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# International Relations



## 7.1 Activities of the CNB in Connection with the Relations between the Republic of Croatia and the European Union

The accession of Bulgaria and Romania on 1 January 2007 rounded off the fifth wave of EU enlargement, bringing the total number of EU Member States to 27 and the total number of EU population to nearly 500 million. With its total GDP standing at EUR 12,253bn in 2007, the EU economy stands out as the world's largest single economic area. The eurozone also expanded in 2007 to include one more member, Slovenia.

The signing of the Lisbon Treaty in October 2007 amending the Treaty on European Union and the Treaty establishing the European Community is important for Croatia because it removes institutional obstacles to EU enlargement. The Lisbon Treaty is expected to come into force on 1 January 2009, following the process of ratification in all EU Member States.

Further progress was achieved in the process of EU accession negotiations of the Republic of Croatia in 2007. In terms of negotiating chapters which fall under central bank competence, negotiations relating to Economic and Monetary Policy have made most headway. In December 2006, the EU Council adopted its Common Position to open this chapter for negotiations, and set as a closing benchmark the achievement of full legislative alignment of the Act on the CNB, particularly as regards central bank independence. The benchmark is expected to be met and the chapter closed with the entering into force of the amended Act on the Croatian National Bank in 2008.

As regards the chapter Financial Services, the Croatian authorities were invited in January 2007 to submit their negotiating position which they did in March of the same year. The EU Council adopted its Common Position in June, setting five closing benchmarks, largely related to legislative alignment with the *acquis communautaire* in the area of credit institutions, insurance, financial market infrastructure, investment services, and securities market. To meet the set benchmarks, the authorities formed task forces for the adoption of relevant legislation. The operation of savings and loan associations is regulated by the Credit Unions Act adopted in December 2006. The Financial Collateral Act was adopted in August 2007. Other relevant legislation is planned for adoption in 2008.

To open the chapter on the Free Movement of Capital, the authorities have to meet two benchmarks set by the EU Council concerning the purchase of property by non-residents (EU Member States citizens) and the prevention of money laundering and financing of terrorism. In February and March 2008, the Republic of Croatia submitted its reports on the progress made in achieving these benchmarks and expects to receive positive opinion on them in the forthcoming months and an invitation to submit a negotiating position for that chapter.

As regards liberalisation of capital transactions, the 2007 liberalisation plan, submitted to the European Commission, was successfully completed and fully implemented.

As regards alignment of the Croatian legislation with the *acquis communautaire*, all the decisions envisaged under the 2007 National Programme for the Integration of the Republic of Croatia into the European Union have been adopted. CNB experts also participated in the drafting of the part of the 2008 National Programme for the Integration of the Republic of Croatia into the European Union which relates to economic criteria, free movement of capital, financial services, Economic and Monetary Union and financial control. Presenting accession-related activities in the forthcoming period, the Programme focuses especially on measures related to the alignment of Croatian legislation with the *acquis communautaire* in 2008. It was adopted at the session of the Government of the Republic of Croatia on 7 February 2008. At its session on 5 March 2008, the Croatian Parliament adopted an accompanying plan of legislative alignment.

In 2007, the CNB experts participated in the drafting of the part of the fourth Pre-accession Economic Programme 2008-2010 (PEP) relating to current economic developments, macroeconomic programme, and the financial sector. A document prepared annually by each EU candidate state in order to prepare for participation in the procedure of multilateral supervision and EU economic policy coordination.

In 2007, the CNB also participated in the work of, or preparation of materials for the bodies set up pursuant to the Stabilisation and Association Agreement, such as for instance, meetings of the Subcommittee on Economic and Financial Matters and Statistics and the Subcommittee on Internal Market and Competition, where they gave an overview of current macroeconomic developments in the Republic of Croatia, most notably those associated with monetary and exchange rate policies and the external sector, and discussed financial sector developments. CNB experts also prepared relevant materials for the regular meetings of the Stabilisation and Association Council and the Stabilisation and Association Committee.

