Željko Rohatinski: What 2010 may hold for the Croatian economy

Address by Dr Željko Rohatinski, Governor of the Croatian National Bank, at the business conference "Big Plans Day", organised by the Lider business weekly, Zagreb, 26 October 2009.

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After a turbulent 2009, the year 2010 is expected to be mostly a year of stagnation (viewed statistically), without major structural changes in the real and financial sectors. More important than the statistics, however, is that no significant changes are expected in the modalities of economy functioning, as there are no substantial changes in the economic policy.

But this does not mean that 2010 is going to be a "calm year" and that the "status quo" will be restored and maintained by itself, particularly in the context of current domestic developments which may postpone the country's exit from recession.

The three key determinants of our economic situation in the coming year are the following:

(1) Stagnation in Croatia's most important partner countries in the European Union and in the region will curb export demand, while, given the poor propulsiveness of our export demand, an "active" improvement in the current account can hardly be expected. Goods and services exports could go up about 5.5% (dropping by 18.1% in 2009).

A rational domestic demand and import policies will be required (with a 5.3% rise in imports, given the oil price growth), in order to keep the current account deficit at about 6.5% of GDP (EUR 3 billion), the same as in the current year.

Of course, this implies a continuation of heavy dependence on foreign sources of financing in 2010.

(2) Given stagnation in direct and portfolio investments (EUR 2.1 billion in 2009 vs. EUR 2.3 billion in 2010), this would mean that:

– the current account deficit will have to be financed by foreign borrowing;

– the external debt-to-GDP ratio will increase from 83% last year and about 93% in 2009, to about 100%, which is feasible, but will certainly not improve the country's credit rating, and the question is to what extent the global downward trend in interest rates can carry over to this country.

This is all too important, as we know that in 2010:

– total debt repayments (EUR 8.3 billion in principal and EUR 1.4 billion in interest) will amount to EUR 9.6 billion (EUR 10.8 billion in 2009); and

– total utilisation of foreign sources of financing will stand at EUR 12.6 billion (13.5 billion in 2009).

(3) The anticipated fiscal deficit reduction, in terms of consolidated general government (including HAC), from HRK 15 billion to HRK 12.1 billion, i.e. from 4.5% to 3.6% of GDP, with the deficit being predominantly financed by foreign borrowing, would slow down government demand for domestic borrowing. The growth in government demand for credit could decrease from this year's 32.7% to about 6%. However, even with this relatively low growth rate, there will be little room for the re-channelling of banks' domestic credit potential towards the private sector.

The situation can be further aggravated by shipbuilding, which is not included in these estimates, but can nevertheless affect the budget and its borrowing in 2010.

(X) Under such circumstances, monetary policy will have to balance between reducing the current account deficit and providing for the aggregate domestic credit growth accompanied by exchange rate (foreign exchange reserves) stability.

Consequently, we expect to continue implementing the existing instruments (foreign exchange interventions and open market operations), for now, without changing the reserve requirements (because of the favourable liquidity situation in the banking sector), or relaxing the prudential measures, as well as without raising regulation costs. We anticipate that total liquid assets, money supply and bank placements will increase by about 7%, 4.5% and 4.4% respectively.

(X) Bank behaviour

It can be expected that the following trends, observed in the previous part of the current year, will continue into 2010:

(1) stagnation in high foreign sources of financing (standing at EUR 10 billion, of which about EUR 2 billion represents short-term inflows from parent banks in late 2008, which remained in the country throughout the year) and a very slight increase in domestic deposits (by 3.2%, suggesting that there is no potential for any significant strengthening of banks' credit activity;

(2) gradual extension of the maturity structure of both foreign sources (62%–68%) and domestic ones (73%–77.4%), which is good in terms of safety, and facilitates longer maturity placements, but these sources are more expensive;

(3) an increase in the foreign-currency portion of reserve requirements (71%–76%), which also magnifies the currency risk, both on the assets and liabilities sides;

(4) banks trying to reduce credit risk, which also leads to changes in the credit structure: an increase in the share of credit to government (from 8.7% to 13.1%) at the expense of consumer credit (declining from 27.5% to 25.0%);

(5) an increase in bad placements (to 6%), but still a relatively strong resistance to shocks (provided that the currency shock is prevented);

Conclusion: Banks' policies are expected to be very cautious in 2010, without any significant changes, with regard to both the growth and purpose of placements.

(X) Essentially, the year 2010 is supposed to be some kind of "the day after", or the year of "coming to our senses", which will show that we became smarter after the crisis, that we learned enough from it, and that we are prepared to act differently.

The question is, however, whether this comes true, not only due to defending particular interests, but also because not even others know exactly what to do.

There is not much use in repeating generally known facts. The general pattern has lately been to inject liquidity and strengthen regulations. We, too, injected liquidity (over EUR 5 billion, in a very short term), but we had to relax regulations in order to activate it.

So, the stereotype that in the period of expansion we implemented restrictive monetary policy and in recession we should adhere to expansive policy – does not apply. Our monetary policy has never been really restrictive, but was even hyper-expansive in 2009, although this was not reflected in the monetary statistics.

The problem is evidently not in the quantity of money but in its allocation, i.e. the purpose for which it is spent, and the effects produced by such spending. This was not so obvious in the period of expansion (when there was enough money for everyone). At the time of recession and stagnation, the change in allocation has a key role. However, no significant changes are possible without the government playing its part.

(X) “A million dollar question” has been asked at Forbes, about whether exchange rate stability can be maintained under such circumstances. The answer is: yes, given the current modalities, it can be maintained as long as we manage to repay our debts and as long as we can obtain new loans from abroad.

In this respect, the current world situation is favourable, because free liquidity grows again and waits to be placed, credit supply goes up and buyers are sought for this money. A continuation of EU accession negotiations improves the political perception of Croatia as a debtor. Therefore, I have no doubts that the current search for a billion dollars, or euros or whatever, will be successful.

This is a relief, but it also poses the most serious dangers to this country: the danger of inactivity, the danger of believing that we can go on functioning by following the established routine and the danger that we neither have learned, nor will learn enough from the crisis.

It is often repeated that our problems are of a structural nature and that it takes time to carry out the necessary reforms. This statement is not unfounded. However, an old Chinese wisdom says: “Even the longest way starts with the first step.” The truth is that the first step is often the most difficult, and we have been putting it off for a long time.