Annual report

2003

CROATIAN NATIONAL BANK

Summary

In 2003, the Croatian economy recorded solid economic growth and low inflation. However, large current account and fiscal deficits, and a sharp rise in the country's external debt, posed important challenges to policy makers.

The central bank responded to these challenges with policies aimed at slowing down credit growth, which had reached the very high rate of 30% in 2002. The central bank targeted credit growth with the intention of limiting the current account deficit, containing the growth of the external debt and preventing increases in bad loans that can easily arise if increased lending is accomplished by lowering credit underwriting standards. It was recognised that these measures would most likely lead to a temporary reduction in economic growth, but this was seen as preferable to running the risk of much more severe problems in the future. The central bank introduced measures to penalise rapid credit growth and to ensure that banks hold adequate foreign exchange liquidity in January 2003, and reinforced these measures with tightened reserve requirements (increases in the percentage of the reserve requirement on foreign exchange obligations that must be held in kuna from 25% to 35% in September and from 40% in November to 42% in December).

To begin with economic growth. Real GDP grew 4.3% in 2003, down from the 5.2% rate in 2002. The driving forces behind growth in 2003 were investment, above all in public infrastructure, and personal consumption. Investment grew some 16.8% in real terms, even higher than the 10.1% growth of 2002. Personal consumption growth slowed from 6.6% in 2002 to 4.1%. There were some signs that the consumption boom of recent years began to taper off in the second half of 2003, although automobile sales remained brisk and helped swell the trade deficit.

Government consumption stagnated during 2003, as it did during the preceding two years. Foreign demand once again made a negative contribution to GDP growth, with merchandise imports again growing strongly. Both imports of capital goods and imports of consumer durables grew rapidly as a result of fast growth in investment and personal consumption respectively. The growth rate of merchandise exports increased in 2003 relative to the low rate seen in 2002, and the growth rate of services increased very sharply. Tourism revenues were up some 47% in kuna terms.

As a result of solid economic growth, employment grew by 2.5%, or 33,000, in 2003. This was a substantially larger gain than in 2002. Registered unemployment also fell, by some 19.3% or 73,000. However, the causes of decreases in registered unemployment are harder to sort out, because of recent changes in relevant legislation that have changed eligibility for registration. Survey unemployment data, which is compatible with the internationally-accepted methodology of the ILO, showed unemployment falling from 15.2% in the first half of 2002 to 14.1% in the first half of 2003.

Wage growth was modest in 2003. Tax decreases led to more rapid increases in net wages than gross wages. Net wages, the amount that employees actually get after taxes and contributions, grew 3.8% in real terms, while gross wages paid by employers rose 2.8%.

Such mild wage pressures were one of the factors contributing to low inflation in 2003. The average annual rate of increase of retail prices was 1.5% in 2003, 0.7% less than in 2002. Exchange rate stability vis-à-vis the euro also played a major role in keeping inflation low. Furthermore, the appreciation of the kuna against the US dollar insulated Croatia from the effects of increased oil prices on the international market. Low inflation in the European countries and Croatia's main trading partners also helped keep imported inflation low. Administrative price increases were modest, but prices of agricultural products rose sharply due to a prolonged drought. Core inflation, which excludes both administrative prices and prices of agricultural products, rose by a mere 0.7% in 2003.

In keeping with the central bank's policy of maintaining a broadly stable exchange rate, the average daily exchange rate of the kuna against the euro depreciated 2.1% in 2003. The kuna appreciated strongly against the US dollar, with the average daily exchange rate of the kuna strengthening some 14.8% compared to 2002. This led to an appreciation of the real effective exchange rate of the kuna (deflated by retail prices) of 2.5%. It is important to note that the impact of this appreciation is quite uneven, since some sectors of the Croatian economy hardly use the dollar at all, while others, such as the shipbuilding industry, realise most of their export proceeds in this currency.

