# Annual Report 2008

CROATIAN NATIONAL BANK

# Summary

The year behind us was unusual in many ways. The first half of the year saw a surge in the general price level, while the negative effects of the spillover of global financial crisis to the real sector of the economy began to be increasingly felt in its second half. The current account imbalance grew due to an increase in and the high level of prices of key imported raw materials, while external debt indicators worsened on account of a strong and permanent dependence of domestic sectors on non-resident savings. The first indications of a change in capital inflows appeared by the end of the year against a background of the country's growing external exposure, putting into question the coverage of accumulated deficits. In response to such conditions, the CNB took timely action to enable the economy to overcome the difficulties in the easiest possible way. Implementing a series of measures, the CNB contributed to halting the withdrawal of deposits from domestic banks and ensuring smooth government financing in the domestic market. In the course of the year, being aware of negative consequences that may arise from sudden and rapid exchange rate fluctuations in Croatia's highly euroised economy, the CNB first alleviated appreciation pressures, and then, by the end of the year, mounting depreciation pressures. The turbulences in 2008 notwithstanding, the interventions of the central bank proved effective in maintaining exchange rate stability and contributed to attaining its main objective – the preservation of price stability.

The average annual consumer price inflation rate went up to 6.1% in 2008, an increase of 3.2 percentage points from 2007. This was in consequence of a marked pass-through of inflation from 2007 (3.3 percentage points) and a strong growth in the prices of energy and food in the first seven months of 2008 arising from high raw material prices in the world market. In the same period, domestic inflationary pressures also stemmed from the time-lagged effect of the strengthening of domestic demand in the previous year and from rising unit labour costs. These trends reversed around mid-year and, coupled with a drop in world raw material prices and a sharp slowdown in personal consumption, consumer price inflation started to decelerate significantly in the second half of the year, dropping to 2.9% in December.

Other major price indicators in Croatia showed similar trends. The average annual core inflation rate, which excludes agricultural product prices and administrative prices, rose from 3.0% in 2007 to 5.7% in 2008. The acceleration in core inflation in the first seven months of 2008 was primarily due to the price increase in industrial food products, stemming from the price growth of agricultural raw materials and energy in the world market. When these prices fell after July, core inflation decelerated. Industrial producer prices increased at the highest rate compared with other aggregate price indicators, from 3.4% in 2007 to 8.4% in 2008. The steep rise in these prices in the first seven months was also caused by the price growth of crude oil and other raw materials in the world market.

After having surged in the past few years, real estate prices in Croatia started decelerating towards the end of 2007 and were down to 5.8% annually in 2008. The deceleration was predominantly due to a weakening demand for real estate, which was a consequence of a slowdown in real disposable household income and a drop in home loan demand. The latter was influenced by an increase in nominal interest rates on home loans, tightened lending conditions and increased insecurity regarding future economic developments, all contributing to a decline in consumer optimism. In addition, in the expectation that the slowdown in real estate prices would continue, households postponed their decisions to purchase residential real estate.

According to preliminary CBS data, the economic growth rate in 2008 was the lowest since 1999, with real GDP increasing by a slight 2.4%. Economic activity slowed throughout the year, recording a negative rate of change in the third and fourth quarters, according to seasonally adjusted data.

An analysis of aggregate demand components shows that the largest contribution to trends in overall real growth came from a slump in personal consumption. Household consumption weakened because of adverse changes in real disposable household income and growing consumer pessimism. In addition, the sluggish performance of the export sector combined with steady import growth resulted in the negative contribution of net foreign demand to real economic growth. However, public and private sector investments accelerated in 2008, offsetting, to some degree, negative trends in other aggregate demand components.

The prices of final domestic goods and services rose significantly in 2008 as a result of sharp price increases in important raw materials in the world market and the growth of domestic energy prices and enterprise financing costs. The general price level, measured by the GDP implicit deflator, rose 6.4% in 2008, making a significant contribution to nominal GDP growth (HRK 342.2bn in 2008).

Labour market developments were relatively positive in 2008. Average unemployment was lower than in 2007, with the average unemployment rate down to 13.4%. Employment increased by an average of 1% relative to the previous year, as shown by preliminary CBS data. However, in line with the weakening of overall economic activity, the pace of decrease in unemployment and increase in employment decelerated towards the end of the year.

Nominal gross and net wages grew significantly in 2008, among other things as a result of the agreement on initial salaries of public-sector and government employees, amendments to some regulations and the adjustment of the labour price for inflation. The nominal wage dynamics was sufficient to offset the negative impact of the accelerated inflation rate on the dynamics of real wages, which increased slightly.

