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Macroeconomic Developments

1.1 International Environment

1.1.1 World

The year 2001 was marked by a rapid slowdown in world economic activity. This was particularly reflected in reduced industrial production and increased unemployment not only in the United States but also in the EU, Japan and transition countries.

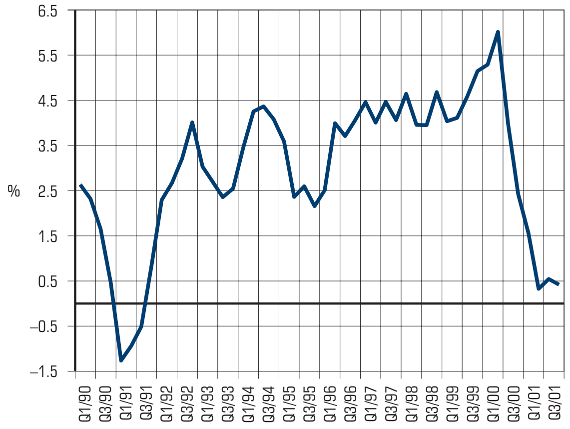
The ten-year period of rapid economic growth in the USA, stimulated primarily by a widespread application of the IT technologies in production and business, ended in 2000. In the second half of the year, numerous companies dealing with IT technology started to report losses, and the price of their shares on the world stock exchanges dropped significantly. Despite a more realistic evaluation of the "new economy" in the USA, the American economy still grew at the high annual rate of 4.1% in real terms in 2000 (the same as in 1999).

In the first half of 2001, there was a sharp downturn in the three-month year-on-year growth rates of the American economy, with negative growth rates in industrial production. Unfavorable reports on the financial operations of certain companies resulted in a further decline in share prices on stock exchanges, while the economic slowdown in the USA is expected to continue. In order to encourage investment and the growth of industrial production, and to reduce unemployment, the FED lowered its discount rate as early as January. Moreover, due to the global economic slowdown in the first quarter of the year, crude oil prices on the world market went down.

Figure 1.1

Three-month GDP in the USA

at 1996 prices, real rate of change compared to the same quarter previous year



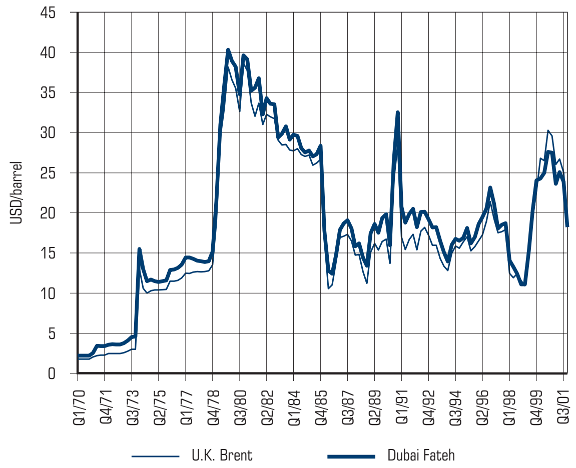
Source: IMF, *International Financial Statistics.*

The terrorist attacks on New York and Washington in September 2001 immediately destroyed all prospects for a relatively quick recovery of the American economy. The general insecurity resulted in particularly heavy losses in transportation (air transport) and catering and tourism. The payment of enormous compensations was a direct and severe shock to the financial sector (insurance companies). Consumer confidence was seriously eroded.

The seasonally adjusted unemployment rate rose from about 4% in late 2000 to 5.4% in October 2001. In the same month, the consumer confidence index fell to 85.5 (confidence level in 1995=100), reaching its lowest value since February 1994. (As personal consumption accounts for two thirds of the American GDP, erosion of consumer confidence has a strong impact on its GDP).

Figure 1.2

Movements in Crude Oil Prices on the World Market



Source: IMF, *International Financial Statistics*.

As early as September 2001, the American Congress provided a set of incentives (primarily aimed at reducing corporate taxes) to the value of USD 100bn in order to mitigate the adverse consequences of the terrorist attacks and to boost production. At the same time, the FED continued to lower its discount rate: it stood at 6% per annum at the beginning of 2001 and was reduced (for the eighth time in 2001) to only 2.5% per annum after the September attacks, which is the lowest rate since 1962.

The news about the successful achievement of military goals in Afghanistan, as well as the comprehensive and strict security measures in the United States, resulted in a gradual restoration of domestic consumer confidence. The fall in stock exchange indices recorded immediately after the September attacks was also partially offset. Despite concern that the negative developments would continue, preliminary data for the fourth quarter shows that the real GDP in the US in the fourth quarter did not decrease, but, seasonally adjusted and indexed to the changes in the number of business days, remained the same as in the fourth quarter of 2000. A great number of economic experts agree that this was not the result of typical cyclical fluctuations (indicating a negative growth rate) but rather the result of deferred consumption in the fourth quarter, caused by a boost in consumer confidence, and the aggressive price policy and promotional activity pursued by car producers and dealers. Thus the total annual growth of the American GDP in 2001 amounted to 1.2% in real terms.

During 2001, the annual GDP in Japan dropped by 0.5% in real terms. Despite indications of economic recovery in Japan in 2000, the terrorist attacks against the USA pre-

Table 1.1 Movements in Key Macroeconomic Indicators
annual rate of change, in %

	2000	2001	2002
Real GDP			
USA	4.1	1.2	1.5
Japan	2.4	–0.5	–1.0
EMU Member States	3.3	1.5	1.4
CPI			
USA	3.4	2.8	1.6
Japan	–0.7	–0.7	–1.0
EMU Member States	2.3	2.5	1.4
Unemployment			
USA	4.0	4.8	6.0
Japan	4.7	5.0	5.7
EMU Member States	8.8	8.3	8.6

Note: IMF estimate for 2002.
Sources: ECB and IMF, *World Economic Outlook*, December 2001.

vented the country from coming out of a years-long recession. An extremely difficult situation in the banking sector, a huge budget deficit, deflation, reduced industrial production and rising unemployment are only some of the negative characteristics of the Japanese economy in 2001. The economic recovery of Japan, and also that of the whole of Southeast and East Asia, continues to depend on the quick recovery and growth of the world (primarily the American) economy.

The zero economic growth in the USA also jeopardized the economic recovery of the Latin American countries. The financial crisis in Argentina, which came to a head in 2001, together with the resulting slowdown in the country's economic activity, represent an additional hindrance to the development of that region. The above-mentioned circumstances and the economic developments in the USA also affected the economy of the European Union.

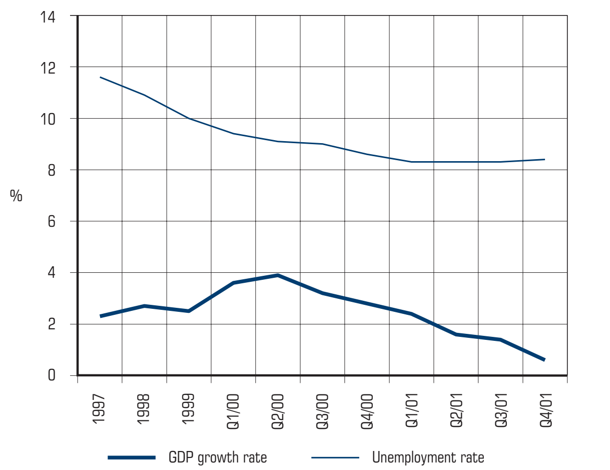
1.1.2 European Union and EMU Member States

The annual GDP growth in EMU member states in 2001 was 1.5% in real terms, whereas it was 3.3% in 2000. The year-on-year quarterly growth of real GDP in EMU member states dropped from 1.4% in the third quarter of 2001 to only 0.6% in the fourth quarter. The economic slowdown is also reflected in the data on manufacturing, where negative growth rates and higher unemployment were recorded in the second half of 2001. In the first three quarters of 2001, unemployment stood at 8.3% (according to a survey carried out in accordance with the ILO standards) and reached 8.4% during the last quarter.

The decline in oil prices in 2001 and the economic slowdown in the EMU member states, which resulted in a reduced aggregate demand and consequently lower prices, allowed the European Central Bank (ECB) to increase the total amount of currency in circulation without threatening its main goal of price stability. As a consequence, the

Figure 1.3

Real GDP Growth and Unemployment in EU-11

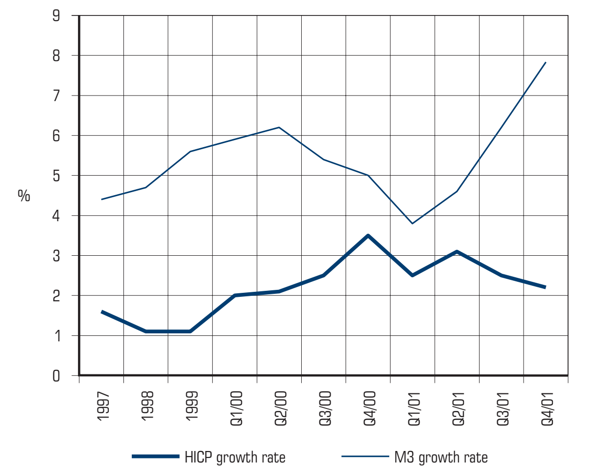


Note: Greece became EMU member state in 2001; therefore the data for that year relate to EU-12.

Source: ECB.

Figure 1.4

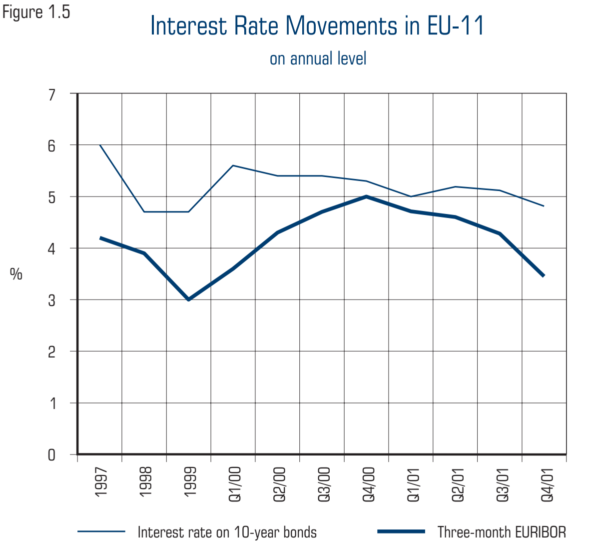
HICP and M3 Developments in EU-11



Note: Greece became EMU member state in 2001; therefore the data for that year relate to EU-12.

Source: ECB.

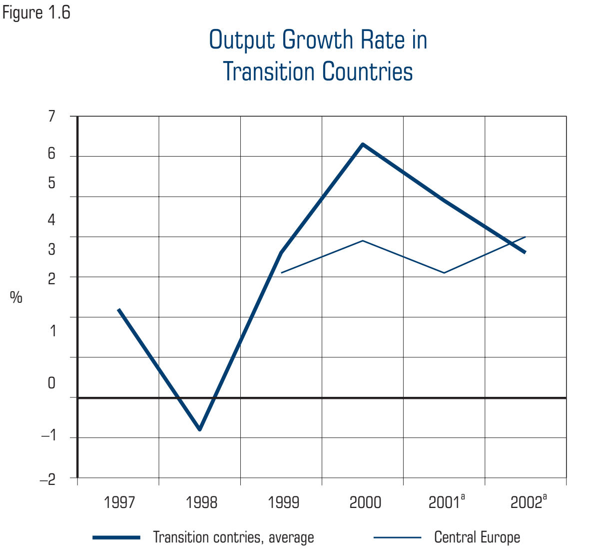
Figure 1.5



Note: Greece became EMU member state in 2001; therefore the data for that year relate to EU-12.

Source: ECB.

Figure 1.6



[a] IMF estimate.

Source: IMF, *World Economic Outlook*,October 2001.

HICP ranged from 2.2% to 3.1% per annum in 2001, while the M3 monetary aggregate (reflecting total deposits of all sectors with commercial banks) grew from about 4% at the beginning of the year (at the annual level) to about 8% in the last quarter.

Until the September events, the ECB did not significantly change its discount rate (reductions of 0.25 percentage points were made in May and August). Shortly after the terrorist attacks in America, the ECB reduced its discount rate by 0.5 percentage points. This rate remained unchanged till November, for the strengthening of the euro had a beneficial effect on inflation control. In November, the ECB reduced its discount rate by a further 0.5 percentage points. This contributed to a reduction in interest rates in the EMU money markets.

1.1.3 Transition Countries

According to the available data for the first three quarters of 2001, the transition countries of Central and Eastern Europe recorded a mild decline in economic growth during that year. The greatest negative development was recorded in Poland, which was marked by a very low domestic aggregate demand and a decline in investments in 2001. Lower GDP growth rates were also recorded in the Czech Republic and Hungary. In Slovenia, which is the most successful transition country, the annual GDP growth rate dropped from 4.6% in 2000 to 3% in 2001. However, the increasing convergence of some countries from this region towards the European Union could stimulate growth in foreign trade and offset the damage resulting from the adverse global developments.

1.2 General Characteristics of Economic and Monetary Developments

1.2.1 Economic Activity

Demand

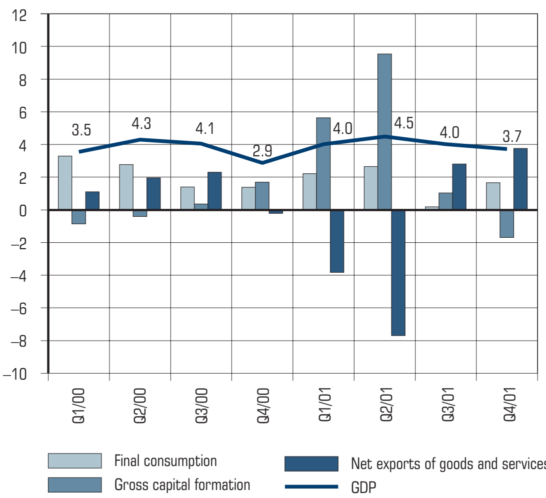
The economic growth that began in 2000 after the 1999 recession continued in 2001. Real GDP grew by 4.1% compared with 2000 despite some undesirable factors, such as the government-stimulated imports in the first half of 2001 and the economic slowdown in the international environment. The lowest growth rate compared with the same quarter of the previous year was recorded in the fourth quarter, at 3.7%, with an extremely high growth in exports of goods and services, as well as investments. In the first three quarters these rates were 4% or more. In the first half of 2001, GDP growth was based on domestic demand, while in the second half of the year it relied on exports, despite unfavorable developments in foreign demand. The total domestic demand contribution to GDP growth in 2001 was 5.3 percentage points, while net foreign demand made a negative contribution of –1.2 percentage points; in 2000, these contributions were 2.4% and 1.3% respectively. The main generator of GDP growth in 2000 and 2001 was domestic demand, while in 1998 and 1999 it was net foreign demand.

In the second half of 2001, the growth in the GDP deflator fell to 3.1% at the annual level. In the third quarter, most consumption categories recorded very low deflator growth rates compared with the same quarter of the previous year, while in the last quarter the rates were mostly negative. Along with the above-mentioned real economic growth and growth in prices, nominal GDP, according to the preliminary data for 2001, amounted to HRK 169bn, which is HRK 11.5bn more than the previous year.

Figure 1.7

GDP Growth Rates (in %) and Relative Contribution of Consumption Categories (in percentage points)

seasonally adjusted



Sources: CBS data processed by the CNB.

Personal consumption rose by 4.5% in 2001 compared with the previous year. A 5.5% growth rate in consumption in the first half was followed by a significant slowdown in the third quarter, but then it recovered, reaching 3.7% in the fourth quarter compared with the same period of the previous year. 2001 was the second consecutive year of personal consumption growth following the decline in consumption in 1998 and 1999. This consumption growth was primarily the result of an increase in the wage bill and government transfers to households, but also of new household sector borrowing from banks. Commercial banks' credits to households rose by approximately 30.9% in nominal terms or by 29.3% at the December level. Lower income tax rates in 2001 and a low price growth produced a beneficial effect on consumption. While the personal consumption growth in the second half of the year was slowed down by the reduction in the number of public sector employees, it was boosted by the payment of Christmas bonuses and gifts for children, as part of an agreement between the government and trade unions. As a result, the consolidated central government net wage bill in 2001 was reduced by only 2.3% in nominal terms on a cash basis, although a more substantial reduction was planned.

Government consumption in 2001 followed a downward trend, which resulted in a decline of 3.9% at the annual level. This was a sharper contraction of consumption compared with 2000. This decline in consumption is reflected in the consolidated central government budget, i.e. reduced expenditures on goods and services, as well as wages. The purchase of other goods and services on a cash basis was reduced by 11.8%.

Investments in gross capital formation strengthened domestic demand in 2001. With a 9.8% growth at the annual level, they contributed 2.2 percentage points to GDP growth. Favorable developments in the demand and financing conditions encouraged investment consumption. One of the main sources of corporate investment financing was bank credits, which rose by approximately 12.7% in nominal terms in 2001 compared to 2000, or by 21.3% at the December level. Imports of capital equipment were very high in 2001, indicating that companies replaced their outdated equipment after a long period of time. Imports of capital goods, expressed in US dollars, grew by 16.1% compared to the previous year. According to the categories of capital goods, high imports accompanied by a high annual growth were recorded in road vehicles and electrical machinery and apparatus, industrial machinery, telecommunication apparatus and office machinery.

According to the balance of payments data, Croatia recorded a merchandise trade deficit of USD 4bn in 2001, one quarter above that of 2000, marking the end of a continuous three-year deficit reduction. This deficit increase was caused by a strong imports growth of 12.8% in US dollars (11.3% in real terms, according to GDP calculation), while goods exports rose by 4% (5.1% in real terms). This growth in exports of goods was the highest since 1998 and is very high considering the international environment. The 2001 growth in imports was fuelled by car import benefits and a growing demand for capital equipment. In the second half of the year, imports slowed down as a result of the cancellation of the car import benefits. An additional reduction towards the year-end was caused by postponing import to 2002, when tariff rates are to be reduced for most food and agricultural products. The real GDP growth in 2000 was 6.4%, but it was based on a sharp fall in imports in the base year. It is encouraging that the imports growth in the last two years was accompanied by an overall economic recovery.

It can be assumed that the effects of trade liberalization were not fully shown in 2001. The implementation of free trade agreements with a number of countries and the temporary free trade agreement with the EU will not start before 2002.

Exports of non-factor services in 2001 grew by 12.9% in real terms compared with 2000. This was a continuation of the 18.8% growth of the previous year. Imports of non-factor services grew by 1.6% in real terms, following a 4.6% fall in the previous year.

A significant annual growth in exports and imports of goods and services was recorded in 2001. Exports of goods and services grew by 8.3% in real terms and imports by 9.4%. The contribution of exports of goods and services to GDP growth was 3.6 percentage points in 2001, while the contribution of imports of goods and services was –4.9 percentage points. As a result, the total contribution of net external relations to GDP growth was negative and amounted to 1.2 percentage points.

Output

The annual growth in gross value added was 4.2% in 2001. Particularly high outputs were recorded in industry, trade and financial services, with signs of a notable recovery in construction and transport in the last quarter. Excluding the recession in 1999, gross value added grew faster in 2001 than in 1998 or 2000.

Industry

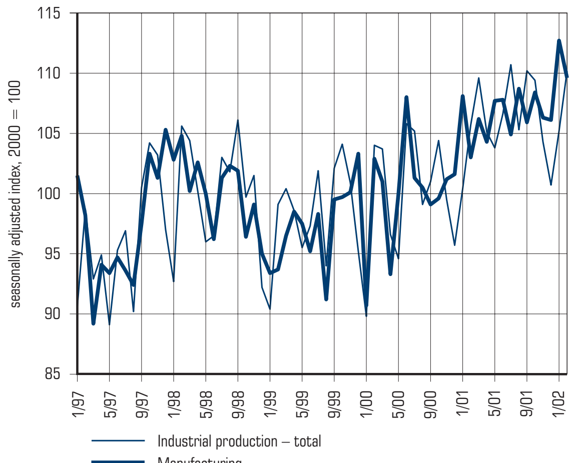
The growth of gross value added in industry was faster in 2001 (4.6%) than in the two previous years. In 2001, the total volume of industrial production grew by 6.0% compared with the previous year. In the last quarter of 2001, production fell by 3.6% compared with the previous quarter. However, in the first quarter of 2002, production went up again, reaching the growth rate of 3.8%. Among the main industrial groupings, capital goods grew at the highest rate of 15.5% in 2001. This was the main reason why the relative share of this grouping in the total industrial production structure increased from 11.0% to 12.2% compared with the previous year. Non-durable consumer goods grew by 7.8% and intermediate goods by 4.1%.

In 2001, positive growth rates were recorded in all the three sections belonging to the NCEA industrial production: mining and quarrying grew by 2.0%, manufacturing by 6.5% and electricity, gas and water supply by 5.0%. High growth rates within manufacturing were recorded in the manufacture of other transport equipment (36.2%), the manufacture of machinery and equipment (17.8%), the manufacture of electrical machinery (19%), the manufacture of paper (23.2%) and in publishing and printing (13.4%). These activities also made a large contribution to the total growth of industrial production.

In 2001, the highest exports were recorded in the manufacture of other transport equipment (USD 728.7m or 16% of total industrial exports). This marked the end of the downward trend in this division recorded in 1999

Figure 1.8

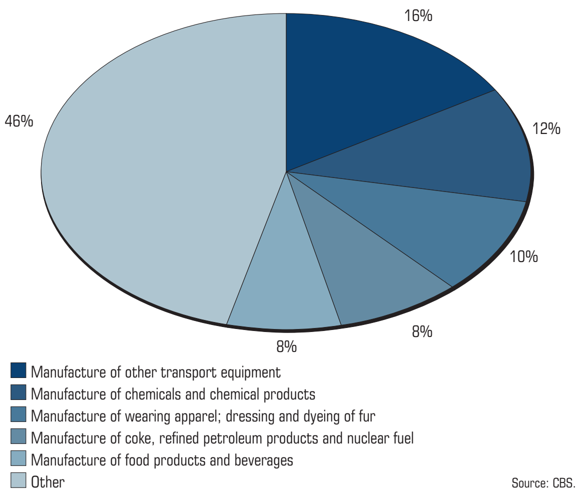
Total Industrial Production and Manufacturing



Sources: CBS data processed by the CNB.

Figure 1.9

Structure of Industrial Goods Exports in the Period between 1998 and 2001



Source: CBS.

and 2000. Major exports were recorded in the manufacture of chemicals and chemical products, and in the manufacture of coke, refined petroleum products and nuclear fuel, despite a reduced volume of production in these divisions. In 2001, the decline in exports in the manufacture of wearing apparel observed in the two previous years was halted to remain at the 2000 level.

In 2001, negative contributions to the growth of industrial production were made by: the manufacture of radio, television and communication apparatus and equipment (1 percentage point), the manufacture of chemicals and chemical products (0.5 percentage points), the manufacture of coke, refined petroleum products and nuclear fuel (0.2 percentage points) and the manufacture of wood and wood products (–0.1 percentage points).

Until July 2001, stocks of finished industrial products were either at or below the level in the corresponding months in 2000. However, towards the year-end, a slight upturn was observed compared with the same period of the previous year. A more rapid growth in stocks was recorded in the first two months of 2002.

A 9.6% growth in labor productivity in 2001, accompanied by a decrease in real gross wages in the overall economy, had a positive impact on the competitiveness of the economy. The labor productivity growth in industry, after a several-year decline, was primarily the result of positive developments in production and not just of reduced employment. The competitiveness of exporters was improved by a moderate growth in domestic prices, but it also worsened owing to the appreciation of the domestic currency against the majority of the European currencies. The nominal effective kuna exchange rate appreciated by 1.2% compared with the annual average for 2000, while the real effective exchange rate of the kuna deflated by retail prices (mainly owing to a faster growth in the domestic prices of services than in the prices of goods) appreciated by 3.4%, or, deflated by producer prices, by 2.7%.

Construction

Following a two-year decline and zero growth in 1998, gross value added in construction grew by 2.8% in 2001 compared with 2000. This growth was the result of a good performance in the first and last quarters (a growth of 6.9% in the last quarter compared with the same quarter of the previous year). The volume of construction works in 2001 grew by 3.6%, following a decrease of 7.7% in 1999 and 9.1% in 2000. This upward trend continued into the first two months of 2002, when the volume of construction works recorded an increase of 11.3% compared with the same period of the previous year.

The upward trend in construction in 2001 is also reflected in a 22.7% increase in the value of net construction project orders in Croatia, a 23.2% growth in the value of completed projects, a 19.2% growth in the number of completed dwellings and a

15.2% increase in the floor space of completed dwellings. The number of building permits issued in 2001 rose by 24.3% compared with the previous year, anticipating a 50.2% increase in the value of construction works.

Tourism

In 2001, gross value added in hotels and restaurants rose by 6.0% compared with the previous year, with a more rapid growth in the second and third quarters. The growth rate in 2001 was lower than in 2000 (16.2%), but it should be noted that the 2000 rate included the low-base effect.

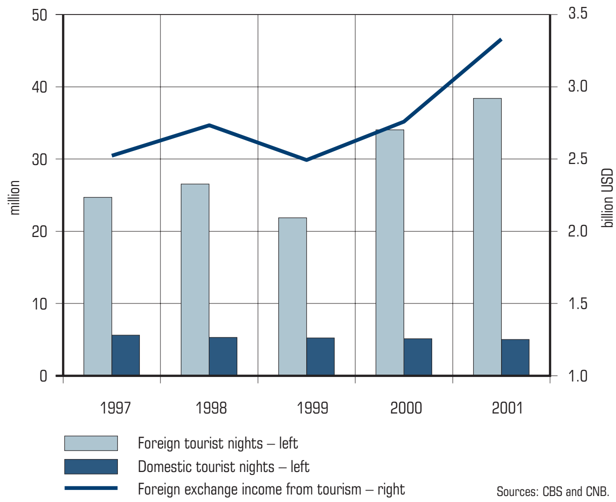
There were 7.9 million tourist arrivals and 43.4 million tourist nights in 2001, of which 88% were foreign tourist nights. Tourist nights rose by 10.8% compared with the previous year. This growth was the result of an increase in foreign tourist arrivals, since domestic tourist arrivals stagnated in 2001 and domestic tourist nights declined. A particularly rapid growth in tourist nights was recorded in the second quarter (due to an earlier start to the season), as well as in October and November. Unusually favorable weather conditions in October extended the season, while a big inflow of European tourists in the aftermath of the terrorist attacks in America additionally improved the November results.

The growth in physical indicators is confirmed by the growth in financial indicators. In 2001, foreign exchange income from tourism amounted to USD 3.3bn, which is 20.9% more in nominal terms than in the previous year. This shows that, along with the growth in physical indicators, tourist spending power increased in 2001.

The highest absolute increase in the number of tourist arrivals and nights in 2001 (24% compared with the previous year) was recorded in German tourist arrivals, which accounted for 25% of total foreign tourist arrivals and nights. Austrian tourist nights rose by 7% (their share in the total foreign tourist nights structure was 9%), Polish tourist nights grew by 38% (with a 7% share in the total structure), Hungarian tourist nights by 10% (with a 4% share in the total structure) and Slovakian tourist nights by 7% (with a 4% share in the total structure).

Figure 1.10

Tourist Nights and Foreign Exchange Income from Tourism



Sources: CBS and CNB.

Transport and Communication

In 2001, gross value added in transport, storage and communication grew by 7.3% compared with the previous year. This is the highest growth rate in the last three years. The growth rate in the fourth quarter was exceptionally high compared with the same quarter of the previous year (10.2%).

The physical indicators in transport also grew, but at a slower rate than gross value added. The number of transported passengers in 2001 rose by only 1.4% compared with the previous year, while the quantity of transported goods rose by 2%. Owing to the well-known incidents in air transport, the number of transported passengers stagnated in the fourth quarter compared with the same quarter of the previous year, while a growth of 16.1% was recorded for the year. The air transport of goods also remained at the same level as in the corresponding quarter of the previous year but grew by 5.4% for the year.

Data on airports are even more illustrative of the air transport difficulties in the last quarter of 2001. In the fourth quarter, aircraft traffic declined by 20%, passenger traffic by 8.5% and cargo traffic by 10% compared with the same quarter of 2000.

The number of minutes spent in telecommunications continued its upward trend. The three mobile networks (Mobitel, Cronet and Vipnet) recorded a 37.7% growth in the number of minutes spent compared with the previous year. The data on the immobile network cannot be compared owing to the new tariffs introduced in mid-2001.

Trade

Gross value added in trade grew by 11.8% in 2001 compared with 2000, while in the previous year the growth rate was 10.5%. A marked growth was recorded in the first half of the year, while the growth rate was halved in the second half. For the second consecutive year, trade was the main positive contributor to the growth in gross value added.

The 2001 growth in personal consumption was reflected in the growth in retail trade turnover and imports of consumer goods. Turnover rose by 10.0% in 2001 and by 9.9% in 2000. There were several reasons for such a high growth in retail trade over the last two years: control of the black economy in the trade sector, opening of large foreign shopping centers and the liberalization of foreign trade that stimulated competition and resulted in lower margins. The final effect was a slowdown in price growth and an increase in supply that fuelled domestic demand. In 2001, the import of durable consumer goods rose by 25.6% in US dollars compared with the previous year and the import of non-durables by 13.9%. A large contribution to the retail trade turnover was made by the sale of imported cars: the number of cars with first registrations rose by 17.3% in 2001 compared with the previous year.

1.2.2 Labor Market

2001 was marked by encouraging changes in the labor market. A rapid growth in registered unemployment was accompanied by a growth in total employment, reversing a years-long downward trend. Despite the economic recovery, wages grew at the lowest rate in the whole post-stabilization period. This was primarily the result of a more restrictive wage policy, for the rapid growth of average wages over the previous years had caused wages to reach the pre-transition period level of 1990, while GDP still remained at a 10% lower level in 2001 than in the early 1990s. In other transition countries of Central and Eastern Europe, the average wage was still almost 20% lower in the late 1990s than at the beginning of the transition period.

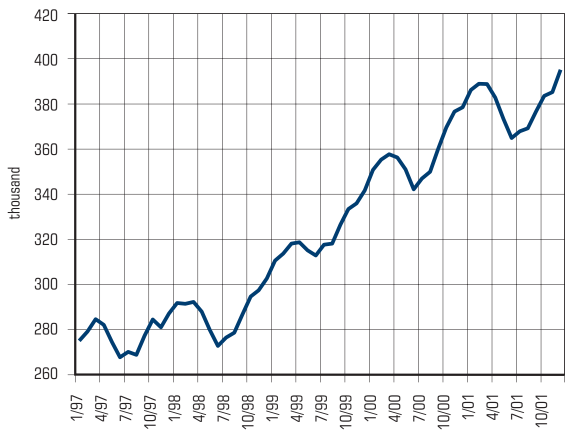
Gross labor market flows continued to improve in 2001. Total inflows into the CEI register in 2001 were 281,000, or 7.3% more than in 2000, reaching 16.5% of the average labor force in 2001. Despite a 17.5% increase in outflows from the CEI register in 2001, which is a much stronger growth than the growth in inflows, total outflows stood at 264,000, remaining lower than total inflows. Registered employment rose by 24.9% in 2001 and was the most dynamic outflow component. As a result of these developments in the labor market, registered unemployment reached 395,000 in late 2001, which is 17,000 (4.4%) more than at the end of 2000.

Despite the slowdown in registered unemployment in 2001 compared with the previous two years, growth accelerated again towards the year-end. The slowdown was caused by the economic recovery that started in 2000 and the rigid wage policy of the government that inhibited the growth of labor costs. On the other hand, the continued growth in registered unemployment, despite the economic recovery, can be mainly accounted for by an accelerated restructuring of companies. The impact of restructuring is observable in the more dynamic inflow into the CEI register. In addition, in late 2001, there was a stronger inflow of war veterans into the CEI, who could only maintain their entitlements pursuant to the new Law on War Veterans by registration with the CEI. That accounts for the accelerated growth in registered unemployment in that period, and, partly, the growth over 2001.

According to the final CBS data, total employment stood at 1,341,000 in late 2001, which was about 20,000 (1.4%) more than in the previous year. This is a reversal of the downward trend recorded in the last decade, suggesting its possible end. However, this reverse situation is not unusual, considering the slower decline in total employment compared with 2000. The structure of total employment in 2001 only shows a fall in the number of actively insured individual farmers – by 5,000 (6.8%). The drop in employment of farmers was more than compensated for by a growth in employment in legal entities (12,000 persons or 1.2%), sole traders and freelancers (12,000 or 6.0%). Considering that the decline in employment of farmers is largely the result of non-payment of pension insurance contributions by a certain number of farmers rather than the termination of their business activities, and that the number of companies that entered bankruptcy proceedings or terminated their business activities rose in 2001, it is natural that the number of workers who received wages grew even faster than employment.

Figure 1.11

Registered Unemployment



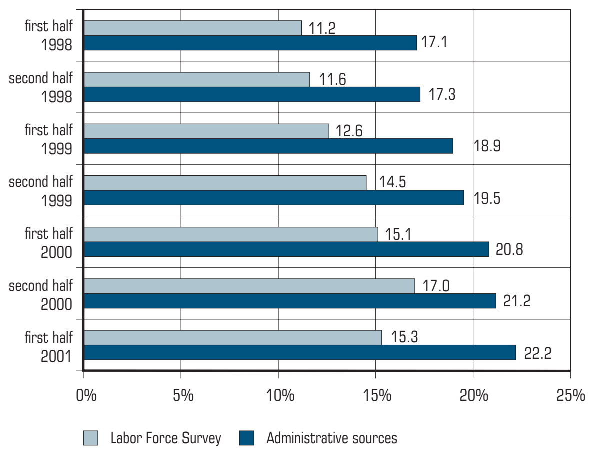
Source: CEI.

Due to the simultaneous growth of total employment and registered unemployment, the labor force increased by almost 36,000 (2.1%). This simultaneous growth of registered unemployment and total employment was partly the result of an economic recovery that raised prospects of employment, as reflected in the development of gross labor market flows. As already explained, this growth was partly caused by institutional reasons, i.e. the required registration of war veterans with the CEI, which increased their inflow into the CEI register in late 2001. As the relative growth of registered unemployment exceeded the growth of employment, the registered unemployment rate increased from 22.3% in late 2000 to 22.8% in late 2001.

The most recent labor force survey, carried out in the first half of 2001 in accordance with the internationally comparable methodology of the ILO, revealed divergent results. The activity rate[1] continued to fall, reaching 49%, which is 2.1 percentage points less than in the second half of 2000 or 1.4 percentage points less than in the first half of 2000. This drop in the activity rate compared with the second half of 2000 was caused by lower employment but also lower unemployment. So the most recent survey indicated an unemployment rate of 15.3%, which is less than in the second half of 2000 but slightly more than in the first half of that year. The fall in the ILO survey employment rate is also understandable, since the survey covered the first half of the year when a decrease in employment of 2,000 (0.3%) was also indicated by the administrative sources data. However, in the second half of the year, employment according to administrative sources rose by 17,000 (1.3%). Therefore, an increase in ILO survey employment in the same period can also be expected.

Figure 1.12

Labor Force Survey and Administrative Unemployment



Source: CBS.

