



Annual Report 2008

CROATIAN NATIONAL BANK



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International Relations

7.1 CNB Activities Connected with the Relations between the Republic of Croatia and the European Union

In 2008, further progress was achieved in accession negotiations between the EU and Republic of Croatia. The CNB participated in the negotiations as competent or co-competent authority for the following four chapters: Free movement of capital, Financial services, Economic and monetary policy and Financial control.

The most progress was made in the negotiations on Chapter 17 – Economic and monetary policy. Specifically, the preconditions for fulfilling the benchmarks for the closure of this chapter were created by the coming into effect of the new Act on the Croatian National Bank. Following a positive evaluation by the European Commission and a discussion on the preparedness to close this chapter at the Enlargement Working Group of the Council of the EU, this chapter was provisionally closed at the Intergovernmental Conference on 19 December 2008.

Chapter 9 – Financial services sets benchmarks to be met by the Republic of Croatia in order for this chapter to be temporarily closed. They are primarily related to the alignment of legislation with the *acquis* in the area of credit institutions, insurance, financial market infrastructure, investment services and the security market. In this regard, in 2008 the Croatian Parliament adopted a number of new acts (or amendments to existing acts): the Act on Amendments to the Insurance Act, the Credit Institutions Act, the Act on Electronic Money Institutions, the Act on Settlement Finality in Payment and Financial Instruments Settlement Systems, the Act on Amendments to the Deposit Insurance Act and the Financial Conglomerates Act.

Two benchmarks had to be met for the opening of Chapter 4 – Free movement of capital: one related to the acquisition of real property by non-residents (EU member state citizens) and the other related to the prevention of money laundering and terrorist financing. In April 2008, the European Commission concluded that the Republic of Croatia was ready to open this chapter and the negotiating position was submitted in June to the EU Council Presidency. However, although it was expected that negotiations would be opened at an intergovernmental conference in October, and then again in December, they were not opened in 2008.

One of the five benchmarks to be met to close negotiations on Chapter 32 – Financial control falls within the scope of the CNB. This benchmark involves the implementation of measures to protect the euro against counterfeiting. In line with this, in March 2008 the CNB established the National Counterfeit Centre, the National Analysis Centre and the Coin National Analysis Centre. Having completed their trial run in late February 2009, the centres became fully operational at the beginning of March.

As regards the fulfilling of the obligations under the 2008 National Programme for the Integration of the Republic of Croatia into the European Union, in 2008 the CNB adopted all the implementation measures within its competence as laid down by the Programme. CNB experts also participated in the drafting of the 2009 National Programme for the Integration of the Republic of Croatia into the European Union, in the part relating to economic criteria, free

movement of capital, financial services, economic and monetary policy and financial control. Presenting accession-related activities in the forthcoming period, the Programme especially focuses on the measures related to the alignment of Croatian legislation with the *acquis* in 2009. The Programme was approved at the Government session held in December 2008.

In 2008, CNB experts participated in the drafting of the part of the fifth Pre-accession Economic Programme 2009-2010 (PEP) relating to current macroeconomic developments, the medium-term macroeconomic programme and the financial sector. This document is prepared annually by each EU candidate country in order for it to prepare for participation in multilateral supervision and EU economic policy coordination procedures.

In 2008, CNB representatives also participated either in the work of or in the preparation of materials for the bodies set up pursuant to the Stabilisation and Association Agreement, such as the Subcommittee on Economic and Financial Matters and Statistics and the Subcommittee on the Internal Market and Market Competition. The two bodies reviewed current macroeconomic developments in the RC, focusing on monetary and exchange rate policies and the external sector, and also discussed financial sector developments. CNB experts also prepared relevant materials for the meetings of the Stabilisation and Association Council and the Stabilisation and Association Committee.