Evidence of further progress achieved in the process of Croatia's EU accession can be found in the European Commission Croatia 2007 Progress Report issued in November 2007. The Commission views Croatia as a functioning market economy whose economic growth remains robust, although based on strong domestic demand and points to significant widening of the current account deficit and gross external debt growth, albeit at a slower rate. As regards the country's capabilities concerning the assumption of obligations arising from membership and in connection with the chapters with the CNB as the competent authority, the Report points to certain or considerable progress achieved in all the three chapters. As regards each of the chapters individually, the Report points to certain progress in free movement of capital, mainly in terms of liberalisation of capital and financial transactions accounts, and obligations arising under the Stabilisation and Association Agreement in connection with the purchase of property by EU Member States citizens. Further efforts are needed towards legislative alignment, administrative and implementing capacity building relating to anti-money laundering and combating the financing of terrorism. As regards financial services, the Report noted certain progress too. Much headway has been achieved in alignment with the *acquis communautaire* in the areas such as insurance and investment funds. Increased efforts are needed to strengthen bank supervision and authorities of the body responsible for the supervision of the non-banking financial sector to meet the demands of the *acquis communautaire* in the area of financial services. Finally, as regards the chapter dealing with the Economic and Monetary Union, the Report noted considerable progress in alignment with the *acquis communautaire* in the area of monetary policy. The Report noted particularly the December 2006 adoption of the Amendments to the Act on the Croatian National Bank, which provided for considerable strengthening of the CNB independence. However, it also noted that Croatia had not yet completed the necessary alignment, particularly that related to privileged public sector access to financial institutions and full central bank independence.

To ensure the exchange of experiences, the CNB met several times during 2007 with representatives of other EU Member States central banks, including the representatives of the European Central Bank. To ensure as close as possible a contact with EU institutions representatives, the CNB appointed its representative to the Mission of the Republic of Croatia to the European Communities in Bruxelles in early 2006 whose main task is to deal with issues related to the three negotiating positions which fall within central bank competence. Having proved useful and beneficial, after expiry of the term of office of the first representative, the position was filled again with a new representative in Spring 2008.

## 7.2 International Monetary Fund (IMF)

The quota of the Republic of Croatia in the IMF remained unchanged in 2007 (SDR 365.1m), and so did its voting rights (0.18% of total voting rights). The Republic of Croatia continued to realise its interests within the IMF through the Dutch constituency, which in addition to Croatia includes another 12 countries (Armenia, Bosnia and Herzegovina, Bulgaria, Cyprus, Georgia, Israel, Macedonia, Moldova, Montenegro, the Netherlands, Romania and Ukraine). The voting power of the Constituency is 4.8% of the total votes in the IMF, which makes it the seventh strongest constituency out of the total of 24 constituencies. The Constituency is headed by a Dutch representative acting as Executive Director of the Constituency. In accordance with the rules governing the work of the Constituency, the Republic of Croatia appointed in October 2007, for a two-year term, its representative to the post of Advisor to the Executive Director.

The Republic of Croatia continued its cooperation with IMF experts in 2007 through this institution's Representative Office in the Republic of Croatia and multiple visits of IMF representatives to Croatia and visits of representatives of the Republic of Croatia to the IMF. This was also the last year of the work of IMF Representative Office in Croatia, which closed down in June 2007, after 12 years of operation.

Regular annual Article IV consultations with the Republic of Croatia were concluded on 16 February 2007. On this occasion, the Executive Board of the IMF, based on IMF Mission report and the Executive Board discussion, noted that the country's economic growth had been strong, inflation low and that the progress achieved in the context of EU accession activities improved Croatia's investment outlook. However, the Executive Board expressed its concern over external vulnerability as seen in the large external debt to GDP ratio and widening of the current account deficit, and stressed the need for additional efforts towards more ambitious fiscal reforms, faster structural adjustment, and significant improvement in the business environment crucial for attracting foreign direct investment. The Board views as positive the CNB's monetary policy, and noted particularly central bank readiness to address the risks associated with foreign bank borrowing and fast credit growth of banks. The members of IMF Mission also prepared four studies dealing with the promotion of economic growth and reduction of external and financial vulnerabilities in Croatia. To present the contents of their studies to wider audiences in this field, they visited Zagreb again towards the end of May 2007 to hold a presentation.

Bearing in mind the progress achieved and the changes in the Croatian financial system in the period following its assessment in the context of 2002 FSAP, the Croatian authorities have requested that the FSAP Update be carried out. In accordance with that request, the IMF/World Bank FSAP Update missions visited Croatia towards the end of October and early November 2007 and closely cooperated with a European Commission Financial Sector Peer Assessment mission, which focused primarily on alignment of the Croatian regulatory framework in the area of non-banking financial services with international standards. The Executive Board of the IMF discussed the Final FSAP Update report simultaneously with Article IV consultations between the Republic of Croatia and the IMF for 2008.