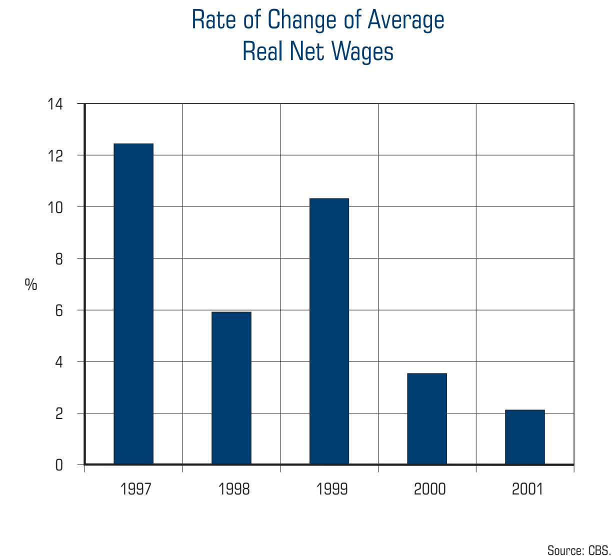
The divergence between registered and ILO survey unemployment rates continued in 2001 owing to the fact that the CEI register included both persons employed in the "grey economy" and those who did not actually seek jobs. It is expected that the entering into force of the amendments to the Law on Employment in early 2002 and other legislative changes aimed at greater flexibility in the labor market will reduce the gap between registered unemployment and ILO survey unemployment. The convergence of the registered unemployment rate with the "real" ILO survey unemployment rate should be stimulated by several factors. Firstly, certain rights, e.g. health insurance entitlements, should be related to a person rather than "status" in order to reduce motivation to register with CEI except for the purpose of job seeking. Moreover, all persons who earn some income irrespective of the type of their labor relationship would be removed from the register. This would result in harmonizing the definition of registered unemployment with that of survey unemployment. Secondly, by applying the "active job-seeking criterion" more strictly, persons who do not actually look for jobs would be removed from the register. The ex-

[1] Activity rate represents the share of active persons, i.e. the employed and unemployed, in the non-registered working-age population. For comparison between labor force surveys, which use different estimates of the number of residents in the surveyed area, it is necessary to observe activity rates rather than the absolute employment levels.

pected impact of the legislative changes could reduce the reliability of the registered unemployment rate in the transition period. However, after adjustment, it will be a much more reliable indicator of economic developments for economic policy-makers.

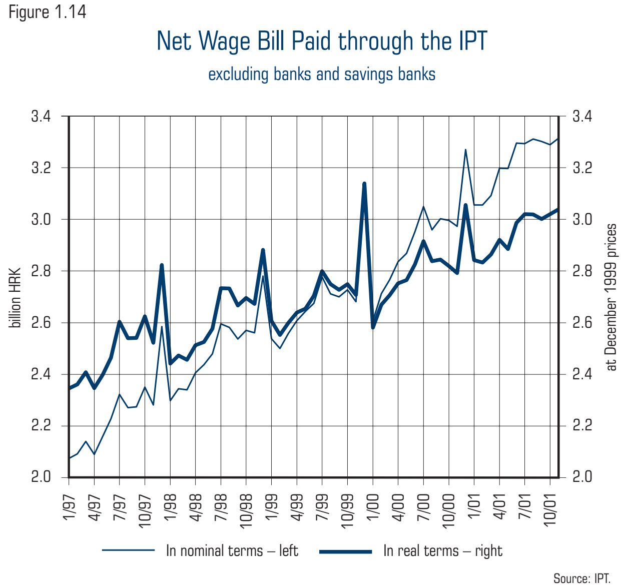
In 2001, the government continued with its restrictive wage policy, which is one of the key supporting elements of fiscal consolidation. According to the CBS data, the average net wage in Croatia in 2001 was HRK 3,534, which is 2.1% more in real terms than in the previous year[2]. This was the lowest real growth of average net wage in the post-stabilization period, resulting primarily from a public sector wage control policy. Thus, the real average net wage in the health and public administration sectors declined, while the average wage in education, calculated in accordance with a new coefficient system, kept pace with the rise in the cost of living and so remained stagnant. However, a significant real growth in average wages was recorded in manufacturing, trade, transport and communications, tourism and construction.

Figure 1.13



Despite the zero growth in average wages, the net wage bill paid through the IPT continued to expand in 2001. Excluding the influence of wages in banks and savings banks, which were "unjustly" left out of the statistics at the beginning of 2001, the net wage bill rose by 4.7% in real terms, pointing to an accelerated growth in the wage bill compared with 2000. In view of the slowdown in average wage growth in 2001, the growth in the number of employees paid through the IPT, i.e. the growth in employment, becomes increasingly important.

Figure 1.14



The increase in employment and the wage bill provided an impetus to the growth of ULC in industry, following a years-long decline. The growth was achieved despite an accelerated growth in industrial production over 2001.

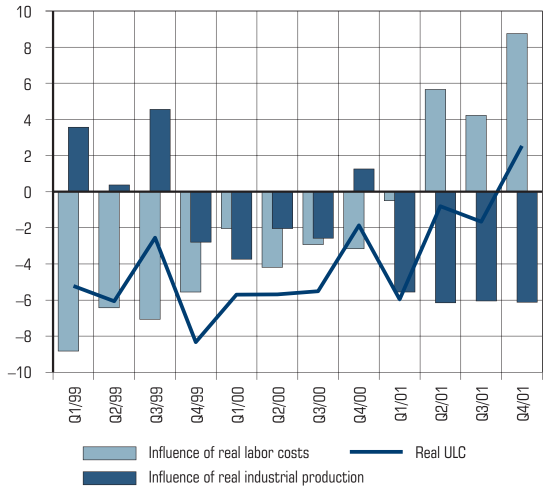
The strong inflow of war veterans into the CEI register in late 2001 continued in 2002. In the period between October 2001 and March 2002, following a continuous slowdown, the number of registered war veterans rose by almost 12,000, which accounts for more than one third of the total growth in registered unemployment in the

2 The surveyed wages are wages paid "within the month" and not wages paid "for the month", as surveyed by the CBS. In addition, cost-of-living indexation was made on a monthly basis.

Figure 1.15

Influence of Real Labor Costs and Industrial Production on ULC

annual rate of change

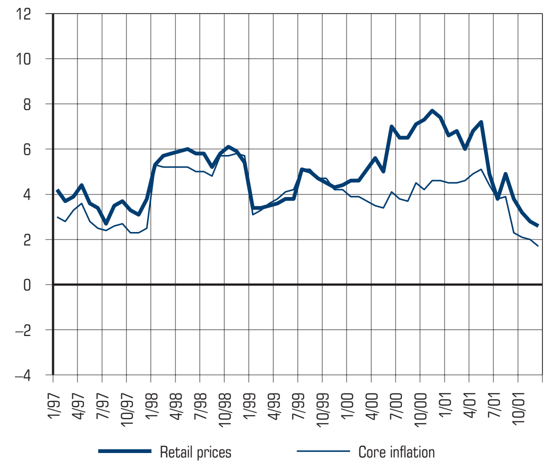


Source: Calculation based on CBS and IPT data.

Figure 1.16

Retail Prices and Core Inflation

year-on-year rate of change



Source: CBS.

observed period. Excluding the impact of the accelerated growth in the number of registered war veterans, no upward trend in the registered unemployment is really noticeable at the beginning of the current year. According to the preliminary CBS data, total employment increased by about 12,000 (1%) in the first two months of 2002 in comparison with the same period of 2001. Since the registered unemployment grew faster than employment, the unemployment rate increased and averaged 23.7% in the first two months of 2002, up by 1.0 percentage point over that in the same period last year.

In early 2002, wages also continued the trends from 2001. In the first two months of 2002, the average net wage rose by 1.9% in nominal terms compared with the previous year, or by 0.6% in real terms.

1.2.3 Prices and Exchange Rate

Prices

All relevant CBS aggregate indicators on movements in prices showed a substantial downward trend in inflation in 2001 in comparison with 2000. The year-on-year inflation rate measured by changes in retail prices stood at 2.6% in December 2001, which was markedly lower than the 7.4% rate of December 2000. The core inflation rate decreased by 2.9 percentage points in 2001,[3] from 4.6% in December 2000 to 1.7% in December 2001. The average year-on-year growth rate of retail prices was 4.9% in 2001, down by 1.3 percentage points in comparison with 2000. The average year-on-year core inflation rate fell from 4.0% in 2000 to 3.6% in 2001. The average year-on-year growth rate of producer prices of industrial products also decreased substantially, from 9.7% in 2000 to 3.6% in 2001. The significant factors that resulted in the easing of inflationary pressures in 2001 include the fall in crude oil and raw materials prices in the world market, the decrease in producer prices of industrial products in

3 The Central Bureau of Statistics calculates the core inflation in the manner that agricultural products prices and administrative prices (which among others include the prices of electricity and refined petroleum products) are excluded from the RPI. Agricultural products prices and administrative prices are the RPI components whose changes to a great extent cannot be controlled by the monetary authorities. A total of 88 goods and services are excluded and their share in the RPI basket stood at 22.06% in 2001 (of which: agricultural products accounted for 2.28 percentage points, and administrative prices for 19.78 percentage points). Along with monitoring movements in the consumer price inflation, an increasing number of central banks lays great stress on the monitoring of the core inflation (e.g. in United Kingdom, Canada, Slovenia, the Czech Republic and Hungary).

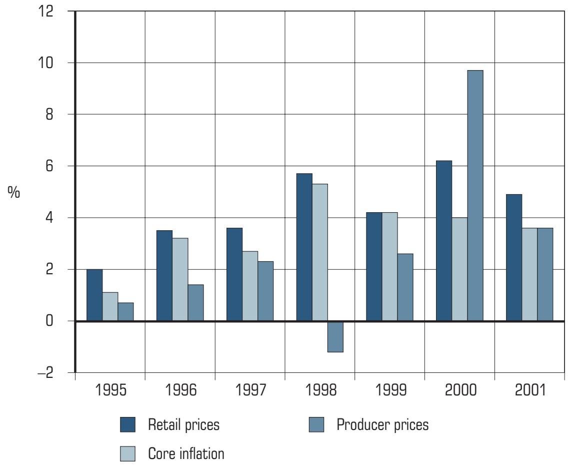
Croatia and in the countries that are its most important trading partners, the stable exchange rate, the moderate wage increase, a gradual decrease in tariff rates and increased competition in the domestic market with the arrival of new chain stores.

The slowdown trend in inflation growth in 2001 can largely be ascribed to a substantial reduction in the contribution of goods prices to total inflation measured by movements in the retail price index (RPI) in 2001 in comparison with 2000. Moreover, the direct contribution of retail refined petroleum products prices to total inflation rate was much lower due to a fall in crude oil prices in the world market.

Figure 1.17

Retail Prices, Core Inflation and Producer Prices

average annual rate of change



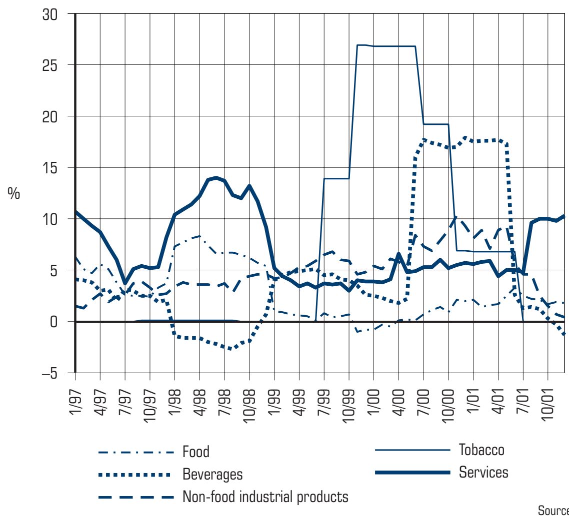
Source: CBS.

The average monthly spot price of crude oil went down by 26.5% in the world market in 2001, from $25.2 a barrel in December 2000 to $18.5 a barrel in December 2001. This was a result of a slowdown in global economic activity and reduced airline traffic. The slowdown in the core inflation growth in 2001 indicates, among others, that the indirect effects of previous increases in refined petroleum products prices on other products and services prices were limited in both intensity and duration, which in turn eased the inflationary pressures from the demand side. The described movements in refined petroleum products prices in the domestic market resulted in a considerable decrease in the contribution of administrative prices to the overall retail price inflation rate, from 3.7 percentage points at end-2000 to 1.2 percentage points at end-2001. In addition, the contribution of tobacco and beverage prices to the inflation rate decreased as well.

Figure 1.18

Retail Prices by Components

year-on-year rate of change



Source: CBS.

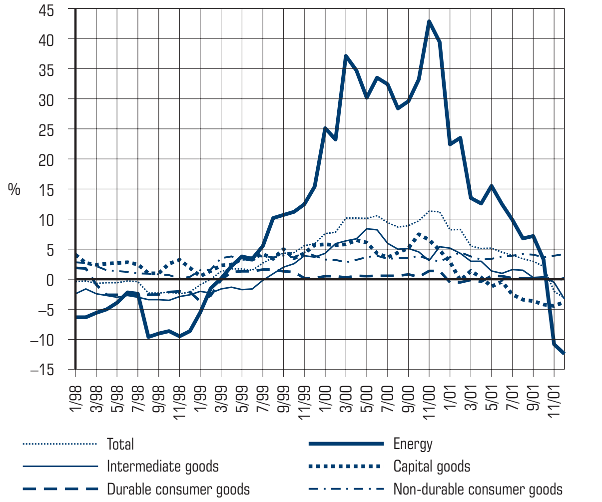
In addition to the above-mentioned movements in crude oil prices, the weakening of inflationary pressures from abroad in 2001 is also indicated by other components of imported inflation. Data on changes in the prices of raw materials in the world commodity exchanges, compiled within the aggregate HWWA index excluding energy,[4] show that these prices fell on average by 14.4% in December 2001 in comparison with the same

4 The Hamburg Institute of International Economics (Hamburgisches Welt-Wirtschafts Archiv, HWWA) constructed the aggregate index of raw materials prices in the world market, the HWWA. The HWWA index indicates the movements in costs of imported raw materials (it includes a total of 29 raw materials, or 27 excluding energy) and is used in analyzing the influence of changes in the prices of raw materials in the world market on changes in prices in industrial countries. The index is calculated on the basis of raw materials prices expressed in US dollars.

Figure 1.19

Producer Prices of Industrial Products by Main Industrial Groupings

year-on-year rate of change



Source: CBS.

period of 2000. This caused a decrease in domestic producer prices of industrial products and in the producer prices in the countries that are Croatia's most significant trading partners. Although these prices grew by 5.6% year-on-year in the euro-zone in December 2000, their aggregate level fell by 1.1% in December 2001 in comparison with the same period last year.

Inflationary pressures in 2001 were also eased through the relative stability of the kuna/euro exchange rate, which guarantees the stability of inflationary expectations. Efforts to restrain wages in the government and public sector also diminished inflationary pressures. Increased competition in the domestic market due to the arrival of new chain stores, and a gradual decrease in tariff rates following Croatia's accession to the WTO, additionally eased inflationary pressures in the domestic commodity market.

On the other hand, the year-on-year growth rate of services prices (from the RPI) rose from 5.7% in December 2000 to 10.3% in December 2001. This was, above all, the result of a significant increase in telecommunication services prices and increases in the prices of specific utility services, compulsory motor vehicle insurance and city transport. However, services prices that are not administratively regulated also rose considerably. As a result, services prices that are covered by the core inflation index grew by 5.6% year-on-year in December 2001, up 2.1 percentage points in comparison with end-2000.

The relative stability of the index of the nominal effective kuna exchange rate, the fall in prices of crude oil and other raw materials, a modest increase in outlays for wages and the downward trend in lending rates to enterprises lessened the inflationary pressures generated by the increase in production costs. The year-on-year growth rate of domestic producer prices of industrial products fell from 11.2% in December 2000 to 3.1% in December 2001. Energy prices decreased by 12.4% in 2001 and thus gave a negative contribution to the year-on-year growth rate of producer prices recorded at end-2001. The fall in capital and intermediate goods prices was somewhat lower in 2001 (3.8% and 3.2% respectively). The increase in durable consumer goods prices was negligible (0.2%), while December 2001 saw a somewhat stronger year-on-year growth in producer prices in the industrial grouping that manufactures non-durable consumer goods (4.2%).

Retail prices rose by a total of 1.3% in the first quarter of 2002 in comparison with end-2001, and the annual inflation rate rose from 2.6% in December 2001 to 3.2% in March 2002. The monthly inflation measured by changes in the RPI fluctuated substantially in the first quarter; it stood at a high 0.8% in January, fell to 0.1% in February and increased again in March to 0.4%. The considerable January growth in retail prices resulted from factors that have a one-off effect on the prices growth rate and do not have a permanent effect on the inflation growth rate and seasonal factors (increase in agricultural products prices, growth in retail beverage prices due to increases in excises on beer and certain administrative prices – road tolls, compulsory motor vehicle insurance, vehicle inspection, railway transport of passengers). In addition, the increase in crude oil prices in the world market and the depreciation of the kuna/US dollar exchange rate caused a 3.5% increase in refined petroleum products prices in January. A substantial contribution to the March growth in retail prices was again brought about by the increase in the prices of refined petroleum products (4.4% on average). The rise in crude oil prices in the first quarter of 2002 resulted from the reduced production agreed between OPEC countries and other important oil producers, and was further stimulated by the tense political situation in the Middle East. At end-March, the U.K. Brent crude oil price stood at $25.6 a barrel, a 32.6% increase compared with $19.3 a barrel at the end of 2001. The first quarter of 2002 also saw a growth in prices of other raw materials traded in the world commodity exchanges, and the aggregate HWWA index (excluding energy) rose by a total of 18.8% in comparison with end-2001. Since the core inflation basket does not include energy products prices, this indicator on price movements saw a modest growth in comparison with the overall RPI in the first quarter of 2002. Prices that are included in the core RPI basket grew by 0.6% in the observed period, while the annual core inflation rate rose from 1.7% in December 2001 to 1.8% in March 2002.

Exchange Rate

The average annual effective kuna exchange rate[5] appreciated by 1.2% in nominal terms in 2001 in comparison with 2000. The kuna strengthened against the basket of currencies due to a 2.2% nominal appreciation of the average annual exchange rate of the kuna against the euro (the euro accounts for 66.2% in the basket of currencies). In contrast, the kuna depreciated against the US dollar by 0.8% (the US dollar accounts for 30.6% in the basket of currencies). The influence of other currencies on movements in the index of the nominal effective kuna exchange rate was less dominant. It should be noted that the average annual exchange rate of the kuna strengthened against the pound sterling and the Slovene tolar (4.1% and 7.3% respectively) but weakened against the Swiss franc (0.9%) in 2001 in comparison with 2000. Unlike 2001, 2000 saw the average annual exchange rate of the kuna against the US dollar depreciate strongly (16.3%), which, despite a slight nominal appreciation of the kuna against the euro (0.7%), resulted in a depreciation of the average annual nominal effective kuna exchange rate of 5.4% in comparison with the previous year.

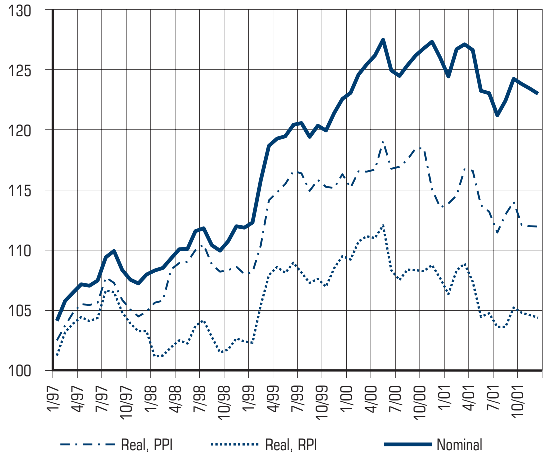
The nominal appreciation of the average annual effective kuna exchange rate of 1.2%, accompanied by a somewhat higher average annual growth rate of prices in the country

[5] The index of the nominal effective exchange rate of the kuna is a weighted average of the index of bilateral exchange rates of the kuna against the euro, the US dollar, the Swiss franc, the pound sterling and the Slovene tolar. Weightings assigned to a particular foreign currency reflect their average shares in the structure of the current account of the balance of foreign currency transactions. The index of the nominal effective exchange rate is an aggregate indicator of changes in the average value of the kuna against the basket of currencies, whereby an increase in the index indicates the nominal depreciation of the exchange rate of the kuna against the basket of currencies and vice versa.

Figure 1.20

Indices[a] of Nominal and Real Effective Kuna Exchange Rates

with retail and producer prices, 1995 = 100



[a] The fall of index denotes appreciation of the kuna.

Source: CNB.

than abroad, resulted in the real appreciation of the average annual effective exchange rate of the kuna[6] of 2.7% (producer prices) and 3.4% (retail prices) in 2001 in comparison with 2000.

The average annual exchange rate stood at 7.47 HRK/EUR in 2001 and appreciated by 2.2% in nominal terms in comparison with the average exchange rate of 7.63 HRK/EUR recorded in 2000. The value of the euro fell from 7.60 kuna at 31 December 2000 to 7.37 kuna at 31 December 2001. As a result, the appreciation of the kuna/euro exchange rate was more pronounced and stood at 3.0% (the euro conversion) if compared with exchange rates at the end of the year. For most of the year, the central bank had to deal with appreciation pressures on the domestic currency that were stronger than in the previous year, although the nominal kuna/euro exchange rate depreciated slightly at the beginning of the year and at end-November and strongly in August. In an effort to ease the strong appreciation pressures, the central bank purchased USD 374.4m (net) at its foreign exchange auctions held in 2001, substantially more than in 2000 when it purchased USD 104.8m (net). In 2001, the foreign exchange supply grew in the domestic market owing to a successful tourist season, significant inflows of foreign exchange from government borrowings abroad and privatization receipts, the inflow of foreign currency that households deposited in foreign exchange accounts at the end of the year, and the implementation of measures within the CNB's authority (the reduction of the permitted exposure of the total foreign exchange position to currency risk from 25% to 20% of bank risk-based capital and the allocation of part of the foreign exchange reserve requirements in kuna). The CNB's net purchases of foreign exchange from the Ministry of Finance were considerable in 2001 at USD 480.0m (USD 298.0m in 2000).

The beginning of 2001 was marked by the usual seasonal depreciation of the nominal exchange rate of the kuna against the euro due to the repayment of due installments of foreign loans. Additional pressure on the increased demand for foreign exchange was created by increased household kuna liquidity arising from further disbursements of insured deposits. The CNB intervened twice in the foreign exchange market in this period by selling foreign exchange and withdrawing the seasonal surpluses of reserve money. It sold to banks a total of USD 41.9m at an auction held on 25 January and an additional USD 17.7m at an auction held on 2 March, thus withdrawing HRK 147.3m.

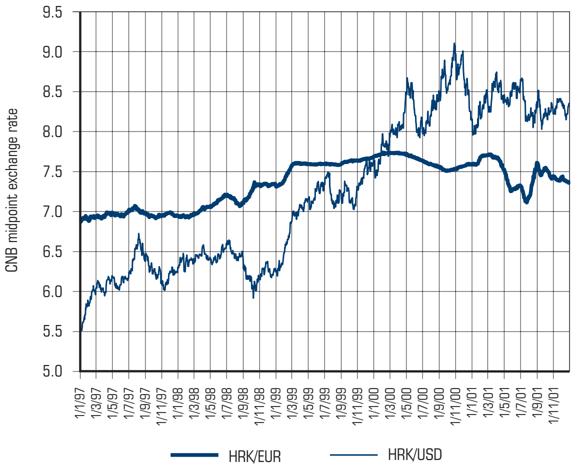
The appreciation trend in the kuna exchange rate from mid-March increased the value of the kuna against the euro by a total of 5.5% at end-May. At its foreign exchange auc-

6 The index of the real effective exchange rate is a weighted average of the index of bilateral exchange rates of the kuna against the euro, the US dollar, the Swiss franc, the pound sterling and the Slovene tolar corrected for the respective indices of relative prices in the country in comparison with abroad. If the prices grow faster in the country than abroad, the real effective exchange rate of the domestic currency will appreciate (decrease) despite the unchanged nominal effective exchange rate. The increase in the index of the real exchange rate indicates a fall (depreciation) in the real kuna value.

tions held in this period, the central bank purchased from banks a total of USD 182.4m (USD 45.4m in April and USD 137.0m in May). A further accelerated growth in the value of the kuna against the euro was halted at end-May and the kuna weakened by a total of 0.6% in June in comparison with the exchange rate at end of the previous month. Judging that the situation in the foreign exchange market had stabilized, the central bank did not intervene in the domestic foreign exchange market in June. At the time, the CNB also took additional measures aimed at modernizing the reserve requirement instrument. Accordingly, the reserve requirement rate was decreased from 23.5% to 22.0%, and the foreign exchange base for calculating reserve requirements was extended to include short-term foreign exchange loans obtained abroad. As a result, kuna liquidity increased and part of the foreign exchange liquidity was withdrawn.

Figure 1.21

Daily Nominal Exchange Rate – HRK vs. EUR[a] and USD



[a] ECU until January 1999.

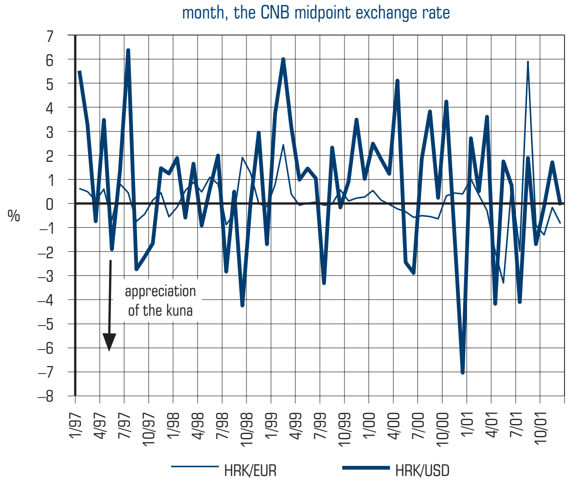
Source: CNB.

July 2001 was characterized by a seasonal nominal appreciation of the kuna/euro exchange rate that, although expected, was much stronger than in 2000. The kuna/euro value grew by 1.8% in nominal terms in July in comparison with end-June, while it had strengthened by 0.5% in July 2000. In an effort to ease the intense appreciation of the exchange rate of the kuna against the euro, the central bank purchased from banks a total of USD 122.9m at an auction held on 11 July. In addition, it purchased USD 86.7m from the Ministry of Finance. This halted the appreciation trend in the kuna/euro exchange rate in the last week of July.

Figure 1.22

Rate of Change of the Nominal Exchange Rate – HRK vs. EUR and USD

at the end of the month compared to the end of the previous month, the CNB midpoint exchange rate



Source: CNB.

However, the kuna exchange rate did not stabilize at that point but was marked by a strong and seasonally unusual depreciation of the kuna/euro exchange rate that began as early as in August. The kuna exchange rate lost 5.9% of the value recorded at end-July, reaching 7.6 HRK/EUR. In an effort to contain the depreciation pressures on the domestic currency exchange rate, the CNB intervened on three occasions in August by selling a total of USD 370.8m to banks. The banks' reactions to the CNB's foreign exchange interventions can be described as typical currency speculation: they persisted in purchasing foreign exchange, their long foreign exchange positions reached maximum and the kuna shortage was compensated through intensive utilization of Lombard loans. The depreciation pressures noted in August, the month in which the price of foreign exchange in previous years was generally the lowest, also resulted from the increased demand for foreign exchange by enterprises. This caused a fall in corporate demand deposits accompanied by an increase in corporate foreign exchange deposits with banks.

In response, the CNB enacted several decisions[7] aimed at easing depreciation pressures on the domestic currency exchange rate. On 16 August 2001, it enacted a decision on reducing the permitted exposure of the total foreign exchange position to currency risk from 25% to 20% of bank risk-based capital and eliminated the possibility of making exceptions to this decision. In addition, on 5 September, the central bank enacted the decision on the increase in the interest rate on Lombard loans from 9.5% to 10.5%, the decision on the reduction of the remuneration rate calculated on the allocated kuna reserve requirements from 3.5% to 2.0%, and the decision on the gradual unification of the currency of required reserves. The enactment of these decisions was stimulated by the CNB's awareness of the extent to which the exchange rate may influence inflation (directly, through increases in the prices of imported products, and indirectly, through the creation of inflationary expectations whose strengthening may result in more permanent growth in the inflation rate in the future).

The August interventions and other CNB measures reduced the demand for foreign exchange and the kuna liquidity in the domestic market and halted the depreciation of the exchange rate of the kuna against the euro in the first half of September. In an effort to partially restore and stabilize the kuna liquidity of banks at a level that would ensure the normal lending activity of banks and a further fall in interest rates, the central bank purchased a total of USD 161.1m from banks in September and an additional USD 169.8m from the Ministry of Finance, thus creating HRK 2.7bn.

The last quarter of 2001 was marked by a nominal appreciation of the kuna against the euro of 2.3%, with the euro declining from 7.54 kuna at end-September to 7.37 kuna at end-December. Although an important characteristic of the fourth quarter is the seasonal current account deficit which causes, as a rule, the depreciation of the exchange rate of the kuna against the euro, this deficit was not recorded in the last quarter of 2001. The foreign exchange supply in the market was abundant owing to the inflow of foreign currency savings that most savers elected to deposit with banks in order to avoid conversion fees. In an effort to keep exchange rate movements within satisfactory stability boundaries, the central bank purchased from banks a total of USD 338.5m (net) in the foreign exchange market in the last quarter of 2001. In addition, a part of the foreign exchange inflow from the sale of a stake in Croatian Telecom that amounted to USD 43.3m was purchased from the Ministry of Finance in November and USD 89.6m (net) from the government in December.

The net purchase of foreign currency from households reached the usual level in January 2002. As a result of increased demand for foreign exchange, above all by legal entities, banks intensified their purchases of foreign exchange in the domestic foreign exchange market. Accordingly, the kuna exchange rate fell against the euro by 2.7% nominally in January 2002 in comparison with end-2001. At its foreign exchange auctions held in January, the CNB sold to banks a total of USD 124.05m. The seasonal depreciation of the kuna/euro exchange rate came to a halt at the beginning of February 2002, and the domestic currency exchange rate reversed its trend. Appreciation pressures on

7 In order to keep to the quarterly floors under the net usable international reserves of the CNB that were the quantitative performance criterion specified under the MEFP concluded with the IMF, the central bank did not intervene further by selling foreign exchange to banks at its auctions.

the kuna were expected since there was a large supply of foreign exchange in the market that was expected to further increase due to planned borrowings by the government and Croatian Highways abroad and the inflow of foreign exchange from privatization and the export of tourist services. During February and March, the nominal exchange rate of the kuna strengthened by 2.2% in comparison with the exchange rate at end-January, and the euro fell from 7.57 kuna to 7.40 kuna. In an effort to preserve the stability of the kuna/euro exchange rate, the central bank purchased USD 268.04m from banks at foreign exchange auctions held within the period.

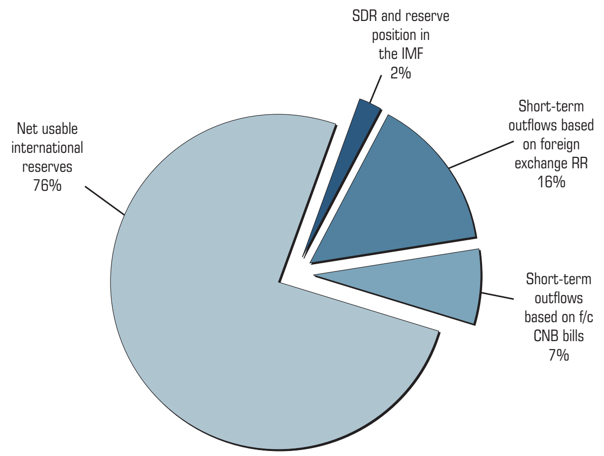
1.2.4 Monetary Developments and International Reserves

The environment within which the central bank operated in 2001 was largely marked by the intensification of the economic growth that had started in 2000, with a significant growth in all monetary aggregates and the credit activities of banks. The broadest monetary aggregate, total liquid assets, grew by 45.2% (December level), especially because of a rapid growth in foreign exchange deposits compared with 2000. This was accompanied by heightened credit activities of banks. The banks increased both their household lending and corporate lending. Household lending increased by 29.3% in 2001 (21% in 2000) and corporate lending by 21.3% (0.9% in 2000). Despite the rapid growth in monetary and credit aggregates, the rate of inflation was below the level projected for 2001 and met the primary objective of the central bank.

In the area of monetary regulation, several significant changes took place last year. The Decision on the Beginning of Operation of the National Clearing System and its Use for the Execution of Payment Orders (official gazette, *Narodne novine,* No. 131/2000) marked the successful launching of the second phase of the payment system reform in the first quarter of the year. The beginning of the second quarter saw the enactment of the Law on the Amendments to the Law on the Foreign Exchange System, Foreign Exchange Operations and Gold Transactions (official gazette *Narodne novine*, No. 32/2001). The main purpose of the changes in foreign exchange regulation was to liberalize foreign exchange operations for legal persons, facilitating their foreign exchange purchases and their use of foreign exchange. The effects of the new regulation were felt with a time shift of several months. Soon after the amendments to the foreign exchange regulation were enacted, the new Law on the Croatian National Bank came into force (official gazette *Narodne novine*, No. 36/2001). This Law unambiguously defined price stability as the primary objective of the central bank, in accordance with the best practices of central bank legislation in developed countries. Compared with the previous Law, the new Law strengthened central bank independence and defined the central bank's functional, institutional, personal and financial independence. The responsibilities of the Governor and the other members of the bank's Council were also defined, as well as the grounds for their removal from office. 2001 saw the first concrete results of succession negotiations. According to the Agreement on Succession Issues, Croatia was entitled to 28.49% of the assets of the former SFRY in the accounts of the BIS, which comprised USD 8.32m in foreign exchange and 13.127 tons of gold ingots. The gold was sold, and the foreign exchange that was received is now in the CNB portfolio.

Figure 1.23

Structure of Total International Reserves of the CNB on 31 December 2001

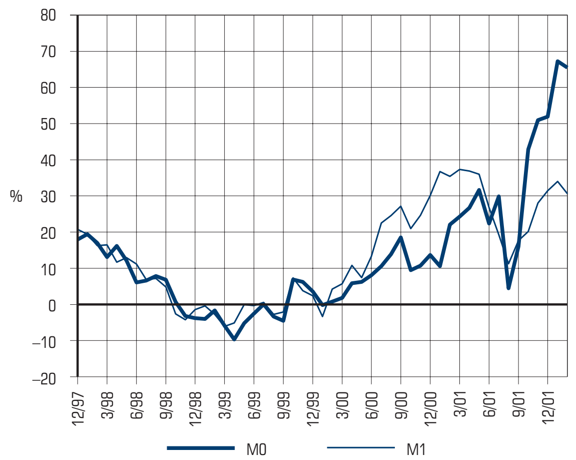


Source: CNB.

Figure 1.24

Year-on-Year Growth Rates of Reserve Money (M0) and Money (M1)

rate of change compared to the same month previous year



Source: CNB.

Reserve money, the basic monetary aggregate of the central bank grew by 51.9% in 2001 (13.6% in 2000) as a result of significant changes in monetary policy instruments but also as a result of rapid growth in the broadest monetary aggregates. However, the largest single factor affecting reserve money dynamics were changes in the reserve requirements.

In accordance with the trends from previous years, there were further cuts in the reserve requirement rate. The rate was cut from 23.5% at the beginning of the year to 22% in July and finally to 19% in December 2001. In the first five months of 2001, there were no changes in the elements of the reserve requirements, which increased by virtue of the increased base. Starting from June 2001, the base for the foreign exchange reserve requirements included received foreign credits, which helped provide an equal treatment for different sources of bank funds. The increase in the base of HRK 14bn, representing the aggregate amount of received foreign exchange credits, was performed in two steps, one in June and the other in July, to lessen the impact on the foreign exchange liquidity of banks. Banks with a large share of credits in their sources were offered the option of gradually increasing their allocation over the following four months. In addition to providing equal treatment for different sources, the increase in the allocated foreign exchange reserve requirements also helped to relieve appreciation pressures in the foreign exchange market.

