

Annual Report

2004

CROATIAN NATIONAL BANK

Summary

In 2004, Croatia experienced somewhat slower economic growth than in the preceding two years. At the same time, the country made progress in reducing external imbalances, and inflation remained low.

The central bank's policy measures in 2004 aimed above all at restricting foreign borrowing. By contrast, the central bank's measures aimed at restricting credit growth, enacted in January 2003, expired in January 2004. However, the central bank maintained its minimum foreign exchange liquidity requirement (on each day, liquid foreign currency claims had to amount to at least 35% of foreign currency liabilities). In July 2004, the CNB adopted a new decision whereby it stipulated a marginal reserve requirement to be allocated on increases in banks' foreign liabilities. In addition, the central bank actively supported the replacement of government external debt by domestic debt. In these ways, the central bank changed its focus in 2004 from restraining credit growth to restraining foreign borrowing.

Real GDP growth fell from 4.3% in 2003 to 3.8% in 2004. Personal consumption continued to play a strong role in growth, contributing some 2.4 percentage points. However, investment in fixed capital, which has been crucial to the recent expansion, fell off in the second half of the year after the completion of the main works on the Zagreb-Split highway. Overall, investment growth fell from 16.8% in 2003 to only 4.4% in 2004. By contrast, for the first time since 2000, net exports of goods and services made a positive contribution to GDP growth during the year as a whole (0.5 percentage points), and this partially compensated for the drop-off in investment.

Growth in value-added in industry slackened from 4.5% in 2003 to 3.9% in 2004. Growth in output of non-durable consumer goods slowed, while growth in intermediate goods accelerated noticeably. The largest fall in output, however, came in the field of construction, where value-added grew by only 5.6% in 2004 as compared to 20.2% in 2003. Value-added in trade also fell mildly, under the influence of slowing consumption growth, and value-added growth in the hotel and restaurant sector, the most visible indicator of tourism growth in output statistics, slowed as well.

Employment also grew slower in 2004 than in 2003. According to the CBS, total employment grew by 1.2% in 2004 compared to 2.5% growth in 2003. However, this figure includes strong contraction in the number of individual farmers (13.0%), which may not reflect actual employment trends accurately. Excluding individual farmers, employment growth fell from 3.1% in 2003 to 2.0% in 2004. Still, even this figure is not entirely accurate as it includes a large decrease in public administration employment (of 7.7%), which mostly resulted from updating of employment figures for the army and police.

Registered unemployment was 1.1 percentage points lower on average in 2004 than in 2003, and it ended the year down by only 0.2 percentage points compared to the end of 2003. This seems to be partly due to the effects of the 2002 reforms in the CES. These reforms tightened the definition of unemployment, leading to sustained decreases in registered unemployment during much of 2002 and 2003. But, although this “clean-up” of the unemployment rolls has finished, a sizable gap remains between registered unemployment and unemployment measured by semi-annual surveys using the ILO methodology.

Lower employment growth was accompanied by moderate wage growth. Real net wage growth fell to 3.8% in 2004 from 4.5% in 2003, while real gross wage growth rose to 4.2% from 3.1%. Some of the decrease in real net wage growth can be explained by the interaction between rising gross wages and the progressive tax system, which increased the tax burden on some workers. Public sector wage policy played an important role in containing wage growth, with real public sector wage growth falling from 4.8% in 2003 to only 1.8% in 2004.

Consumer prices rose by 2.1% on average in 2004, up from 1.8% in 2003. However, when we compare end-year data, inflation was up to 2.7% in December 2004 from 1.7% in December 2003. Increases in prices of refined petroleum products, along with natural gas and household water supply, made major contributions to inflation in 2004. In addition, price increases of tobacco products, caused by increases in excises enacted in July, contributed significantly to increased CPI inflation.

Core inflation also rose during 2004, reaching 2.3% year-on-year in December. Among others, this increase was caused by the increase in tobacco product prices, a sizable jump in meat prices (whose rate of inflation rose from -2.6% in December 2003 to 3.5% in December 2004) and the spillover of increased oil prices onto other areas, such as road and air transport. However, decreasing agricultural prices and a fall in automobile prices helped limit overall inflation.

The bulk of the inflationary pressures seen in 2004 and early 2005 have come from increasing energy prices in the world market. One-off domestic factors, such as the increased excise on tobacco products and the jump in meat prices, have been present, but their effects are likely to be temporary. As of yet, there are no signs of significant domestic inflationary pressures.

The CNB sees exchange rate stability as a key means to limit inflation and prevent the build-up of inflationary expectations. The average daily exchange rate of the kuna against the euro appreciated by 0.9% in 2004. The nominal effective exchange rate of the kuna against a basket of currencies appreciated by some 3.9%, largely due to nominal appreciation of 7.9% against the US dollar. The real effective exchange rate appreciated by a similar percentage (4.0% using consumer prices and 4.1% using producer prices), reflecting the fact that inflation in Croatia was essentially equal to inflation in its main trading partners. Nominal appreciation limited the impact of imported inflation during 2004.

During 2004, appreciation pressures were much more frequent than depreciation pressures, reflecting continued strong capital inflows. In its 2004 interventions in the foreign exchange market, the CNB made net purchases of EUR

510.2m from banks, creating HRK 3.8bn of reserve money. These interventions constituted the main channel of money creation, relieving appreciation pressures.

At the same time, the central bank sold a total of EUR 94.7m (net) to the MoF, removing HRK 741.7m from circulation. These transactions with the government were undertaken to facilitate the repayment of government external debt and its replacement with domestic borrowing. In particular, the central bank decreased the reserve requirement rate from 19% to 18% in November 2004, which freed banks' funds that the government then borrowed via a bond issue and used to buy foreign exchange for debt repayment. Similarly, in February 2005, the central bank lowered the minimum foreign exchange liquidity ratio from 35% to 32% to free up foreign exchange so that banks could purchase government foreign exchange bonds, allowing the government to repay its foreign exchange obligations.