Visits of central bank representatives to the IMF in 2007 were also marked by discussions regarding Article IV consultations, preparations for the FSAP Update and the activities concerning the participation in the work of IMF management bodies (the Constituency, the International Monetary and Financial Committee and the Board of Governors). Through these visits, the Croatian representatives were able to get acquainted more closely with a range of topics that the IMF deals with in the context of its mid-term development strategy planned in 2006 to adapt as successfully as possible to the new circumstances in the global economy. IMF efforts in this regard in 2007 were also focused on issues such as modernisation of the system of supervision of economic policies of the member countries, crisis prevention, improved cooperation with poorer countries, IMF management reform and development of a new model of long-term financing of IMF operations. In this context, note should be taken of more intensive efforts towards quota and voting power reform in the IMF, as planned under Resolution No. 61-5 of September 2006 of the Board of Governors.

Croatia continued to use IMF technical assistance in 2007. Note in this regard should be taken in particular of technical assistance provided to CNB experts in the area of macroeconomic modelling and forecasting.

As the fiscal agent of the Republic of Croatia and a depository of the International Monetary Fund (as regulated by the Act on Accepting Membership of the Republic of Croatia in the International Monetary Fund and Other International Financial Organisations on the Basis of Succession), the Croatian National Bank is responsible for keeping deposit accounts of the IMF and, in the name and on behalf of the Republic of Croatia, for regular servicing of succession-related obligations arising from the allocation of special drawing rights (total XDR 1.83m in 2007).

### **7.3 Bank for International Settlements (BIS)**

At its Annual General Meeting held on 24 June 2007, which was attended by the CNB Governor, as the representative of the Croatian National Bank, BIS adopted its Annual Report and decided on dividend payouts of XDR 255 per share.

Regular meetings of central bank governors from BIS member states, at which topical issues in the area of international banking and finance are discussed, continue to provide a strong incentive to central bank cooperation in this area. Important in the context of promoting this cooperation are committees and expert bodies which operate within the BIS and which also gather CNB representatives. In this context, the CNB hosted an event from 18-20 February 2007, gathering in Zagreb for the meeting of the BIS working group for monetary policy of Central and Eastern Europe, BIS representatives and representatives of the relevant countries as well as several eurozone central banks representatives and an ECB representative.

Another important form of cooperation between the CNB and the BIS was achieved in the area of international reserves management.

### **7.4 Cooperation with Other International Financial Institutions**

The bulk of CNB's cooperation with other international financial institutions entails its cooperation with development banks of which the Republic of Croatia is a member, such as the World Bank Group, the European Bank for Reconstruction and Development (EBRD) and the Inter-American Development Bank (IDB). Membership of the Republic of Croatia in these banks is regulated by special acts, pursuant to which the Croatian Ministry of Finance is the authority responsible for cooperation with the World Bank Group, EBRD and IDB, and as such is authorised to perform all operations and transactions in the name of the Republic of Croatia that are permissible under these institutions' articles of association. The CNB is the depository, i.e. it keeps all deposit accounts owned by these international financial institutions, in the name and on behalf of these financial institutions, and performs financial transactions with these organisations as the payment agent of the Republic of Croatia. It is also responsible for the execution of withdrawals and repayments of funds based on structural loans granted by the IBRD to the Republic of Croatia.

In addition to these legally prescribed tasks, in 2007 the CNB representatives exchanged information at meetings with the representatives of the World Bank and the EBRD on the macroeconomic situation in Croatia and on the planned strategy of these development banks for the Republic of Croatia in the forthcoming period.

In 2007, the CNB cooperated with many other international financial institutions and organisations, such as the European Investment Bank, the Institute of International Finance and the Japan Center for International Finance.

## 7.5 Foreign Exchange System and Foreign Exchange Policy Measures of the Republic of Croatia

The legal basis for the foreign exchange system in the Republic of Croatia is provided by the Foreign Exchange Act.<sup>1</sup> The framework for the instruments and measures for the implementation of the foreign exchange policy is provided by relevant subordinate legislation.

Foreign exchange policy measures are used to determine the degree of restrictions on capital movements between residents and non-residents and the terms and the manner of use of foreign means of payment and kuna between residents and residents and non-residents.