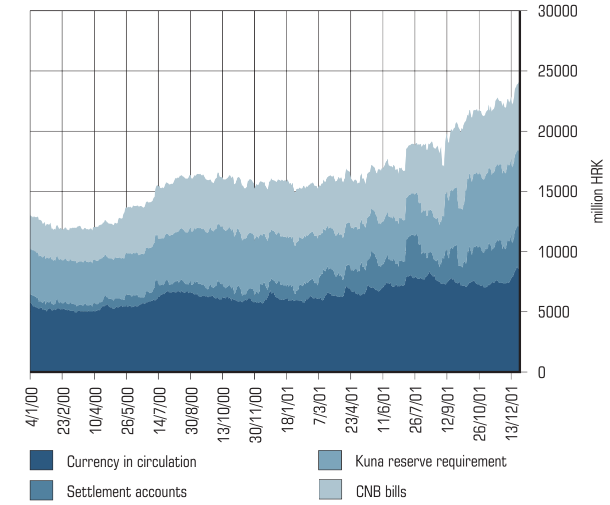
A minimum of 40% of the reserve requirements may be allocated into special accounts with the CNB and a maximum of 60% may be met by liquid claims. Since the foreign exchange assets of banks held in accounts abroad were sufficient to cover the increased reserve requirements maintenance, additional effort was needed only in the case of the 40% allocation in the accounts with the CNB. The allocated foreign exchange reserve requirements grew by HRK 0.6bn. Although the foreign exchange reserve requirements are not part of reserve money, their level and dynamics of change after September 2001 greatly affected the movements in reserve money. In September 2001, 10% of the foreign exchange reserve requirements were allocated in kuna, which helped increase the kuna reserve requirements and reserve money. This percentage was raised to 20% in October and finally to 25% in December. In a broader context, the unification of the reserve requirements took place simultaneously with the seasonal increase in kuna liquidity in the system.

The period of depreciation in 2001 started sooner than usual, in mid-summer, when the foreign exchange inflow is still seasonally large and there is a seasonal appreciation of the kuna. At the beginning of August, legal persons, either acting on their own or on the advice of their commercial banks, started making use of the new opportunities provided by the new foreign exchange law and purchased foreign exchange for the purpose of depositing it into their accounts. The increased demand for foreign exchange was sufficient to reverse the exchange rate trend, causing the kuna to start weakening somewhat earlier than is usual for the season. The central bank decided that the kuna liquidity of the system was sufficient to enable a smooth transfer to the increased allocation of kuna reserve requirements. To enable a smooth transfer to the new system for those banks whose liquidity was below the system's average, the central bank intervened by purchasing foreign exchange.

Kuna reserve requirements allocated in the reserve requirement account with the CNB amount to at least 40% of the calculated reserve requirements, while the remaining requirements, to a maximum of 60%, are maintained in the banks' settlement accounts. The changes in the allocation of the foreign exchange reserve requirements caused both categories of reserve money to increase. The rapid growth in the foreign exchange base and the allocation of part of the foreign exchange reserve requirements in kuna more than made up for the reserve requirement rate cut and a somewhat slower increase in the kuna base (kuna nonmonetary deposits and demand deposits) compared with 2000. The balances in the banks' **settlement accounts** increased by a high 433.2% in 2001 (85.4% in 2000), while the allocated kuna reserve requirements increased by 54.2% (9.9% in 2000).

Figure 1.25

Structure and Daily Changes of Reserve Money and CNB Bills

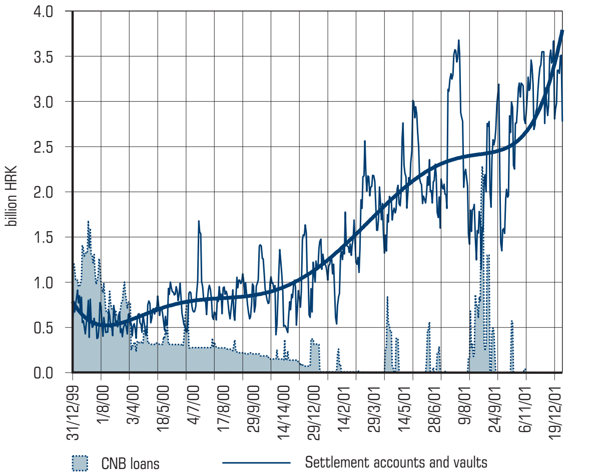


Source: CNB.

The developments in the foreign exchange reserve requirements are inversely proportionate to the developments in the kuna reserve requirements. Changes in the instruments, which enabled a part of the foreign exchange reserve requirements to be allocated in kuna, helped decrease kuna liquidity and increase foreign exchange liquidity. The continued decrease in the foreign exchange reserve requirements during the fourth quarter caused an increase in the foreign exchange liquidity of banks and helped increase the net foreign assets of banks as well as the stock of subscribed foreign exchange CNB bills. However, despite the cut in the reserve requirement rate and the decrease in the foreign exchange part of the allocated reserve requirements, the rapid growth in the base caused the foreign exchange reserve requirements to increase. In particular, the growth in the base reflects an increase in foreign exchange deposits, which started in summer 2001 and accelerated until the end of the year. As a result, the foreign exchange reserve requirements increased by 3.9% compared with end-2000, reaching HRK 5.7bn by end-2001. In October 2001, hybrid and subordinated instruments were included in

Figure 1.26

Banks' Settlement Accounts with the CNB and Liquidity Loans



Source: CNB.

the base for calculating reserve requirements. The effects of this change were not significant as these instruments represented small amounts (HRK 2.2bn), but their introduction helped foster regulatory discipline.

The rapid growth in **currency** of 28.2% (11.4% in 2000) complements the picture of accelerated growth in reserve money (described in more detail in Monetary and Credit Aggregates). At the end of 2001, reserve money stood at HRK 17.8bn, of which deposits and cash in vault accounted for HRK 9.3bn and currency for HRK 8.5bn.

Kuna CNB bills grew by 44.4% in 2001 (91.2% in 2000). Despite good kuna liquidity during the whole year (exceptions excluded), several factors played a role in the slower growth rate in 2001 compared with 2000. Already at the beginning of February, the stock of subscribed treasury bills of the Ministry of Finance exceeded the stock of subscribed kuna CNB bills, and this trend continued until the mid of the year. At the end of 2000, kuna CNB bills stood at HRK 2.5bn. During the first half of 2001, they held steady at approximately the same level. Treasury bills stood at HRK 1.5bn at the end of 2000, or less than half the HRK 3.5bn at the end of the first quarter of 2001. In April, different maturities and different dynamics of issuing CNB bills were introduced. The previous maturities of 35, 91 and 182 days were replaced by new standardized maturities of 35, 70 and 105 days. More importantly, auctions were not to be held every week but every five weeks. During the transition period, the frequency of auctions was gradually decreased until the desired monthly frequency was reached.

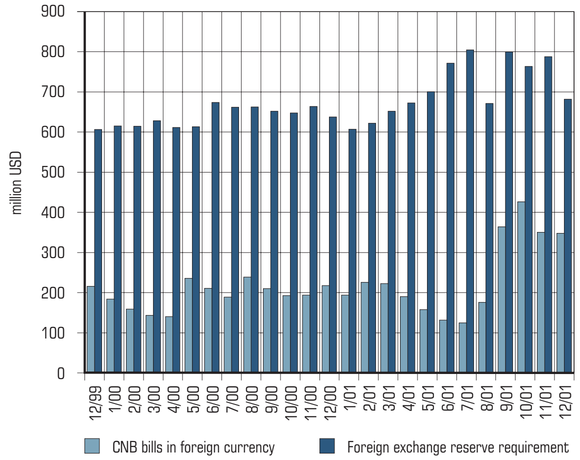
This change was motivated by the decreased competitiveness of CNB bills and T-bills and even more by the need to promote the development of the secondary market and the banks management of their own liquidity. Regular weekly auctions by the Ministry of Finance proved more attractive to banks, which continued to increase their T-bills subscriptions. However, the central bank held extraordinary CNB bills auctions whenever there was a need for them. CNB bills auctions are the most flexible and most efficacious instrument of monetary policy, whose quantity and price are used by the central bank to affect the level of liquidity in the system. Extraordinary auctions were commonly held after foreign exchange interventions, to decrease the system's liquidity. An extraordinary auction was held at the beginning of June, following three foreign exchange auctions in May when over HRK 137m was purchased, bringing the level of CNB bills to over HRK 3bn. The good liquidity and large foreign exchange purchases in July (USD 122.9bn) caused a continued growth in demand for CNB bills, whose level rose constantly during the summer. In August, the level of CNB bills reached almost HRK 4.5bn. This enabled further changes in the reserve requirements. The stock of kuna CNB bills at the end of 2001 was HRK 3.5bn, an increase of 44.4% compared with December 2000.

Foreign exchange CNB bills increased by 60.7% in 2001 to HRK 2.9bn at end-December 2001. Foreign exchange CNB bills are not such a significant instrument of monetary policy as kuna CNB bills. The interest paid by the central bank on these bills equals the interest the central bank earns on bank funds placed abroad (reduced by the amount of costs, or 1/16). Thus the central bank acts as an intermediary and is not actively involved in dictating the quantity or price of these securities. The banks may use them as collateral for the Lombard loan facility. They may also be used as liquid claims to meet the banks' foreign exchange reserve requirements and to help banks manage their currency risk exposure. Weekly auctions were retained in respect of these bills.

Central government deposits with the central bank are also an efficient instrument of sterilization and liquidity management, provided there is good co-operation with the Ministry of Finance. Kuna government deposits with the central bank increased by 20.9% compared with December 2000. However, on account of large oscillations in these accounts during the year, a better illustration of movements across these accounts is obtained by looking at their average balances. The average balance in these accounts in 2001 increased by 84.9% compared with 2000. This is an indication of a different government approach to liquidity management as a result of the introduction of a single treasury account and a higher level of public revenues.

Figure 1.27

Changes in Foreign Exchange Reserve Requirements and CNB Bills in Foreign Currency

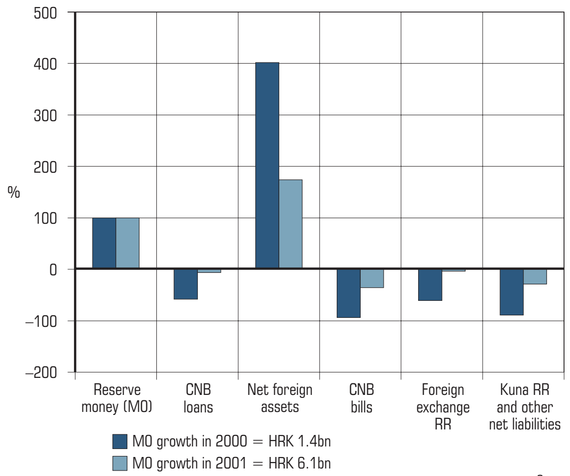


Source: CNB.

The government deposited foreign exchange with the central bank on three occasions in 2001. In mid-March, the government deposited USD 91.6m, a portion of the receipts from the issue of eurobonds amounting to EUR 500m, for a period of almost 6 months. At the end of October, EUR 48m was deposited for a period of approximately ten days. At the end of the year, from 14 December to 21 December, following the government's placement of eurobonds in the domestic market, government deposits with the central bank stood at EUR 58.7m.

Figure 1.28

Contribution of Individual Monetary Policy Instruments to Creation and Withdrawal of Reserve Money (M0 Growth = 100%)



Source: CNB.

The flows of creating and withdrawing reserve money in 2001 were mostly directed to foreign exchange transactions with the banks and the government. Kuna credits were used on only a few occasions. Interventions in the foreign exchange market, significant purchases of foreign exchange from the Ministry of Finance and the gold and foreign exchange inflow arising from the succession caused the net international reserves to increase by over USD 1bn, with a net positive monetary effect of HRK 7.3bn (net purchases in 2000 were USD 432.5m, with a monetary effect of HRK 3.6bn). International reserves in 2001 achieved a record annual growth.

In *the first quarter*, the central bank organized two foreign exchange sales totaling USD 59.6m, thus withdrawing HRK 490m. The central bank activities in the first quarter of 2001 were not different from those in the previous years. Every year, the seasonal increase in the demand of the government and the private sector for foreign exchange, coupled with mild depreciation pressures, create the need for additional central bank foreign exchange sales. In *the second quarter*, the usual seasonal inflow of foreign exchange took place, resulting in the usual purchases of foreign exchange from the central bank. However, the intensity of the purchase is what marked 2001. In March, the government placed abroad EUR 500m worth of eurobonds, and the central bank purchased from the government USD 69.2m worth of foreign exchange. At four interventions in April and May, a total of USD 182.4m was purchased from the banks, creating a net monetary effect of over HRK 1.5bn. During the same period, the banks intensified their credit activities, thus decreasing their foreign assets. The seasonal inflow of foreign exchange intensified towards Easter. Nevertheless, the kuna continued to strengthen significantly. The high level of foreign exchange purchases resulted in surplus liquidity, which was partly neutralized by withdrawals through auctions of kuna CNB bills. An extraordinary auction of CNB bills was held on the value date of the foreign exchange auction (16 May), which was followed by a regular CNB bills auction on 23 May. At the end of May, kuna CNB bills stood at HRK 2.7bn.

The *third quarter* started in the usual way, with a seasonal inflow of foreign exchange and with foreign exchange purchases by the central bank, which reached a high USD 122.9m as early as the beginning of July. Only two days later, USD 86.7m was purchased from the government. The resulting kuna liquidity was not additionally sterilized because the kuna continued to appreciate in July. Due to the high liquidity, the interest rates on the money market and on CNB-bills and T-bills continued to fall. What differentiates developments in the third quarter of 2001 from those in the previous years were large foreign exchange sales at the beginning of August. High liquidity, low short-term kuna interest rates, anticipated seasonal exchange rate changes in September and a rapid increase in the demand of private companies for foreign exchange caused a sudden depreciation of the kuna. In response, the central bank sold a total of USD 370.8m, thus withdrawing almost HRK 1.5bn. This helped stabilize the exchange rate and restore the balance in the foreign exchange market. The previous foreign exchange purchases ensured that the foreign exchange sales could be effected without difficulty. During this period, it was decided that the previously described method of satisfying a part of the foreign exchange reserve requirements in kuna should continue to be implemented in September. Although the kuna liquidity of the banking system was generally good at the beginning of September, the foreign liquidity of certain banks exceeded their kuna liquidity. The central bank intervened with a foreign exchange purchase whose value date coincided with the first kuna part allocation of the foreign exchange reserve requirements, thus enabling banks to satisfy their new obligations on time and without difficulty. The August sales of foreign exchange and September purchases are rather unusual for the central bank and are probably an indication that the liberalization of the capital account of the balance of payments may affect the usual seasonal dynamics of foreign exchange inflows and exchange rate movements. During September, the central bank purchased foreign exchange from the government on two occasions, to a total of USD 169.8m.

In the *fourth quarter*, the activities of the central bank were marked by the conversion of the EMU member states' currencies into the euro. The first foreign exchange purchases relating to the effects of the euro conversion started as early as mid-September, continued into October and intensified in November and especially in December. From mid-September to the end of the year, there was a total of nine foreign exchange interventions (excluding one which took place at end-December, whose value date falls in 2002). The total amount of foreign exchange purchased at these nine auctions was USD 390.8m and the total amount of kuna created was HRK 3.2bn. Nevertheless, despite this bustling activity, the exchange rate appreciated at the end of the year to 7.37 HRK/EUR on 31 December 2001. In view of the high liquidity of the kuna, the steps taken to sterilize it were of a corresponding magnitude. In the last quarter of 2001, eight kuna CNB bills auctions were held; three of them were regular auctions and the remaining five were extraordinary. The stock of purchased CNB bills at the end of December was HRK 3.5bn. A further step taken to sterilize kuna liquidity involved the continued obligation of banks to allocate a part of their foreign exchange reserve requirements in kuna. This measure proved to be so strong that by mid-October, at the time when the foreign exchange allocation is made, a significant amount of kuna CNB bills had been sold. Their stock fell to a historical low of HRK 1.7bn. The banks sold their CNB bills in order to ensure sufficient liquidity for their foreign exchange purchases from households. Their liquidity soon improved, due to the central bank interventions, and there soon followed an increase in the stock of purchased CNB bills. Finally, the unusually large demand of households for currency, also as a result of the introduction of the euro, added to the sterilization efforts of the central bank.

In short, the macroeconomic developments in 2001 required more vigorous action by the central bank than is usually necessary. While the external factors requiring such actions are specific for that year and will not be repeated (the introduction of the euro and its effects), other factors point to possible lasting changes in the environment. These factors include a more active and aggressive banking system, trying to earn additional profit by arbitrages; increasing liberalization of the foreign exchange transactions, with companies developing into independent players in these transactions; financial deepening; and an ever-increasing number of various types of financial institutions which, each in their own way, promote a certain segment of the market. These factors are elements of the new financial "landscape" which the central bank must take into account in the future. Preserving the stability of the exchange rate against the background of an increasingly dynamic environment calls for more intensive use of central bank instruments. 2001 has shown that rapid and sudden changes are becoming a common rather than exceptional occurrence in the financial market. Therefore, the private sector will also need to make faster adjustments to the market mechanisms for the protection against currency and other risks, since the central bank will only act to the extent needed to satisfy its primary objective.

Developments in Liquidity at the Beginning of 2002

During the first four months of 2002, the liquidity of the banking system was high. The increase in the reserve requirements allocation, continued sales of foreign exchange by the central bank in January aimed at withdrawing kunas from the system and oscillations in central government deposits did not cause the high liquidity of commercial banks to deteriorate.

The last phase of the payment system reform, involving the final transfer of depositors' accounts to commercial banks, was completed almost without any problems. The problems that were encountered were solved along the way. The increased liquidity of commercial banks in the first four months was partly caused by raising the liquidity level out of caution, pending the final closing of accounts of business entities in the FINA, in the same way as at the beginning of 2001 when the NCS was put into operation. It can also be attributed to the entry into the banking system of deposits of budget beneficiaries not yet integrated into the state treasury. The average level of funds in giro accounts in the first four months was a high HRK 2.9bn. Interest rates in the money market were low, and there was a balance of demand and supply. The increase in liquidity at the beginning of April was a result of smaller subscriptions of kuna CNB bills, which fell from HRK 4bn to HRK 2.8bn.

The instruments of monetary policy used at the beginning of 2002 were mostly foreign exchange interventions. Kuna instruments were used to improve the liquidity of Riječka banka, where the central bank played the role of the lender of last resort. The events associated with Riječka banka culminated in the week before Easter, from 18 to 22 March (for details, see The Use of Monetary Instruments in 2002 following the Announcement of Losses in Riječka banka). In addition to being granted to Riječka banka, the Lombard loan was granted two more times in 2002. At end-February, HRK 1bn was extended to a number of banks to assist in their active management of reserve requirements maintenance in their settlement accounts, and HRK 0.4bn was granted at the beginning of March. On both occasions, the Lombard loan was repaid on the following day.

In short, Riječka banka excluded, the kuna secondary sources of liquidity were scarcely used in 2002, in line with the trend which marked the whole of 2001.

Monetary and Credit Aggregates

Developments in total aggregates in 2001 were very dynamic, and there was a rapid growth in all monetary and credit aggregates. The major factor contributing to the growth in monetary and credit aggregates was real economic growth, as in 2000. Monetary developments in 2001, and especially at the end of the year, were marked by a large inflow of foreign exchange into the banking system. This was due to the euro conversion and the large increase in household foreign exchange deposits, which caused an increase in most monetary aggregates at the end of the year. The effects of the introduction of the euro were limited to the end of 2001 and the beginning of 2002.

Total Liquid Assets

In 2001, developments marking **total liquid assets (M4)**, the broadest monetary aggregate comprising money and total kuna and foreign exchange deposits, can be divided into two periods. During the first nine months, total liquid assets grew with the same intensity as in 2000. This growth was the result of economic recovery in 2000 and economic growth in 2001, as well as the development of the banking system, which contributed to the deepening of the financial system, that is, to a more rapid growth in monetary rather than real aggregates. In the last quarter of 2001, on the other hand, M4 growth intensified due to a rapid growth in household deposits. The general public soon realized that the cheapest way to convert EMU member states' currencies held outside the banking system into the euro was to deposit them in the banks. As a result, M4 increased by HRK 17.7bn nominally in the last quarter (the quarterly growth rate of the seasonally adjusted real value of M4 amounted to an annual 89%), which is more than in the first three quarters put together. Owing to their rapid growth in the last quarter, total liquid assets reached HRK 106.1bn in nominal terms at the end of 2001, with an annual growth rate of 45.2% (28.9% in 2000). It should be stressed, however, that the effects of depositing cash in banks for conversion into the euro subsided at the end of 2001 and the beginning of 2002. It is therefore expected that the growth rates of monetary aggregates in the next period will be more moderate and consistent with developments in economic activity and the further development of the financial system.

Another event that affected monetary developments in 2001 was the foreign exchange liberalization, which caused changes in the structure of M4. The Law on the Amendments to the Law on the Foreign Exchange System, Foreign Exchange Operations and Gold Transactions was passed in April 2001 and came into effect in June. This Law brought about a significant liberalization of foreign exchange transactions in Croatia, enabling legal persons to freely buy and sell foreign exchange for the purpose of depositing it in their accounts and to take foreign exchange credits. Corporate funds account for only 1/5 of total liquid assets, but companies tend to be more active in their asset management than households, and the legislative amendments have created further room for this. The amendments to the foreign exchange legislation enabled companies to freely transfer their funds from kuna into foreign exchange and vice versa. As a result, there was a gradual increase in corporate foreign exchange deposits, which culminated in August. These developments were reflected in the account balances of kuna liquid assets, demand deposits, and savings and time deposits in kuna. The transfer of funds

Table 1.2 Monetary and Credit Aggregates
in billion HRK and %

	RESERVE MONEY (M0)	TOTAL LIQUID ASSETS (M4)						NET DOMESTIC ASSETS (NDA)	NET FOREIGN ASSETS (NFA)
		Money supply (M1)			Savings and time deposits	Foreign currency deposits	Total (M4)		
		Currency in circulation (C)	Deposit money (D)	Total (M1)					
December 31, 1998	10.0	5.7	7.8	13.5	5.8	38.0	57.3	44.6	12.7
December 31, 1999	10.3	6.0	7.9	13.9	5.8	37.0	56.7	40.0	16.7
December 31, 2000	11.7	6.6	11.4	18.0	8.1	46.9	73.1	44.0	29.0
December 31, 2001	17.8	8.5	15.2	23.7	10.5	71.8	106.1	57.4	48.7
Growth rate									
Dec.-to-Dec.									
1998	–3.8	7.7	–7.3	–1.5	6.1	21.4	13.0	31.9	–24.8
1999	3.6	4.2	1.1	2.4	–0.1	–2.6	–1.2	–10.4	31.0
2000	13.6	11.4	44.2	30.1	39.3	26.9	28.9	10.1	74.2
2001	51.9	28.2	33.4	31.5	29.5	53.2	45.2	30.3	67.7
Monthly average									
1998	–0.3	0.6	–0.6	–0.1	0.5	1.6	1.0	2.3	–2.4
1999	0.3	0.3	0.1	0.2	0.0	–0.2	–0.1	–0.9	2.3
2000	1.1	0.9	3.1	2.2	2.8	2.0	2.1	0.8	4.7
2001	3.5	2.1	2.4	2.3	2.2	3.6	3.2	2.2	4.4

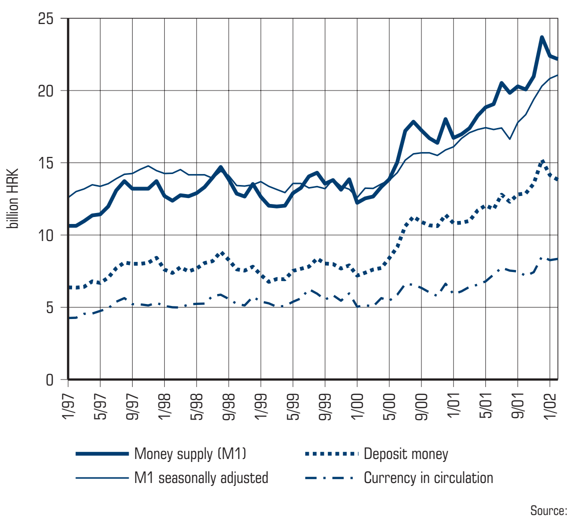
Source: CNB.

from kuna to foreign exchange accounts continued in the months that followed, but these transfers were much smaller than those that took place during the initial adjustment period, when companies aimed at raising the level of their foreign exchange deposits to desired levels.

Money (M1) is the most negotiable monetary aggregate and accounts for a little less than 1/4 of total liquid assets. Since the components of money are used for the financial settlement of liabilities, developments in money strongly correlate with economic activity, especially consumption and retail trade. Since seasons play an important role in the developments in money, it is important that the seasonally adjusted value of money and its subcategories are taken into account. The seasonally adjusted value of M1 grew continually from the beginning of 2000, as a result of the economic recovery that started at that time. The developments in money in 2000 were largely affected by the settlement of government arrears, causing a rapid growth in corporate demand deposits at the beginning of the year. In 2001, the increase in money of 31.5% was similar to that in 2000 (30.1%); however, the dynamics of the increase were somewhat different. In the first half of 2001, M1 grew steadily until summer, at rates similar to those in the previous year. Then the liberalization of the foreign exchange legislation enabled companies to actively purchase foreign exchange, and they made use of this, especially in August, when a change in the direction of the exchange rate took place. The companies increased their foreign exchange deposits significantly, simultaneously decreasing their kuna liquid assets, which led to a fall in corporate demand deposits, including M1. However, after this August fall, demand deposits recovered in September and October. The introduction of the euro also affected developments in money. A part of the foreign exchange cash was converted into kuna at the end of the year, leading to a robust growth in currency and also to a growth in demand deposits. At the end of December, money stood at HRK 23.7bn, which is an increase of HRK 5.7bn, or 31.5%, compared with the end of 2000.

Figure 1.29

Money Supply



Source: CNB.

Thus, unlike in 2000, when the main generators of growth in money were demand deposits, the growth in money in 2001 is to be attributed equally to currency and to demand deposits. **Currency in circulation** grew at an accelerated rate in 2001. It had increased moderately in 2000, following two years of stagnation and fall in the real value of currency. It increased considerably in the first quarter of 2001 but less considerably in the second and the third quarters, at rates equaling those in the previous year. Currency growth accelerated in the fourth quarter, partly as a result of its recovery from the decrease in August and mainly as a result of the increased sales of foreign exchange by households who wished to convert the EMU member states' currencies before their expiration at the beginning of 2002. At the end of 2001, currency in circulation stood at HRK 8.5bn, which represents an annual growth of 28.2%. The growth in currency in 2000 was 11.4%.

Unlike 2000, when the growth in **demand deposits** was the main generator of growth in M1, their growth in 2001 was somewhat lower and equaled that of currency. The largest factor influencing demand deposits were corporate demand deposits, which accounted for 60% of demand deposits. They are more prone to oscillation than household demand deposits, and their oscillations increased following the foreign exchange liberalization in June. Household demand deposits, which accounted for 1/3 of demand deposits, are much more stable and follow movements in wages. Like currency, demand deposits grew at higher rates at the beginning and at the end of the year and at lower rates in the middle of the year. The slowdown in the middle of the year was mainly the result of a fall in the seasonally adjusted value of demand deposits of companies, which changed their behavior and gradually started purchasing foreign exchange as soon as it was made possible for them in June. This growth in corporate foreign exchange deposits culminated in August. Demand deposits' growth in the last quarter was partly due to recovery in corporate demand deposits following a large decrease in August but also to the rapid growth in corporate and household demand deposits in December. The December growth in household demand deposits was due to foreign exchange conversions, while companies lowered their foreign exchange deposits in December. At the end of 2001, demand deposits stood at HRK 15.2bn, which is an annual growth of 33.4%. Demand deposits growth in 2000 was 44.2%. Corporate demand deposits increased by 26.7% and household demand deposits by 39.2% in 2001.

Table 1.3 Total Liquid Assets (M4)
end of period, in million HRK and %

	AMOUNT				SHARE			
	1998	1999	2000	2001	1998	1999	2000	2001
TOTAL LIQUID ASSETS (M4)	57,340.2	56,659.3	73,061.1	106,071.4	100.0	100.0	100.0	100.0
1. Money supply	13,531.4	13,858.9	18,030.3	23,703.5	23.6	24.5	24.7	22.3
1.1. Currency in circulation	5,718.8	5,958.9	6,636.7	8,507.4	10.0	10.5	9.1	8.0
1.2. Dep. money of other dom. sectors	7,812.6	7,900.0	11,393.6	15,196.1	13.6	13.9	15.6	14.3
2. Non-monetary deposits (quasi-money)	43,808.8	42,800.4	55,030.8	82,367.8	76.4	75.5	75.3	77.7
2.1. Savings and time deposits[a]	5,837.9	5,834.3	8,129.2	10,530.9	10.2	10.3	11.1	9.9
2.2. Foreign currency deposits	37,970.9	36,966.0	46,901.6	71,836.9	66.2	65.2	64.2	67.7
SECTORAL STRUCTURE OF M4								
Local government	719.1	627.4	966.9	1,381.0	1.3	1.1	1.3	1.3
Enterprises	10,057.2	9,503.3	15,277.2	20,349.3	17.5	16.8	20.9	19.2
Households	45,298.3	44,218.6	53,591.6	78,439.0	79.0	78.0	73.4	73.9
Other banking and financial institutions	1,265.5	2,310.1	3,225.4	5,902.0	2.2	4.1	4.4	5.6
TOTAL	57,340.2	56,659.3	73,061.1	106,071.4	100.0	100.0	100.0	100.0

[a] Including bonds and money market instruments.
Source: CNB.

Developments in **kuna deposits** in 2001, like those in demand deposits, were determined by developments in corporate deposits. While kuna household deposits increased steadily, corporate kuna deposits decreased in the third quarter and recovered in the fourth. At the end of 2001, kuna deposits stood at HRK 10.5bn, which is an annual growth of 29.5% (39.3% in 2000). Household kuna deposits stood at HRK 4.3bn, which is an annual growth of 36.0%, and corporate kuna deposits stood at HRK 3.7bn, which is an annual growth of 23.0%.

Foreign exchange deposits are the largest component of total liquid assets, accounting for 2/3 of the total. As mentioned previously, monetary developments in 2001 were characterized by a growth in foreign exchange deposits, mainly household foreign exchange deposits, at the end of the year. In the first half of 2001, foreign exchange deposits increased by 27% at an annual level, which equals their growth rate in 1999. Their growth rate accelerated after the foreign exchange liberalization and particularly in August, when companies increased their deposits by as much as 1/3 (EUR 300m). The growth rate of household foreign exchange deposits accelerated at the end of the year, when the general public deposited EMU member states' currencies into bank accounts. Household foreign exchange deposits in the last quarter of 2001 increased by almost EUR 2bn, or 29.0%, of which EUR 1.3bn in December alone. Developments at the beginning of 2002 indicate that the household foreign exchange deposited into banks at the end of 2001 will to a large extent remain in the banking system.

At the end of 2001, total foreign exchange deposits stood at HRK 71.8bn, which is an annual growth of 53.2% (26.9% in 2000). Household foreign exchange deposits, accounting for almost 90% of total foreign exchange deposits, stood at HRK 63.4bn, which is an annual growth of 54.1% (23.9% in 2000). Corporate foreign exchange deposits stood at HRK 7.5bn, which is an annual growth of 45.4% (57.1% in 2000).

Assets of Monetary Institutions

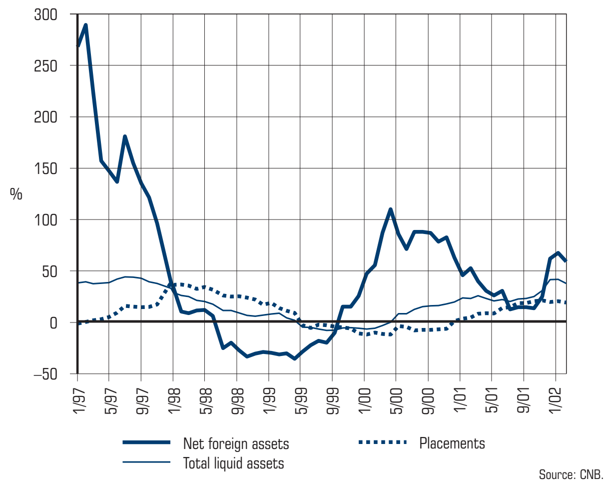
Simultaneously with the growth in the liabilities of the banking system, mainly foreign exchange deposits, the assets of banks also increased and underwent a significant structural change. With regard to their structure, there are net domestic assets (NDA) and net foreign assets (NFA). The end-year data shown in Table 1.2 suggest that NFA increased twice as fast as NDA. It has to be added, however, that as much as half the growth in NFA in 2001 took place in December, as a result of the rapid growth in foreign exchange deposits. In addition, the NFA does not reflect the significant amount of household foreign exchange deposits placed in banks in the last days of December, since the transfer of funds commonly takes a few days. It also takes some time for the banks to increase their credit activities following an increase in their sources. At end-November 2001, both NDA and NFA exhibited the same growth rates.

Figure 1.30

Net Foreign Assets, Total Liquid Assets and Bank Placements to the Private Sector

real growth rate of seasonally adjusted values compared to the same month previous year

December 1999=100



Source: CNB.

As a result of the end-year developments, **net foreign assets (NFA)** of the monetary system were again the main generator of total growth in M4 in 2001. The exchange rate effects excluded, NFA increased by 67% in real terms in 2001, equaling their growth rate in 2000. However, developments in NFA in the first and second halves of 2001 differed greatly. In the first half of the year, NFA grew only slowly, at the seasonally adjusted annual rate of 6%. In the second half of the year, NFA grew exponentially with the end of the year approaching, reaching a seasonally adjusted annual growth rate of a high 116%, of which the seasonally adjusted monthly growth rate in December alone was a high 22%.

Net foreign assets of the Croatian National Bank account for the major share of net foreign assets of the monetary system. The CNB has a strong presence in the foreign exchange market. It purchases surpluses in the foreign exchange market and ensures foreign exchange sales in cases of foreign exchange shortages. During 2001, there was an increase in the inflow of foreign exchange into the market. The CNB intervened by purchasing USD 374m (net) from commercial banks and an additional USD 480m directly from the central government. Increased foreign exchange sales took place only in August and at the beginning of September. In 2001, the CNB increased its NFA by HRK 10.6bn or 39.1% (HRK 5.7bn or 26.3% in 2000) to HRK 37.7bn or USD 4.5bn.

Net foreign assets of commercial banks underwent more significant oscillations. The commercial banks significantly reduced their NFA before summer 2001 in the expectation of an exchange rate appreciation. This led to an increased appreciation of the kuna a few months before it is seasonally usual, i.e. during the tourist season, when there is an increased inflow of foreign exchange. At the beginning of August, the commercial banks significantly increased their NFA in the expectation of an exchange rate depreciation at the end of the tourist season. In this way, the banks provoked a change in the direction of the exchange rate and provided a boost to corporate foreign exchange deposits in that month. The end of the year saw an increase in the NFA of commercial banks due to the large inflow of foreign exchange into the banking system. As previously mentioned, it takes some time to start intensive credit activities and, until such time, the funds are commonly held in accounts abroad. As much as 50% of the commercial banks' foreign assets growth in December can be attributed to the entry of foreign exchange cash into the banking system in the last few days of the year. At the end of 2001, the NFA of commercial banks was HRK 11.0bn, compared with HRK 1.9bn at the beginning of the year. The share of foreign assets of commercial banks amounted to HRK 32.8bn, an annual growth of 66.4% (59.0% in 2000). The foreign exchange liabilities of commercial banks grew much more moderately, and this growth mainly related to credits granted by foreign banks to domesticbanks under their ownership. At the end of the year, commercial banks' foreign assets stood at HRK 21.9bn, representing a growth of 22.7% (3.5% in 2000).

