Željko Rohatinski: Recent economic and financial developments in Croatia

Address of Dr Željko Rohatinski, Governor of the Croation National Bank, at a press conference, Zagreb, 18 February 2009.

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I am glad that you have responded to our invitation. At a similar gathering less than two months ago, we informed you about CNB's views of the then current economic situation and our preliminary expectations regarding trends in 2009. In the interim, some of our assumptions have proved to be correct and the CNB has taken, and will continue to take, appropriate measures. Now I would first like to inform you about the measures taken, putting them in the context of wider international and domestic developments.

The slowdown in economic growth, evident in the second and third quarters of 2008, in the fourth quarter virtually turned into stagnation at an annual level, so that – despite the annual growth rate of about 2.3 percent for 2008 as a whole – the slowdown in economic activity is obviously continuing into 2009. The two key problems in the Croatian economy, deteriorating over the years, have been seriously aggravated under such circumstances: the problem of the current account deficit, estimated at about EUR 4.5bn or 11 percent of GDP in 2008, and that of external debt, standing at EUR 39bn at the end of 2008 and accounting for 94 percent of GDP. These two major problems will determine general economic trends in 2009 as they represent the main challenge for overall economic policy. This policy will have to address the issue of preventing the escalation of their negative consequences against a background of the global financial and economic crisis, which is, in both its aspects, affecting Croatia as well.

This policy will be faced with several serious limitations. The first is related to a drop in export demand, estimated at about 3 percent in the goods and services sector. The second involves a sharp decrease in foreign direct investments, due to the fact that not much is left to be sold following the privatisation of a share in Ina. The third limitation relates to a halt in the growth of foreign borrowing by enterprises, caused by the capital market contraction, and is further exacerbated by concerns about to what extent it will be possible to refinance their existing debt in 2009. The fourth limitation is posed by the high repayments of total external debt falling due this year, approximately amounting to EUR 12.8bn in principal and EUR 1bn in interest, which is about one third of GDP. This amount includes an approximate EUR 6bn in outstanding principal of enterprise and government debt. In consequence of these external limitations, import financing will be impossible to keep at the present level. Accordingly, we estimate a decrease of about 8 percent in imports, and of about 5 percent in imports excluding oil, which would also result in the current account deficit narrowing from about 11 percent of GDP in 2008 to 6-6.5 percent of GDP in 2009.

Such a situation leaves little room for maneuver when it comes to deciding on the economic policy to be implemented in this year, and probably in the following year. This policy should be aimed at halting the growth of domestic consumption, changing its structure and creating savings at all levels. The previously-mentioned external limitations and such economic policy will inevitably produce a negative impact on economic growth and on the society as a whole. The main concern in this regard should not be about whether the GDP rate will be reduced by 1 or 2 or 3 percent, but about maintaining a healthy core of the economy and ensuring its financing and operation under these aggravated conditions.

It need not be emphasised that the financial sector and its stability play a major role in this process. There are two parallel objectives that need to be achieved in order for this stability to be sustained: one is to maintain the country's external liquidity and the other is to maintain the stability of the exchange rate. These two objectives are interrelated and inseparable. A failure to achieve them would result in the activation of all types of risks: currency risk, credit risk, risk of a rating drop, risk related to the price increase and halted inflow of foreign currency funds, in short, of risks leading to the collapse of the financial system. There is no doubt that the normal functioning of the financial system would be undermined and that all the participants that directly or indirectly constitute this system, and have a major impact on its functioning, especially banks, would be affected.

It is a well-known fact that banks in Croatia had good financial results at the end of 2008 and that they even outperformed their parent banks. Their rate of return on capital exceeded 10 percent and the capital adequacy ratio stood above 14 percent, which enabled them, and continues to enable them, to safely conduct their business operations. However, it is also the fact that their operating conditions have considerably changed and that this change is reflected on the possible modalities of their operation in 2009. The changed conditions include a decline in external financing and an increase in its costs, a rise in domestic foreign exchange demand and an increase in domestic borrowing requirements of the government, which will, in this way too, have to refinance the repayment of a portion of its external debt.

This change in the conditions has also resulted in banks' efforts to influence, through proposed arrangements with the CNB and some other channels, some aspects of the central bank's monetary policy. During the negotiations between the Ministry of Finance and a bank consortium on the granting of a EUR 750m loan, banks caused an unprecedented situation, conditioning the granting of the loan upon four major changes to be made in the CNB's policy. These requirements were as follows: to abolish the limits imposed on credit growth, or to monitor this growth on the basis of original currencies in which loans are granted, to reduce the kuna allocated portion of reserve requirements from 75 to 50 percent, to ensure sufficient levels of kuna liquidity in order to constantly keep the money market interest rate below 10 percent, and to harmonise the central bank's exchange rate control mechanism with banks.

I would like to clarify the background to these requests, not with an intention to criticise banks, but to explain which elements the central bank takes into account in defining and implementing its measures. Let me start with the statement, coming not only from the banking circles, that under the deteriorated foreign borrowing conditions there is no point in insisting on curbing the growth of banks' credit placements, especially in a situation when banks themselves are planning for the growth in 2009 to remain below the prescribed limits. Some were also of the opinion that some banks have to altogether cease lending because of the imposed limits. However, banks' household and corporate placements increased by 11.2 percent at the end of January this year relative to December 2007, which was the basis for the calculation pursuant to the decision to limit banks' placement growth. With the limit for growth set at 13 percent, banks in January had sufficient room for normal credit growth. The "catch" was, however, in the foreign currency clause, which, each time when the exchange rate depreciates to a more significant degree, increases the nominal value of loans and lowers the limits for banks. This is not a problem with loans indexed to the euro, as the kuna has depreciated versus the euro by only 0.7 percent in the past 13 months. However, it has depreciated by 12.3 percent against the Swiss franc, so that banks having a large share of loans indexed to the Swiss franc have found the limits "too low", and have also had to slow down their placement growth in order to avoid purchasing CNB bills.