In response to mounting inflationary pressures in the first seven months of 2008, monetary policy aimed to curb inflation primarily by maintaining the stable nominal exchange rate of the domestic currency. Exposed to mild appreciation pressures in the first nine months of the year, the kuna/euro exchange rate came under depreciation pressures in the following period. However, the CNB intervened only twice in the foreign exchange market in 2008. At the first auction, held in January, a decline in kuna liquidity led to the strengthening of appreciation pressures, and at the second auction, held in October, an increase in foreign exchange demand caused an increase in depreciation pressures. Foreign exchange transactions with banks had an almost neutral effect on money supply at the annual level, while foreign exchange transactions with central government resulted in the issue of HRK 1.2bn. The nominal daily kuna/euro exchange rate fluctuated in a narrow band (between –1.6% and 1.8%) around the average daily exchange rate of HRK 7.22/EUR.

In addition to appreciating slightly versus the euro, the average kuna exchange rate appreciated strongly against the US dollar in the first seven months of the year, with the result that the nominal effective exchange rate of the kuna appreciated by an average of 3.5% relative to the previous year. These trends, and a faster growth of domestic than foreign prices, show a deterioration in the indicators of export price competitiveness in 2008.

In 2008, the CNB continued to use and implement changes to monetary policy instruments focusing on maintaining exchange rate stability and achieving in this way its main objective – the preservation of price stability. The counter inflationary monetary policy measures included tightening money supply and restricting bank lending. In addition, bank foreign borrowing was until late in the year penalised by the marginal reserve requirement, which prompted banks to substitute domestic deposits and capital for foreign liabilities.

Reverse repo auctions were the main instrument for the creation and withdrawal of reserve money in 2008. They were used less than in the previous year so that the decline in turnover led to an interest rate increase. As a consequence, excessive exchange rate fluctuations and depreciation expectations reduced towards the end of the year.

At the end of the year, under the conditions of economic slowdown and limited net foreign capital inflows, the CNB primarily focused on securing sufficient liquidity for domestic sectors by implementing changes to monetary policy instruments. The collapse of Lehman Brothers and the consequential slump in some European banks' share prices in October led to a drop in optimism among domestic savers and a partial withdrawal of deposits from domestic banks. The central bank responded promptly and resolutely by abolishing the marginal reserve requirement and, by the large amounts of foreign currency thus released, facilitating the payment of foreign currency deposits for banks. The MoF provided support by increasing the insured deposit amount from HRK 100,000 to 400,000 and the deposit withdrawal was quickly and successfully halted. The CNB remained proactive in the rest of the year. The reserve requirement rate was cut from 17% to 14% in December in order to correct money market imbalances and facilitate domestic government financing without squeezing out the private sector.

The growth rate of net domestic assets accelerated, but net foreign assets reduced sharply. This led to a substantial decrease in total liquid assets (M4). Money (M1) decreased in the same period, as a result of the real economic downturn and lending slowdown, but also due to the central bank's tightening of money supply. Savings and time deposits of domestic sectors increased in the course of the year, but the increase was half lower than in 2007. Deposit interest rates trended upwards, while interest rates on corporate time deposits mainly dropped.

Bank placements to the non-banking sector showed moderate growth in 2008, remaining below the 12% limit imposed by the central bank. The slowdown in placements relative to the previous years was due to a decrease in demand for loans caused by tightened financing conditions, an increase in lending interest rates, the overall economic slowdown and pessimistic expectations regarding future economic trends. The trends in placements confirm that CNB measures were not an impediment to lending to the domestic private sector.

The central bank was also very active in the field of banking system supervision, carrying out on-site examinations of 24 banks and 10 savings and loan cooperatives and imposing corrective measures to eliminate the established violations and irregularities. In the second half of 2008, the CNB intensified liquidity risk monitoring, both at the level of individual banks and the system as a whole, in order to ensure adequate monitoring and timely information. The cooperation with foreign supervisors of the banking groups that include domestic banks also intensified. Substantial progress was made in the field of legal regulations. By drafting the Credit Institutions Act, the CNB completed the alignment of domestic banking regulations with relevant EU directives and ensured the conditions for the implementation of Basel II standards.

Central government continued to meet its financing needs in the domestic market in 2008. This tendency was especially strong in the last quarter due to a limited access to foreign capital. The central bank also supported government efforts towards deficit financing from domestic sources by adapting monetary policy measures. In May, the CNB reduced the prescribed minimum foreign currency liquidity ratio and released funds, which the banks used to grant a syndicated foreign currency loan. In addition, the abolishment of the marginal reserve requirement and the reduction of the reserve requirement rate also contributed to ensuring sufficient liquidity to finance large placements to the government.

