

# Summary

In 2002, the Croatian National Bank met its primary and legally prescribed goal of achieving and maintaining price stability. Retail price growth in Croatia amounted to 2.2% in 2002, which is less than in 2001 when year-on-year price growth reached 4.9%. Inflation in Croatia thus corresponds to inflation in the area of the European Economic and Monetary Union in 2002. The inflation rate was low over the entire 2002 and was on the decline until the very end of the year, which contributed to a 0.1 percentage point reduction in the average year-on-year inflation compared to December 2002.

Core inflation rate, which is calculated by excluding from the basket of goods and services, used for the calculation of the retail price index, prices of agricultural products and administrative prices, fell during 2002 even more than inflation measured by retail price growth, reaching 1.2% in December. Since the rate of core inflation encompasses prices of products that are set by the market, it reflects better a change in the prices that can be controlled by the central bank's monetary policy. Core inflation was lower than an increase in retail prices, which shows that inflationary pressure was caused by a price increase of energy products and administrative prices, whereas demand-pull inflationary pressures were contained.

The achievement of the central bank's primary goal – price stability maintenance – requires a restriction on the kuna exchange rate extensive fluctuations. Although during 2002, the kuna exchange rate was not under such a strong pressure as in 2001, the appreciation pressures during the entire 2002 were generated by significant foreign exchange inflows from tourism, along with foreign borrowing of the government and banks, foreign loans used for the financing of major infrastructure projects, privatization of domestic enterprises, restructuring of banks' foreign assets into domestic assets, as well as the expectations of market participants. The Croatian National Bank responded to the appreciation pressures by purchasing foreign exchange, which prevented excess volatility of the kuna exchange rate. The average exchange rate in 2002 was 7.41 HRK/EUR, which is only a 0.83 percent increase compared to the exchange rate recorded in the previous year.

In the conditions of a strong capital inflow, the Croatian National Bank generated liquidity by purchasing foreign exchange from deposit money banks and the government in order to mitigate the appreciation pressures on the kuna exchange rate. In 2002, the Croatian National Bank thus purchased foreign exchange, net worth USD 604m, by issuing HRK 4.8bn. A direct sterilization of the generated surplus liquidity by means of a rise in the kuna reserve requirement calculation base was not sufficient by itself, so that issuance of CNB bills increased, reaching HRK 5.2bn in late 2002, which is HRK 1.7bn more than at end-2001.

Monetary developments in 2002 were marked by a strong credit activity growth of deposit money banks. A growth in domestic placements began in early 2002, following a strong growth in banks' sources of funds as a result of foreign exchange deposit inflow due to the euro banknote introduction. However, domestic sources were not sufficient

and banks increasingly used foreign sources for financing very profitable domestic loans. Bank placements to non-banking sector in 2002 increased by as much as 30%, which can primarily be accounted for by household loans, which rose by 43%, whereas corporate loans rose by 22.6%. In order to slow down a growth in domestic placements and foreign borrowing, the Croatian National Bank issued two decisions within its competence at the beginning of 2003. One of the decisions imposes financial penalties for banks if their domestic placement growth exceeds 16% in the entire 2003, allowing a three-month growth dynamics of 4%. The other decision prescribes a requirement for banks to maintain on a daily basis foreign exchange claims at a minimum level of 35% relative to their foreign exchange sources of funds.

Following a breakout of crisis in Riječka banka in March 2002, the Croatian National Bank, as a lender of last resort, provided for that bank the required kuna and foreign exchange liquidity. By a successful action of the CNB and the Government of the Republic of Croatia the crisis in Riječka banka was resolved and it did not spill over into other banks.

Monetary policy pursued by the Croatian National Bank in 2002 stimulated economic growth, so that according to the quarterly report prepared by the Central Bureau of Statistics (CBS), GDP increased by 5.2% in 2002. In that year, GDP stood at HRK 176bn in nominal terms, a HRK 13.5bn growth compared to the previous year. Such an accelerated growth relative to the previous year was parallel to the overall global growth deceleration – in the USA, EU and Japan. Nevertheless, the Central European transition countries managed to maintain the economic growth at a high level and even to accelerate it to a certain extent (as was the case in Croatia), as a result of acceleration of structural reforms and EU accession processes.

GDP growth was influenced by an increase in personal consumption and gross capital formation, whereas a contribution of net export of goods and services to economic growth was negative in 2002, as well as the influence of government consumption decline. Growth can mostly be accounted for by personal consumption which rose by 6.6% in 2002. Its growth was stimulated by a wage bill increase as a result of the average wage growth, slightly increased employment and new household borrowing from deposit money banks. Investment in inventories also significantly contributed to growth, together with investments in gross fixed capital formation which increased by 10.0% in 2002. Naturally, it should be noted that investment growth contributed not only to private sector activity but also to public investment in infrastructure (road construction), which has a long payback period.