Table 1.4 Net Domestic Assets
end of period, in million HRK and %

	AMOUNT				GROWTH RATES			
	1998	1999	2000	2001	1998	1999	2000	2001
Net domestic assets	44,626.8	40,003.8	44,043.9	57,410.0	31.9	–10.4	10.1	30.3
1. Assets								
1.1. Claims on central govenment (net)	9,916.3	12,899.2	13,666.7	15,388.1	4.1	30.1	5.9	12.6
1.2. Placements	59,792.0	55,875.8	60,863.3	74,868.1	22.4	–6.5	8.9	23.0
1.3. Other assets (net)	–25,081.5	–28,771.2	–30,486.1	–32,846.2	2.1	14.7	6.0	7.7
2. Liabilities								
2.1. Total liquid assets (M4)	57,340.3	56,659.3	73,061.1	106,071.4	13.0	–1.2	28.9	45.2
2.2. Foreign liabilities (net)	–12,713.5	–16,655.5	–29,017.2	–48,661.3	–24.8	31.0	74.2	67.7

Source: CNB.

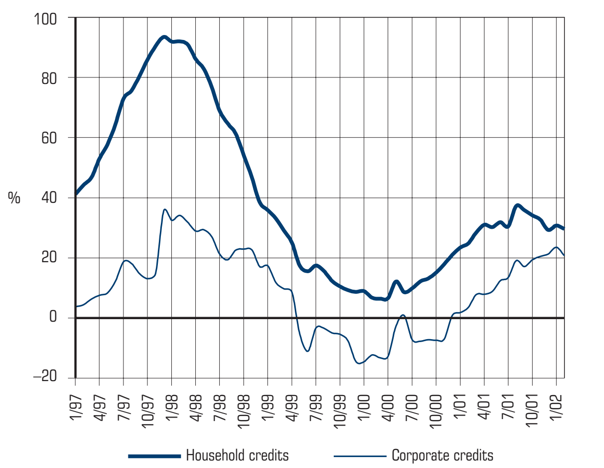
Unlike net foreign assets, **net domestic assets (NDA)** grew steadily from mid-2000, when their falling trend was halted. Thus, following a 10.4% decrease in 1999 and a 10.1% growth in 2000, NDA increased by as much as 30.3% in 2001. At end-2001, NDA amounted to HRK 57.4bn.

The largest factor influencing developments in NDA are **bank placements to other sectors.** These placements have been growing steadily since end-2000, following their decline in 1999 and stagnation in 2000. Credits account for the largest share, or 94% of placements, while equities account for a mere 5%. The smallness of the share of securities and bonds in placements to other sectors indicates that the domestic capital market is underdeveloped, thus making companies rely exclusively on credits (or turn to foreign capital markets). The largest share of placements to other sectors relates to placements to companies (56%), while household claims account for 43% of placements. Structurally, kuna credits account for 15% of placements to other sectors, credits with a foreign currency clause for 72% and foreign exchange credits for 13%. This loan structure reflects the currency structure of the liabilities of the banking system, where foreign exchange sources of funds (foreign exchange liabilities and foreign exchange deposits) dominate with a 66% share. At end-2001, placements to other sectors amounted to HRK 74.9bn, an annual growth of 23.0% (8.9% in 2000).

Figure 1.31

Household and Corporate Credits

rate of change compared to the same month previous year



Source: CNB.

Household lending has been growing faster than corporate lending for several years. This is due to the fact that the household sector had traditionally been disregarded, i.e. credits were mainly given to companies. Banks turned to households because of the low level of household indebtedness and because this new market is known to make its payments as they fall due, which enables easier risk assessment in conditions of insufficient creditor protection. This has led to a balance in the total amount of credits granted to households and to companies, in comparison with the previous situation when significantly more credits were granted to companies. The fast growth in household lending in the past few years has increased the indebtedness of the household sector, which is currently among the highest in transition countries but still significantly lower than in the European Union. Household lending continued to rise in 2001, mainly because of the credit policies of banks and new credit products. At the end of 2001, household lending reached HRK 30.1bn, which is an annual growth of 29.3%. This was an even more rapid growth than in 2000, when household lending increased by 21.0%.

Unlike household lending, which has consistently had high credit growth rates, corporate lending experienced a decline at the end of the 1990s due to problems in the banking sector and a slowdown in economic growth that prompted banks to monitor credit risk more closely. However, corporate lending grew from mid-2000, with a tendency of growth acceleration. In the last quarter of 2001, corporate lending grew even more rapidly than household lending, which was the first such quarter since 1995, and ended the year at HRK 39.8bn, which is an annual growth of 21.3% (only 0.9% in 2000).

Net claims on the central government in 2001 were strongly determined by the budget deficit funding policy, which largely relied on foreign borrowing. This policy had a favorable effect on the increased placements of banks to other sectors, which had considerably higher growth rates than placements to the central government. At an annual level, net claims on the government grew at approximately the same rates as in 2000. This growth was provoked by stagnation in credits that the central government received from domestic banks as well as by a mild decline in government deposits with banks. The major share of growth in government borrowing in 2001 took place at the beginning of the year and was due to increased T-bill issues. EUR 400m worth of government bonds was issued in the fourth quarter and sold directly to a syndicate of domestic banks, but this did not contribute significantly to the growth in government indebtedness with banks. The banks resold these bonds soon after they were issued to other domestic sectors against a commission. At end-2001, net placements to the central government stood at HRK 12.8bn, which is an increase of 14.1% (11.2% in 2000). Bank placements to the central government stood at HRK 20.2bn, while government deposits in the banking system stood at HRK 7.4bn.

Monetary Developments at the Beginning of 2002

The first half of 2002 saw a continued growth of those monetary aggregates that reflect real developments in a more immediate way. This relates primarily to the growth in money, which grew at rates which were twice those in 2001. The large inflow of foreign exchange towards the end of 2001 encouraged accelerated growth in placements to other sectors in the first quarter of 2002, where the financing of domestic placements involved a reduction in the foreign assets of commercial banks.

However, total liquid assets in the first quarter held steady nominally due to a slight fall in foreign exchange deposits in March. This fall was the result of the Riječka banka crisis and the withdrawal of deposits from this bank and also to a very mild autonomous decline in foreign exchange deposits following the completion of the euro conversion. Foreign exchange deposits in the first quarter of 2002 fell by a total of 1.3%.

1.2.5 Money Market

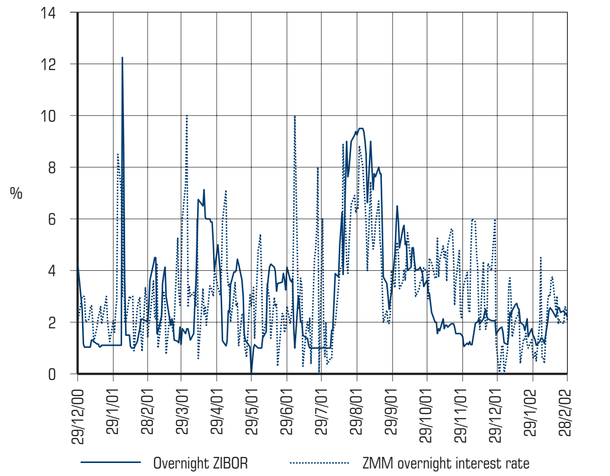
The interest rate trend in 2001 did not differ significantly from that in the previous year. Interest rates in the money market and the primary market of short-term CNB bills and Ministry of Finance treasury bills were on a downward trend, as were interest rates on deposit money bank loans. A sharp short-term rise in interest rates occurred at the end of the summer. Its short-term effect was evident in curbing the fall in the lending rates of deposit money banks, whereas deposit interest rates continued trending downwards.

Money Market Interest Rates

The average interest rate in the money market fell over the first half of 2001 owing to high banking system liquidity. In June and July, it reached a low 2% and 3%, respectively. This interest rate fall was accompanied by a kuna appreciation and high kuna liquidity. These developments changed in mid-August, when banks decided to reduce their CNB bills and treasury bills subscription and increase their foreign exchange in-

Figure 1.32

Average ZMM Overnight Interest Rates and Overnight ZIBOR



Sources: ZMM and CNB.

vestments abroad. In late August and early September, interest rates thus jumped to above 8%. As early as in mid-September, the situation in the money market stabilized and interest rates started to decline again. During October and November, occasional fluctuations were recorded. In late December 2001 and over the first two months of 2002, the average interest rate in daily trading, as well as in overnight trading, fell below the level of 1%.

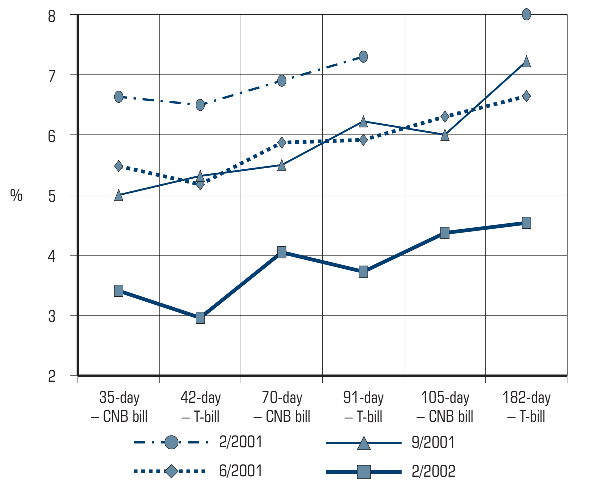
The average daily turnover in the money market in the first quarter of 2001 continued its downward trend from 2000. In March 2001, it stood at HRK 105m. Over the following two months, the average daily turnover grew, only to fall again to HRK 87m in July as a result of the high liquidity of the system. In August, September and October, money market trading was affected by the developments in the foreign exchange market in August as well as by the growing foreign exchange liquidity of the system due to the foreign currency inflow from the tourist season. The average daily turnover exceeded HRK 240m. In the last two months of 2001, the favorable liquidity of the system led to a turnover and interest rate fall in the money market.

Interest-Rates in the Short-Term Securities Market

Interest rates on CNB bills (both kuna and foreign currency denominated) and Ministry of Finance treasury bills fell considerably in 2001. This fall continued the 2000 trend. Interest rates on kuna denominated securities adjusted to the overall downward trend in interest rates, reflecting the high kuna liquidity of the banking system. Interest rates on CNB bills followed the interest rate reduction in the world markets as a consequence of recession in the USA and slowed growth in the EU.

Figure 1.33

Average Interest Rates on CNB Bills and MoF T-bills



Sources: CNB and MoF.

Interest rates on kuna CNB bills fell over the previous year (February 2001 – February 2002) between 263 (105-day bills) and 322 basis points (35-day bills), depending on maturity. The present level of interest rates (3.41% – 35-day bills, 4.05% – 70-day bills, 4.37% – 105-day bills) is almost half that of the beginning of 2001. In early August, the subscribed amount of kuna CNB bills reached HRK 4.7bn. In the following months, the amount of CNB bills decreased, and their highest level never again exceeded HRK 3.5bn.

Interest rates on T-bills fell in the same reporting period of one year (February 2001 – February 2002) between 360 and 365 basis points depending on maturity (42, 91, and 182 days). The present level of interest rates (2.9%, 3.65%, and 4.35%) is thus more than 50% lower than in the previous year (excluding the longest maturities). The interest rate fall was curbed in August and September 2001, but soon afterwards it continued as a result of the high liquidity of the banking system. The largest amount of T-bills was subscribed in end-July 2001, when they reached HRK 5.5bn. During August and September, the subscription declined by more than HRK 2bn. After that it started to rise again, but without ever reaching the end-July level, mainly because the Ministry of Finance auctions were more modest and some bids were even rejected.

Interest rates on foreign currency denominated CNB bills were on the decline over the entire 2001. This fall was curbed in January 2002, when interest rates began to rise slightly. These interest rates are set according to the movements of the EUR and USD LIBOR, and the fall resulted from the LIBOR movements. Interest rates on euro funds fell more slowly than interest rates on US dollars. During 2001, interest rates on CNB bills denominated in US dollars fell by as much as 462 basis points (to 1.68% for 63-day bills). Interest rates on EUR-denominated CNB bills fell at the same time by 156 basis points (to 3.11% for 63-day bills).

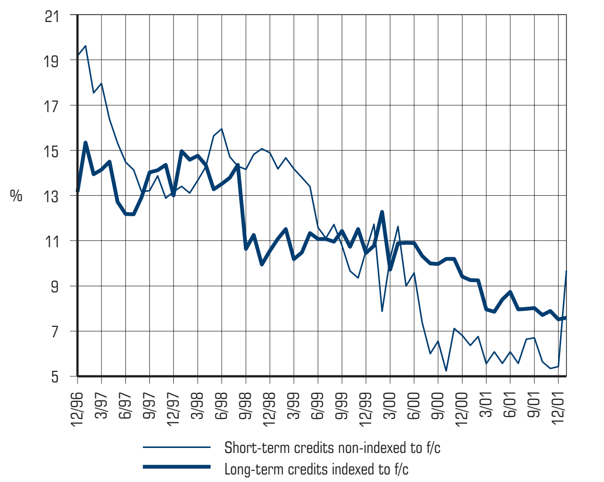
The subscribed amount of foreign currency denominated CNB bills was on the decrease over the first half of 2001, whereas it was on the increase in August and September (from HRK 1.1bn to HRK 3.6bn in October), standing at HRK 3bn at the end of 2001. Although bill subscription denominated in both currencies was on the increase, the September events in the USA stimulated banks to decrease the amount of USD-denominated bills and to subscribe almost exclusively to bills denominated in EUR. The inflow of foreign exchange deposits in the last months of 2001 did not cause a further growth in CNB bills, since banks rather increased their foreign assets and placements channeled to domestic sectors, both to companies and households.

Deposit Money Banks' Interest Rates

The lending rates of deposit money banks trended downwards over 2001 as well, i.e. they continued their downward trend from the previous years, but with a somewhat

Figure 1.34

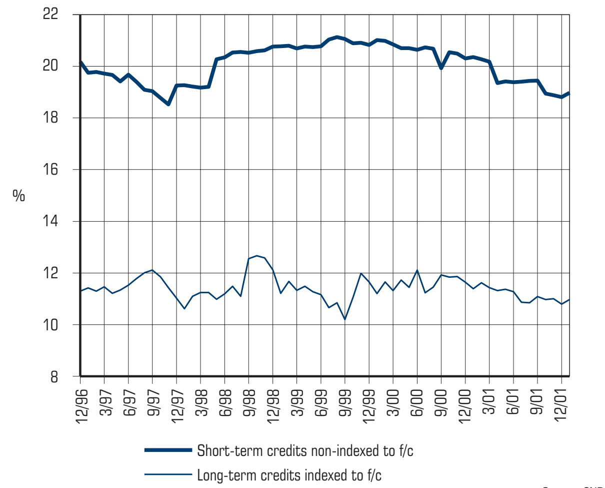
DMBs' Interest Rates on Corporate Credits



Source: CNB.

Figure 1.35

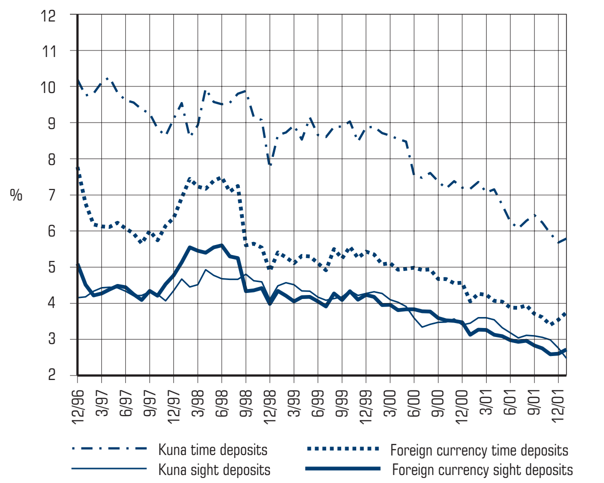
DMBs' Interest Rates on Household Credits



Source: CNB.

Figure 1.36

DMBs' Interest Rates on Deposits



Source: CNB.

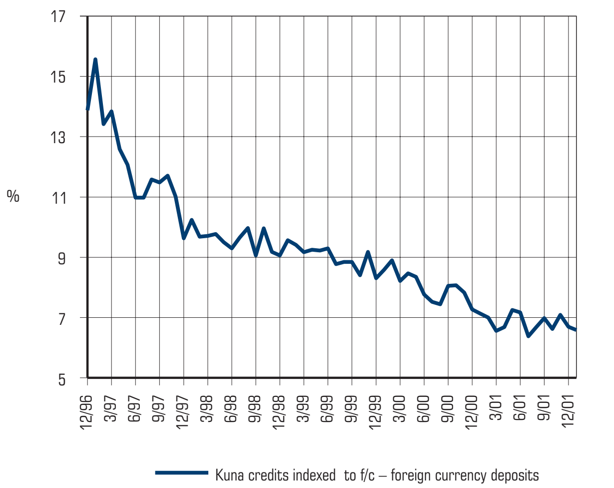
weaker intensity. They even increased in September and October. Deposit interest rates decreased continuously over the year, while deposits grew irrespective of the interest rate fall, and the spread between lending and deposit interest rates increased in that period.

Movements of interest rates on kuna loans non-indexed to foreign currency, including loans to government, non-financial institutions and financial institutions, show that the fall was curbed at 5.5% and that interest rates slightly fluctuated around that level during the last quarter of 2001. According to data for January 2002, when interest rates on corporate loans (excluding government and financial institutions) were separately reported for the first time, the average interest rate on these loans jumped to 9.7% due to a change in methodology. The average interest rate on long-term corporate loans indexed to foreign currency remained relatively stable at the level of 7.6%.

Short-term interest rates on household loans remained very high in 2001, with a slightly downward trend. The reason for this is that 99% of the newly-granted short-term household loans can be accounted for by household overdraft facilities bearing 19% interest. In early 2001, the average interest rate on short-term household loans was 20.4%, whereas it was below 19% at the end of that year. Long-term household loans indexed to foreign currency had a larger share in bank balance sheets. The average interest rate on long-term household loans was reduced during 2001 by a mere 60 basis points (from 11.6% to around 11.0%). The average interest rate on home loans amounted to 8.85% in January 2002, while it was 11.6% on other long-term household loans. Total household loans accounted for 40.9% of total loans, and corporate loans accounted for 52.1%.

Figure 1.37

Spread between Credit and Deposit Rates



Source: CNB.

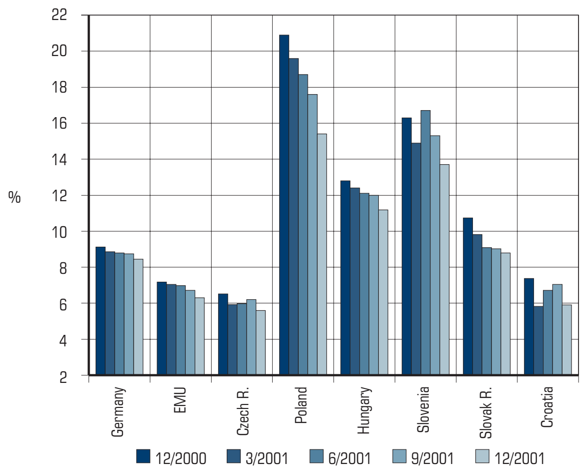
DMB's deposit interest rates were on the decline over the entire 2001. The average interest rate on kuna and foreign exchange deposits fell below 3%. The average interest rate on kuna time deposits was thus reduced by 152 basis points or 21% during 2001, and the average interest rate on foreign exchange time deposits fell by 103 basis points or 22.5%. Irrespective of such movements in interest rates, total savings and time deposits together with demand deposits grew by 47% in 2001.

The spread between lending and deposit interest rates was on the decline until September 2001. The fall in lending interest rate was also curbed at that time, while deposit interest rates continued to decrease, so the spread increased slightly. The spread ranged between 6.5 and 7 percentage points at end-2001.

The movements of lending interest rates in Croatia correspond to the movements of interest rates in the EMU and other comparable transition countries. More specifically, interest rates in all these economies have been on the decline. The stabilization of macroeconomic conditions is the main cause of this fall in transition countries (GDP growth and inflation rate fall), along with banking system consolidation and growing competition. The interest rate fall in the EMU member states is rather a consequence of the ECB monetary policy measures. During 2001, interest rates on ECB deposit facilities fell from 3.75% to 2.25%.

Figure 1.38

Nominal Interest Rates on Short-Term Corporate Credits in Selected Countries



Sources: Central banks' bulletins.

1.2.6 Capital Market

Domestic Market

The domestic capital market was characterized by a steep growth in both prices and market capitalization in 2001. The volume of share trading on the Zagreb Stock Exchange (ZSE) fell considerably (36.7%), but bonds became more liquid and their turnover grew by 54.2%. The Ministry of Finance placed two bond issues, totaling EUR 400m in nominal terms, in the domestic market. Thus, after a long time, the number of government bonds listed in the market grew to five. Two corporate bonds were placed on the ZSE in the first two months of 2002. Although only EUR 29m worth of these bonds was issued, their successful placement has stimulated other companies to consider this type of financing, so that new issues have been announced.

The trading volume on the ZSE reached HRK 1,684.9m in 2001 or 15.3% less than in 2000. Trading in shares accounted for the major share of the total trading volume (57.5%) in 2001, trading in bonds grew to 42.2% of the total trading volume, whereas the rest related to trading in rights in the portfolios of various ministries. Market capitalization rose by 16.4% owing to the rise in prices (the CROBEX grew by 16.3%), reaching HRK 25.8bn (15% of GDP) at end-2001. The shares of companies with the largest market capitalization (Pliva, Zagrebačka banka, Privredna banka Zagreb and Podravka) were the main reason for the upturn in prices on the ZSE, whereas bonds played the major role with regard to trading volume.

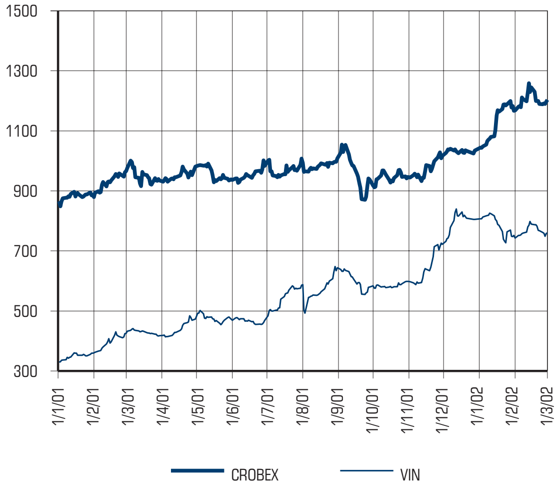
Trading in shares dominated the ZSE in the first two months of 2002 (61.1% of the total trading volume), accompanied by a steep rise in both prices and turnover. The rise in prices led to a rise in the CROBEX to 1200 points, and the market capitalization reached HRK 29.3bn. In this period, the trading volume reached HRK 532.6m, or almost a third of the total trading volume in 2001.

On the Varaždin Securities Market (VSM), both prices and market capitalization increased in 2001. This was accompanied by an upsurge in trading volume (a 51.9% increase compared with 2000) that was based on an increase in the prices of privatization investment funds shares (328.2% on average compared with end-2000) and a rise in trading in these shares (an increase of 327.9%).

The trading volume on the VSM reached HRK 1,057.0m, and market capitalization stood at HRK 14.3bn in 2001 (a 110.8% increase compared with end-2000). Boosted by the rise in prices, the VIN index reached its historic high (839.6 points), recording a 143.9% increase on an annual basis at end-2001. The supply and demand quotation accounted for the largest share in trading (50.3%), followed by trading in PIF shares (39.5%), whose prices grew the most. Trading in rights (the portfolios of various ministries) accounted for 10% of trading, and a small portion related to securities in the market quotation.

Figure 1.39

CROBEX and VIN



Sources: ZSE and VSM.

In the first two months of 2002, the prices of privatization investment funds shares fell by almost 20% on average, and the VIN index dropped by 5.7%. However, trading in PIF shares accounted for the major share of the total trading volume (57.1%). The trading volume totaled HRK 251.4m or 23.7% of the total trading volume in 2001, which means that it remained at the level reached in the last months of 2001 and that its further increase is to be expected in 2002.

The continued development of the domestic capital market is observable from the growth in both the number of listed securities and the number of actively traded securities on the ZSE and VSM. At end-2001, 565 securities were listed on the VSM (1 bond) and 79 on the ZSE (6 bonds), whereas 166 securities were actively traded on the VSM and 60 on the ZSE. Equally

Table 1.5 Comparison of Capital Markets Indicators

December 2001	Bratislava	Budapest	Ljubljana	Prague	Warsaw	Zagreb
Average daily volume of trade, shares (million USD)	8.2	22.8	6.4	20.8	27.6	0.5
Average daily volume of trade, bonds (million USD)	52.8	9.4	2.3	210.9	1.4	0.9
Volume of trade/GDP[a], annual level (%)	8.1	9.8	8.5	8.0	3.5	0.6
Volume of trade/GDP[a], annual level (%)	51.5	4.1	3.1	80.8	0.2	0.9
Volume of trade velocity[b]	42.6	45.5	40.4	45.4	23.0	3.4
Market capitalization (million USD), end month	3,483.7	10,209.5	3,426.8	9,342.7	25,931.7	3,099.8
Market capitalization (million USD), end month	6,102.5	12,661.4	1,814.4	8,808.8	–	892.7
Market capitalization/GDPa, end month (%)	18.9	21.7	21.0	17.6	15.1	16.4
Market capitalization/GDPa, end month (%)	33.1	26.9	11.1	16.5	–	4.7
Index movement from the beginning of the year (%)	31.4	–9.2	19.0	–17.5	–22.0	16.3
Index movement from the beginning of the month (%)	0.9	0.1	1.0	0.5	–0.8	1.7

[a] GDP 2000.
[b] Monthly volume of trading in shares x 100/market capitalization of shares.
Sources: Reports from BSSE, BSE, PSE, LJSE, WSE, ZSE and FIBV Statistics (www.fibv.org).

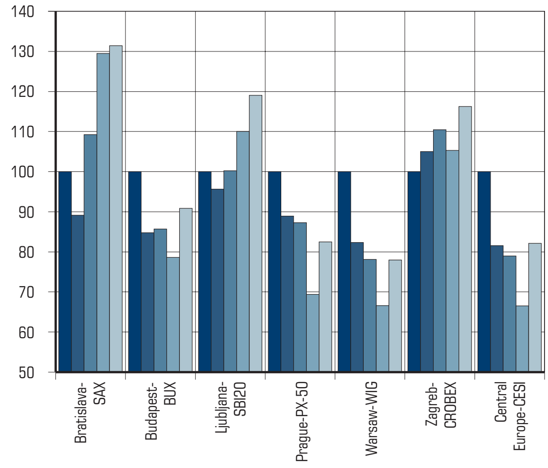
important was the increase in the number of bonds on the domestic capital markets; their market capitalization stood at HRK 7.4bn at the end of 2001.

A comparison of the Croatian capital markets with capital markets of selected transition countries (stock exchange data) shows that Croatia is not lagging far behind these countries any longer. However, Croatia is still far behind according to the volume of trading. The average daily trading in bonds and shares was only USD 1.3m in December 2001, whereas it was a high USD 231.7m in Prague. Considering the trading in shares alone, the largest daily trading occurred on the Warsaw Stock Exchange, whereas the largest volume of trading in shares compared with GDP occurred on the Budapest Stock Exchange.

Figure 1.40

Selected Stock Exchange Indices

end of period



Sources: Reports from BSSE, BSE, PSE, LJSE, WSE, ZSE and FIBV Statistics (www.fibv.org).

Index developments on individual stock exchanges indicate that the stock exchanges in Prague, Budapest and Warsaw recovered in the fourth quarter of 2001, which is reflected in the sharp rebound of the Central European Stock Index (CESI). The rise in the index (prices) continued on other stock exchanges and was most pronounced on the Bratislava Stock Exchange (a growth of 31.4% in 2001).

Government Bonds on International Markets

At end-January 2002, 10 Croatian government bonds were issued on world markets (with one issued by the CBRD, which is not shown in Table 1.6). An additional EUR

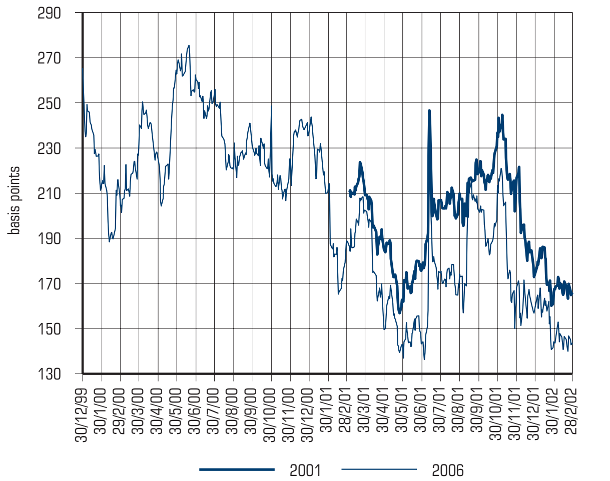
Table 1.6 Issues of International Bonds of the Republic of Croatia

Bond	Currency	Amount	Nominal interest rate	Yield on issue day	Spread[a] 31/12/2000	Spread[a] 31/08/2001	Spread[a] 31/12/2001	Spread[a] 28/02/2002
London Club A	USD	857,796,000	6-month LIBOR + 81.25 b.p.		359	202	200	167
London Club B	USD	604,426,000	6-month LIBOR + 81.25 b.p.		330	199	221	171
Euro-USD bonds, 2002	USD	300,000,000	7%	7.02%	235	139	166	matured on 22 Feb.
Euro-DEM bonds, 2004	DEM	300,000,000	6.125%	6.20%	242	137	126	126
Eurobonds, 2006	EUR	300,000,000	7.375%	7.45%	236	173	156	143
Samurai bonds, 2004	JPY	25,000,000,000	4%	4.00%	n/a	n/a	n/a	n/a
Eurobonds, 2005	EUR	500,000,000	7%	7.06%	230	162	161	154
Samurai bonds, 2007	JPY	40,000,000,000	3%	3.00%	159[b]	159[b]	159[b]	159[b]
Samurai bonds, 2006	JPY	25,000,000,000	2.5%	2.50%		160[b]	160[b]	160[b]
Eurobonds, 2011	EUR	750,000,000	6.75%	6.90%		207	172	165
Eurobonds, 2009	EUR	500,000,000	6.25%	6.45%				156

[a] In relation to benchmark bond.
[b] Upon issuing.
Source: Bloomberg.

Figure 1.41

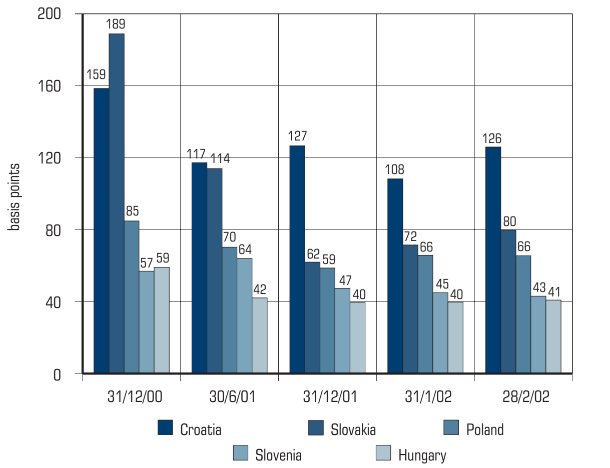
Croatian Eurobonds Spread 2006 and 2011, Compared with Benchmark German Bonds



Source: Bloomberg.

Figure 1.42

Comparison of Croatian Eurobond Spread with Similar Bonds of Selected Transition Countries in Relation to a Benchmark German Bond



Source: Bloomberg.

500m worth of eurobonds was issued, and USD 300m worth of USD bonds came due in February 2002. At end-February 2002, the value of Croatian bonds issued totaled some USD 3.7bn in nominal terms (of which USD 1.1bn relates to the coverage of obligations to the London Club).

Table 1.6 and Figure 1.41 show that the spread on Croatian bonds has steadily improved (declined), and that each new issue of Croatian bonds bears a lower interest rate. The issue of a new Croatian eurobond occurred at the most favorable moment on the world markets as the emerging market bond index EMBI+ (calculated on the basis of the spreads on these bonds in relation to American bonds) plunged by about 38.7%, after Argentine bonds had been excluded from the weighting at the beginning of December 2001.

Despite its downward trend, the spread on Croatian bonds, at above 100 basis points, is still the worst compared with selected transition countries. The spreads on the bonds of other countries also declined. The spread on Slovakian bonds fell the most, coming closer to the spread on bonds of other countries.

Croatia's credit rating remained the same as in the third quarter of 2001 (Fitch IBCA and Standard & Poor's: BBB-, and Moody's: Baa3) and is considered stable. According to some credit rating agencies, Croatia and Slovakia have the same rating, which is the lowest among the countries with which their spreads are compared. According to other agencies, Slovakia's rating is one degree lower than Croatia's, but with a positive sign. Slovenia and Hungary have for a long time been in the group with investment rating Prime 1 (ratings from A above) according to all credit rating agencies, whereas the Czech Republic and Poland are in the Prime 1 group according to almost all credit rating agencies, together with Estonia in the group of Baltic transition countries.

1.2.7 Balance of Payments

Current Account

According to the preliminary data, the current account deficit of the Republic of Croatia stood at USD 623m or 3.1% of GDP in 2001. It had increased substantially in the period between 1995 and 1997, when it reached its peak (11.6% of GDP). Following this period, the current account deficit was on a downward trend, falling to USD 433m (2.3% of GDP) in 2000. This was a result of a fall in the goods account deficit, a substantial increase in the services account surplus and an increase in net income in the current transfers account. The share of the current account deficit in GDP increased in 2001 in comparison with 2000, mostly due to increased imports of goods (above all cars) and an encouraging increase in investment equipment.

There were current account deficits in the first two quarters of 2001 (totaling about USD 1.4bn) and in the fourth quarter (USD 379m). The current account ran a surplus of USD 1.2bn in the third quarter of 2001, mostly due to seasonal influences on economic activities with foreign countries, especially tourism. This surplus, expressed as a ratio of GDP, was higher than those of the third quarters of 1999 and 2000 but insufficient to cover the cumulative negative result recorded in the other three quarters.

The merchandise trade balance was negative in all four quarters of 2001. The merchandise trade deficit stood at USD 4bn in 2001, up 25.2% compared with 2000. Imports of goods grew by 4% in 2001, the same as in the previous year.

The merchandise trade deficit was partially offset by a positive balance in the services account of USD 3bn in 2001. The increase in goods exports of 30.1% in 2001 in comparison with 2000 points to heightened export activity in the domestic economy. The volume indices of tourist services, foreign tourist arrivals and nights indicate a 20% growth in the first half of 2001 in comparison with the same period last year. Despite such favorable movements, the total foreign exchange income from tourism fell by 1.6% in the first half of 2001 compared with the same period of 2000 as a result of the euro/US dollar appreciation that stood at 10% in the first half of 2001.

The successful tourist season and the euro/US dollar appreciation caused by the terrorist attacks in September resulted in a services account surplus of USD 2bn in the third quarter of 2001, of which the travel and tourist services account balance accounted for 97%. The comparison of data on tourist arrivals (which also include arrivals in ports of nautical tourism in 1998, 1999, 2000 and in the first nine months of 2001) shows that the season has lengthened, starting in June in 2000 and 2001. Analysis of the structure of tourists by country of residence suggests that the lengthening of the season resulted mostly from foreign tourist arrivals. Good tourist services results were also achieved in the fourth quarter (a 36% increase in net income in travel/tourism account over that in the third quarter of 2000), mostly due to exceptionally favorable weather conditions and the redirection of European tourist travels. Net income form tourism was USD 2.7bn in 2001, up 24.6% compared with 2000.