As banking system liquidity was good for the most part of 2008, interest rates in interbank overnight trading remained relatively low in the January to September period, jumping, however, and becoming increasingly volatile early in the fourth quarter. This instability was triggered by the INA shareholder payout related to the MOL acquisition of a shareholding in the company, which pushed up demand for kuna and caused the segmentation of the interbank market into banks with substantial liquidity surpluses and those having liquidity shortfalls. Such a money market structure proved to be a fertile soil for an interest rate hike. Money market interest rates returned to their usual levels in early December as a result of the CNB's decision to cut the reserve requirement rate.

The domestic capital market was strongly affected by negative developments in international financial markets, with the result that both the annual share turnover and the prices of most shares listed on the ZSE dropped considerably. Downward trends also prevailed in the Croatian debt security market, as evident from a sharp drop in both the turnover and the value of the bond index CROBIS. As global investors increasingly fled risky investments, required yields on Croatian eurobonds widened significantly on international capital markets, which, in addition to a decrease in required yields on German bonds, resulted in a considerable widening of the spread between these yields.

Stemming from a relatively strong domestic demand, which prevailed throughout most of the year, the increase in the current account deficit was halted as late as in the last quarter, when it held steady at the level reached in the same period in the previous year. However, the current account deficit for the whole of 2008 stood at EUR 4.5bn, or 9.4% of GDP, an increase of EUR 1.2bn, or 1.8 GDP percentage points, from the previous year. The significant worsening of the current account balance is to a large extent attributable to a widening goods trade deficit, primarily caused by surging oil prices. The balance in the factor income account also declined, due to high expenses from direct investments and interest. Only international trade in services recorded positive results, especially in tourism, while the current transfers account mainly held steady relative to 2007.

The balance of foreign trade in goods (at constant US dollars) deteriorated in 2008, with imports rising at the same pace as in the previous year and exports decelerating sharply. Also contributing to this was a decline in competitiveness, arising from an accelerated growth of gross wages, occurring against a background of the appreciation of the effective kuna exchange rate, coupled by a slowdown in labour productivity growth relative to the previous year. The export growth was in 2008 spurred by the strong export performance of trade in other transport equipment and natural and industrial gas. However, if these two divisions and oil and refined petroleum products are excluded, the increase in exports is negligible. The key contribution to a continued strong growth of goods imports in 2008 came from imports of energy products (oil and gas) and other transport equipment, whereas imports of other goods grew at much lower rates, primarily due to a drop in road vehicle imports late in the year.

The current account deficit was financed by strong capital inflows, which, excluding the change in international reserves, amounted to EUR 5.3bn, increasing by 9.1% from 2007. The bulk of the increase in net inflows was accounted for by the growth of external debt by domestic sectors arising from contracted loans and trade credits and currency and deposits of non-residents. Strong inflows also resulted from direct investments, both from direct equity investments and reinvested earnings and from the increase in debt to affiliated enterprises abroad. In contrast, the portfolio investment account recorded an outflow of funds, which was caused not only by the repayment of Samurai bonds but also by the withdrawal of funds invested by non-residents in the domestic capital market and substantial investments of domestic investors in foreign capital markets.

Due to strong debt capital inflows, gross external debt of the RC grew by EUR 5.9bn in 2008, reaching EUR 39.1bn at the end of December. External debt accelerated from the previous year, once again due to strong borrowing by enterprises. Government sector debt dropped only slightly through the year and remained almost unchanged. In contrast with 2007, banks' external liabilities increased. However, the debt was decreasing for most of the year, while the bulk of the increase was generated in the last quarter, when banks borrowed abroad to compensate for an outflow of domestic sectors' deposits and meet substantial central government financing needs. A lion's share of the funds was in that period raised from parent banks, which proves that domestic banks were able to raise finances from their foreign owners despite the crisis in the international financial market. As the increase in external debt in 2008 exceeded nominal GDP growth, the relative indicators of external debt worsened: the gross external debt to GDP ratio was 82.6% at the end of 2008 and the net debt to GDP ratio stood at 44.2%.

Consolidated general government revenues surged for most of the year, while expenditures accelerated following the first three months of the year, when government spending was restricted under the temporary budget then in effect. However, as labour market trends deteriorated towards the end of the year, and the general level of prices and goods imports dropped, total annual revenues fell short of the amount planned in the revised budget. Due to savings on the expenditure side, however, these trends produced no negative effect on the planned deficit.

Net borrowing of consolidated general government (on a cash basis, GFS 2001) amounted to HRK 2.6bn, or 8.0% of GDP, in 2008. It should be noted that the disposal of financial assets failed to generate significant revenues. Government assets in the form of cash and deposit accounts increased in the same period, with the result that general government debt went up by HRK 7.9bn in 2008, reaching HRK 100.2bn, or 29.3% of nominal GDP. The lower level of debt and the lower debt to nominal GDP ratio resulted from the exclusion of Croatian Motorways (CM) from the scope of consolidated general government and a CBS data revision that increased GDP.