Croatia's current account improved in 2003, but the trade balance did not. The current account deficit decreased from some 8.5% of GDP in 2002 to 7.2% in 2003 (preliminary data). The main cause of improvement was the services balance, which rose by some 78.8% in dollar terms, on account of record tourist revenues. Meanwhile, the trade balance deteriorated 40.2%. In looking at both of these figures, it is important to note that they are both substantially inflated by changes in the value of the dollar vis-à-vis the euro and the kuna.

Two other developments are important in assessing the current account in 2003. First, as a result of substantial increases in foreign direct investment in Croatia in recent years, the current account in 2003 includes significant negative items in the form of retained earnings by FDI enterprises. Such items do not represent actual outflows of money from the country, but could in the future form the basis for actual outflows via repatriation of profits.

Second, the current account includes a very large, one-off item: the transfer of patent rights by the Pliva pharmaceutical company to its subsidiary in Hungary. If this unique transaction is excluded from the current account, the deficit would be just about 6% of GDP.

Strong capital inflows characterised the capital account in 2003. Inward FDI grew to USD 1.7bn, with the sale of 25% of the INA oil company to Hungary's MOL for USD 505m being the largest single transaction. Portfolio investment also grew strongly to USD 1.0bn. These capital inflows led to a large increase in the central bank's international reserves, which increased by some USD 1.3bn to USD 8.2bn.

Croatia's external debt grew by USD 8.2bn in 2003, from USD 15.4bn in 2002 to USD 23.6bn in 2003. Again, a substantial portion of this growth, USD 2.8bn, is simply the result the weakening of the US dollar. However, external debt increased well beyond this amount. Banks' external debt grew by some 83.3%, other enterprises' debt 49.5%, and the government's external debt grew by 33.0%. There is no question that Croatia will be able to meet its foreign obligations in the immediate future. Nonetheless, the rate of growth of debt seen in 2003 is clearly unsustainable, and the level of debt is high enough that policy makers should focus on immediate measures to slow the rate of growth of external debt down to approximately the rate of growth of GDP or lower.

In response to these developments in the current account and external debt, the central bank strongly tightened monetary policy in 2003. In January, two measures were taken: the "16% rule", which penalised banks whose loan portfolios grew faster than 4% per quarter by requiring them to buy central bank bills bearing only 0.5% interest in an amount twice as large as the excess of lending over the 4% limit; and the "35% rule", which required banks to hold liquid foreign exchange assets of at least 35% of their foreign exchange liabilities and to maintain this ratio on a daily basis.

The effects of the 16% rule were seen quickly, as most banks reduced their loan growth to stay under the 4% per quarter level. However, the reality was more complex, as banks reduced certain items included in the loan base calculation by, for example, cutting unused credit lines and accelerating loan write-offs. In addition, growing activity by leasing companies, which are independent entities owned by domestic banks or their strategic partners and whose activity was not covered by the measures, partially offset the decrease in loan growth. Also, some banks directed customers to their foreign owners, thereby increasing foreign borrowing. Overall, the growth rate of bank lending fell from 33.6% in 2002 to 11.3% in 2003. However, when leasing and foreign borrowing are analysed, the growth in total credit made available to the economy only decreased from 25.7% in 2002 to 18.0% in 2003.

In short, the January 2003 measures did slow down the rate of credit growth. But they did not lead to an improvement in the trade balance, nor did they slow down the growth in external debt. In fact, the 35% rule, which came into force in phases and became binding for all banks at the end of March 2004, seems to have led to increased foreign borrowing by some banks. This should be a one-off adjustment, contributing to the improvement of banks' balances between foreign exchange asset and foreign exchange liabilities. This balance was seriously undermined in 2002 and proved that the "53% rule" does not guarantee the daily maintenance of a satisfactory ratio between banks' liquid foreign exchange assets and foreign exchange liabilities. The "53% rule" was replaced by the "35% rule", which was observed by banks in 2003 and the first quarter of 2004. Accordingly, it stands to reason that slower credit growth in the future will decrease banks' need for foreign funds.