In this regard, I would like to stress that on several occasions in 2006 and 2007 we publicly warned against risks connected with loans indexed to the Swiss franc, both for clients and for commercial banks. Deputy Governor Vujčić spoke of it in the Parliament, but our warnings fell on deaf ears. Interests on these loans were lower than interests on other loans so demand grew. In the meantime, even with such low interest rates, due to the appreciation of the Swiss franc, the kuna value and repayments of these loans sizeably increased. As a result came the banks' wish to solve their limit problems by removing restrictions on placements and monitoring loans on the basis of their original currency. As regards this issue, the CNB cannot and will not do anything. We warned against the risks, all market players were aware or should have been aware of this. They opted for such loans and are now faced with the consequences. Thus, we do not see any restrictions on the growth of total bank placements arising from the effects of regulation. Provided, of course, that the exchange rate remains stable. However, some banks seem not to share these expectations. Therefore, I think that recent references to the exchange rate depreciation as being very likely were aimed at stepping up banks' requests for removal of limits on placements. True, against strong depreciation, maintaining these limits could lead to a credit crunch in the country. But this is an unrealistic scenario.

The second and the third bank requests relate to the increase in kuna liquidity, while in the background lurks their wish to ensure additional sources of liquidity for continued growth of their placements through intensified CNB issuing activities. This is irregardless of the fact that experience has shown that high kuna liquidity creates direct depreciation pressure on the kuna exchange rate.

The last request, having to do with harmonised efforts of banks and the central bank in maintaining the exchange rate stability involved a scenario under which the CNB would close out banks' short position under a previously agreed exchange rate at the end of each business day. In other words, the stability of the exchange rate would be maintained solely at the expense of the central bank's foreign exchange reserves.

The CNB, of course, did not concede to such request. It is good that the Ministry of Finance managed to secure a credit arrangement worth EUR 750m without attempts to exert pressure on the CNB. However, these elements are still present.

As for the functioning of the banking system under these new circumstances, everything we know tells us that the stability of the financial system is imperative for maintaining a normal economic situation in the country and for the functioning of the economy as a whole. This necessarily presupposes the stability of the exchange rate as the key factor for price stability. All market participants must give their contribution, including commercial banks, not out of altruism but in their own best interest. Rising inflation, rising interest rates, the risk of loan repayment defaults, disturbances in external payments, if it comes to that, would all have significant adverse effects on the operation of banks. One only needs to recollect what happened in other countries, such as Hungary, not to mention any others, and the problems banks were faced with because of such disturbances.

For this reason, we feel that banks in Croatia, regardless of being foreign-owned, cannot operate without taking account of the state of the economy, their clients and the financial system of the country as a whole. It is their interest that must prevail despite the problems faced by their parent banks. In this regard, we explained to Mr Pröll, the Austrian finance minister, that the CNB would not look favourably upon attempts to withdraw capital, deposits or pay out total accumulated profits, because that would destabilise the domestic banking system. In such a case, the CNB would be forced to undertake protective measures, regardless of thus connected risks. We received assurances that there would not be any withdrawals.

The second imperative relates to foreign currency assets at commercial banks, that is, liquid foreign currency claims of EUR 7.6bn (roughly the amount of the CNB's net foreign currency reserves), which under the circumstances must be used for maintaining the stability of the financial system. In October, we repealed the marginal reserve requirement in the amount of EUR 460m, we introduced two changes in the system of currency allocation of the reserve requirement (effect: EUR 1.1bn) and we have recently lowered the minimum rate of foreign currency claims from 28.5 to 25 percent, thus releasing EUR 840m. Today we lowered this rate from 25 to 20 percent, releasing a further EUR 1.25bn. Our further activities will be aimed at direct interventions in the foreign exchange market: today we already sold EUR 185m in the foreign exchange market at the average foreign exchange rate of 7.44 kuna for one euro, while the value of the previous intervention was EUR 328m, which means that in the past three weeks more than half a billion euros was sold to banks. These interventions were aimed at preventing sudden short-term exchange rate fluctuations. However, foreign exchange interventions cannot remain the CNB's only instrument. Indirectly, we will influence the stability of the kuna exchange rate through kuna liquidity: today, for example, out of the HRK 8.5bn bids submitted at the repo auction, a half was accepted.

Hence, we do not intend to change the decision limiting banks' placements growth and we expect the fiscal policy to do its part in preserving stability. We are aware that restrictive kuna liquidity policy leads to the growth of money market interest rates, but this growth does not need to be automatically transferred in the growth of interest rates on household and corporate loans. Still, objectively speaking, it would be difficult to expect interest rates to decline. This, however, does not mean that the CNB is socially insensitive. We feel that debtors are better protected by preventing the foreign exchange rate from depreciating than by preventing interest rate growth. Interest rates have gone up by one to two percentage points, while depreciation is spoken of in two digit numbers. I would like us to remember the 1990s when it was said that inflation of 15 percent a month was not the greatest evil our economy could face and that it would be sufficient only to index salaries, the exchange rate, and interest rates for the system to work. But then inflation soon reached 40 percent a month and the system collapsed. A similar thing would happen with the exchange rate. Once the genie is out of the bottle it is hard to put it back. In a situation like this, the exchange rate is either defended or let go. There is no in between. We all know where depreciation would take us.

This is our view of the situation in 2009. Whether we will succeed in all our plans, we cannot guarantee. Great many things do not even depend on us, not even on the market players in Croatia but on external factors. In any case, we will do everything that is in our power to come out of this situation alive and with as few wounds as possible.