Further progress in accession negotiations was also confirmed by the European Commission Progress Report on the RC 2008, published in November 2008. The Report assesses that, up to the time of its writing, the international financial crisis made only a minor impact on the Croatian economy and financial sector, but warns of substantial external financing needs generated by a widening current account deficit and high external debt. The external imbalances thus make the Croatian economy vulnerable to a possible break in capital inflows. The Report also estimates that the CNB made a very good progress in improving its analytical capacity to compile long-term financial sector stability assessments. In reference to the chapters falling within the competence of the CNB, the Report states that some progress was made regarding Chapter 4 – Free movement of capital, mainly as regards the processing of applications for permits for the acquisition of real property for EU citizens, the payment systems and the adoption of the action plan and new laws on the fight against money laundering. However, the Report stresses the need for the further strengthening of administrative capacities, improving legislation and investing additional effort into the application and implementation of laws. As regards Chapter 9 – Financial services, the overall assessment points to strong progress in that area. Moreover, the progress made in the area of banking and financial conglomerates, especially as regards the adoption of relevant laws, is assessed as substantial. Although the Supervisory Framework is still under development, the supervisory techniques in place pose no risk to the successful implementation of Basel II, and the cooperation between domestic and foreign supervisory bodies improved. As regards Chapter 17 – Economic and monetary policy, the Report stresses the considerable progress made in their alignment with the *acquis*, especially regarding the adoption of the new Act on the Croatian National Bank. Sufficient progress was achieved by further restrictions imposed on the privileged access of government bodies to financial institutions. Regarding economic policy, the Report warns of the slow pace of reforms and the gap between the adopted legislative measures and their implementation. Finally, as regards Chapter 32 – Financial control, the Report states that good progress was made in protecting the euro against counterfeiting. However, it stresses that further efforts are needed to ensure an efficient application of regulations and strengthen the capacities of the newly established anti-counterfeiting centres.

In 2008, with a view to exchanging experiences, the CNB continued the contacts with the representatives of EU member states' central banks, the European Central Bank and other EU institutions. For example, during the stay of an Austrian National Bank representative in Zagreb information was exchanged on the economic and institutional aspects of EU integration and the central bank's role in maintaining financial stability.

7.2 International Monetary Fund (IMF)

The Republic of Croatia's quota in the IMF remained unchanged in 2008 (SDR 365.1m), and so did its voting rights (0.18% of the total voting rights). The Republic of Croatia continued to exercise 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. The Constituency is headed by a Dutch representative acting as Executive Director.

The cooperation and exchange of opinions with IMF experts continued in 2008, the main occasion being the visit of Deputy Managing Director Murilo Portugal and his associates. During his two-day stay, the Deputy Managing Director met with the highest representatives of the Ministry of Finance and CNB.

The regular annual Article IV consultations with the Republic of Croatia were concluded on 9 May 2008. Based on the report of the IMF Mission that visited the RC in late February and early March 2008, and the discussions held, the IMF Executive Board commended Croatia for its strong economic growth and accompanying increase in employment. Also commended was the progress in policy implementation, especially as regards the general government deficit reduction since 2003, and the ongoing strengthening of financial supervision. At the same time, concerns were raised about a growing current account deficit, the external debt level and inflation rate growth. As regards exchange rate policy, the Executive Board stated that the real exchange rate is broadly in line with fundamentals and confirmed the advantages of maintaining a stable exchange rate in a situation of high euroisation and vulnerability to balance sheet mismatches. Emphasising that this policy, in order to continue successfully, needs to be supported by other economic policies, the Board welcomed the intention of the authorities to continue reducing the general government deficit to reach the targeted fiscal balance planned for 2011. In the opinion of the Board, the bulk of the fiscal adjustment (including the saving of surplus revenue) should be front-loaded and the fiscal deficit should be targeted to 1% of GDP or less in 2009. This would directly facilitate the reduction of large external imbalances, while increasing confidence in the achievement of recommended objectives. As concerns other policies, it was stressed that it was important to accelerate structural reforms, which should contribute to reducing vulnerabilities, raising the standard of living and successfully concluding accession negotiations with the EU, and to implement tight prudential policies and high quality supervision of the financial sector. IMF mission members also compiled two studies, one of which assesses Croatia's external stability, the other dealing with the efficiency of healthcare, education and social spending. The conclusions of these studies were presented to CNB and MoF representatives and expert audiences.