Although a fiscal contraction continued in 2002, after the adjustments for a statistical impact of the exclusion of Croatian Highways (CH) and Croatian Roads (CR) from the consolidated central government, it is evident that public consumption increased in nominal terms and that its reduction in real terms was less pronounced than in the previous years. 2002 budget was marked by a shift from transfers to households, subsidies and expenditures for the public sector employees wages to capital expenditures. Nevertheless, as a result of lower expenditures of CH and CR than expected, the general government deficit amounted to HRK 8.3bn, or 4.7% of GDP, which is approximately HRK 2bn less than planned.

Positive effects of the economic growth spilled over into the labor market in 2002 as well. For the second consecutive year, employment growth, amounting to 0.6%, was thus recorded in 2002. Early in that year, registered unemployment also started to decline, additionally accelerating in the second half of the year and particularly by the end of the year. Although employment growth was one of the reasons for registered unemployment reduction, employment intermediation reform was the key factor for its acceleration. Labor Force Survey also confirms that employment growth continued in 2002, along with the unemployment reduction.

The average real gross wage increased less than 4% in 2002, which is slightly less than the GDP growth, which points that this was also one of the factors that contributed to the employment growth. Nevertheless, the average wage increase accelerated in the second half of the year and restrictive public sector wage policy weakened at the same time.

International transactions in 2002 were marked by a deterioration of the merchandise trade balance. According to the CBS data, goods exports, in terms of USD, amounted to USD 4.9bn, a 5% increase, while goods imports reached USD 10.7bn, an increase of 17.1%.

As a result of this deterioration, and to a smaller extent, due to pronounced cross-currency changes of the US dollar against the euro and kuna, the current account deficit increased by 3.2 percentage points, compared to 2001, standing at 6.9% of GDP, according to the preliminary data. Deficit growth was caused by foreign trade liberalization together with consumption increase triggered by credit expansion. Nevertheless, the fact that a significant part of the merchandise trade balance deterioration was caused by an increase of USD 467m, or 16.7%, in capital goods imports, is encouraging.

As regards balance of payments capital account, foreign direct investments decreased by 37% relative to 2001, to the level of USD 886m, of which EUR 500m can be accounted for by HT privatization alone. Other investments recorded the most significant changes in the capital and financial account in 2002, increasing from USD 490m to USD 2.7bn. These investments are mostly related to bank portfolio adjustments.

Following a 2001 stagnation, external debt grew by USD 4bn, or 35.1%, during 2002. The largest contribution to the increase in total external debt was made by banks, whose share in total increase was 42.3%. External debt increased by 14% of GDP during 2002, reaching 68% of GDP at the end of the year, which is a margin separating moderately indebted from highly indebted countries.

In April 2002, the National Payment System Act, adopted in late 2001, began to be applied, which implies the implementation of the final and most demanding stage of the national payment system reform. This stage involves closing of transaction accounts of business entities and households with the Financial Agency (FINA) and opening of these accounts with banks. In July 2002, the new Banking Act came into effect, aimed, to a large extent, at achieving compliance with the EU regulations.

At the end of 2002, a total of 50 banking institutions operated in the Republic of Croatia: 46 deposit money banks, 3 housing savings banks and 1 savings bank, 12 less than at end-2001. This reduction was a result of merger of individual banks and savings banks with other banks and the initiation of liquidation or bankruptcy proceedings in several savings banks. Such developments indicate a continuation of a banking system consolidation process. In 2002, market concentration was also reduced. While 3 banking groups, with a share of 57.9% in total assets of the banking system, operated at the end of 2001, there were 6 banking groups, with a share of 79.5% in total assets of the system, at end-2002. Competition strengthening among banking groups led to a further reduction in interest rates. Total bank assets stood at HRK 174.4bn at the end of 2002, which is 17.5% more than at the end of 2001, when bank assets amounted to HRK 148.4bn. This increase is mainly a result of net credit growth to the non-banking sector. Sources of asset growth included a rise in deposits and increased borrowing. A rise in taken loans, reaching HRK 26.4bn, was, however, more significant than deposit growth, which amounted to HRK 19.7bn. The share of bank assets in majority foreign ownership in total bank assets increased by somewhat less than 1 percentage point, whereas the share of banks in majority domestic ownership in total bank assets was on the decrease despite a rise in their number from 16 to 21 bank. At end-2002, bank capital amounted to HRK 14.6bn, an 11.1% increase relative to end-2001, but capital adequacy ratio was reduced from 18.5% to 16.6% as a result of a more rapid asset growth. Asset quality of banks improved, and their total after-tax profit increased by 160% in 2002 compared to 2001.