### 7.5.1 Free Movement of Capital

Under the Stabilisation and Association Agreement which entered into force on 1 February 2005, the Republic of Croatia has undertaken to abolish restrictions on payments and transfers of funds associated with current transactions and restrictions on payments and transfers of funds associated with capital transactions. In the context of capital transactions liberalisation, the CNB adopted towards the end of 2007 a Decision on amendments to the Decision on the manner and conditions under which residents may execute or receive payments arising from transactions with non-residents in domestic cash, foreign cash and checks,<sup>2</sup> thus lifting the restriction on the amount of kuna cash which a resident legal person may collect from a non-resident or pay to a non-resident.

In 2007, the CNB adopted a new Decision on collecting data for the compilation of the balance of payments, external debt and international investment position,<sup>3</sup> repealing the obligation of credit transaction reporting as a precondition for the realisation of credit transactions in a bank, a mild form of capital restriction, though maintaining the obligation of reporting to the Croatian National Bank on foreign credit transactions for the purpose of compilation of external debt statistics. Relevant amendments were made accordingly to the Decision governing the conditions for and the manner of performing external payment operations,<sup>4</sup> and to the accompanying Instruction for the implementation of that Decision.

Against the background of the existing capital transactions restrictions, 470 approvals were issued to residents in 2007 for the opening of accounts and for keeping funds in accounts abroad, with the total balance of these accounts standing at approximately USD 200m. Five hundred eighty seven approvals were granted to domestic banks for cross-border transfer of kuna cash for purchase and sale transactions with foreign banks. Ninety eight approvals were granted for cashless transfers of funds related to gifts and grants and 18 approvals were granted for cash payments and collections in cash in transactions with non-residents. Twenty two approvals were granted to resident natural persons in 2007 for taking foreign cash out of the country.

The remaining restrictions on resident capital transactions relate to the granting of short-term financial loans to non-residents, opening of accounts in foreign financial institutions, the taking in and out of the country of cash in cross-border transactions and payments and collections in foreign cash in non-resident transactions.

### 7.5.2 Exchange Transactions

In 2007, 612 authorisations for the conduct of currency exchange transactions were granted to legal persons and crafts. In terms of their legal status, 63% of the applicants for authorisations were limited liability companies, 26% were crafts, 8% were joint stock companies and 3% were other legal persons. Eighteen authorisations were revoked during the same period. Twenty seven administrative procedures were concluded in 2007 with decisions to reject or

1 OG 96/2003, 140/2005 and 132/2006.

2 OG 132/2007.

3 OG 121/2007.

4 OG 132/2007.

suspend applications for authorisation. Seventy nine decisions were issued on the removal from the court register or the register of crafts of currency exchange transaction activities for those who had conducted currency exchange transactions but had not applied for an authorisation.

Given the expanded scope of the Act on Amendments to the Foreign Exchange Act, which came into force in December 2006,<sup>5</sup> in terms of the criminal offences based on which fitness and properness of the craftsmen, management board members and qualified owners of authorised currency exchange offices are evaluated, a revision was made in 2007 of over 500 cases which had been issued approvals before. Authorised currency exchange offices have to use protected computer program certified by the CNB. The use of such programs was introduced for the purpose of strengthening fiscal and financial discipline and is directly related to the pursuit of anti-money laundering policy. Six certificates were issued in 2007.

According to data on the turnover of authorised currency exchange offices, received and processed by the CNB, the total turnover of authorised currency exchange offices in transactions with natural persons was around HRK 29bn in 2007. Of that amount, HRK 18bn went to the purchase of foreign cash and checks denominated in foreign currency and HRK 11bn went to the sale of foreign cash. The bulk of authorised currency exchange offices' transactions (91.1%) was in euro. HRK 7bn worth of the balance between purchase and sale of foreign cash, was sold to the banks.

### 7.5.3 Activities Related to Anti-Money Laundering, Terrorist Financing and Counterfeiting of Foreign Cash

In March 2007, the authorities established a committee of the Croatian National Bank for the prevention of money laundering and terrorist financing, whose main task is to cooperate with other competent government bodies for the purpose of monitoring and implementing *acquis communautaire* in this field. To achieve this objective, an inter-institutional working group for the prevention of money laundering and the financing of terrorism and an inter-departmental working group for the prevention of money laundering and the financing of terrorism, which includes a CNB representative, were established.

To implement measures against counterfeiting of foreign cash, the CNB informed the banks throughout 2007 about withdrawals and putting into circulation of original foreign banknotes and about the characteristics of counterfeit foreign banknotes detected in the Republic of Croatia.

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<sup>5</sup> OG 132/2006.