In parallel with the Mission report on the 2008 Article IV consultations, the Executive Board accepted the Financial Sector Stability Assessment (FSSA) Update by the joint IMF – World Bank mission within the Financial Sector Assessment Program (FSAP), which visited Croatia in late 2007 at the invitation of Croatian authorities. The Executive Board stressed that the Croatian financial system was sound and commended the measures implemented by Croatian authorities to strengthen the supervision of the banking and non-banking sectors and their plan to compile a financial sector stability report for the future period. However, the ongoing tensions in global financial markets and balance sheet vulnerabilities require the maintenance of high prudential standards and close monitoring of bank lending and risk management practices. The said Report, in a somewhat shortened form, entitled Financial Sector Assessment, was accepted by the Board of Executive Directors of the World Bank in July 2008. It should be noted that more than two thirds of member countries have participated in the joint IMF – World Bank Financial Sector Assessment Program since its inception in 2000, and that in half of them, including Croatia, a reassessment has been or is being conducted.

The visits of CNB delegations to the IMF in 2008 included discussions on the mentioned topics related to Article IV consultations and the FSSA Update and participation in the work of the IMF's governing bodies (the Constituency, the International Monetary and Financial Committee and the Board of Governors). This provided opportunities to Croatian representatives to get a deeper insight into IMF activities.

In addition to carrying out its regular tasks, in the first half of 2008 the IMF focused on completing the tasks established within the medium-term development strategy, planned as early as in 2006. In this connection, the Board of Governors adopted two resolutions (Resolution No 63-2 and Resolution No 63-3), initiating the procedure of adopting the amendments to the IMF Articles of Association in member countries. The amendment to the Articles of Association proposed by Resolution No 63-2 provide for an increase in basic votes of member countries and the appointment of another deputy to the executive directors elected by at least 19 member countries. The acceptance of this amendment would enforce the second increase (9.6%) in the quota of member countries, which would increase the total IMF quota, inclusive of the first increase implemented pursuant to Resolution No 61-5 from 2006 (the so-called Singapore Resolution) by 11.5%. A second round of quota increases would address 54 underrepresented countries, not including the RC. The amendment to the Articles of Association proposed by Resolution No 63-3 relates to the expansion of the IMF's investment authority, which is one of the elements of the new long-term IMF financing model. Croatia accepted the proposed amendments to the IMF Articles of Association by relevant Government regulations published in the Official Gazette – International Treaties No 5 of 13 August 2008. In accordance with the provisions of the IMF Articles of Association these amendments will come into force once they are approved by at least three fifths of member countries, possessing at least 85% of the total voting power.

Early 2008 saw the completion of the initiative to provide financial assistance to Liberia for the payment of arrears to the IMF, in which Croatia also participated.

When the global crisis reached emergency proportions in the second half of 2008, IMF priorities turned to providing financial and advisory assistance to a growing number of member countries. In the period from October 2008 to the end of January 2009, the IMF granted, primarily in the form of stand-by arrangements, SDR 32.0bn from the General Resources Account to the hardest hit countries. At the same time, the IMF also intensified research into the cause of the crisis and specified the reforms necessary to establish a new global financial system and prevent the recurrence of such crises.

Croatia continued to use the IMF's technical assistance in 2008. In this regard, note should be taken of the technical assistance provided to CNB experts in the area of macroeconomic modelling and forecasting.

As the fiscal agent of the RC 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 CNB is responsible for keeping deposit accounts of the IMF and, in the name and for the account of the Republic of Croatia, for regular servicing of succession-related obligations arising from the allocation of special drawing rights (a total of SDR 1.3m in 2008).

7.3 Bank for International Settlements (BIS)

At its Annual General Meeting, held on 30 June 2008, the BIS adopted its Annual Report and decided on dividend payouts of SDR 265 per share.

The regular meetings of central bank governors from BIS member countries 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. Committees and expert bodies operating within the BIS, which include CNB representatives, are also important in the context of promoting this cooperation.

Another important form of cooperation between the CNB and 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). RC membership in these banks is regulated by special acts, pursuant to which the Ministry of Finance of the RC is the authority responsible for cooperation with the World Bank Group, EBRD and IDB, and is as such authorised to perform all operations and transactions in the name of the RC 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 their name and for their account, 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 2008 CNB representatives exchanged information at meetings with World Bank and EBRD representatives on the macroeconomic situation in Croatia and the planned strategy of these development banks for the Republic of Croatia in the forthcoming period.