Table 1.7 Balance of Payments of the Republic of Croatia
in million current USD

	1998	1999	2000	2001	Index 2001/2000
A. CURRENT ACCOUNT (1+6)	–1,530.6	–1,390.4	–432.7	–623.2	144.0
1. Goods, services and income (2+5)	–2,236.6	–2,022.9	–1,315.9	–1,588.9	120.7
1.1. Credit	8,963.5	8,370.0	8,997.2	9,999.5	111.1
1.2. Debit	–11,200.1	–10,392.9	–10,313.1	–11,588.4	112.4
2. Goods and services (3+4)	–2,072.6	–1,673.4	–935.9	–1,060.5	113.3
2.1. Credit	8,568.6	8,117.8	8,663.1	9,598.9	110.8
2.2. Debit	–10,641.2	–9,791.1	–9,598.9	–10,659.4	111.0
3. Goods	–4,147.4	–3,298.6	–3,203.8	–4,011.9	125.2
3.1. Credit	4,604.5	4,394.7	4,567.2	4,752.1	104.0
3.2. Debit	–8,751.9	–7,693.3	–7,770.9	–8,763.9	112.8
4. Services	2,074.8	1,625.2	2,267.9	2,951.4	130.1
4.1. Credit	3,964.1	3,723.0	4,095.9	4,846.8	118.3
4.2. Debit	–1,889.3	–2,097.8	–1,828.0	–1,895.4	103.7
5. Income	–164.0	–349.5	–380.1	–528.4	139.0
5.1. Credit	394.9	252.2	334.1	400.6	119.9
5.2. Debit	–558.9	–601.7	–714.2	–929.1	130.1
6. Current transfers	706.0	632.5	883.2	965.7	109.3
6.1. Credit	919.1	967.4	1,101.0	1,174.5	106.7
6.2. Debit	–213.1	–335.0	–217.8	–208.8	95.9
B. CAPITAL AND FINANCIAL ACCOUNT	1,469.0	2,291.3	927.0	980.0	105.7
B1. Capital account	19.1	24.9	20.9	133.0	637.4
B2. Financial account (excl. reserves)	1,601.5	2,644.9	1,488.3	2,160.0	145.1
1. Direct investment	834.9	1,444.6	1,086.2	1,325.4	122.0
1.1. Abroad	–97.5	–34.4	–28.7	–121.3	423.2
1.2. In Croatia	932.4	1,479.0	1,114.9	1,446.7	129.8
2. Portfolio investment	14.9	574.0	722.2	716.0	99.2
2.1. Assets	–0.1	–0.3	–0.2	–6.3	3,695.7
2.2. Liabilities	15.1	574.3	722.3	722.3	100.0
3. Other investment	751.7	626.3	–320.1	118.6	
3.1. Assets	348.8	–179.9	–848.4	312.2	
3.2. Liabilities	402.9	806.2	528.3	–193.5	
B3. Reserve assets (CNB)	–151.5	–378.5	–582.1	–1,313.1	225.6
C. NET ERRORS AND OMISSIONS	61.7	–900.9	–494.3	–356.8	72.2

Source: CNB.

In addition to services, current transfers help “close” the merchandise trade deficit in the current account due to the huge number of workers temporarily employed abroad. The current transfers account balance amounted to USD 1bn in 1996, fell in 1997 and especially in 1998 and 1999 due to a loss of confidence in the banking system, and then resumed the upward trend. In 2001, the balance in the current transfers account run a surplus of USD 966m, a 9.3% increase over that in 2000 and a 52.7% increase over that in 1999, when the said problems were most pronounced. The income balance slightly worsened the current balance of payments in the period ending in 1997. However, the accelerated growth in government external debt and in FDIs into Croatia in 1997-2000 noticeably widened the income account deficit. This was mostly due to the outflow of income for external debt service and the repatriation of profit to foreign investors. In 2001, the income account incurred a deficit of USD 528m.

Merchandise Trade

In 2002, according to the CBS preliminary data, total exports of goods (f.o.b.) and total imports of goods (c.i.f.) were USD 4,659.3m and USD 9,043.7m, respectively. Although the annual growth rate of exports reached 5.1% in 2001, a strong growth in imports, accompanied by a lower level of the base period, resulted in a 14.7% annual growth rate of imports in 2001. Following the movements in exports and imports of goods in the January-December period of 2001, the foreign trade deficit reached USD 4,384.4bn, up 26.9% compared with 2000. As a result, the coverage of imports by exports was 51.5%.

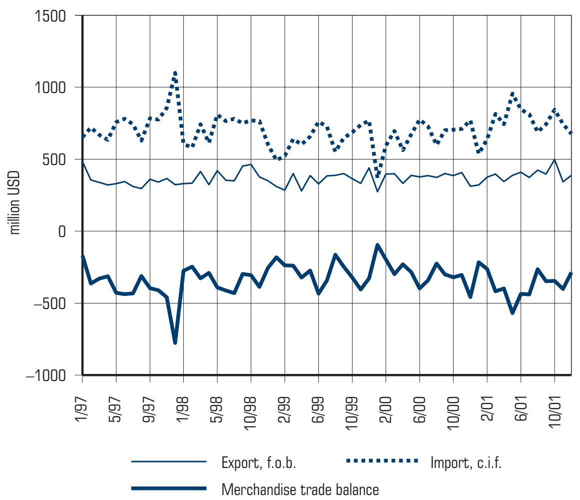
Total exports grew by about USD 230m in 2001 compared with 2000. This was primarily caused by exports of other transport equipment (a 13.8% increase), communication equipment and apparatus, crude petroleum and natural gas and service activities incidental to oil and gas extraction, and machinery and equipment. On the other hand, exports fell by 12.5% on average compared with the previous year in the following activities: the manufacture of coke, refined petroleum products and nuclear fuel, the manufacture of chemicals and chemical products and the manufacture of basic metals.

Almost all activities recorded an increase in imports of goods in 2001. Total imports of goods in 2001 were about USD 1.2bn higher than in 2000, especially due to imports of machinery and transport equipment (up USD 437m) and imports of manufactures classified by material (up USD 395m). The major falls in imports compared with the previous year were recorded by other transport equipment, the extraction of crude petroleum and natural gas, wearing apparel and tobacco products.

According to exports and imports of goods by geographical region, Croatia's exports to developed coun-

Figure 1.43

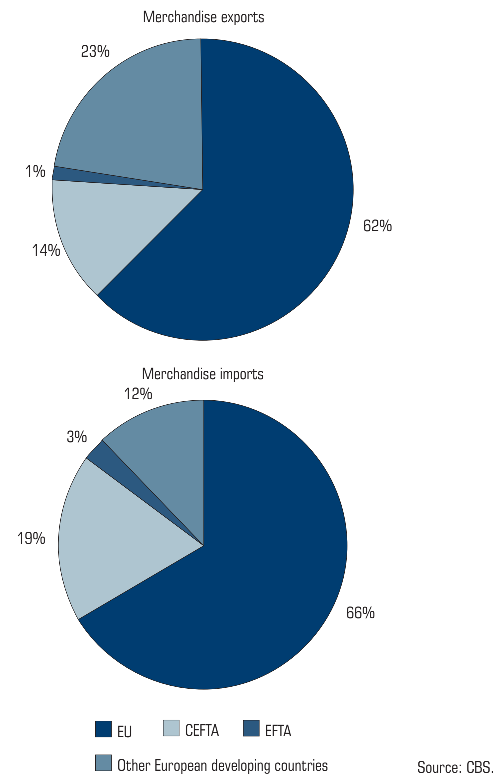
The Republic of Croatia's Merchandise Trade



Source: CBS.

Figure 1.44

The Share of European Partners in Merchandise Trade with Croatia in 2001
in USD



Source: CBS.

tries accounted for 62.2% of total exports in 2001, of which almost 55% relate to exports to EU markets (in which Austria, Germany, Italy are the main trading partners). The remaining 37.8% of exports relate to developing countries, mostly CEFTA countries and former SFRY states. Imports of goods from developed countries accounted for almost 2/3 of total imports, with a slight increase in the share of imports from the EU and Croatia's three main trading partners compared with 2000.

The structure of exports and imports by the NCEA was dominated by trade in manufacturing activities' products (94.7% of exports and 84.4% of imports). The next largest shares in exports were from mining and quarrying (2%), agriculture, hunting and forestry (2%) and fishing (0.9%). On the imports side, mining and quarrying was the second largest activity (11.2%), followed by agriculture and forestry (2.9%) and electricity supply (1%).

Capital and Financial Account

The capital account balance rose by 537.4% in 2001 compared with 2000, reflecting the distribution of the former SFRY assets held in the Bank for International Settlements in Basle. According to the distribution key and the market price of gold in June, Croatia received gold in the value of USD 115m. This was an extraordinary inflow into the balance of payments in the second quarter of 2001 and was recorded as an increase in the CNB's international reserves and as a received capital transfer in the capital account.

Financing through long-term capital flows continued its trend in 2001, primarily through FDIs in the amount of USD 1.4bn (the second phase of the Croatian Telecom privatization and other small-scale privatization projects) and additional borrowings (the issue of government bonds).

The portfolio investment rose by as much as 33.3% compared with the first half of 2000, mostly due to increased government debts created by issuing eurobonds (EUR 500m) and Samurai bonds (about USD 216m). The government placed further issues of bonds in the second half of the year (EUR 250m worth of eurobonds in July, which was a continuation of the March issue, and an additional EUR 200m worth of eurobonds in September and December). As a result, the total new issues of bonds by the Ministry of Finance stood at EUR 1.150m in 2001, of which EUR 400m was sold in the domestic market (the September and December issues).

The CNB's international reserves rose by USD 1.3bn in 2001, the highest annual growth recorded since their formation in mid-1992, mostly due to a net repurchase of foreign exchange from banks and the Ministry of Finance, a net increase in subscribed foreign exchange CNB bills, an increase in reserve requirements, the inflow based on succession to former SFRY assets, and a net increase in returns from invested international reserves.

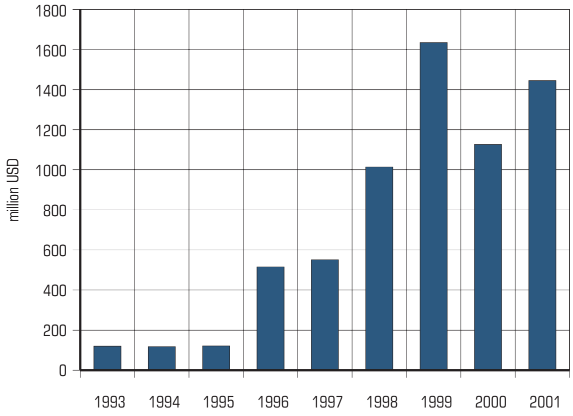
Foreign Direct Investment

Foreign direct investments (FDIs) in Croatia were just above USD 1.4bn in 2001, up 29.8% compared with 2000. According to the preliminary data, ownership investment (direct investment from which the investor's retained profit and other investments such as direct debt investment have been excluded) amounted to about USD 740m in 2001. In 2001, the highest share (61.7%) of equity capital investment went to telecommunications (the Croatian Telecom privatization in November), 15.4% to cement production, 2.9% to hotels and motels, 2.1% to financial intermediation, 2% to gas production and the distribution of liquid fuels, 1.8% to crude petroleum and natural gas extraction, and 14.1% to other sectors. European Union countries invested the largest amount in 2001 (85.2% of the total), followed by other developed countries (9.5%), other European developing countries (4.8%), international financial institutions (0.4%) and other developing countries (0.1%).

Figure 1.45

FDI in Croatia

1993 – 2001



Source: CNB.

Between 1993 and 2001, Croatia received USD 6.6bn of investment. Of this, USD 4.6bn or about 70% was equity investment. 29.4% of the total was invested in telecommunications, 17.3% in other financial intermediation, 15.4% in pharmaceutical products, 5% in cement production, 3.1% in crude petroleum and natural gas extraction, 2.7% in hotels and motels, and 27.1% in other sectors. In the observed nine years, the cumulative ownership investment of European Union countries amounted to 71.9%, followed by other developed countries with 22.6%, other European developing countries with 3.2%, international financial institutions with 1.5% and other developing countries with 0.8%.

Table 1.8 Foreign Direct Investment in the Republic of Croatia by Country of Origin
in million USD and %

	2001	1993 – 2001
EU	85.2	71.9
Other developed countries	9.5	22.6
European developing countries	4.8	3.2
Other developing countries	0.1	0.8
International financial institutions	0.4	1.5

Source: CNB.

External Debt

External debt stood at USD 11,049m or 54.5% of GDP at end-2001, which is lower than at end-2000. Of this, government debt amounted to USD 4.9bn or 44.7%, remaining at the level recorded in the previous year. In 2001, the government repaid a total of USD 1,027m (principal and interest payment of USD 744m and 283m, respectively). The principal payment based on issued bonds (portfolio investment) amounted to USD 230m, while the loan payment amounted to USD 514m (USD 154m of long-term loans and USD 360m of a short-term bridging loan for the completion of the second phase of the Croatian Telecom privatization). The government raised its debt by USD 1,094m (of which 84.8%, or USD 928m, was created by the issue of bonds and USD 166m, or 15.2%, by new loans). Since movements in external debt stock are influenced only by the principal payment, net external debt rose by USD 149m in 2001. In this increase, the effect of cross-currency changes accounted for USD -201.3m. Bonds issued abroad during 2001 were mostly used for financing due repayment obligations. The banking sector borrowed USD 569m abroad in 2001 and paid USD 359m in interest and principal payments on external debt. The principal and interest payments by other domestic sectors (enterprises) amounted to USD 1,147m and mostly related to the repayment of long-term loans. Long-term loans, with a share of 68.5%, also dominate in total new borrowings by enterprises, which reached USD 855.3m in 2001. Banks and other sectors used the new borrowings to refinance their foreign obligations.

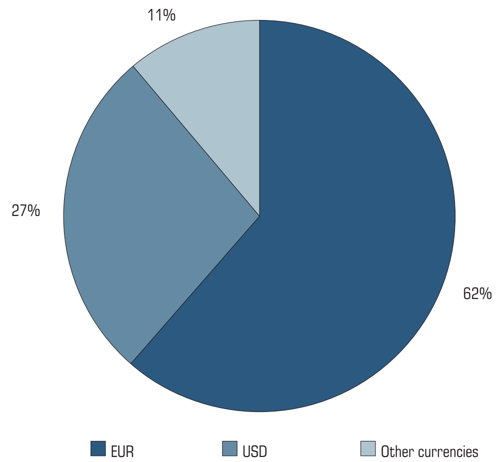
Table 1.9 External Debt of the Republic of Croatia by Debtors
end of period, in million USD and %

	Stock				Structure				Growth		
	1998	1999	2000	2001	1998	1999	2000	2001	1999/98	2000/99	2001/00
1. Direct investment	477	540	1,115	1,080	5.0	5.5	10.1	9.8	13.2	106.5	–3.1
2. Government	3,395	3,973	4,795	4,944	35.4	40.2	43.6	44.7	17.0	20.7	3.1
London Club	1,405	1,381	1,255	1,106	14.7	14.0	11.4	10.0	–1.7	–9.1	–11.9
3. Monetary sector	234	197	159	122	2.4	2.0	1.4	1.1	–15.8	–19.3	–23.3
4. Banks	2,266	1,955	1,597	1,821	23.6	19.8	14.5	16.5	–13.7	–18.3	14.0
Currency and deposits	615	538	433	633	6.4	5.4	3.9	5.7	–12.5	–19.5	46.2
5. Other sectors (enterprises)	3,215	3,208	3,336	3,082	33.5	32.5	30.3	27.9	–0.2	4.0	–7.6
Total	9,586	9,872	11,002	11,049	100.0	100.0	100.0	100.0	3.0	11.4	0.4

Source: CNB.

The structure of external debt by debtor shows that the government retained the highest share in total debt (44.7%) in 2001. Until 1995, the main debtor was the banking sector and, after 1996, the government because of its assumption of some of the Paris and London Club obligations. Owing to a further expansiveness of the fiscal policy, the government share exceeded other sectors' shares. In 2001, along with a slight stagnation of the government share in external debt, the banking sector share increased, mostly due to a rise in long-term loans in the third quarter and deposits received from non-residents in the fourth quarter. Other sectors decreased their external debt as well as their share in total external debt.

Figure 1.46
Currency Structure of Croatia's External Debt on 31 December 2001



Source: CNB.

Owing to the new euro-denominated borrowings, the currency structure of external debt has additionally changed in favor of the euro. At end-2001, the total euro share in the currency structure rose to 61.4%, the

US dollar share fell to 27.4% and the share of other currencies remained at about 11%. The currency structure of external debt thus became almost equal to the currency structure of Croatia's foreign trade.

Table 1.10 Projected Future (Principal) Payments of External Debt by Debtors
in million USD

Flows	2002	2003	2004	2005	2006	2007	2008	2009	Other
1. Direct investment	133.1	150.4	111.7	192.4	240.7	60.5	19.8	12.7	64.1
2. Government	523.9	313.2	729.5	719.8	736.7	507.8	204.5	199.7	926.1
3. Monetary sector	33.0	33.0	33.0	12.7	6.0	3.0	0.0	0.0	0.0
4. Banks	182.1	426.7	139.8	86.6	79.7	50.2	51.4	54.0	666.2
5. Other sectors	668.5	491.1	466.8	275.1	290.2	183.7	130.0	99.4	140.6
Total	1,540.7	1,414.5	1,480.8	1,286.6	1,353.2	805.2	405.7	365.7	1,797.0
Supplement: Projected interest payments	452.5	458.1	388.4	302.0	220.8	148.5	110.5	86.5	144.4

Source: CNB.

1.2.8 Government Finance

Budget Highlights in 2001

Fiscal consolidation was the centerpiece of the Government's 2001 economic program. The Government planned to achieve fiscal consolidation primarily by a faster reduction in the budgetary expenditures to GDP ratio than in the tax revenues to GDP ratio. The medium-term plan of economic policy envisages a consolidated central government deficit (without revenues from privatization) of 5.3% of GDP in 2001, 4.25% of GDP in 2002 and 1.0-1.5% in 2003. A stand-by arrangement with the IMF, which contains a number of quantitative and structural criteria, has been implemented, starting in January 2001.

Under the arrangement with the IMF, the consolidated central government deficit, or the " deficit below the line", stood at HRK 9.2bn (5.4% of GDP) in 2001, which meets the main criterion of the arrangement. The deficit reduction is structurally different from the planned reduction because it was mostly achieved by cuts in capital expenditures instead of current expenditures. The delayed and incomplete implementation of the civil service reform package resulted in a wage bill that surpassed the planned amount by some HRK 0.9bn, and transfers and pension payments exceeded those planned by HRK 1.3bn. These greater outlays were made possible by cuts in expenditures for other purchases of goods and services (HRK 0.7bn), subsidies (HRK 0.4bn), capital expenditures (HRK 1.0bn) and lending minus repayments (HRK 0.1bn). Although the Government did not entirely succeed in reducing current expenditures in nominal terms in 2001, it created the basis for their permanent reduction by preparing eleven "social" laws, which the Parliament passed in the second half of October. In addition, the remaining government arrears stood at HRK 0.5bn at end-2001, compared with HRK 9.5bn at end-1999. Arrears were settled in conditions of a reduced tax burden: income tax rates of 25% and 35% were replaced by 15%, 20% and 35%, profit tax was cut from 35% to 20%[8] and a zero VAT rate was introduced on organized foreign tourist arrivals. The Treasury and a single treasury account began operating in 2001, which improved the control and management of public finances. A further devolution of central government authority to the local level began in mid-2001 (official gazette *Narodne novine*, No. 59/2001), with changes in local government financing and the obligations arising therefrom. Furthermore, Croatian Highways and Croatian Roads were excluded from the budget; in 2002, they will have their own revenues at their disposal, mostly consisting of road tolls and a part of the excises on refined petroleum products.

The problems of budgetary expenditures were visible in high transfers to extrabudgetary funds, the delayed implementation of the new wage coefficients and cuts in the basic wage for civil service employees, and slower than planned cuts in civil service employment. The major transfers were to the pension and health fund and to the child benefit fund. In 2001, transfers to the child benefit fund were double the planned amount. The pension fund was integrated into the government budget by the first "technical" revision of the 2001 budget in June (official gazette *Narodne novine*, No. 59/2001). In the budget for 2002 (official gazette *Narodne novine*, No. 116/2001) the other extrabudgetary funds were almost entirely integrated into the government budget, and two new funds were established: the Development and Employment Fund and the Regional Development Fund.

The problems in the budgetary revenues in 2001 were related to overestimation of revenues from privatization. The shortfall in privatization receipts was offset by alternative sources of deficit financing in the domestic and foreign financial markets. The planned privatization revenues of HRK 8.5bn were adjusted downward in the budget revisions of June and October 2001 to HRK 6.5bn and HRK 5.4bn respectively. In fact, the 2001 privatization revenues reached HRK 4.3bn. Within revenues, car import privileges for war veterans were abolished in June 2001, contributing to a leap in government revenues from international trade in the second quarter of 2001 and a steep rise in the value of imports in the first half of the year.

Croatia incurred additional debt in 2001 by issuing eurobonds and Samurai bonds. The shortfall in privatization receipts led to increased government borrowing in the domestic market and a withdrawal of funds from the international market by continuing the issue of eurobonds. At end-February 2001, the government issued JPY 25bn worth of Samurai bonds (USD 216m), bearing a 2.5% nominal interest and maturing in 2006. In mid-March 2001, the government issued EUR 500m worth of eurobonds, bearing a 6.75% nominal interest rate and maturing in 2011[9]. An additional EUR 250m worth of eurobonds was issued in July. In 2001, the government issued EUR 400m worth of long-term domestic market bonds; EUR 200m was issued at the beginning of September, and EUR 200m was issued in December.

The two events that dominated the second quarter of 2001 were the privatization of an additional 16% of Croatian Telecom and the new Law on the Croatian National Bank.

8 The reduction in the profit tax rate was partially offset by the reduction in the protective interest.
9 In the first quarter of 2000, the same amount of eurobonds was issued bearing a nominal interest rate of 7.0% with a shorter, five-year maturity.

The Croatian Telecom privatization generated an inflow of EUR 500m in October, with an additional release of USD 46m, held up since 1999 by prior agreement between the government and Deutsche Telekom (DT). The new CNB Law, in contrast to the previous CNB Law, does not contain the provision of short-term government borrowing from the central bank of up to 5% of the current year budget.

In 2001, T-bill subscriptions rose by HRK 2.3bn to HRK 4.9bn. The consolidated central government debt stood at HRK 65.9bn (USD 7.9bn) at the end of December 2001[10]. The potential total debt, which includes government guarantees, reached HRK 85.9bn (USD 10.3bn) in 2001, which is an increase of USD 858m (9.1%) compared with 2000.

The Outturn of the Consolidated Central Government Budge

Total, Current and Primary Deficits of the Consolidated Central Government Budget

Under the arrangement with the IMF, the deficit target is determined on an accrual basis and is calculated in such a way that privatization revenues (HRK 5.3bn)[11] are excluded from total revenues, while total expenditures are decreased by the amount of arrears paid (HRK 1.5bn) and increased by payments due on foreign loans to Croatia Airlines and Croatian Railways (a total of HRK 0.4bn) and by the recapitalization costs of Hrvatska poštanska banka. Under the arrangement with the IMF, the ceiling on this deficit was HRK 9.2bn. The actual deficit was below the ceiling, thus meeting the arrangement’s main criterion.

The current deficit of the consolidated central government budget on an accrual basis remained at 1.6% of GDP in 2001, whereas it was 2.1% of GDP on a cash basis. The 2000 and 2001 current deficits on a cash basis are larger than the deficits on an accrual basis due to the settlement of arrears from the previous years. The imbalance in the current account of the consolidated central government budget means that public finances in Croatia are still unable to finance capital expenditures and principal payments from current operations. A surplus from current operations will have to be realized by end-2003 because, once the privatization ends, current revenues will be the only renewable source of government budget revenues.

The primary deficit of the consolidated central government budget on a cash basis fell from 5.7% of GDP in 1999 to 3.5% of GDP in 2001 (preliminary data). This deficit does not include government expenditures for interest payments, which are external factors not under direct government control in the short-term. In other words, the primary deficit shows government spending that is under Government control in the short-term, i.e. spending depending on discretionary measures. The flexibility of budget management is reduced if the costs of debt servicing are high. In 2001, interest payments reached 1.9% of GDP and were on an upward trend. As long as the primary deficit is not turned into a primary surplus, the government will be forced to incur additional debt to settle interest payments, which may be unsustainable in the long run.

[10] The total debt is the sum of the domestic and external debt in kuna at the exchange rate applicable at end-December 2001.

[11] Privatization revenues include capital revenues of extrabudgetary funds, such as the sale of Pliva shares in government ownership.

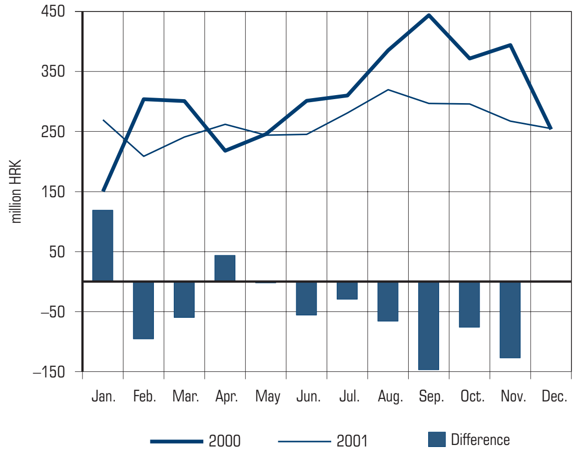
Consolidated Central Government Revenues

Total consolidated central government revenues (privatization revenues included) on a cash basis reached HRK 70.8bn in 2001, HRK 4.0bn higher than in 2000. These revenues were completely in line with those planned in the second budget revision, although government budget revenues were 1.4% less than planned and extrabudgetary funds' revenues were 4.1% higher than planned.[12] Total revenues grew at a slower pace than nominal GDP, which continued a decline in the total revenues to GDP ratio, from 47.3% of GDP in 1999 to 41.9% in 2001. This trend is expected to continue in 2002, and total consolidated central government revenues are projected at around 35.4% of GDP. This is the result of a lower tax burden on households and legal entities – income tax rates of 25% and 35% were replaced with 15%, 20% and 35%, profit tax was cut from 35% to 20%, and a zero VAT rate was introduced on organized foreign tourist stays.

Figure 1.47

Real Revenues from Excises on Refined Petroleum Products

1995 = 100



Sources: MoF and the CNB calculations.

The increase in total revenues in nominal terms in 2001 compared with 2000 can be attributed to higher capital revenues (HRK 2.1bn) and larger current revenues (HRK 1.9bn). Within current revenues (Table 1.11), the share of the two main generators of revenues, VAT and social security contributions, stagnated in 2001 at about 34%. Despite robust economic growth and the good tourist season, the share of excise revenues in current revenues decreased, whereas the share of the profit tax increased substantially. In other words, excise revenues were 13.4% lower than in 2000 (Figure 1.47). Revenues from excises on refined petroleum products fell by HRK 242m, whereas tourist arrivals and tourist nights grew by 10% and 12% respectively in summer 2001 compared with summer 2000. The road transport of goods and passengers also grew at the annual level. One of the government's priorities in 2002 is to solve the problems of the grey economy in the trade of refined petroleum products and cigarettes, which together account for around 90% of total excise revenues.

Revenues from taxes on international trade rose considerably in 2001 owing to import growth, especially in the first half of the year. This growth resulted from a rise in car imports caused by the repeal of war veterans' car import privileges in mid-2001 and a growth in capital goods imports.

[12] This primarily relates to the CIHI; its revenues were 6.9% higher than planned.

Table 1.11 Structure of Current Tax Revenues
in % (cash basis)

	1997	1998	1999	2000	2001
1. Current revenues	100.0	100.0	100.0	100.0	100.0
1.1. Tax revenues	94.2	94.8	95.0	95.1	95.1
Income tax	7.5	7.8	7.5	5.2	5.3
Profit tax	3.3	3.9	3.9	3.0	3.4
Social security contributions	36.7	31.7	32.3	33.5	33.5
Property tax	0.4	0.4	0.4	0.4	0.4
Retail sales tax	27.8	0.0	0.6	0.2	0.2
Value added tax	0.0	35.1	32.4	34.6	34.3
Excises	9.9	9.1	9.8	11.0	10.8
Taxes on international trade	8.6	6.7	7.3	6.4	6.4
Other taxes	0.1	0.0	0.8	0.7	0.7
1.2. Non-tax revenues	5.8	5.2	5.0	4.9	4.9

Source: MoF.

Consolidated Central Government Expenditures

In 2001, total consolidated central government expenditures plus net borrowing reached HRK 74.3bn on a cash basis, up HRK 0.2bn compared with 2000. They were 1.1% or HRK 0.8bn lower than planned in the second budget revision. This continued a falling trend in total government expenditures from 49.3% of GDP in 1999 to 44.0% of GDP in 2001. Such developments indicate increased fiscal discipline on the part of the government, which succeeded in lowering total expenditures despite the settlement of arrears from the previous years. However, the cuts were mostly in capital expenditures rather than current expenditures.

Table 1.12 Structure of Total Expenditures
in % (cash basis)

	1999	2000	2001
1. Total expenditures (–net lending)	100.0	100.0	100.0
1.1. Current expenditures	86.0	90.4	93.0
1.1.1. Goods and services	43.7	46.5	43.3
– wages	23.7	24.2	23.6
– other purchases of goods and services	20.0	22.3	19.7
1.1.2. Interest payments	3.2	3.7	4.3
1.1.3. Subsidies and other current transfers	39.2	40.2	45.4
– subsidies	4.9	5.1	4.9
– transfers	34.3	35.1	40.4
1.2. Capital expenditures	11.8	8.0	5.9
1.3. Lending minus repayments	2.1	1.6	1.1

Source: MoF.

The Government's policy over the first two years of its mandate indicates a change in priorities concerning fiscal policy. This is seen in the reallocation of funds for capital expenditures towards transfers to households (Table 1.12). In 2001, the share of the wage bill in total expenditures fell from 24.2% in 2000 to its 1999 level (23.6% of total expenditures), whereas purchases of other goods and services show a more pronounced downward trend (their share in total expenditures fell to 19.7%). The share of debt servicing costs in total expenditures grew owing to the increase in debt from 3.2% in 1999 to 3.7% in 2000 and to 4.3% in 2001.

Current Transfers and Subsidies

At end-October 2001, the Parliament adopted the Law on the Croatian Defenders' Rights, the Law on Social Welfare, the Law on the Protection of Military and Civil Invalids of War, the Law on the Rights of Ex-political Prisoners, the Law on Pension Insurance, the Law on Health Insurance, the Law on Health Protection, the Law on Child Benefits, the Law on Maternity Leave of Self-employed and Unemployed Mothers, the Law on Personal Income Tax and the Law on Unified Bases for Payments of Obligatory Social Security Contributions. The Law on Health Insurance is to come into force at the beginning of the second quarter of 2002 at the earliest due to the enactment of the relevant by-laws. Under this law, insured persons will pay for 15%, 25%, 50%, 70% and 80% of the price of certain health services. The estimated full-year effect that these laws will have on cuts in government expenditures is around HRK 1.5bn.

By establishing two new extrabudgetary funds, the Government gave a clear political signal of its intention to devote itself to measures to reduce the high level of unemployment. The Development and Employment Fund introduced HRK 900m of incentives for an active industrial policy and employment, and HRK 250m of grants to scientific projects. The projects within the Regional Development Fund do not introduce anything new compared with 2001 but only increase subsidies and grants for public works, reconstruction and construction, mostly for the development of the Adriatic islands.

Wages

At the beginning of 2001, the Government decided to rationalize wages in the public administration as one of the key measures to cut expenditures. After the delayed implementation of new coefficients and an incomplete reform of the public administration, it became obvious that the targeted 10% decrease in the gross wage bill would not be achieved. The actual decrease was 4%. The net wage bill decreased by 2.3% in 2001 compared with 2000. The lack of success in reducing the gross wage bill was due to a wage increase in the science and education sectors, the only partial implementation of wage cuts in the health sector, and the payment of Christmas bonuses in December following negotiations with the unions although these bonuses had not been projected in the budget. Staff layoffs in the public administration have begun in the Ministry of the Interior but are still to take place in the Ministry of Defence.

The Outturn of the Extrabudgetary Funds' Budgets

At the annual level, extrabudgetary funds (pension fund excluded) recorded a consolidated deficit of HRK 0.6bn in 2001, 15% less than in 2000. The deficit of the Child Benefit Fund grew by 88.7% (in real terms). Child benefits paid totaled HRK 2.4bn (1.42% of GDP) in nominal terms in 2001. Transfers from the CIHI fell by 19.6%, whereas its gross wage bill stagnated compared with 2000. The CIHI deficit was thus cut by 44.0%

in real terms. CIHI transfers to households reached HRK 2.2bn in nominal terms (1.3% of GDP), 19.6% less than in 2000. Transfers to households from the Croatian Employment Institute were HRK 0.7bn in nominal terms (0.4% of GDP), 12.6% more than in 2000. Pension payments were HRK 22.3bn (13.2% of GDP), 14.4% more than in 2000. Government transfers to households totaled HRK 27.7bn (16.4% of GDP) in 2001.

Financing

According to the CNB statistics, the consolidated central government debt totaled HRK 65.9bn or USD 7.9bn[13] (39.0% of GDP) at end-December 2001, whereas its potential debt, which includes government guarantees, reached HRK 85.9bn or USD 10.3bn (50.8% of GDP). The total debt and guarantees grew by USD 858m or 9.1% in 2001 compared with 2000. Principal payments in 2001 amounted to HRK 7.3bn (4.3% of GDP), which is an increase of HRK 0.7bn compared with 2000.

Domestic Central Government Debt

The domestic debt of the consolidated central government rose by HRK 3.7bn, reaching HRK 25.0bn or 14.8% of GDP in 2001. This increase was mostly the result of net subscriptions for T-bills (HRK 2.3bn) and bonds issued (HRK 1.3bn), together with a HRK 0.7bn net repayment of bank loans. Extrabudgetary funds incurred an additional debt of HRK 0.7bn, mostly by obtaining commercial bank loans.

Table 1.13 Domestic Debt of Central Government
end of period, in million HRK

	Stock			Change		
	2000	2001		2001		
	Dec.	Jun.	Dec.	Jan.–Jun.	Jul.–Dec.	Jan.–Dec.
1. Domestic debt of central government	21,344.7	22,832.8	25,003.7	1,488.1	2,443.2	3,659.1
1.1. Domestic debt of the Republic of Croatia	18,509.7	20,080.7	21,467.9	1,571.0	1,688.3	2,958.2
Treasury bills	2,564.6	5,579.7	4,892.3	3,015.1	–433.5	2,327.7
Money market instruments	14.2	10.6	7.4	–3.6	–2.9	–6.8
Bonds	14,082.5	13,070.0	15,415.8	–1,012.5	2,411.1	1,333.3
Credits from the CNB	0.0	0.0	–	0.0	–	–
Credits from DMBs	1,848.4	1,420.5	1,152.4	–428.0	–286.5	–696.0
1.2. Domestic debt of central government funds	2,835.0	2,752.1	3,535.8	–82.9	754.9	700.9
Money market instruments	20.5	20.8	96.4	0.2	75.8	75.9
Bonds	1,686.8	1,625.2	1,636.1	–61.6	20.3	–50.7
Credits from DMBs	1,127.6	1,106.1	1,803.3	–21.5	658.8	675.7

Source: CNB Bulletin, Table I3.

