence the development of this segment of financial operations ought to be encouraged.

Another very interesting part of the book concerns corporate governance and privatisation. In the chapter about the funds it was mentioned that they should be stimulated to greater activity in order to promote high standards of corporate governance. Apart from the legal framework that regulates corporate governance, in developed countries it is common practice for the principles of corporate governance to be additionally defined by codes that are on the whole created in an interaction between the private and public sector, along with the coincidence of their interests. Such practice is very important, because it has been shown that countries with more weakly developed corporate governance can also have unstable financial markets, weaker inflows of foreign capital, lower competitiveness and efficacy and hence lower economic growth. Although in Croatia the application of codes is enjoined by statute, no such document, at the time of the writing of the book, was yet in existence. The authors adduce a string of recommendations concerning the desirable contents of codes in connection with equal procedures to shareholders, protection from majority shareholders, role of employees and independent members of Supervisory Boards, publication of information and other important topics. It is also rather important that the emphasis is placed on privatisation and the role of the government in the promotion of high standards of corporate governance. According to the authors, previous privatisation failures can be ascribed precisely to flaws in corporate management. It is recommended that further privatisation should go on via IPOs for the sake of encouraging the development of the capital market and the maximisation of corporate value. Then, irrespective of how much, if at all, equity the state wishes to retain in a firm, the promotion of higher standards of corporate governance should be one of its priorities. This will increase control of the operations of state-owned firms, a high standard would be placed that would have to be followed by the private sector, and if privatisation is embarked upon for a firm or part of a firm, a higher price will be achieved.

Looked at all in all, this is a very good book that in many parts enters into details of the arrangement of financial markets in order for their development to be induced and for the positive effect of financial development on the overall development of the economy to be created or enhanced. With such a detailed and very concrete approach, the book rises above most similar writing, which results in its somewhat greater length. One consequence of this kind of approach is that the fact that the reader, in many reviews of the regulations, can get away from the basic context of the work. The recommendations for those in charge of economic policy are very concrete and well-chosen with respect to the current situation in Croatia. In the view of the present writer, the most important part seems to be the part about corporate governance particularly because of the patent belatedness of Croatia in adopting codes, and because of the opportunity for the government, because of its still relatively large stake in the economy, rapidly and powerfully to take a positive step forward in this area, and to erect standards for the private sector too. Because of future privatisation, and in the light of bad experience from the past, corporate governance gains increasingly in importance.

The book can be recommended to a broad and diverse circle of readers, from those who are concerned with making economic policy, business people and other entities in the capital market to students learning the topic. Since it deals with diverse and contextually related topics, many of the chapters are written in such a way as to repay stand-alone reading, depending on reader concerns.

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