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.¹ The measures for the implementation of foreign exchange policy, defined by relevant subordinate legislation, determine the degree of free movement of capital between residents and non-residents and the terms and manner of using foreign means of payment and kuna in transactions between residents and between 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, Croatia has undertaken to abolish restrictions on payments and transfers of funds associated with current and capital transactions. Restrictions on payments and transfers of funds were retained only for some capital transactions. The Act on Amendments to the Foreign Exchange Act,² which came into effect in December 2006, provided for the abolishment of the remaining restrictions on capital transactions as of 1 January 2009. However, pursuant to the Regulation on Amendments to the Foreign Exchange Act,³ this was postponed until 1 January 2010 in order to protect Croatia from undesired consequences of capital flows under the conditions of the global financial and economic crisis. The only exception was made in granting financial loans with a maturity of up to one year to non-residents, the abolishment of which was postponed until 1 August 2009.

Against a background of the existing restrictions of capital transactions, 355 approvals for the opening of accounts and keeping funds in accounts abroad were issued to residents in 2008, with the total balance of these accounts standing at approximately USD 20m. Domestic banks were granted 631 approvals for cross-border transfer of kuna cash for purchase and sale transactions with foreign banks. 108 approvals were granted for cashless transfers of funds related to gifts and grants and 23 approvals were granted for cash payments and collections in cash in transactions with non-residents. 20 approvals were granted to resident natural persons for taking foreign cash out of the Republic of Croatia.

7.5.2 Authorised Exchange Offices

Pursuant to the Foreign Exchange Act, the CNB issues authorisations to conduct exchange transactions to legal persons and crafts. In 2008, authorised exchange offices were issued 66 authorisations to conduct exchange transactions so that the total number of active authorisations at the end of 2008 stood at 1,255. As concerns their legal form, 63% of authorised exchange offices are limited liability companies, 26% are tradesmen, 9% are joint stock companies and 2% are other legal persons. Also in 2008, 22 authorisations to conduct exchange transactions were withdrawn from authorised exchange offices.

The revision procedure for the authorisations issued in 2006 was also completed in 2008. The revision was conducted due to the coming into effect of the Act on Amendments to the Foreign Exchange Act⁴ in December 2006 since it expands the scope of criminal offences taken into consideration in assessing the fulfilment of the fitness and properness criteria. Therefore the revision process included an expanded verification of the fulfilment of the fitness and properness criteria for all natural and legal persons related to authorised exchange offices whose authorisations were issued in 2006.

Authorised exchange offices have to use protected computer programs 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. Two certificates were issued in 2008.

According to the data on the turnover of authorised exchange offices, received and processed by the CNB, their total

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

2 OG 132/2006.

3 OG 150/2008.

turnover in transactions with natural persons was around HRK 27.5bn in 2008. Of that amount, HRK 17.0bn went to the purchase of foreign cash and checks denominated in foreign currency and HRK 10.5bn went to the sale of foreign cash. The bulk of authorised exchange offices' transactions (92%) was in euro. HRK 6.5bn worth of the balance between purchase and sale of foreign cash was sold to banks.

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

March 2007 saw the establishment of a Croatian National Bank committee 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 the *acquis* in this field. Two working groups were established to achieve this goal: an inter-institutional working group for the prevention of money laundering and terrorist financing and an inter-departmental working group for the suppression of terrorism, which includes a CNB representative.

The Report on the third assessment round for the legislative, financial and repressive system of the RC was defended at the 26th plenary session of the special committee of the Council of Europe – MONEYVAL, held at the beginning of April in Strasbourg. The representatives of the standing delegation at the session were accompanied by five CNB representatives.

In 2008, the Committee cooperated intensively with the Office for Money Laundering Prevention on drafting the new Act on the Prevention of Money Laundering and Terrorist Financing⁵ and on the adoption of the ordinance for the implementation of this Act. In cooperation with the Croatian Chamber of Commerce and the Office for Money Laundering Prevention, in October 2008 a seminar was organised for banks, savings banks and housing savings banks on the interpretation of the new Act and its implementation.

To implement measures against counterfeiting of foreign cash, throughout 2008 the CNB provided information to banks about withdrawals and putting into circulation of genuine foreign banknotes and to banks, the MoF and FINA about the characteristics of counterfeit foreign banknotes detected in the Republic of Croatia.

4 OG 132/2006.

5 OG 87/2008.