13 According to the exchange rate at end-December 2001.

Central Government External Debt

The external debt of the consolidated central government grew by HRK 2.2bn in 2001, reaching HRK 40.9bn or 24.2% of GDP. With regard to its structure, the net increase in the external debt resulted from the issue of central government bonds (HRK 4.8bn), whereas extrabudgetary funds increased their external debt to HRK 2.4bn (1.4% of GDP) by issuing HRK 0.3bn worth of bonds. The central government repaid HRK 2.9bn net of loans.

Table 1.14 External Debt of Central Government
end of period, in million HRK

	Stock			Change		
	2000	2001		2001		
	Dec.	Jun.	Dec.	Jan.–Jun.	Jul.–Dec.	Jan.–Dec.
1. External debt of central government	38,648.2	43,906.2	40,850.5	5,258.0	–2,700.5	2,192.1
1.1. External debt of the Republic of Croatia	36,562.3	41,175.2	38,447.7	4,612.9	–2,390.8	1,870.4
Bonds	25,231.2	29,702.7	30,029.0	4,471.5	504.8	4,797.8
Credits	11,331.1	11,472.5	8,418.7	141.4	–2,895.6	–2,927.5
1.2. External debt of central government funds	2,085.9	2,731.0	2,402.8	645.1	–309.7	321.7
Bonds	386.5	705.3	696.6	318.8	–1.1	310.1
Credits	1,699.3	2,025.7	1,706.2	326.4	–308.6	11.6

Source: CNB Bulletin, Table I3.

Privatization

The 2001 privatization revenues reached HRK 4.3bn or 2.5% of GDP, which is 79% of the amount planned in the second budget revision at end-2001, or only 50% of the amount expected at the beginning. In December 2001, the shortfall in inflows from privatization was bridged by a domestic market bond placement (HRK 1.3bn), loans from foreign commercial banks (HRK 0.2bn) and subscriptions for T-bills (HRK 0.3bn). The major portion of privatization revenues was generated by the sale of a 16% stake in Croatian Telecom (EUR 500m), with an additional release of USD 46m, held up since 1999 by prior agreement between the government and Deutsche Telekom (DT).

2.1 Monetary Policy Instruments

The high liquidity of the banking system in 2001 did not require a large-scale use of secondary sources of liquidity but created a growing need for sterilization, which was mainly conducted by issuing kuna CNB bills and by means of the reserve requirement instrument.

In 2001, the monetary policy instruments of the Croatian National Bank, mainly those used for withdrawing liquidity, underwent certain changes. Further unification of the reserve requirements provided for a certain percentage of the calculated part of the reserve requirements to be allocated in kuna. In addition, a reduction in the reserve requirement rate was phased in, and the accounting base for foreign exchange and kuna reserve requirements was widened. Furthermore, the maturities of kuna CNB bills were changed and the frequency of auctions was reduced. To bring it in line with the Law on the Croatian National Bank, the instrument of short-term liquidity loan also had to undergo certain changes; these related to a more precise definition of assets acceptable as a pledge for loans. With regard to repo auctions, the banks entered into a Master Repurchase Agreement with the Croatian National Bank at the end of 2001. Further changes involved the deposit and credit interest rates of the Croatian National Bank. The Lombard rate was changed several times, and the remuneration rate, including remuneration charged for reserve requirements that are not maintained and not allocated, was also reduced.

2.1.1 Relations with Commercial Banks

Because of the high level of liquidity that prevailed most of the year, secondary sources of liquidity were used rarely and only for short periods of time.

Table 2.1 Stock of Croatian National Bank Loans
end of period, in million HRK

	2000	2001			
	Dec.	Mar.	Jun.	Sep.	Dec.
I. LOANS GRANTED TO BANKS	313.6	6.5	209.7	0.0	0.0
Lombard loans	0.0	0.0	0.0	0.0	0.0
Short-term liquidity loans	0.0	0.0	0.0	0.0	0.0
Intervention loans	14.0	6.5	1.7	0.0	0.0
Repo arrangements	299.6	0.0	208.0	0.0	0.0
Other loans	0.0	0.0	0.0	0.0	0.0

Lombard Loans

In 2001, banks and savings banks could use Lombard loans in the amount of up to 50% of the nominal value of purchased kuna CNB bills and T-bills of the Ministry of Finance and up to 30% of the nominal value of foreign exchange CNB bills, for a maximum of 15 working days in a month. The interest rate charged on this loan was changed several times during the year in line with monetary developments and interest rates developments in the market. The interest rate was lowered from 12% to 9.5% in May, increased to 10.5% in September and finally decreased to 10% in November.

The average monthly amount of Lombard loans used by banks and savings banks in 2001 was HRK 168.2m, compared with HRK 74.3m in 2000. The use of these loans varied greatly during the year. In January, the Lombard loan was used for one day only, in the amount of HRK 0.1m. By contrast, this facility was used much more by banks and savings banks in August and September, both with regard to the amount used and the number of days: the daily average of Lombard loans used by banks and savings banks was HRK 609.8m in August and HRK 768.7m in September, for a period of 14 and 9 days, respectively. It has to be stressed that the increased amount of Lombard loans used by banks was due to their more active participation in the foreign exchange market and not their need for primary liquidity. While the average use of Lombard loans was 11 days a month in 2000, it was only 4 days a month in 2001. There was a surplus liquidity in the system, so banks and savings banks did not need to borrow additionally from the central bank. In November and December, the banks and savings banks did not use Lombard loans at all.

Short-Term Liquidity Loans

In 2001, not a single bank or savings bank made use of short-term liquidity loans, the central bank's lender of last resort facility. Banks tended to satisfy their temporary liquidity needs with cheaper funds in the money market. The interest rate on the short-term liquidity loan was the interest rate on Lombard loans plus 0.5 percentage points for a loan utilization period of up to 3 months and 1 percentage point for longer utilization periods.

Intervention Loans

In December 2000, the Croatian National Bank decided to abolish intervention loans starting from February 2001, simultaneously with the introduction of the National Clearing System (NCS), i.e. small value payments settlement system. Only one intervention loan was granted in 2001 (in February). It was granted to Kaptol banka in the amount of HRK 2.9m. The total stock of intervention loans, including this loan and claims on banks and savings banks in bankruptcy proceedings arising from intervention loans granted in the previous years, amounted to HRK 111.7m at the end of the year.

Repo Auctions

The Croatian National Bank held nine repo auctions of CNB bills and T-bills in 2001, which is two auctions more than in 2000. Four auctions were held in April, two in both

June and October and one in September. These were the months in which the system's liquidity was lower. A total of HRK 4.2bn was placed at the auctions, which is 2.4 times more than in 2000. An average of HRK 465.9m was placed per auction. However, at the September auction, HRK 1,299.5m was placed to satisfy the additional liquidity needs arising from a new regulation prescribing that one part of the foreign exchange reserve requirements be allocated in kuna. The weighted interest rate at all auctions ranged between 4.64% and 7.23%, averaging 5.78%. There is a great difference compared with 2000: the average amount placed in 2001 was almost double the HRK 247.7m placed in 2000, while the average weighted interest rate in 2001 was almost half the 10.6% in 2000.

Table 2.2 Survey of Repo Auctions
in million HRK and %

Date of the auction	Total amount of offers accepted	Weighted interest rate (%)
11 April 2001	240.5	5.94
13 April 2001	541.7	6.00
18 April 2001	455.5	5.97
27 April 2001	373.4	6.00
14 June 2001	469.0	5.78
29 June 2001	208.0	5.37
10 September 2001	1,299.5	7.23
12 October 2001	568.9	5.01
31 October 2001	36.6	4.64

Reserve Requirements

In view of the growing orientation towards market-based instruments of monetary policy and a decreasing reliance on reserve requirements, this instrument underwent significant changes in 2001. The reserve requirement rate was lowered several times along with the widening of the calculation base. In June, received foreign exchange credits were included in the foreign exchange reserve requirement calculation base, and, in November, hybrid and subordinated instruments were included in the calculation base of both the kuna and foreign exchange reserve requirements. A more significant change in the basic elements of reserve requirements took place in September, with the beginning of the last phase of reserve requirement unification, i.e. the unification of the currency of the reserve requirements. The part of the unification process completed by then included the unification of the base with regard to type and maturity, the unification of the accounting and maintenance periods, and the unification of the percentage of allocation and maintenance and the reserve requirement calculation. A decision was enacted in September, stipulating that a specific part of the calculated foreign exchange reserve requirements be met by kuna and be added to the kuna reserve requirements. This part initially amounted to 20% of the calculated foreign exchange reserve requirements and was raised to 25% in November. Furthermore, the reserve requirement rate was lowered from 23.5% to 22% in September because of the policy of a long-term reduction in this rate. November saw a further cut in this rate, this time to 19%.

Until July 2001, the Croatian National Bank remunerated banks and savings banks for their kuna reserve requirements deposited in their accounts with the CNB at the rate of 4.5%. From August 2001, the remuneration paid to banks by the Croatian National Bank for their kuna reserve requirements held in their accounts with the CNB and maintained in their settlement accounts with the CNB fell to 3.5% a year. In September this rate was further cut to 2% a year. The remuneration rate on the foreign exchange reserve requirements set aside with the CNB equaled the market interest rate the CNB earned on the corresponding part of its portfolio abroad.

Croatian National Bank Bills in Kuna

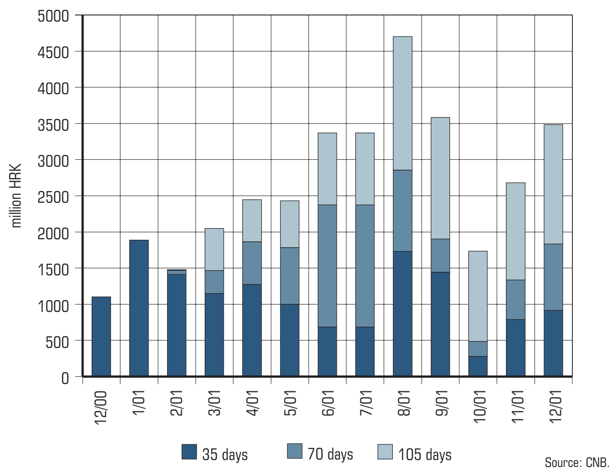
Kuna CNB bills underwent several changes in 2001. At the beginning of the year, their maturities were 35, 91 and 182 days and they were auctioned every Wednesday. In February 2001, a decision made by the Governor of the Croatian National Bank in December 2000 was implemented, prescribing new maturities of 35, 70 and 105 days and auctions to be held every fifth Wednesday instead of once a week. Kuna CNB bills in nominal amounts of 100,000.00 kuna were auctioned through the multiple-price method with discount. Against the background of such changes, the average monthly stock of purchased kuna CNB bills was HRK 2.9bn, which, compared with HRK 2.1bn in 2000, is an increase of 38%. The stock of purchased kuna CNB bills ranged between HRK 1.7bn and HRK 4.7bn during the year.

Table 2.3 Survey of Purchased Kuna CNB Bills by Maturity
nominal value, end of period, in million HRK

Year	Month	Maturity					Total
		35 days	70 days	91 day	105 days	182 days	
2000	December	1,103.0	–	1,025.3	–	458.6	2,586.9
2001	January	1,886.8	–	702.4	–	485.6	3,074.8
	February	1,413.1	56.5	578.7	8.5	412.6	2,469.4
	March	1,148.2	319.0	476.8	582.5	330.0	2,856.5
	April	1,273.5	591.0	–	583.5	175.0	2,623.0
	May	999.5	785.0	–	646.0	95.0	2,525.5
	June	685.7	1,689.7	–	993.6	50.0	3,419.0
	July	685.7	1,689.7	–	993.6	–	3,369.0
	August	1,729.0	1,126.5	–	1,844.6	–	4,700.1
	September	1,443.7	460.3	–	1,678.6	–	3,582.6
	October	279.5	205.0	–	1,249.0	–	1,733.5
	November	789.8	547.0	–	1,342.0	–	2,678.8
	December	914.8	920.0	–	1,651.0	–	3,485.8

Figure 2.1

Survey of Purchased Kuna CNB Bills by Maturity
nominal value, end of period



Source: CNB.

Croatian National Bank Interest Rates and Remuneration

The high liquidity of the system and the interest rates fall on the money market affected central bank interest rates. The interest rate on the Lombard loan was reduced from 12% at the beginning of the year to 10% at year-end. Also, the remuneration charged for reserve requirements that were incorrectly calculated or not maintained was cut from 18% to 15%. The general trend of falling interest rates was reflected, albeit not markedly, in the repo auctions of the Croatian National Bank. The average weighted interest rate achieved at repo auctions in 2001 was 5.78%, but it should be noted that the weighted interest rates at the first four auctions were above the average and that the interest rates at the remaining auctions were below the average. The September auction was an exception in that, due to a liquidity shortage, the amount of funds placed increased and the weighted interest rate was above average.

There were changes in deposit interest rates as well. The remuneration rate for the kuna part of the reserve requirements fell from 3.5% to 2% in September. The average weighted interest rates on 35-day kuna CNB bills fell from 6.64% in January to 3.36% in December. From February, when the new maturities were introduced, to December 2001, the average interest rates on 70-day CNB bills fell from 6.82% to 4.26%, and those on 105-day CNB bills fell from 6.97% to 4.85%.[1]

2.2 The Use of Monetary Instruments in 2002 following the Announcement of Losses in Riječka banka

The media reports on the arrest of the chief dealer in Riječka banka d.d., Rijeka and the amount of losses incurred by this dealer caused a run on the bank by depositors seeking to withdraw their savings deposits. Thanks to its high liquidity level, the bank managed to provide funds for these significant withdrawals without outside help for several days.

However, the run on the bank didn't subside despite reassurances from high government and CNB officials. Therefore, on 18 March 2002, Riječka banka applied to the Croatian National Bank for a Lombard loan in the maximum amount possible. At that time, Riječka banka held in its portfolio purchased kuna CNB bills amounting to HRK 320m and purchased T-bills of the Ministry of Finance amounting to HRK 494m, totaling HRK 814m. Pursuant to a decision of the CNB on the terms and conditions for granting short-term liquidity loans (the Lombard loan) on the basis of pledged securities, the said T-bills and CNB bills met the criteria for pledged securities criteria on the basis of which Lombard loans may be granted up to the amount of 50% of their nominal value. Therefore, on 18 March 2002, Riječka banka was granted a Lombard loan in the amount of HRK 407m.

However, in view of the proportion of withdrawals and potential risks associated with them, the bank subsequently, on the same day, applied for the bills' repurchase before maturity by the CNB, pursuant to paragraph 2, item IV of the Decision on Issuing Croatian National Bank Bills Denominated in Kuna. The application was approved and the

[1] Until April 2001, the calculation of weighted deposit interest rates included interest rates achieved at extraordinary auctions.

Governor of the CNB issued a Decision on the repurchase of the kuna CNB bills before maturity whereby the CNB bills, amounting to nominally HRK 320m, were redeemed for HRK 317,199,512.32. This amount was used by Riječka banka for partial repayment of the Lombard loan. At the close of day on 18 March 2000, the Lombard loan balance with Riječka banka was HRK 89,800,487.68 against the pledge of T-bills of the Ministry of Finance amounting nominally to HRK 179.9m.

In addition to applying for the repurchase of kuna CNB bills before maturity, Riječka banka applied to the Croatian National Bank for a short-term liquidity loan on 18 March 2002. The application included a list of the Bank's assets, i.e. securities, which the Bank intended to pledge with the Croatian National Bank in exchange for the requested liquidity loan. On the basis of the Decision on the Short-Term Liquidity Loan, on 19 March 2002 the Croatian National Bank extended the requested liquidity loan to Riječka banka, amounting to HRK 408m, against securities falling due within two years. One part of the loan was used to repay the balance of the previously granted Lombard loan, amounting to HRK 89,800,487.68. Of the remaining HRK 318,199,512.32, HRK 233,637,585.00 was used for foreign exchange purchases from the Croatian National Bank, and the balance, amounting to HRK 84,561,927.32, was put into the settlement account of Riječka banka.

On 18 and 19 March 2002, Riječka banka had applied for foreign exchange purchases from the Croatian National Bank amounting to EUR 61,367,147.45 and USD 11m. This, using the CNB selling rate of 19 March 2002, totaled HRK 546,268,943.00. Therefore, the foreign exchange sale was partly covered by the liquidity loan, while the remaining HRK 312,631,358.00 was settled by Croatian National Bank purchases of T-bills.

After repaying the Lombard loan with the liquidity loan, Riječka banka received back its collateral consisting of T-bills of the Ministry of Finance. On 19 March 2002, it offered the said T-bills, amounting nominally to HRK 313,200,000.00, for redemption to the Croatian National Bank for the purpose of its foreign exchange purchase. The Croatian National Bank accepted the offer and redeemed the said nominal amount of T-bills for HRK 312,725,561.56. Of that amount, HRK 312,631,358.00 was used for the foreign exchange purchase, and the remaining HRK 94,203.56 was put into the settlement account of Riječka banka.

Following the extension of the HRK 408m liquidity loan on 19 March 2002, Riječka banka submitted another application for a short-term liquidity loan on the basis of securities with maturities of over 2 years. This type of loan requires a government guarantee, in line with a decision governing short-term liquidity loans. On 21 March 2002, the Government of the Republic of Croatia issued a guarantee on behalf of the Croatian National Bank in the amount of HRK 863,700,000.00, and the requested loan in the same amount was granted to Riječka banka.

Riječka banka did not utilize the whole amount of HRK 863,700,000.00 but, on 22 March 2002, requested the Croatian National Bank for a transfer of HRK 150m under the said loan. Simultaneously, Riječka banka put up for sale its remaining stock of T-bills of the Ministry of Finance, amounting to HRK 180,800,000.00 nominally. The Croatian

National Bank redeemed the said nominal amount of T-bills for HRK 179,776,365.32.

The T-bills redeemed from Riječka banka by the Croatian National Bank in the total nominal amount of HRK 494m partly fell due, while the remaining nominal amount of HRK 334m was sold in the secondary market.

On 22 March 2002, CNB claims on Riječka banka arising from the short-term liquidity loan totaled HRK 558m. The said amount was fully repaid on 9 April 2002, following the extension of a syndicated loan in the same amount to Riječka banka by commercial banks in Croatia.

From 10 April 2002, the Croatian National Bank had no further claims on Riječka banka.

Looking back at the events in Riječka banka, we can conclude that the bank, in one week and with the help of the central bank as the lender of last resort, managed to stabilize its liquidity and carry out all its banking activities without interruptions and without larger disturbances.

In the period from 18 March to 22 March, Riječka banka prevented the endangerment of its liquidity by promptly withdrawing a total of HRK 1bn in CNB loans (HRK 0.4bn Lombard loan and HRK 0.6bn in liquidity loan) and by selling securities to the central bank for HRK 0.8bn. Using the total of HRK 1.8bn from the primary issue, the bank purchased HRK 0.5bn of foreign exchange and improved its current liquidity by HRK 0.8bn, repaying at the same time the HRK 0.4bn Lombard facility.

As stated previously, Riječka banka repaid the HRK 558m worth of liquidity loan to the central bank on 9 April 2002. In this way, it settled all its obligations towards the CNB,

Table 2.4 Transactions between Riječka banka d.d., Rijeka and the Croatian National Bank in the Period between 18 March and 22 March 2002
in HRK

Transaction date	Utilized funds by type	Amount used	Purpose of funds used		
			Liquidity	Lombard loan repayment	Foreign exchange purchase
18 March	Lombard loan	407,000,000.0	407,000,000.0	0.0	0.0
18 March	CNB bills repurchased before maturity, HRK 320,000,000, nominal value	317,199,512.3	0.0	317,199,512.3	0.0
19 March	T-bills purchased HRK 313,200,000, nominal value	312,725,561.6	94,204.0	0.0	312,631,358.0[b]
22 March	T-bills purchased HRK 180,800,000, nominal value	179,776,365.4	179,776,365.3	0.0	0.0
	Total T-bills purchased HRK 494,000,000, nominal value	492,501,926.9	179,870,569.3		312,631,358.0
19 March	Short-term liquidity loans with collateral of up to 2 years	408,000,000.0	84,561,927.3	89,800,487.7	233,637,585.0[b]
22 March	Short-term liquidity loans with collateral of more than 2 years, guaranteed by the Croatian government, HRK 863,700,000	150,000,000.0	150,000,000.0	0.0	0.0
	Total short-term liquidity loans	558,000,000.0	234,561,927.3	89,800,487.7	233,637,585.0
	Total liquidity loans granted: HRK 1,271,700,000				
	of which: HRK 713,700,000 unused				
	Total	1,774,701,439.2	821,432,496.6	407,000,000.0	546,268,943.0[a]

[a] Riječka banka purchased from the CNB a total of EUR 61,367,147.45 and USD 11,000,000.
[b] At the CNB selling rate.

and, by the end of the first ten-day period of April, all funds from the primary issue extended to Riječka banka by the CNB had been sterilized.

2.3 International Reserves Management in 2001

The total international reserves of the Croatian National Bank in 2001 increased by USD 1,152.0m, the largest growth since 1992, when they were set up. Compared with end-2000, the international reserves of the CNB increased by 32.7%. At end-2001, the total international reserves of the CNB stood at USD 4,676.6m, compared with USD 3,524.6m at end-2000.

Table 2.5 International Reserves[a]
end of period, in million USD

Year	Month	Total reserves
2000	December	3,524.6
2001	January	3,393.9
	February	3,466.6
	March	3,513.9
	April	3,635.7
	May	3,694.3
	June	3,798.3
	July	4,175.6
	August	4,101.1
	September	4,416.1
	October	4,504.6
	November	4,614.7
	December	4,676.6[b]
Change Jan.–Dec. 2001		1,152.0

[a] Excluding reserve position in the IMF of USD 0.2m.
[b] Excluding the effect of the first revaluation of securities and interest accrued on deposits (USD 27.4m on 31 December 2001).

The main factors contributing to the growth in total international reserves of USD 1,152m were

- net foreign exchange purchases in the amount of USD 374m;
- net foreign exchange purchases from the Ministry of Finance of the Republic of Croatia in the amount of USD 480m;
- gold and foreign exchange inflow arising from the succession amounting to USD 126m;
- income earned from (net) investment of CNB foreign exchange reserves amounting to USD 122m; and
- foreign exchange purchases arising from the sale of kuna cash amounting to USD 25m, with the total net effect of other transactions, including the exchange rate effect, amounting to USD 25m.

The Croatian National Bank intervened in the market by buying from and selling foreign exchange to,

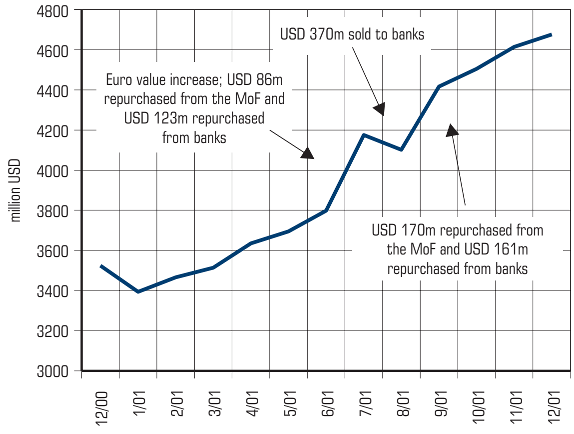
- domestic banks, through auctions;
- Ministry of Finance of the Republic of Croatia; and
- foreign banks (in exchange for kuna cash).

At these interventions, the CNB purchased USD 1,320.66m and sold USD 440.79m worth of foreign exchange. Interventions in the domestic market increased total international reserves by USD 879.86m. With net purchases of this foreign exchange, the CNB issued HRK 7,296.64 of reserve money.

Monetary developments in 2001 were marked by a large foreign exchange inflow. With its interventions in the foreign exchange market, the Croatian National Bank sought to mitigate the fluctuation of the exchange rate of the kuna against the euro and especially to ease the appreciation pressures. With twenty-one auctions, the Croatian National Bank had a strong presence in the foreign exchange market in 2001.

Figure 2.2

CNB's International Reserves



Source: CNB.

Table 2.6 Total CNB Turnover on the Foreign Exchange Market in the Period between 1 January 2001 and 31 December 2001
in million, at the exchange rate applicable on the intervention date

	Purchase		Sale		Difference	
	USD	HRK	USD	HRK	USD	HRK
Auction	811.37	6,756.36	436.92	3,636.09	374.44	–3,120.27
Ministry of Finance	482.32	3,981.09	2.30	19.33	480.02	–3,961.76
CNB bills repurchased before maturity	0.05	0.38	0.00	0.00	0.05	–0.38
Repurchases based on foreign exchange reserve requirements	0.04	0.29	0.00	0.00	0.04	–0.29
Sale of domestic currency cash	26.88	226.94	1.57	13.00	25.31	–213.94
TOTAL IN USD	1,320.66	10,965.06	440.79	3,668.42	879.86	–7,296.64
Foreign exchange inflow based on succession	8.32					
Foreign exchange inflow from the sale of gold	117.31					
TOTAL IN USD	125.64					

On 10 April 2001, in Brussels, the Republic of Croatia signed the Annex to the Agreement on Succession Issues for the distribution of part of the assets of the former SFRY deposited with the Bank for International Settlements in Basle (BIS). As a result of this Agreement, which stipulated that Croatia's share in the assets of the former SFRY in the accounts with the BIS was to be 28.49%, Croatia gained title over USD 8.32m in foreign exchange and 13.127 tons of gold bars.

The gold was sold to the BIS on two separate occasions. The yield on the total amount of succession gold sold (13.127t, i.e. 422,027.985 ounces) between 13 April and 25 September was 7.44% annually.

In managing the international reserves, the Croatian National Bank is guided by the principles of security and liquidity. The managers responsible for CNB portfolio management have strictly defined guidelines (benchmark portfolios) limiting exposure to financial risks in international reserves management. The yields on CNB international reserves investments are in line with the risks assumed. In view of the strictly defined investment criteria and guidelines for CNB international reserves management, the income on investing international reserves cannot vary significantly and is therefore very stable, even in conditions of great turmoil in financial markets.

The Croatian National Bank invests international reserves funds into high-quality instruments:

- government securities with fixed and variable interest rates;
- central bank instruments and instruments of international financial institutions;
- collateralized deposits (reverse repo agreements),
- deposits of commercial banks with a long history of investment rating of at least AA– ; and
- certificates of deposit.

The investment criteria prescribe the minimum credit rating of AA– for countries in which the international reserves of the CNB are invested. On 31 December 2001, 70.81% of total international reserves were invested in countries with an AAA rating.

Total profit from the investment of net international reserves was USD 121.96m.

The average yield on the CNB portfolio in EUR was 4.63%, and the average yield on the CNB portfolio in USD was 4.72%.

Table 2.7 Realized Income and Average Yields on CNB's Foreign Exchange Portfolios in 2001
at market value, in million EUR and USD and %

Portfolios	Realized income	Average amount invested	Annual yield rate		
	2001	2001	2001	2000	1999
EUR	96.4	2,072.5	4.63%	4.38%	2.81%
USD	42.5	894.1	4.72%	6.56%	5.02%

3

Banking System of the Republic of Croatia

3.1 Characteristics of the Banking System

At the end of 2001, the banking system comprised 62 licensed banking institutions of which 43 were banks (42 commercial banks and one branch of a foreign bank), 15 savings banks and 4 housing savings banks.[1]

The total assets of the banking sector amounted to HRK 151bn at end-2001, a rise of HRK 37.6bn or 33.1% compared to end-2000. Bank assets grew by 32.9%, housing savings bank assets grew by as much as 124.6%, and savings banks assets grew by 7.4%. Savings banks and housing savings banks accounted for only 1.6% of the total assets of the banking sector. The relatively large asset growth of the banking system was partly caused by the growth of received deposits in euro-in currencies for euro conversion and partly by the large asset growth of individual banks in majority foreign ownership.

The total profit of the banking sector in 2001 was HRK 1,979.8m (HRK 1,240.1m in 2000). Banks recorded profits for the year of HRK 2,003.5m, while savings banks incurred losses of HRK 23.47m.

As shown in Table 3.1, 38 banks and one branch of a foreign bank had full authorization, which includes the performance of international credit transactions as well as domestic and international payment transactions. Three banks had medium authorization, which includes receiving all types of deposits, granting all types of loans, performing securities transactions, and other legally prescribed banking operations. One bank had limited authorization, implying limited banking operations. In compliance with the provisions of the Banking Law, all banks and savings banks are structured as joint stock companies.

Table 3.1 Number of Authorized Banking Institutions

Institution type	1999	2000	2001
1. Banks	53	43	43
1.1. With full authorization	47	39	38
1.2. With medium authorization	–	2	3
1.3. With limited authorization	5	1	1
1.4. Branches of foreign banks with full authorization	1	1	1
2. Savings banks and housing savings banks	34	26	19
2.1. Savings banks	30	22	15
2.2. Housing savings banks	4	4	4
Total	87	69	62

The number of banks remained at the 2000 level. During 2001, one bank was forced to exit the banking system[2], and one savings bank was granted a bank operating license

[1] All financial data cited in this chapter is based on preliminary unaudited bank reports for 2001 in which losses in Riječka banka d.d., Rijeka are not reported.
[2] The license was revoked for Kaptol banka d.d., Zagreb.

since it had adjusted its equity capital to the provisions of the Banking Law.[3] The number of savings banks fell from 22 at the end of 2000 to 15 at the end of 2001. The savings banks were obliged to adjust their operation to the provisions of the Banking Law by the end of 2001, i.e. to increase the amount of paid-in equity capital to a minimum of HRK 20m. During 2001, two savings banks met the conditions for registering as banks (Primorska štedionica d.d., Rijeka, operating as Primorska banka d.d., Rijeka since the end of 2001, and Štedionica Sonic d.d, Zagreb, registered as a bank in early 2002). Four housing savings banks operated in the banking system at the end of 2001, as was the case in the previous two years.

Table 3.2 Changes in the Number of Banking Institutions

Banks	1999	2000	2001
Number of banks at the beginning of the year	60	53	43
Former savings banks which were granted bank license	–	–	+1
Banks that merged with other banks	–	–4	–
Banks undergoing bankruptcy proceedings	–7	–4	–
Banks whose license was revoked	–	–1	–1
Banks that fail to comply with the Banking Law	–	–1	–
Number of banks at the end of the year	53	43	43
Savings banks	**1999**	**2000**	**2001**
Number of savings banks at the beginning of the year	35	34	26
Savings banks transformed into banks	–	–	–1
Savings banks that merged with other banks/savings banks	–1	–	–2
Savings banks undergoing liquidation	–	–	–2
Savings banks undergoing bankruptcy proceedings	–1	–1	–
Savings banks whose license was revoked	–	–7	–2
New housing savings banks	+1	–	–
Number of savings banks at the end of the year	34	26	19

In 2001, foreign investor interest in the Croatian banking market continued. The share of banks in direct or indirect ownership of foreign shareholders in total bank assets grew from 86.7% in late 2000 to 89.3%. This can be accounted for by the entry of three banks into the group of banks in majority foreign ownership.[4] In 2001, the Consortium (UniCredito Italiano S.p.A. and Allianz AG) expressed a strong interest in purchasing a majority stake in Zagrebačka banka. In view of the fact that UniCredito already had a majority interest in Splitska banka d.d., Split, it was obliged to sell this interest in order to avoid a concentration that would threaten free market operations. In 2001, the Croatian National Bank approved the change in shareholders in Zagrebačka banka d.d., Zagreb and Splitska banka d.d., Split, which was effected in 2002. However, this did not affect the ownership structure since both banks were already in majority foreign ownership.

In late 2001, three banks were in majority state ownership: Hrvatska poštanska banka d.d., Zagreb, and two banks rehabilitated by the state (Dubrovačka banka d.d., Dubrovnik, and Croatia banka d.d., Zagreb). In 2002, Dubrovačka banka d.d., Dubrovnik was taken over by Dalmatinska banka d.d., Zadar, and Croatia banka d.d., Zagreb is expected to be sold this year.

3 Primorska banka d.d., Rijeka has medium authorization.

4 These are: Sisačka banka d.d., Sisak (following the purchase of its majority stake by Dalmatinska banka d.d., Zadar, which itself is in majority ownership of a foreign investment fund), Primorska banka d.d., Rijeka (by the transformation of Primorska štedionica, which was in majority foreign ownership, into a bank), and Riadria banka d.d., Rijeka (after Privredna banka d.d., Zagreb, which is in majority foreign ownership, increased its shareholding in that bank).

Table 3.3 Ownership Structure of Banks

Ownership structure	Number of banks			Share of assets in total bank assets		
	1999	2000	2001	1999	2000	2001
Banks in total or majority private ownership of domestic shareholders	30	19	16	14.5	7.6	5.6
Banks in total or majority state ownership	10	3	3	45.6	5.7	5.0
Banks in total or majority foreign ownership	13	21	24	39.9	86.7	89.3
Total	53	43	43	100.0	100.0	100.0

Table 3.4 shows the number of banks classified by the size of their assets. The number of banks with assets larger than HRK 5bn increased from 5 to 6 in 2001. This group includes Zagrebačka banka d.d., Zagreb, with assets amounting to HRK 41.1bn, and Privredna banka Zagreb d.d., Zagreb, with assets amounting to HRK 27.6bn. They are followed by Riječka banka d.d., Rijeka, Splitska banka d.d., Split and Raiffeisenbank Austria d.d., Zagreb, while Hypo Alpe-Adria-Bank d.d., Zagreb joined this group in 2001. The share of banks with assets exceeding HRK 5bn in total assets grew from 66.3% in 2000 to 70.7% in 2001. At end-2001, the assets of 14 banks ranged from HRK 1bn to 5bn. The share of this group in total bank assets fell as a result of the movement of Hypo Alpe-Adria-Bank d.d., Zagreb into the higher group. The last two groups of banks had a very small share in bank assets.

Table 3.4 Number of Banks by Asset Size
in million HRK and %

Assets	Number of banks			Share of assets in total bank assets		
	1999	2000	2001	1999	2000	2001
Assets exceeding 5,000	4	5	6	58.2	66.3	70.7
Assets from 1,000 to 5,000	15	13	14	31.6	25.5	23.1
Assets from 500 to 1,000	5	8	7	3.3	4.6	3.3
Assets below 500	29	17	16	6.9	3.6	2.9
Number of banks at the end of the year	53	43	43	100.0	100.0	100.0

In conclusion, the characteristics of the banking system in 2001 were the following: a further increase in the share of foreign ownership, a strong interest of foreign investors in the Croatian banking market, stronger competition, and a relatively large bank asset growth. In 2001, there was stronger competition among the banks and bank groups that strengthened their position in the Croatian market.

3.2 The Balance Sheet Structure of the Banks

The balance sheet structure of the banks in 2001 was characterized by an unusually large growth in received deposits, as much as HRK 32bn compared to end-2000. The banks placed part of these funds in loans (net loans grew by HRK 14.6bn in 2001) and the remaining part in other asset items, particularly cash and deposits. This led to greater bank liquidity and further interest rate reduction, but also increased credit risk due to the sharp placement growth. While bank capital grew in nominal terms as a result of the considerable asset growth, the relative ratio of bank capital to total assets trended downwards in 2001.

3.2.1 Bank Asset Structure

Total bank assets amounted to HRK 148.6bn at end-2001, which is a 32.9% increase over that at the end of 2000 when it stood at HRK 111.8bn.

Net loans to other clients (non-banking sector), amounting to HRK 64.7bn at the end of 2001, had a downward trend in the asset structure despite their large nominal growth. Corporate loans had the largest share in the structure of total loans (49% share), as was the case in the previous year, with an upward trend as compared to 2000. The share of household loans (42.5% of total loans) also had an upward trend, whereas the share of other loans (8.5% of total loans) had a downward trend. The share of long-term loans in total loans increased from 55% at end-2000 to 64.7% at end-2001. Figure 3.1 shows loans by the type of user.