The banking system, despite the measures, displayed strong profitability, with the return on average equity reaching 15.6% in 2003. Fully recoverable assets grew slightly, to 94.9% of risk assets, and irrecoverable assets fell to 1.6% from the 2.3% seen in 2002. The capital adequacy of the banking system remains strong at 15.7%. Thus, at this point, there are no signs of a deterioration in banks' portfolio quality due to the rapid growth of 2002. Although it is possible that the negative effects of rapid growth on banks portfolios may still appear in the coming period, it seems that the central banks' measures to slow loan growth in 2003 have prevented such problems from building up.

The measures and the generally tighter stance of monetary policy did result in slower growth of monetary aggregates. M1 grew by 9.8% in real terms in 2003, approximately three times less than in 2002. M4 also grew moderately, at 11.0%. Deposit growth was moderate, with foreign exchange deposit growth returning to positive figures at 5.5%. In the last decade, foreign exchange deposits have usually grown much more rapidly, but the euro conversion process in late 2001 and the beginning of 2002 seems to have exhausted most of the sources of increased foreign exchange deposits.

A new and somewhat unexpected development in the monetary aggregates in 2003 is the increased importance of kuna quasi-money (a 44% growth). This new phenomenon can partly be explained by banks' eagerness to avoid increasing their foreign exchange liabilities in light of the 35% rule. It may also be the result of savers' increased confidence in the stability of the kuna exchange rate and of the banking system.

In 2003, the channels of money creation differed somewhat from previous years. Purchases of foreign exchange by the central bank, which had in previous years accounted for the vast majority of money creation, played a smaller role than the decrease in CNB bills. The central bank, by offering an interest rate of only 2.5% on CNB bills, allowed the stock of bills to decrease by some HRK 5.0bn. Net purchases of foreign exchange from banks and the government only created HRK 965m. These money creation flows were partly sterilised by increases in the kuna portion of the foreign exchange reserve requirements, resulting in the modest increases in monetary aggregates indicated above.

One of the motivations for not raising interest rates on CNB bills was to avoid high costs of monetary sterilisation. The central bank, in fact, realised net interest income of some HRK 642m, only 7% lower than the HRK 691m realised in 2002. However, the central bank showed an overall operating deficit of HRK 342m, thanks to negative valuation adjustments of HRK 610m brought by changes in the dollar component of its international reserves. This deficit was far smaller than the HRK 597m deficit in 2002. Two-thirds of the central bank's international reserves are held in euros, and one-third in US dollars. This currency structure mirrors the currency structure of both Croatia's foreign trade and its external debt. A currency structure reflecting trade flows and debt obligations is used by most central banks, because the international reserves of the central bank in a sense "stand behind" economic actors and can be sold to the market as needed. If the currency structure of the reserves were substantially different than the debt and trade flows, agents would have to buy one currency from the central bank, and then purchase the needed currencies on private markets, most likely abroad. This would be a rather cumbersome and costly process.

One implication of this currency structure of international reserves is that the value of the dollar in terms of kuna can vary substantially from year to year. The losses generated by negative valuation effects are paper losses only. Since the dollar's value fluctuates in a 5-10 year cycle against the euro, and therefore against the kuna as well, there are years when valuation changes causes losses, and years when they cause gains. Over the cycle, the expected loss or gain is zero. Thus there is no reason to incur the substantial costs of hedging, since over time any losses will be evened out by gains.

Turning now to the other major macroeconomic policy component, fiscal policy was more expansionary than planned in 2003. Although revenues were very close to target, expenditures exceeded plan by about 0.5% of GDP. This led to a deficit of consolidated general government of 5.1% of GDP, according to preliminary data from the Ministry of Finance. The deficit was largely financed from foreign sources, which is more expansionary than domestic financing. Both foreign borrowing and privatisation contributed significantly to deficit financing in 2003. General government debt increased by HRK 9.4bn in 2003, reaching 44% of GDP at year-end. General government external debt increased by HRK 6.3bn, and amounted to 29.6% of GDP. In the future, both decreases in the government deficit and increases in the use of domestic financing will be needed to bring Croatia's foreign borrowing under control and to preserve and strengthen the country's access to international financial markets.