In addition, the central bank sought to limit capital inflows by imposing a marginal reserve requirement on the increase in foreign liabilities of banks, starting in July 2004. The marginal reserve requirement rate was initially set at 24%, but was raised to 30% in February 2005. This measure makes it more expensive for banks to use foreign funding sources. However, it is not expected to eliminate new foreign borrowing, since banks turn to foreign sources for reasons other than price. That is, banks borrow from abroad because of the longer term of such sources compared to domestic ones, and because domestic deposit growth is not always adequate to finance banks' placement growth projected in their business plans.

In the beginning of 2004, the central bank also tightened monetary conditions by limiting the use of Lombard loans to only 5 days per month, by eliminating regular auctions of kuna CNB bills, and by ending the issuance of foreign currency CNB bills.

In April 2005, the central bank introduced reverse repurchase agreement auctions, a new instrument for creating and fine-tuning liquidity of the banking system. Repo auctions and other new instruments, such as the deposit facility at the central bank, are expected to help increase the effectiveness of monetary policy and to decrease undesired volatility.

While desiring to maintain tight monetary conditions to avoid excessive credit expansion and control the current account deficit, the central bank has also seen the need to create liquidity to prevent excessive appreciation pressures and to facilitate domestic financing of the budget deficit. The result has been moderate growth in monetary aggregates. M1 grew by only 2.0% in 2004, down from 9.8% in 2003, while M4 grew by 8.5%, down from 10.5% in 2003. To some extent, the slow growth of M1 may be due to better liquidity management by companies, whose non-monetary deposits grew rapidly as companies sought to maximise returns on their financial assets and decrease excess liquidity holdings. Continued solid M4 growth is above all the result of growth in foreign currency deposits, which grew by 7.5% in 2004, a slight increase from the year before. In addition, kuna non-monetary deposits registered strong growth, but these deposits have remained relatively small in the overall M4 aggregate.

Bank placements grew at an essentially unchanged rate of 14.0% in 2004. Loans to households again grew faster than loans to enterprises, by 18.7% vs.

8.0%. However, the gap between the two rates narrowed considerably from the previous year's 27.7% and 5.1% respectively. In part, this is the result of the removal of the central bank's 2003 lending measures, which provided incentives for banks to encourage corporate customers to use leasing or to borrow directly from their foreign parent banks, and thus avoid booking the loans on their balance sheets.

The fact that bank placements grew more rapidly than monetary aggregates explains the continued growth of banks' foreign borrowing. Banks increased their foreign liabilities by some HRK 11.2bn in 2004, while increasing their foreign assets by HRK 8.2bn.

Improved profitability motivated banks to maintain a brisk lending pace in the face of slower domestic funding growth. Although interest rate spreads fell in 2004, return on average assets (ROAA) rose from 1.59% to 1.70%, and return on average equity (ROAE) rose from 14.5% to 16.6%. Improved credit quality was one of the main reasons for improved profitability, as the ratio of total value adjustment and provisions to total placements and contingent liabilities fell from 4.1% in 2003 to 3.6% in 2004.

While bank foreign borrowing did contribute to an increase in Croatia's external debt, central bank measures to discourage such borrowing, the redirection of some government borrowing from the foreign to the domestic market, and a decrease in the overall fiscal deficit helped to slow the growth of the external debt. At the end of 2004, the overall external debt of the economy stood at EUR 22.7bn, an increase of 14.5% compared to 2003. This rate of growth was less than half of that recorded in 2003 (31.6%), and led to an increase in the debt/GDP ratio from 77.6% in 2003 to 82.1% in 2004. The ratio of external debt to total exports of goods and services rose to 157.3% at the end of 2004.

Looking at the growth of the debt by sectors, bank borrowing grew the fastest in 2004, by 25.0%. External debt of other domestic sectors grew by 18.9%, while government external debt grew by only 9.6%. While the decrease in the growth rate of the external debt in 2004 was encouraging, further efforts to stabilise the debt/GDP ratio will be needed, above all fiscal consolidation.

In addition, Croatia's current account deficit fell to 4.6% of GDP in 2004 from 6.9% in 2003. This substantial adjustment was in part the result of improved merchandise trade and a decline in net outflows based on factor income. It should be noted that this annual decline was strongly affected by substantial outflows recorded in 2003 on the basis of direct investment, which were mostly due to the transfer of patent rights by the pharmaceutical company Pliva to a foreign subsidiary. Excluding the effects of this transaction on results in the base year 2003, the annual drop in the current account deficit would be 1.2 percentage points in 2004.

Merchandise exports grew by 18.5% while imports grew by only 6.2%. The largest share of increased exports came from exports of ships and refined petroleum products. Ships are an important Croatian export, and the order books of Croatian shipbuilders suggest that ship exports will continue to be strong in the coming years. However, increased exports of refined petroleum products mainly

reflect increased prices rather than any increases in output. It is therefore noteworthy that exports excluding ships and refined petroleum products grew by 15.3%. The most important contributors to export growth outside shipbuilding and refined petroleum products were production of electrical machinery, equipment and apparatus, fur and leather products, machinery specialised for particular industries, non-ferrous metals and other metal products.

In 2004, tourism revenues, a key positive item in the current account, held steady at their 2003 level. Although physical indicators show that more tourists came to Croatia in 2004 and night-stays increased, the financial indicators grew very little, as larger numbers of tourists stayed in free accommodations. Tourism seems to have reached a plateau, and future growth in tourism revenues may require further investment in accommodation capacity and related services.