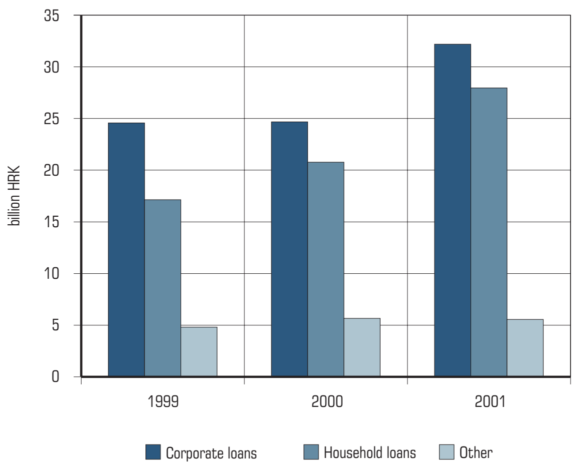
Table 3.5 Structure of Bank Assets
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	9,733.5	10.4	11,489.3	10.3	18.0	22,216.5	15.0	93.4
1.1. Money assets	1,245.9	1.3	1,506.3	1.3	20.9	7,843.8	5.3	420.7
1.2. Deposits	8,487.6	9.1	9,983.1	8.9	17.6	14,372.7	9.7	44.0
2. Deposits with banking institutions	10,312.5	11.0	17,695.3	15.8	71.6	23,900.1	16.1	35.1
3. Treasury bills and CNB bills	3,139.5	3.4	6,059.0	5.4	93.0	9,687.1	6.5	59.9
4. Trading portfolio of securities	1,067.8	1.1	2,462.4	2.2	130.6	4,806.8	3.2	95.2
5. Loans to financial institutions	1,246.2	1.3	1,085.6	1.0	–12.9	1,175.3	0.8	8.3
6. Loans to other clients	45,391.5	48.5	50,130.7	44.8	10.4	64,751.5	43.6	29.2
7. Investment portfolio of securities	15,477.1	16.5	14,167.5	12.7	–8.5	12,750.9	8.6	–10.0
8. Investments in subsidiaries and associates	1,768.6	1.9	2,411.0	2.2	36.3	2,296.4	1.5	–4.8
9. Foreclosed and repossessed assets	447.2	0.5	614.5	0.5	37.4	474.3	0.3	–22.8
10. Tangible assets and software (net of depreciation)	3,164.6	3.4	3,252.5	2.9	2.8	3,505.2	2.4	7.8
11. Interest, fees and other assets	2,518.1	2.7	3,169.2	2.8	25.9	4,068.4	2.7	28.4
12. Net of: Specific reserves for unidentified losses	743.6	0.8	699.4	0.6	–6.0	1,002.7	0.7	43.4
TOTAL ASSETS	93,522.9	100.0	111,837.7	100.0	19.6	148,629.8	100.0	32.9

Deposits with banking institutions increased by 35.1% compared to end-2000, and their share in assets grew from 15.8% at end-2000 to 16.1% at end-2001. 95.9% of total deposits with banking institutions were deposited with foreign banks. At the end of 2001, the money assets of banks amounted to HRK 7.8bn, exceeding the year-end 2000 level more than four times. Such a large increase can be accounted for by a strengthened inflow of funds into the banks at the end of the year for the purpose of the euro conversion. Deposits with the Croatian National Bank amounted to HRK 14.3bn or 9.7% of total assets. Their considerable growth of 44% was a result of an increase in the reserve requirements set aside with the Croatian National Bank (as a result of deposit growth) and a strong growth in funds in settlement accounts. As in the previous years, investments in Ministry of Finance treasury bills and CNB bills continued to grow considerably, both in nominal terms and in terms of the share in assets, amounting to HRK 9.7bn at the end of 2001, which is 6.5% of total bank assets.

Figure 3.1

Granted Loans by User Type



The investment portfolio of securities had a downward trend, both in nominal terms and in terms of the share in total assets, as a result of redemption of a part of the bonds of the Republic of Croatia. The trading portfolio of securities grew by a significant 95%, continuing the trend of relatively fast growth that started in 1999. Banks have continuously increased their volume of securities trading, most frequently bonds of the Republic of Croatia and bonds of foreign countries and foreign financial institutions. The share of bank assets denominated in foreign currency in total assets amounted to 35%.

3.2.2 Bank Liability Structure

Deposits predominate in the bank liability structure and increased significantly in the reporting period, both in nominal terms and in their share in liabilities. The recent introduction of the euro as a cash payment instrument caused a deposit growth in euro-in currencies for the purpose of the euro conversion. Total deposit growth in 2001 amounted to HRK 32bn, which is a 44% increase over 2000. As in the previous years, the majority of deposits were denominated in foreign currency (74.9%). Received loans (loans from financial institutions and other loans) in the liability structure had a downward trend and their absolute value moderately decreased. 19.3% of total received loans were received from domestic financial institutions (CBRD and other financial institutions), 9.7% from the Republic of Croatia and 71% from foreign entities, among which foreign financial institutions predominate. The received loans had a similar structure in 2000. 93.9% of total received loans had maturities longer than 1 year. Interests, fees and other liabilities accounted for 4.5% of bank liabilities.

Table 3.6 Structure of Bank Liabilities
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	5,282.3	5.6	3,510.9	3,1	–33.5	3,628.5	2.5	3.3
1.1. Short–term loans	2,088.7	2.2	1,130.8	1,0	–45.9	595.7	0.4	–47.3
1.2. Long–term loans	3,193.7	3.4	2,380.1	2,1	–25.5	3,032.8	2.1	27.4
2. Deposits	56,997.0	60.9	72,683.4	65,0	27.5	104,691.7	70.4	44.0
2.1. Giro account and current account deposits	9,216.9	9.9	12,619.0	11,3	36.9	16,548.1	11.1	31.1
2.2. Savings deposist	13,678.0	14.6	17,689.3	15,8	29.3	26,373.9	17.7	49.1
2.3. Time deposits	34,102.1	36.5	42,375.1	37,9	24.3	61,769.7	41.6	45.8
3. Other loans	15,007.5	16.0	16,329.0	14,6	8.8	15,947.7	10.7	–2.3
3.1. Short–term loans	1,652.8	1.8	503.3	0,4	–69.6	594.0	0.4	18.0
3.2. Long–term loans	13,354.7	14.3	15,825.7	14,2	18.5	15,353.7	10.3	–3.0
4. Debt securities issued	0.0	0.0	0.0	0,0	–	19.4	0.0	–
4.1. Short–term debt securities issued	0.0	0.0	0.0	0,0	–	0.0	0.0	–
4.2. Long–term debt securities issued	0.0	0.0	0.0	0,0	–	19.4	0.0	–
5. Supplementary capital	343.1	0.4	520.3	0,5	51.7	2,663.8	1.8	411.9
5.1. Subordinated instruments issued	105.5	0.1	282.9	0,3	168.1	347.4	0.2	22.8
5.2. Hybrid instruments issued	237.5	0.3	237.4	0,2	0.0	2,316.4	1.6	875.7
6. Interest, fees and other liabilities	4,849.2	5.2	5,475.5	4,9	12.9	6,642.7	4.5	21.3
7. Profit/loss for the current year	466.4	0.5	1,123.2	1,0	140.8	1,897.5	1.3	68.9
8. Capital	10,577.3	11.3	12,195.5	10,9	15.3	13,138.5	8.8	7.7
TOTAL LIABILITIES	93,522.9	100.0	111,837.7	100,0	19.6	148,629.8	100.0	32.9

3.3 Bank Capital

At the end of 2001, bank capital amounted to HRK 13.1bn, a 7.7% rise compared to 2000 (bank assets increased by 32.9% in the same period). Over the same period, share capital grew in nominal terms, but its share in total capital fell. In the capital structure, legal reserves and other reserves grew both in nominal terms and in terms of their share (as a result of profit distribution). They grew by HRK 723.6m or 21% compared to 2000.

Risk-based capital is a calculation category to measure a bank's ability to cover unexpected losses. At the end of 2001, the risk-based capital of banks amounted to HRK 13.9bn, which is a 7.8% increase over that at the end of 2000 when it stood at HRK 12.9bn. Supplementary capital, which is included in risk-based capital, had a relatively small share in the risk-based capital structure but grew nominally by 76.7% in 2001 as compared to the end of 2000. This increase can be accounted for by a significant growth in hybrid instruments issued. From mid-2001, the foreign exchange part of the reserve requirement calculation base included all received foreign exchange loans, and banks that reported liabilities based on loans from foreign banks redirected these funds into hybrid instruments. These instruments were subsequently included in the foreign exchange part of the reserve requirement calculation base.

The capital adequacy ratio at the banking system level at the end of 2001 amounted to 18.4%, which is less than at the end of 2000 when it stood at 21.3%. At the end of

2001, all banks reported capital adequacy above the minimum prescribed ratio of 10% (ranging between 10.4% and 92.2%).

Capital grew more slowly than bank assets, despite capital strengthening on the basis of distributed profit. The lower ratio of capital to assets brings the domestic banks closer to the banks in Western Europe, which is a natural trend but implies certain hazards and risks.

Table 3.7 Structure of Bank Capital
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	8,219.7	77.7	8,549.9	70.1	4.0	8,966.5	68.2	4.9
2. Retained income/loss	73.7	0.7	326.2	2.7	342.7	129.0	1.0	–60.4
3. Legal reserves	1,540.2	14.6	2,098.8	17.2	36.3	2,522.4	19.2	20.2
4. Reserves provided for by the articles of association and other capital reserves	743.8	7.0	1,220.5	10.0	64.1	1,520.6	11.6	24.6
TOTAL CAPITAL	10,577.3	100.0	12,195.5	100.0	15.3	13,138.5	100.0	7.7

3.4 Bank Asset Quality

Banks assess the quality of their assets in accordance with the internal placement classification system based on the Decision on the Classification of Placements and Assessment of Bank Exposure. This Decision was enacted pursuant to the Banking Law and prescribes the classification of bank placements (including off-balance sheet items) by risk categories. For the purpose of adjustment to International Accounting Standard 39 Financial Instruments – Recognition and Measurement, the above Decision was complemented by the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards.

The placements that, prior to the enactment of the above Decision, were classified into risk categories A, B, C, D and E are now classified into three major categories. The first category encompasses fully recoverable placements, which are assessed with certainty as fully recoverable according to the debtor's financial position and available instruments of collateral (categories A and B). These placements are not subject to value impairment. The second category encompasses partly recoverable placements (categories C and D). These placements involve a loss on doubtful debts corresponding to the difference between their book value and the present value of discounted expected cash flows arising from these placements. The third category (category E) includes placements whose present value equals zero (100% loss).

Losses arising from doubtful debts and placements whose present value equals zero represent bank expenses of the amount by which the asset items are reduced and strongly affect bank performance. Although placements graded A and B are not subject to individual reduction corresponding to the value of loss, banks are obliged to form reserves for them for unidentified losses. For placements graded A, banks are obliged to form (set aside) reserves in compliance with the Decision on the Amount and the Method of Forming Specific Reserves to Ensure Against the Potential Losses of Banks. For placements classified into category B, banks are obliged to form reserves according to their policy, based on the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards.

Table 3.8 Classification of Bank Placements by Risk Categories
end of period, in million HRK and %

Placements	1999		2000		2001	
	Amount	Share	Amount	Share	Amount	Share
A and B	96,568.5	89.7	112,198.3	90.5	140,821.0	92.8
C and D	7,143.6	6.6	6,923.1	5.6	6,659.1	4.4
E	3,903.3	3.6	4,803.1	3.9	4,253.3	2.8
Total	107,615.4	100.0	123,924.5	100.0	151,733.4	100.0

At the end of 2001, fully recoverable placements (categories A and B) grew by 26% compared to 2000 and accounted for 92.8% of total risk assets. Partly recoverable placements (categories C and D) and placements whose present value equals zero (category E) accounted for 4.4% and 2.8% respectively of total risk assets. As shown in Table 3.9, following a rise in 2000, total impairment (placements reduced by the amount of established losses arising from doubtful debts along with reserves for unidentified losses) fell to HRK 9.4bn in 2001, which is a level comparable to that in 1999. The share of total impairment in placements has a downward trend that was especially pronounced in 2001. This downward trend of total impairment, both in its absolute amount and relative to total placements, resulted from an increase in the share of categories A and B. This is supported by the structure of total impairment: while placement reduction by the amount of established losses arising from doubtful debts has a downward trend, specific reserves for unidentified losses have constantly been growing, both in nominal terms and in terms of their share in total reserves. The reported decline in total impairment (provisions) in 2001 can partly be accounted for by the application of International Accounting Standard 39.

Table 3.9 Provision to Placement (A , B, C, D, E) Ratio of Banks
end of period, in million HRK and %

	1999	2000	2001
1. Total impairment	9,476.2	10,176.6	9,444.6
1.1. Individual impairment corresponding to the value of loss	8,673.6	9,355.4	8,264.7
1.2. Provisions for unidentified losses	802.6	821.2	1,179.9
2. Total gross placements (A, B, C, D, E)	107,165.1	123,924.5	151,733.4
3. Relative ratio of total provisions to total gross placements	8.8%	8.2%	6.2%

3.4.1 Prescribed Limitations

In accordance with the Banking Law, banks are obliged to report to the Croatian National Bank on the amount and type of their exposure and to comply with the following ratios and levels of exposure:

- Bank exposure to a single borrower or group of related borrowers must not exceed 25% of its risk-based capital.
- The total sum of bank's large exposures must not exceed 400% of its risk-based capital. A bank's large exposure is exposure to a single borrower or group of related borrowers exceeding 10% of its risk-based capital.
- Bank exposure to a single shareholder with more than 3% of bank shares (and their related persons) must not exceed 5% of the bank's risk-based capital.
- A bank's investment in tangible assets (land, buildings, equipment and refurbishing of business premises) must not exceed 30% of its risk-based capital.
- A bank's investment in tangible assets together with equity participation in companies must not exceed 70% of its risk-based capital.

The purpose of these limitations is to limit the risk to which a bank is exposed in its operation in view of the amount and concentration of granted loans and investments. For banks that have violated the provisions of the Banking Law, i.e. subordinate legislation enacted on the basis of the Banking Law and referring to exposure and investment limitations, the Croatian National Bank may prescribe measures for improving the bank's condition. These measures set a time-limit for a bank violating a particular limitation to adjust to the limitation. Practice shows that the most frequent non-compliance with the limitations concern bank exposure to a single borrower or group of related borrowers, which indicates that some banks are related to individual groups of companies or industries.

3.5 Bank Earnings Quality

In 2001, the banks reported a profit of HRK 2,003.5m. 38 of the 43 banks earned profit amounting to a total of HRK 2,147.7m, whereas 5 banks incurred losses amounting to a total of HRK 144.2m in. As shown in Table 3.10, net interest income increased by 6.8% as compared to 2000 due to interest income growth larger than interest expenses growth. Net non-interest income rose by 11.3% compared to the previous year due to a growth in non-interest income that was larger than the growth in non-interest expenses. The share of interest income in the structure of income varied between 72% and 74% in all three reporting years, indicating that it still accounts for the largest part of bank income (although banks increased the volume of their non-interest income bearing activities). Net interest income against average interest bearing assets fell from 4.6% in 2000 to 3.9%, since interest income growth was slower than assets growth. The share of interest expenses in the expenses structure (before loan loss provisions) was 46% (downward trend), non-interest expenses had a share of 11%, and general administrative expenses and depreciation had a share of 43% (upward trend).

Table 3.10 Bank Income Statement
in million HRK and %

	1999	2000		2001	
	Amount	Amount	Change	Amount	Change
1. Net interest income	3,893.4	4,325.1	11.1	4,618.8	6.8
1.1. Interest income	7,816.1	8,398.0	7.4	8,933.0	6.4
1.2. Interest expenses	3,922.7	4,073.0	3.8	4,314.2	5.9
2. Net non-interest income	2,035.5	1,980.6	–2.7	2,204.8	11.3
2.1. Non-interest income	2,962.4	2,878.8	–2.8	3,226.9	12.1
2.2. Non-interest expenses	926.9	898.1	–3.1	1,022.1	13.8
3. General administrative expenses and depreciation	3,211.1	3,577.7	11.4	3,991.0	11.6
4. Net operating income before provisions	2,717.9	2,728.0	0.4	2,832.6	3.8
5. Loan loss provision expenses	1,898.4	1,298.6	–31.6	682.7	–47.4
6. Pre-tax profit/loss	819.4	1,429.4	74.4	2,149.9	50.4
7. Income tax	104.8	123.3	17.7	146.4	18.7
8. After-tax profit/loss	714.6	1,306.1	82.8	2,003.5	53.4

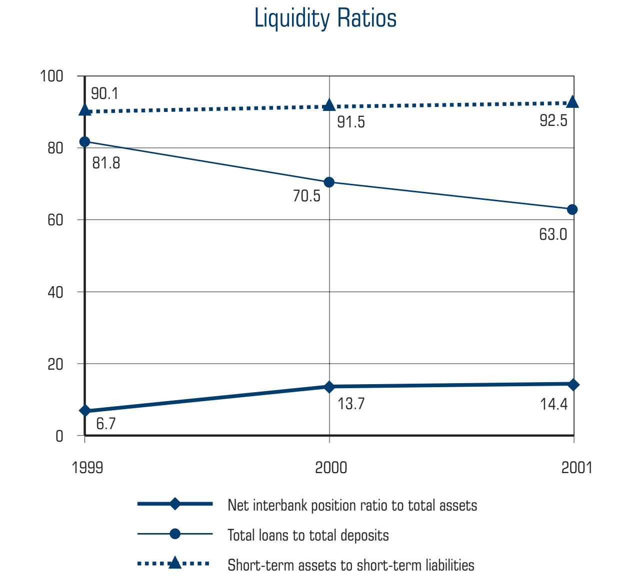
The 47.4% reduction in loan loss provision expenses is a result of the previously reported increase in fully recoverable placements along with a fall in partly recoverable placements and placements whose present value equals zero.

Earned profit grew by 53.4% over that in the previous year, increasing against average assets from 1.39% in 2000 to 1.65% in 2001. The reduction in loan loss provision expenses rather than the increase in net income before provisions contributed most to profit growth.

3.6 Bank Liquidity

Maintaining optimum liquidity is one of the permanent tasks of a bank. When managing liquidity, banks take into account, among other things, the stability of the received deposits, the availability of assets that can easily be converted into cash, access to money markets, central bank lending, and the asset and liability maturity structure match. In order to assure their liquidity reserve, banks place part of their assets in securities that bear lower interest and can easily be converted into liquid assets. Figure 3.2 shows some liquidity ratios trends at the level of all deposit money banks. The net interbank position ratio represents the difference between assets placed with financial institutions and assets received from financial institutions, relative to total assets. The changes in this ratio, as well as in the other liquidity ratios shown, indicate that bank liquidity has been constantly growing over the past three years. Data on subscribed CNB bills also point to the same conclusion.

Figure 3.2



According to the average daily balances for December 2001, HRK 2,656.2m in CNB bills denominated in kuna were purchased (HRK 1,348.7m in 1999 and HRK 2,496.0m in 2000). HRK 1,892.7m of CNB bills denominated in foreign currency were also purchased (HRK 1,507.6m in 1999 and HRK 1,692.7m in 2000). At the end of 2001, CNB loans were not utilized by any of the banks. The high liquidity of banks in 2001 was mostly due to the previously mentioned deposit growth in bank liabilities, amounting to as much as 44% compared to 2000.

3.7 Savings Banks and Housing Savings Banks Performance

At the end of 2001, 15 savings banks and 4 housing savings banks were in operation. All the savings banks were in private ownership. Savings banks founded before the Banking Law came into force, which were issued with operating licenses according to the previously valid Law on Banks and Savings Banks, had to adjust their operation to the Banking Law by the end of 2001 and increase their paid-in capital to a minimum of HRK 20m. As already reported, during 2001 two savings banks increased their equity capital (Primorska štedionica d.d., Rijeka, operating as Primorska banka d.d., Rijeka since the end of 2001, and Štedionica Sonic d.d., Zagreb, registered as a bank in early 2002). Two savings banks entered the liquidation process in 2001, the licenses of two savings banks were revoked, and two savings banks merged with other savings banks. Savings banks assets amounted to HRK 2,372m at the end of 2001, a 50.4% increase compared to total savings banks assets at the end of 2000. This increase was mostly due to the asset growth of housing savings banks of 124.6%, whereas the assets of other savings banks rose by only 7.4%. The share of housing savings bank assets in total savings bank assets grew from 36.6% at the end of 2000 to 54.7% at the end of 2001.

3.7.1 The Structure of Savings Banks and Housing Savings Banks Balance Sheet

Following a fall in 2000, loans to other clients increased by 10.1% in 2001, but their share in savings bank assets in the reporting period had a downward trend. As in the previous year, all securities items (Ministry of Finance treasury bills, CNB bills, trading portfolio of securities, investment portfolio of securities) recorded a significant growth, both in nominal terms and in terms of their share in savings bank assets, as a result of their growth in housing savings bank assets. In comparison with the previous year, the share of money assets and deposits with the CNB increased, while the share of other items in savings bank and housing savings bank assets decreased.

Deposits were dominant in the liability structure of savings and housing savings banks, amounting to HRK 1,959.2m at the end of 2001. Their share in total liabilities had an upward trend, growing by 63.7% in nominal terms compared to 2000, mainly as a result of deposit growth in housing savings banks. The share of all other liability items in total liabilities was lower than in 2000.

Table 3.11 Structure of Savings Bank and Housing Savings Bank Assets
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Money assets and deposits with the CNB	89.8	7.0	91.6	5.8	2.1	154.4	6.5	68.5
1.1. Money assets	24.3	1.9	34.5	2.2	42.1	54.5	2.3	57.9
1.2. Deposits	65.5	5.1	57.1	3.6	–12.8	99.9	4.2	74.9
2. Deposits with banking institutions	93.1	7.2	99.0	6.3	6.3	123.3	5.2	24.6
3. Treasury bills and CNB bills	126.4	9.8	237.3	15.0	87.7	418.9	17.7	76.5
4. Trading portfolio of securities	3.1	0.2	144.4	9.2	4,605.6	432.7	18.3	199.7
5. Loans to financial institutions	50.5	3.9	10.8	0.7	–78.7	14.4	0.6	34.4
6. Loans to other clients	662.3	51.5	625.7	39.7	–5.5	688.9	29.0	10.1
7. Investment portfolio of securities	32.4	2.5	190.9	12.1	488.4	376.5	15.9	97.3
8. Investments in subsidiaries and associates	1.4	0.1	1.4	0.1	2.6	1.1	0.0	–18.1
9. Foreclosed and repossessed assets	25.8	2.0	17.7	1.1	–31.3	16.2	0.7	–8.4
10. Tangible assets and software (net of depreciation)	66.5	5.2	57.2	3.6	–14.0	56.3	2.4	–1.5
11. Interest, fees and other assets	142.5	11.1	109.6	6.9	–23.1	98.1	4.1	–10.5
12. Net of: Specific reserves for unidentified losses	7.6	0.6	7.9	0.5	4.6	8.8	0.4	12.0
TOTAL ASSETS	1,286.2	100.0	1,577.6	100.0	22.7	2,372.0	100.0	50.4

Table 3.12 Structure of Savings Bank and Housing Savings Bank Liabilities
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Loans from financial institutions	28.8	2.2	13.6	0.9	–52.8	3.5	0.1	–74.1
1.1. Short-term loans	24.8	1.9	12.4	0.8	–50.1	2.5	0.1	–79.8
1.2. Long-term loans	4.1	0.3	1.2	0.1	–69.9	1.0	0.0	–15.9
2. Deposits	826.3	64.2	1,197.0	75.9	44.9	1,959.3	82.6	63.7
2.1. Giro account and current account deposits	6.6	0.5	7.0	0.4	5.5	6.6	0.3	–5.9
2.2. Savings deposist	38.6	3.0	46.9	3.0	21.4	46.8	2.0	–0.2
2.3. Time deposits	781.1	60.7	1,143.2	72.5	46.4	1,905.9	80.3	66.7
3. Other loans	8.4	0.7	4.4	0.3	–48.0	1.2	0.0	–73.1
3.1. Short-term loans	7.8	0.6	3.8	0.2	–51.2	1.2	0.0	–69.1
3.2. Long-term loans	0.6	0.0	0.6	0.0	–5.5	0.0	0.0	–100.0
4. Debt securities issued	0.0	0.0	0.0	0.0	–	0.0	0.0	–
4.1. Short-term debt securities issued	0.0	0.0	0.0	0.0	–	0.0	0.0	–
4.2. Long-term debt securities issued	0.0	0.0	0.0	0.0	–	0.0	0.0	–
5. Supplementary capital	52.0	4.0	52.5	3.3	1.1	27.8	1.2	–47.2
5.1. Subordinated instruments issued	12.8	1.0	7.9	0.5	–38.4	3.9	0.2	–50.4
5.2. Hybrid instruments issued	39.2	3.0	44.7	2.8	14.0	23.9	1.0	–46.4
6. Interest, fees and other liabilities	53.0	4.1	64.5	4.1	21.7	77.6	3.3	20.3
7. Profit/loss for the current year	–41.4	–3.2	–66.1	–4.2	59.6	–27.2	–1.1	–59.0
8. Capital	359.1	27.9	311.6	19.8	–13.2	329.8	13.9	5.8
TOTAL LIABILITIES	1,286.2	100.0	1,577.6	100.0	22.7	2,372.0	100.0	50.4

3.7.2 Savings Bank and Housing Savings Bank Capital

Following a fall in 2000, savings bank and housing savings bank capital increased by 5.8% in 2001 due to an increase in the share capital of housing savings banks. The other capital items had a downward trend as a result of operating losses incurred by savings banks in the reporting period. The share of capital in total liabilities fell from 27.9% at the end of 1999 and 19.8% in 2000 to 13.9% at the end of 2001.

Table 3.13 Structure of Savings Bank and Housing Savings Bank Capital
end of period, in million HRK and %

	1999		2000			2001		
	Amount	Share	Amount	Share	Change	Amount	Share	Change
1. Share capital	369.4	102.9	339.5	109.0	–8.1	376.4	114.2	10.9
2. Retained income/loss	–46.1	–12.8	–52.9	–17.0	14.7	–63.2	–19.2	19.6
3. Legal reserves	13.6	3.8	4.0	1.3	–71.0	3.6	1.1	–7.9
4. Reserves provided for by the articles of association and other capital reserves	22.2	6.2	21.0	6.7	–5.3	13.0	3.9	–38.3
TOTAL CAPITAL	359.1	100.0	311.6	100.0	–13.2	329.8	100.0	5.8

At the end of 2001, the risk–based capital of savings banks and housing savings banks amounted to HRK 294.8m, up from HRK 257.3m as at 31 December 2000. Risk-based capital was lower than the reported total capital since it included loss for the current year. The capital adequacy ratio of savings banks and housing savings banks stood at 37.3% at the end of 2001, compared to 37% at the end of 2000. Considerably high capital adequacy was reported by housing savings banks due to low risk-weighted assets (low credit activity).

3.7.3 Asset Quality of Savings Banks and Housing Savings Banks

At the end of 2001, fully recoverable placements (categories A and B) accounted for 93.6% of total risk assets of savings banks and housing savings banks. Partly recoverable placements (categories C and D) accounted for 4.4% of total risk assets, while non-recoverable placements (category E) accounted for 2% of total risk assets. Total impairment (placement reduction by the amount of established losses arising from doubtful debts together with reserves for unidentified losses) amounted to HRK 82.0m or 4.6% of total placements at the end of 2001. It had a downward trend in the reporting period, both in nominal terms and in terms of share in total placements. Despite the favorable trend in the described ratios, the quality and structure of savings bank and housing savings bank assets do not earn income and operating losses were incurred in the reporting period.

Table 3.14 Classification of Savings Bank and Housing Savings Bank Placements by Risk Categories
end of period, in million HRK and %

Placements	1999		2000		2001	
	Amount	Share	Amount	Share	Amount	Share
A and B	1,018.1	83.5	1,239.1	90.5	1,679.6	93.6
C and D	156.3	12.8	86.8	6.3	79.1	4.4
E	44.6	3.7	43.8	3.2	35.7	2.0
Total	1,218.9	100.0	1,369.6	100.0	1,794.4	100.0

Table 3.15 Provision to Placement (A , B, C, D, E) Ratio of Savings Banks and Housing Savings Banks
end of period, in million HRK and %

	1999	2000	2001
1. Total impairment	129.2	94.9	82.0
1.1. Individual impairment corresponding to the value of loss	121.6	87.2	73.2
1.2. Provisions for unidentified losses	7.6	7.7	8.8
2. Total gross placements (A, B, C, D, E)	1,218.9	1,369.6	1,794.4
3. Relative ratio of total provisions to total gross placements	10.6%	6.9%	4.6%

3.7.4 Savings Bank and Housing Savings Bank Earnings Quality

In 2001, savings banks and housing savings banks incurred operating losses amounting to HRK 23.7m. Losses totaling HRK 15.3m were reported by housing savings banks, while other savings banks reported losses of HRK 8.3m.

Net interest income in 2001 amounted to HRK 91m, a 19.6% rise compared to the previous year. Net non-interest income also grew considerably. Despite the described favorable trends, net operating losses before forming (setting aside) loan loss reserves, after general expenses and depreciation, amounted to HRK 8.5m. It can be concluded that savings banks and housing savings banks could not earn net operating income with the existing asset structure. This can partly be accounted for by housing savings banks, since they still do not generate high income from interest on loans.

Table 3.16 Savings Bank Income Statement
in million HRK and %

	1999	2000		2001	
	Amount	Amount	Change	Amount	Change
1. Net interest income	114.0	76.0	–33.3	90.9	19.6
1.1. Interest income	231.4	193.8	–16.2	208.6	7.6
1.2. Interest expenses	117.4	117.8	0.3	117.7	–0.1
2. Net non-interest income	26.9	9.9	–63.2	46.8	373.2
2.1. Non-interest income	60.4	72.1	19.3	101.3	40.5
2.2. Non-interest expenses	33.6	62.2	85.4	54.5	–12.4
3. General administrative expenses and depreciation	122.8	131.1	6.8	146.2	11.5
4. Net operating income before provisions	18.0	–45.3	–351.0	–8.5	–81.2
5. Loan loss provision expenses	66.0	16.2	–75.5	11.4	–29.6
6. Pre-tax profit/loss	–48.0	–61.4	27.9	–19.9	–67.6
7. Income tax	1.2	4.6	278.4	3.8	–17.9
8. After-tax profit/loss	–49.2	–66.0	34.1	–23.7	–64.1

3.8 The Supervision of Banks and Savings Banks

3.8.1 Bank Supervision Function and Organization

The objective of the bank supervision function is to protect savers and depositors and to safeguard the stability and safety of the banking system. To this end, compliance of bank operations with the law and banking risk management are examined.

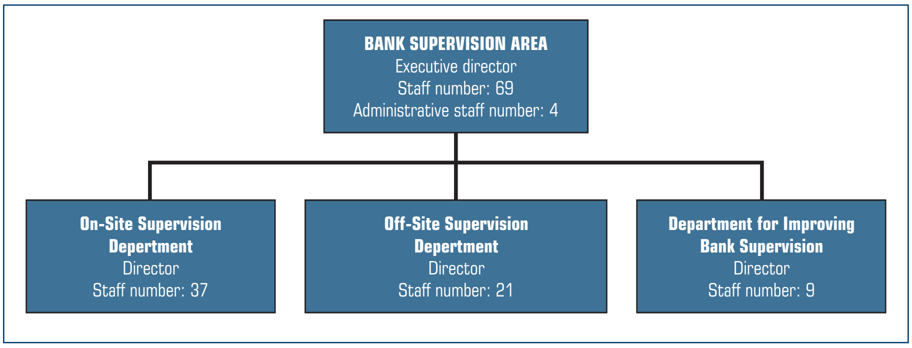
The central bank cannot by itself, through its prudential supervision function, assure the overall stability of the banking system. As in many other cases, it is necessary to co-ordinate the work of all the important entities that, acting within their authorities, may contribute to achieving and maintaining the stability and safety of the system. The role of prudential bank supervision is to constantly implement measures with the aim of minimizing all types of risks and to promptly solve individual problems in order to prevent possible adverse effects on the overall system.

For the purpose of the effective and efficient performance of its tasks, the prudential supervision of banking institutions requires a legal framework that allows quality and independent functioning. In this context, the recommendations of developed countries with a long tradition of prudential supervision are contained in the 25 BIS core principles for effective prudential bank supervision, which provide the minimum required framework for the effective performance of supervisors/supervisory institutions.

The Croatian National Bank performs supervision of banks and savings banks pursuant to the authorities prescribed by the Law on the Croatian National Bank and the Banking Law. Prudential bank supervision, established in 1993 as the Bank Supervision Area within the Croatian National Bank, has followed the BIS recommendations since its establishment and has continuously enhanced its performance, which depends, among other things, on the conditions in the environment.

Since its establishment, there have been significant improvements in prudential bank supervision within the Croatian National Bank. The Bank Supervision Area has been organizationally structured and new staff has been recruited, most of the basic regulations have been adopted, the staff has undergone professional training and regular bank supervision has started.

In order to perform all the prudential bank supervision tasks more efficiently and effectively, the Bank Supervision Area is divided into three departments: the On-Site Supervision Department, the Off-Site Supervision Department and the Department for Improving Bank Supervision. The Foreign Trade Transactions Control Department is also within the organizational structure of the Bank Supervision Area. At the end of 2001, the Bank Supervision Area had a staff of 69[5]. The organizational strengthening was in compliance with the Strategic Development Plan.



5 The total number of employees does not include those employed with the Foreign Trade Transactions Control Department nor those responsible for administrative tasks.

On-Site Supervision Department

The main function of this department is the on-site supervision of banks and savings banks. CNB employees examine bank operations in the bank itself, checking that procedures are applied and that the bank and savings bank business records are true and correct, in accordance with the regulations. They also assess the methods of business process management with the aim of minimizing all types of operational risks.

Ongoing activities:

A On-site supervision preparation

1) Mathematical and logical examination of data received from the Off-Site Supervision Department;
2) Individual analysis of bank and savings bank financial position;
3) Co-operation with other departments of the Croatian National Bank regarding on-site supervision;
4) On-site supervision planning concerning human resources and supervision period;
5) Communication with the bank or savings bank regarding the preparations for the on-site supervision.

B On-site supervision

1) Supervision of bank and savings bank operation by examining business records, bookkeeping and other documentation, on-site examination of prescribed reports in order to assure that they operate on the principles of liquidity, safety and profitability;
2) Supervising whether the activities are performed in accordance with the operating license;
3) Supervision of capital adequacy, formation and amount;
4) Supervision of asset quality, risk grades of asset and appropriate off-balance sheet items;
5) Supervision of the method of providing and maintaining liquidity;
6) Supervision of the management method and adequacy;
7) Supervision of the profit amount and distribution;
8) Supervision of the adequacy of managing credit, interest rate, currency, market and other risks arising from operation;
9) Supervision of payment transaction performance;
10) Supervision of compliance with the law, subordinate legislation and regulations, as well as banks' or savings banks' by-laws regulating their operation;
11) Supervision of other bank or savings bank operating conditions, when needed, which directly or indirectly influence their operating liquidity, safety and profitability;
12) Meetings with the management and supervisory board;
13) Issuing conclusions determining the time-limit for updating records and accounts in case of irregular and untimely bookkeeping and other records, as well as original documentation based on which entries are made and records updated;
14) Control of the implementation of the current monetary and foreign exchange policy measures;
15) Co-operation with other departments of the Croatian National Bank regarding on-site supervision.

C On-site supervision final activities

1) Meetings with the management and supervisory board;
2) Preparing the Information on the performed on-site examination;
3) Drawing up a written document, following the on-site examination, by the authorized person and presenting the document to the bank or savings bank;
4) Taking measures against a bank or savings bank, as well as against responsible persons in the case of identified illegal or irregular activities; filing a request for initiating minor offence or criminal procedures in accordance with the regulations;
5) Drawing up a proposal for the activities aimed at eliminating irregular operations, or an order for the elimination of irregular activities.

D Other activities

1) Issuing instructions for preparing the on-site examination findings;
2) Issuing instructions for preparing the information technology examination findings;
3) Issuing a manual for performing information technology supervision;
4) Co-operation with other departments within the Area for the purpose of setting up the Central Banks' Records;
5) Participation in task forces at the Croatian National Bank level for certain projects;
6) Participation in the task force for the implementation of the UN Security Council Resolution on fighting terrorism (with other government bodies);
7) The organization and keeping of records on the supervision carried out and measures taken;
8) Establishing, documenting, monitoring and compiling banks' ratings based on the CAMELS method;
9) Documenting, monitoring, initiating supervision, and supervising the implementation of activities aimed at eliminating irregular operations, or orders for the elimination of illegal and irregular activities;
10) Testifying in minor offence and criminal procedures against banks and savings banks;
11) Co-operation with other departments of the Croatian National Bank;
12) Co-operation with other government bodies regarding issues in the area of bank and savings bank supervision (Money Laundry Office, Ministry of the Interior, Foreign Exchange Inspectorate, State Attorney's Office, etc.).

Off-Site Supervision Department

The main function of this department is the ongoing analysis of the financial position of individual banks or savings banks and the overall system, on the basis of received data. These analyses should be a guideline for on-site supervision and a preventive means in the form of corrective measures against particular banks or savings banks.

Ongoing activities:

A Tasks related to individual banks

1) Collection of data and reports in certain intervals (quarterly preliminary reports, annual audited reports, annual consolidated reports);
2) Mathematical and logical examination of the collected data;
3) Processing and compilation of the collected data;
4) Periodical analysis of individual bank and savings bank financial standing, and determining a bank's rating according to the CAMELS method;
5) Audit reports analysis, on which a special report is prepared;
6) Providing information on individual bank operation as a preparation for meetings with bank representatives and drawing up minutes of meetings;
7) Filling in the Banks' Records with various data on individual banks and savings banks;
8) Preparing data for the Banks Bulletin;
9) Initiating the on-site supervision of a bank or savings bank when there are indications, based on data analysis, of possible illegal activities and jeopardized safety, liquidity or profitability;
10) Preparing examination reports or prescribing measures in the case of confirmed illegal or irregular activities of a bank or savings bank;
11) Monitoring the implementation of the measures prescribed by the Order;
12) Communication and correspondence with other departments of the Croatian National Bank, banks, savings banks, various institutions and individuals (e.g. responses to banks' inquiries and to savers' and other bank clients' complaints).

B Activities related to banking system analysis

1) Determining certain indicators and analyses of the overall banking system; for example, analysis of the banking system for the CNB Annual Report, drawing up quarterly reports on the banking sector;
2) Receiving and processing the reports on debtors whose borrowing exceeds HRK 5m, preparing the report and presenting it to the Area and CNB management;
3) Collecting data at the banking system level, as required by the IMF and other international institutions, as well as participation in the meetings with the representatives of these institutions.

C Licensing[6]

1) Processing applications and making proposals to the Licensing Committee for particular bank operation areas; for example: issuing and revoking the operating license of a bank, approvals for acquiring an interest in bank equity capital, approvals for exceeding the limitation on investment in tangible assets and equity participation, bank merger and acquisition, compliance with the law and other regulations;

[6] From 1 February 2002, licensing activities are performed by the Department for Improving Bank Supervision.

2) Processing applications and making proposals related to savings and loan co-operatives to the Licensing Committee.

D Other activities

1) Participation in the data base and information system development for analyzing bank financial reports and the overall banking system;
2) Preparation of the manual for the Department's operations;
3) Participation in task forces at the level of the Area and CNB for particular projects (preparing draft regulations);
4) Co-operation with other departments within the Area regarding the preparation of the Central Banks' Records.

Department for Improving Bank Supervision

The main function of this department is the monitoring of the application of prudential regulation and proposing improvements, the development and improvement of internal work methodologies, the monitoring of international trends and co-operation with other institutions.

Ongoing activities:

1) Improvement and development of Bank and Savings Bank Supervision Methodology;
2) Monitoring and studying international bank standards;
3) Monitoring regulations, studies and other literature on bank and savings bank supervision, as well as informing other departments within the Area thereof;
4) Studying and proposing bank and savings bank supervision regulations,
5) Developing the data base and information system for bank financial reports and overall banking system analysis;
6) Transparency improvement for the purpose of informing the public on bank operation (Banks Bulletin);
7) Organizing and carrying out Area employee training;
8) Stating opinions regarding individual inquiries about the application of laws and other regulations, in co-operation with other departments;
9) Co-operation with other departments of the Croatian National Bank and other government bodies in carrying out projects;
10) Maintaining contacts with bank supervisory authorities in other countries as part of co-operation and mutual assistance in banking system supervision;
11) Participating in meetings with representatives of domestic and international financial institutions and organizations, domestic and foreign prudential supervisory institutions, foreign banks, etc.

3.8.2 The Bank Supervision Area's Activities in 2001

The outcome of the Bank Supervision Area's regular activities in 2001 was as follows:

- a total of 32 regular examinations of banking operations were conducted (in 23 banks and in 9 savings banks), which accounts for 52.46% of the banking system in terms of the number of institutions or 52.98% of the banking system in terms of the share in assets (in 2000, on-site supervision was performed in 24 banks and 21 savings banks, which is 56.46% of the overall system),
- 6 examinations of the implementation of measures for the improvement of condition were conducted (in 2 banks and 4 savings banks,)
- 3 examinations of liquidation process were carried out (in 2 banks and 1 savings bank),
- 6 off-site examination findings were prepared,
- 29 orders for the improvement of conditions and the elimination of illegal and irregular activities were issued – these measures partly refer to the establishment of time-limits for complying with prescribed exposure limitations,
- 28 citations were processed (11 minor offence citations, 6 citations for financial infractions and 11 citations for infringement of currency regulations).

Additionally, in accordance with the provisions of the Banking Law, a total of 67 applications of banks and savings banks for various approvals were processed, which resulted in issuing bank operating licenses (3), granting approvals for exceeding the investment limitations (15), extending time-limits set by various decisions (5), granting specific prior consents (42) and withdrawing licenses (2).

In 2000, the majority of activities and resources were directed towards solving problems that remained from the previous years and towards completing the banking system consolidation process. Although more examinations of banking operations were conducted in 2000, the banks examined in 2001 were considerably larger by size and volume of operations than the banks examined in the previous year.

Regulation

Banking Bill

Since the enactment of the basic regulations in 1993, they have constantly been amended and improved for the purpose of improved compliance with the BIS core principles for effective banking supervision, International Accounting Standards and EU Guidelines. The current Banking Law of 1998 allowed the Croatian National Bank to act efficiently in mitigating the consequences of the 1998/99 banking crisis.

For the purpose of further compliance with the European Union regulation, a Banking Bill was prepared, which is presently in the process of enactment by the Croatian Parliament. The aim of the Banking Bill is to create the preconditions for regular banking operation through a high level of prevention, which primarily must be assured by the banks themselves. Pursuant to the new Banking Law, new subordinate legislation will also be adopted.

The Banking Bill introduces new provisions or amends the existing provisions, of which most important are the following:

- provisions on the freedom of banks of the EU Member States to provide banking and other financial services;
- provisions on co-operation with other supervisory authorities, with a special emphasis on co-operation with the supervisory authorities of the EU Member States;
- provisions on risk management, including market risk and other risks;
- provisions on bank supervision on the basis of consolidated financial reports;
- provisions on the legal protection of persons authorized for bank supervision;
- provisions allowing the Croatian National Bank to monitor market competition in the banking services market and to take appropriate measures for assuring the same;
- consumer protection provisions;
- provisions on special administration (which should allow the greater efficiency of the special administration appointed by the Croatian National Bank).

Other Regulation

In co-operation with the Research and Statistics Department, and for the purpose of better consumer protection, the Decision on the Uniform Method of Expressing the Effective Lending and Deposit Interest Rate was adopted. For the purpose of improving the compliance of the existing subordinate legislation with International Accounting Standard 39 – Recognition and Measurement, the Decision on the Method of Improving the Compliance of the Croatian National Bank Subordinate Legislation with the International Accounting Standards was also issued.

Additionally, considerable efforts were made within the Bank Supervision Area in the following operating segments:

- improvement of transparency in informing the public about the conditions in the system (the Banks Bulletin publication was started),
- internal organization and procedure improvement (internal reorganization was carried out and supervisory function operating procedures were prepared),
- development of the data base and information system for the banking system financial report and overall banking system analysis,
- further improvement in the application of the CAMELS method in the area of bank supervision in general,
- setting up the Central Banks' Records,
- co-operation with other government bodies regarding issues related to the area of bank and savings bank supervision,
- co-operation with government bodies from other countries regarding issues re-

lated to the area of bank and savings bank supervision,

- active participation in projects at the Croatian National Bank level,
- active participation in inter-institutional projects (in the areas related to money laundering and fighting terrorism),
- intensifying activities aimed at employees' professional training.

Employees' Training

For the purpose of the continuous training of all the employees of the Area, there were intensified efforts in 2001 aimed at internal training within the Bank Supervision Area; professional training was also provided in co-operation with other organizational units of the Croatian National Bank. In 2001, Bank Supervision Area employees attended various seminars and other forms of training in the country (organized by reputable Croatian institutions in the area of banking and finance) and abroad (organized by BIS, Financial Stability Institute, IMF, JVI, Ministry for the European Integration and several European central banks). In addition, 11 employees of the Area were provided with professional training in the United States.

The intensity of activities and the dynamics of the further development of the supervisory function largely depend on the available resources but also on general conditions in the environment, particularly the ability to apply the new regulatory framework modeled on that in the developed countries.

3.8.3 Guidelines for Supervisory Function Development

Prudential bank supervision is not the only pillar of banking system financial stability and it cannot be expected to perform the tasks that are within the authority and jurisdiction of other bodies (management and supervisory boards), other companies (auditing companies) and institutions (courts, etc.). However, we believe that further efforts are required concerning its development so that it could become a source of stability for the other pillars on which the banking system stability rests.

The further development and strengthening of prudential bank supervision is one of the Croatian National Bank's long-term strategic goals. The guidelines for the development of the supervisory function in the near future are the following:

- regulatory improvement, i.e. enactment of the new subordinate legislation pursuant to the new Banking Law;
- continuation of efforts to issue written rules and procedures;
- performing supervision on the consolidated basis;
- strengthening co-operation with other financial supervisory authorities;

- strengthening co-operation with foreign supervisory authorities;
- strengthening co-operation with external bank auditors;
- continuous training of employees;
- strengthening bank operation transparency.

3.9 Riječka banka d.d., Rijeka

Following the resolution of the second banking crisis, the banking system of the Republic of Croatia has consolidated and strengthened considerably over the past few years, regaining public confidence.

In contrast to inadequate credit risk management as the most frequent cause of bank problems, fraud in foreign exchange operations, i.e. in activities related to international market transactions, was the cause of problems in Riječka banka d.d., Rijeka (hereinafter: the Bank). This was the first time that operational risk, i.e. the risk of fraud, had caused problems in a Croatian bank.

This case differs from the others not only in the cause of the operational problems but also in the promptness with which measures were taken to stabilize the Bank's condition.

3.9.1 Bank Operation

Following its rehabilitation, the Bank was privatized in June 2000 through international tender. Bayerische Landesbank Girozentrale of Munich became the majority shareholder with 59.9% of the share capital, the State Agency for Deposit Insurance and Bank Rehabilitation retained 25.1%, and other shareholders retained the remaining 15%. Bayerische Landesbank Girozentrale was interested in expanding its operation in the banking market of the Republic of Croatia.

The Bank is licensed to perform all types of banking operations and belongs to the group of larger banks with a usual organizational structure. According to the functional principal, i.e. the operations that it performs, it is divided into areas whose managing directors are responsible for their work to the Bank's management board (hereinafter: Management Board).

With the approval of the Supervisory Board, the Bank adopted several by-laws regulating its operation. Special rulebooks define the methods, authorizations and procedures for individual activities. Additionally, the Bank adjusted its operation to the ISO 9001 quality system.

Over the last three years, the Bank has continuously participated in activities aimed at increasing its market share by improving and expanding the quality and volume of its services and by expanding its operating network. At the same time, the Bank has improved its credit risk management, channeling funds into safer placements in order to reduce repayment risk. A large amount of funds was thus placed in liquidity reserves, i.e. high quality short-term securities: Ministry of Finance treasury bills and CNB bills. According to the received data, the Bank's performance was stable and profitable, and there were no specific indications of any problems or any irregular or illegal activities. The fraudulent activities, as will be shown later, were deftly covered up in the bookkeeping records.

The examinations and control of the Bank's overall performance were carried out for different purposes. Foreign consultants (Delloitte Touche, HSBC and Norton Rose) were engaged in the privatization project and the sale of the Bank through international tender, and detailed joint and individual controls (due diligence) were performed, ensuring potential buyers the conditions for obtaining data on the Bank's operations. Until 1999, the Bank's financial reports were audited by PWC; following the entry of the new owner, a new audit company was appointed – KPMG. The internal control and audit performed regular, special and additional examinations of the Bank's performance.

3.9.2 Support to the Bank

In March 1999, the Croatian National Bank received an anonymous complaint about irregular activities in the Bank's foreign exchange operations.

Since the Croatian National Bank did not have reliable information that fraud had been committed and the complaint implied that the Management Board had not been aware of the existence of possible irregular activities, the CNB notified the Management Board thereof, requesting a written statement from the Board.

The suspicion of fraud was averted since the Management Board reported that it had taken measures for the establishment of the internal control mechanisms and performance monitoring systems. Additionally, for the purpose of control and daily monitoring of transactions, organizational changes were made so that the front office was strictly separated from the back office. Internal control regularly inspected all operations, including operations in the foreign exchange market, but irregular operations were not identified. Nor did the external auditor detect irregular operations.

The Management Board statement was not contested by the external auditor's report drawn up in accordance with the Croatian National Bank's Decision on the Form and Minimum Scope and Content of an Audit and Reports on Audits of Banks, which assessed as appropriate the Bank's internal control system and the form and scope of the internal control task performance, confirming the correctness and systemic and systematic operation of internal audit as well as compliance with the adequate principles and standards.

In mid-2000, the Croatian National Bank carried out an on-site examination of the

Bank's performance. The on-site examination encompassed the following areas: asset quality, earnings, capital, sources of funds and liquidity, the implementation of monetary and foreign exchange policy measures, internal control and audit, and Bank organization. Apart from establishing the need for forming additional specific reserves for potential losses that might arise from exposure to three Bank clients, amounting to HRK 1.6m, and a violation of the maximum exposure to a single borrower, the on-site examination did not identify other material irregular activities. The Bank's Supervisory Board was warned of the inappropriate organization of internal control and internal audit, whereby the operations and authorities of internal control and internal audit overlap, and of the need for the functional and organizational separation of these functions.

In January 2002, the Croatian National Bank received a second anonymous complaint, also related to the Bank's irregular activities in foreign exchange operations. In order to obtain more information, the Croatian National Bank again requested the Management Board to provide a written statement and to re-examine this part of the Bank's operations as well as its internal control systems, after which an on-site examination of the Bank's operation was to take place.

On 8 February 2002, the Bank's Management Board stated that no irregular activities had been identified in the regular and special controls carried out for this purpose, and confirmed that all the transactions in the foreign exchange market were conducted in a regular manner. It also stated that an external audit was in progress that had not detected any irregularities in the foreign exchange operations. In view of the information received, the Management Board had been informed of possible irregular activities and their potential effect on the financial reports, and, if it suspected the existence of irregularities, it should have immediately notified the external auditor.

On 10 March 2002, the Management Board notified the Croatian National Bank that the Bank's internal control had detected fraudulent activities related to foreign exchange market transactions, estimating the losses at between USD 83m and USD 103m. On 12 March 2002, auditors KPMG notified the Croatian National Bank of the withdrawal of their audit report for 2001. On 13 March 2002, the Croatian National Bank was informed that Bayerische Landesbank Girozentrale did not intend to solve the problems in the Bank by recapitalization. When the Bank's problems were announced in the media, households began to withdraw their savings deposits and legal persons began to withdraw part of their deposits.

The Ministry of the Interior launched an investigation to identify the perpetrators, accomplices, motives and methods of these fraudulent activities. Additionally, the Croatian National Bank began a special on-site examination of the Bank's operation in order to determine the scope of the detrimental activities and their effect on the Bank's financial performance.

The Croatian National Bank was immediately engaged in the process of solving the Bank's problems in order to fulfil its primary tasks: maintaining banking system stability and public confidence in the banking system, protecting depositors' interests and protecting the soundness and stability of the banking system.

At first, the Bank managed to settle its obligations with its own liquid funds, but, due to the increasing withdrawal of savings deposits, it was soon forced to turn to secondary sources of liquidity, i.e. that part of the Bank's assets that can be easily converted into cash[7]. The amount of Bank investment in CNB bills and treasury bills had constantly been growing, reaching HRK 1.2bn at the end of 2001. These funds, placed in low-risk government and central bank debt securities, represented the basis for the Bank support.

Since, excluding its fraudulent activities, the Bank was sound and had a quality portfolio, it was allowed early redemption of CNB bills in the amount of HRK 317m to help it overcome the operational difficulties that had arisen. In addition, a short-term liquidity loan of HKR 408m was granted on the basis of pledged securities.

However, there was a continued run on deposits and a continued threat to liquidity. Between 28 February and 19 April 2002, deposits of a total of HRK 2,593m were withdrawn from the Bank, of which HRK 2,135 were household deposits. Therefore, the Bank was allowed to make additional borrowing, if needed, from the Croatian National Bank on the basis of pledged securities, up to the amount of HRK 863.7m.

Following the public announcement of the problems, the Bank was excluded from the Europay international card system, as a result of which the authorization of cards issued by the Bank was suspended. The Croatian National Bank immediately intensified its efforts in providing assistance to the Bank with the result that the Bank, with the support of a Croatian government guarantee, was reintegrated into the international card system. This prevented a possible adverse effect on the overall banking system stability of Croatia.

After the chairman of the Management Board had withdrawn his savings deposit, which additionally undermined public confidence and could have caused even stronger pressures for deposit withdrawal, the Croatian National Bank agreed to appoint its own experts to the new Management Board.

The awareness that the media reports on the Bank might also undermine confidence in other banks encouraged six Croatian banks, members of the Croatian Bank Association, to grant the Bank a syndicated loan of HRK 1.2bn, which sufficed to settle the Bank's liabilities toward the Croatian National Bank.

The majority owner expressed unwillingness to recapitalize the Bank, when discussing possible solutions to the Bank's current problems and future prospects, Therefore an agreement was reached between Bayerische Landesbank Girozentrale and the State Agency for Deposit Insurance and Bank Rehabilitation by which the latter acquired the former's 59.9% share for the symbolic amount of USD 1, thus becoming the owner of 85% of the Bank's shares.

7 See Chapter 2.2 for details.

Given the circumstances and the threat of systemic risk, the government acted promptly, effectively and in the only way possible when deciding to purchase the share in the Bank. This prompt action by the government prevented the potential adverse effects that, by triggering the deposit insurance mechanism or causing the domino effect, could have undermined confidence in the banks and damaged the government budget.

The government, deeming recapitalization to be necessary for the Bank's future stable and safe performance and taking into account the additional expenses for the government budget that this would incur, decided to sell its shareholding.

The great interest of other banks in purchasing the Bank confirmed that the Bank is sound, when its fraudulent activities are excluded. On the basis of the received bids, the State Agency for Deposit Insurance and Bank Rehabilitation decided to sell its 85% shareholding in the Bank to Erste Bank of Vienna, which offered EUR 55m for the shares and EUR 100m for the recapitalization. This would generate revenues for the government budget, considering the circumstances under which the shares had been acquired.

The Croatian National Bank and the Government of the Republic of Croatia had acted promptly:

1) by offering public support to the Bank;
2) by providing the required liquid funds for the Bank;
3) by promptly settling the ownership relations with the previous owner;
4) by appointing the Croatian National Bank's experts to the Management Board; and
5) by assisting in the Bank's reintegration into the Europay card system;

The above activities enabled the maintenance of banking system stability and confidence in the banking system, the protection of the interests of the Bank's depositors, and the protection of the soundness and stability of the overall banking system. Due to the co-operation between the Croatian government and the Croatian National Bank and the co-ordination of their activities, the Bank's condition has stabilized.

3.9.3 Fraudulent Transactions

Parallel to its active participation in the process of solving the Bank's problems, the Croatian National Bank began an on-site supervision of the Bank's operations on 16 March 2002 with the aim of establishing the real scope of the fraudulent transactions in the foreign exchange market.

Foreign Exchange Operations Structure

The Bank had by-laws for the individual parts of its operations that regulated employees' authorities and methods of performing particular tasks, methods of delegating authority, restrictions on particular activities, and quality procedures in accordance with the ISO standard on quality performance.

The operations related to transactions in the foreign exchange market are thus regulated in the appropriate manner. The Bank's by-laws regulate individual authorities and restrictions on performing particular activities, as well as periodical reporting requirements to the Management. For every foreign exchange transaction, the procedure sequence, documentation reference, responsibilities and authorities are in compliance with the ISO procedures.

The foreign exchange transactions are conducted in the Foreign Exchange Market Division, an organizational unit within the Foreign Exchange Asset Department and Asset Management Area.

The Bank's by-laws set out the delegation of the individual authorities of the Area Managing Director and the restrictions in foreign exchange operations on approving short-term foreign exchange deposits, purchasing and selling foreign exchange in domestic and foreign markets, and exchange arbitrage operations in particular. The Director of the Foreign Exchange Asset Department, the Head of the Foreign Exchange Market Division (chief dealer) and employees of the Foreign Exchange Market Division are thus authorized to approve short-term foreign exchange deposits and the purchase and sale of foreign exchange and cash of a value of up to 10% of the Bank's risk-based capital. The Director of the Foreign Exchange Asset Department and the Head of the Foreign Exchange Market Division (chief dealer) are authorized for exchange arbitrage operations of a value of up to 10% of the Bank's risk-based capital, whereas the amount for employees of the Foreign Exchange Market Division may not exceed 2% of the risk-based capital. All these persons are obliged to report to the Area Managing Director on their decisions every 15 days.

A special by-law regulates that the Head of the Foreign Exchange Market Division (chief dealer) performs exchange arbitrage operations under the following restrictions: the Bank's total exposure may at no time exceed USD 50m, and the amount of an individual transaction may not exceed 10% of the risk-based capital in the case of the chief dealer or 2% of the risk-based capital in the case of all other dealers. Additionally, all positions opened during the day must be closed at the end of the same day. An individual dealer is permitted to have, at any time, open positions totaling USD 5m, provided that each individual transaction does not exceed 2% of the risk-based capital.

The Head of the Foreign Exchange Market Division (chief dealer), the Asset Management Area Managing Director, the Foreign Exchange Asset Department Director and the competent Management Board member must at all times have at their disposal the information on the current balance of income and expenditures arising from daily transactions and on bank exposure. Reports on the foreign exchange market operations are presented to the Management Board every 15 days.

The Bank established the ISO quality procedures for the above operations, which determine the procedure sequence, documentation reference, responsibilities and authorities, and procedure details.

Control and Audit

The Bank's internal control and audit have continuously performed regular, special and additional examinations during which no irregular activities were identified in this part of the Bank's operations.

Internal auditors have regularly expressed their opinion that the Bank's financial reports provide a true and fair account of the Bank's performance.

The on-site examination findings of mid-2000 found the incorrect classification of three clients and made recommendations concerning the organizational and functional separation of internal control from internal audit. Apart from that, it did not report any materially irregular activities in the Bank's performance.

Current On-Site Examination Findings Related to the Fraudulent Activities

A few days following the start of the on-site examination, it was clear that the entire procedure for determining the real financial position of the Bank would be prolonged and difficult. It was found that the prescribed procedures for foreign exchange operations were inconsistently applied and that there was a lack of procedure compliance control. This had created room for possible fraud, which had been systematically committed over several years. The fraud had been deftly covered up by forged documentation and facilitated by the inconsistent application of the envisaged control procedures.

The Bank's chief dealer had engaged in detrimental activities related to transactions in international money and capital markets, and exchange arbitrage in particular. In order to clarify these fraudulent activities, a short overview of the method of conducting these transactions follows.

In addition to the standard operations of making foreign exchange time deposits, and purchasing and selling foreign exchange cash and other operations related to its foreign exchange position, the Bank performs exchange arbitrage in the foreign exchange market. Exchange arbitrage may be non-risky or risky, i.e. speculative.

Non-risky exchange arbitrage includes foreign exchange purchasing and selling operations with smaller Croatian banks that do not have access to international foreign exchange markets and thus perform these operations through the Bank. For example, a smaller bank wants to buy German marks from the Bank in exchange for US dollars. The Bank then contacts a foreign bank, buys German marks for US dollars, and sells these German marks to the former bank for its US dollars at a rate that is more favorable for the Bank. The Bank then closes its position and earns a profit. These are relatively tight-margin transactions, and losses cannot be incurred in general.

Risky (speculative) exchange arbitrage includes transactions in which one currency, e.g. X, is purchased for another currency, e.g. Y, in the expectation that the value of currency X, measured in currency Y units, will rise, and that currency X will be sold during the day, earning a certain profit. For example, a dealer decides to buy USD 1m and pays DEM 2m for them (exchange rate: USD/DEM 2.00). The exchange rate increases to DEM 2.05 for USD 1 during the day, and the dealer decides to sell USD 1m, which is now worth DEM 2.05m. The dealer thus earns DEM 0.05m as a result of a favorable change in the USD/DEM exchange rate. The transaction technology is identical to non-risky arbitrage, apart from a single difference – the dealer does not have a bank on the other side to which he will sell the purchased currency at a definitely more favorable exchange rate but rather speculates that the exchange rate will move in the desired direction during the day and that he will close out the open position with a profit. Accordingly, in risky differential arbitrage there is the possibility of both profit and loss.

Additionally, if a dealer, when opening a position, buys dollars for marks from one bank, he is not obliged to close the position, i.e. to sell dollars for marks, with the same bank but may do this with another bank.

The Bank's chief dealer, trying to earn a profit in foreign exchange markets, incurred losses that were not entered in the Bank's bookkeeping records. The losses were covered up in several ways:

- by unauthorized borrowing of funds in the form of received deposits from foreign banks,
- by recording nonexistent deposits in bank assets,
- by contracting exchange arbitrage and not fulfilling the obligations arising from them,
- by recording exchange arbitrage at an incorrect value date.

The chief dealer, contrary to every business practice in foreign exchange markets, simultaneously traded, engaged in transfers of funds through SWIFT, and ordered false or incorrect entry of these transactions in the accounting records.

The exact amount of losses incurred from his transactions will be determined only when details of all the transactions entered in the Bank's accounting records are established, starting from overvalued foreign deposits in assets, a large number of borrowed deposits that were not recorded in the bank's liabilities, and a large number of transactions in which the Bank's chief dealer purchased and sold one currency for another without fully reporting to the Bank about them.

The investigation carried out by the Bank revealed that all the suspicious transactions were conducted in the back office and with the same password.

Complaints about the Bank's unsettled obligations were frequently received, but no adequate action was taken. The SWIFT messages containing complaints or that were for any reason unclear to the back office/accounting department employees were forwarded for clarification to the chief dealer.

According to the currently available data, a total loss of USD 98m was incurred in the described transactions:

- a loss of USD 38.95m in artificial, nonexistent deposits;
- a loss of USD 23.6m in borrowed deposits of which no-one had any knowledge;
- a loss of USD 9.9m in open foreign exchange transactions;
- a loss of USD 1.17m in two margin accounts,
- a loss of USD 24.3m in 5 open foreign exchange arbitrages.

The chief dealer's knowledge of the internal control and reporting system in the Bank allowed him to perform operations that were incorrectly recorded and which exposed the Bank to high risks. The incurred losses were covered up by failure to enter or false entry in the Bank's bookkeeping records and financial reports, as a consequence of the inadequate implementation of the envisaged control mechanisms.

These are criminal activities that caused serious losses for the Bank. Unfortunately, the Bank's owner was unwilling to recapitalize the Bank and so this problem could not be solved "silently", as is common practice in the banking world in order to reduce the potential adverse effects on banking system stability. However, the Croatian government and the Croatian National Bank took prompt measures, curbing the downward trends and allowing the Bank's condition to stabilize, which prevented the problem from spreading. In addition, the problem was solved in a way that incurred no additional expenses for the government budget and also protected the Bank's depositors.

The investigation into the fraudulent activities is continuing: on the part of the Ministry of the Interior in order to identify the real perpetrators, accomplices, motives and methods of the criminal acts, and on the part of the Croatian National Bank in order to determine the scope of these detrimental activities and their impact on the Bank's financial performance.

4

Payment Operations

Activities focusing on the further implementation of payment system reform in the country continued in 2001. They included the enactment of the necessary legislation and regulations that regulate the reform and the pursuance of the specific operative activities connected with the reform. In addition to these core activities, supervision was conducted over the institutions authorized to perform payment operations (Financial Agency, FINA and Croatian Post).

4.1 National Clearing System (NCS)

The National Clearing System became operative on 5 February 2001. It is the second interbank payment system in the country, after the Croatian Large Value Payment System (CLVPS) introduced in April 1999. The NCS is an interbank, small payment system, or a system for the settlement of all interbank payment transactions that are not conducted through the CLVPS. Before it became operative, all accounts of banks/savings banks were transferred from the Institute for Payment Transactions (hereinafter: FINA) to the Croatian National Bank. By definition, the NCS is a system for the settlement of interbank payment transactions on the net multilateral principle. Settlement on the net multilateral principle is settlement that is performed continuously during the whole settlement day, whereby the payments debited and credited to banks' clearing accounts with the NCS are mutually cleared (netted). The result of such settlement is a corresponding net position in a bank's clearing account with the NCS. The net position in a bank's clearing account with the NCS has a cover or limit that the bank determines before the beginning of each settlement day in the NCS by transferring funds from its clearing account to its cover account.

Each bank's net position in the NCS is transferred at the end of the settlement day to its settlement account with the CNB for final settlement. Since the method for the determination of the limit (the guaranteed limit) is defined, settlement in a bank's account is ensured for all payments cleared through the NCS.

The launching of the NCS was the final step in providing the infrastructure (that includes the existing CLVPS) for the performance of interbank payment transactions in accordance with the provisions of the new Law on the National Payment System. This infrastructure, along with the formation of the Unified Register of Business Entities' Accounts, created the prerequisite for keeping business entities' accounts with banks.

This system for the settlement of interbank payment transaction is in compliance with the BIS recommendations for the development of domestic payment systems. In addition, it finally made it impossible to perform cashless payment transactions into and from clients' accounts when there is no adequate cover for their execution with the depository bank.

As a result, the banks were enabled to improve their management of daily liquidity, and the CNB was enabled to improve its management and monitoring of the daily liquidity of the banking system as a whole.

4.2 The Transfer of Payment Operations related to Business Entities' Accounts to Banks

At its meeting in July 2001, the Council of the Croatian National Bank granted approval to 9 banks for keeping accounts of business entities in private and majority private ownership. These banks were allowed to begin opening and keeping business entities' accounts as of 15 October 2001.

The precondition for obtaining these approvals by the CNB was the submission of an application form whose content was determined by the CNB decision. By submitting it, banks demonstrated their ability to perform payment operations in accordance with the provisions of the Law on the National Payment System and the regulations enacted on the basis thereof. To date, 31 banks have been granted approval for keeping accounts of business entities.

Although the approvals were based on the provisions of the old Law on the National Payment System, they should be viewed in the context of preparations for the implementation of the new Law on the National Payment System. That is, they gave the banks to opportunity, before the enactment of the new Law, to meet the demanding technical and operative preconditions for the performance of payment operations. However, it should be noted that only about 2000 accounts of business entities were opened with banks by 1 February 2001, i.e. before the implementation of the provisions of particular articles of the new Law on the National Payment System.

4.3 Unified Register of Business Entities' Accounts (URBEA)

The Unified Register of Business Entities' Accounts keeps a record of all accounts that business entities open with banks and the CNB for their regular operations. Each business entity is assigned an identification number by the CBS, so it is possible to locate every account opened by one business entity with banks.

The URBEA became operative on 15 October 2001. All banks, savings banks and the FINA were required to submit data on the business entities' accounts kept with them. Communication with the database in the URBEA is performed via Internet interface. The formation of the URBEA in the CNB created a unique database on all business entities in the country. It enabled the implementation of the Decision that regulates the execution of payment orders from the funds in payer's accounts kept with different banks. In addition, the procedures are in place for blocking all the business entity's accounts in the case that there are registered arrears.

4.4 Enforcement of Regulations related to the Payment System Reform

The changes that took place in 2001 necessitated the preparation of new legislation and regulations.

The following regulations were introduced in 2001:

1) Decision on the Unified Register of Business Entities' Accounts (official gazette *Narodne novine*, Nos. 68/2001 and 74/2001),
2) Decision on the Terms and Conditions for Opening Business Entities' Accounts with Authorized Institutions (official gazette *Narodne novine*, No. 68/2001),
3) Decision on the Keeping and the Content of the Register of Business Entities' Accounts with Authorized Institutions (official gazette *Narodne novine*, No. 68/2001), and
4) Decision on the Execution of Payment Orders from the Funds in the Payer's Accounts Kept with Different Authorized Institutions (official gazette *Narodne novine,* Nos. 68/2001 and 74/2001).

4.5 The New Law on the National Payment System

The enactment of the new Law on the National Payment System at the end of 2001 was the final step in providing the legal framework for the reform of the payment system in the country. Its basic characteristics are:

- the CNB and banks are the payment transaction agents,
- the accounts of the participants in the payment system are opened and kept by banks,
- the accounts of banks and the accounts of the Republic of Croatia are opened and managed by the CNB,
- a business entity may open an account with any bank but it must specify the main account,
- a bank may not open an account for a blocked business entity,
- as of 1 February 2001, all banks may open and manage the accounts of juridical persons in the country (prior approval by the CNB is not required),
- with the exception of a few articles, the Law on the National Payment System is applied as of 1 April 2002.

4.6 Operating Activities and Procedures related to the Payment System Reform in the Country

The introduction of the NCS and URBEA required an integral technological framework, linkage with all payment system participants and the creation of the necessary test environment before running live.

During the year, supervision was exercised over the institutions authorized to perform payment operations (FINA and Croatian Post); it included direct oversight and numerous contacts with these institutions.

Direct oversight was performed in six operating units of the FINA and ten operating units of Croatian Post.

4.6.1 Improvement of Existing Systems

The activities carried out in 2001 included the improvement of existing solutions in the national payment system. Several technological modifications were made in the CLVPS:

- ❑ CAS 2.50, the new version of CAS, was installed in the CLVPS within the regular annual program upgrade,
- ❑ the option to use the new payment message MT 103 in the CLVPS was introduced,
- ❑ following the NCS launching, the application of the File Account Transfer (FAT) option began, which enables the partial automatization of CLVPS operations,
- ❑ SWIFT Alliance Access 4.1, the new version of the SWIFT application, was installed.

Developments at the Beginning of 2002

These changes in the payment system had been carried out within the framework of the old Law on the National Payment System, and the CNB was obliged to adjust the existing regulations to the new Law on the National Payment System. Acting in accordance with its authorities, the CNB passed numerous regulations (official gazette *Narodne novine*, No. 14/2002) with the aim of adjusting the performance of the new payment system operations to the new Law. The application of these regulations was set for 1 April 2002.

The new Law prescribes the terms and methods of cash payments whereby cash is supplied by the CNB to banks and by banks to their clients. In accordance with this, the

CNB passed the Decision on Supplying Banks with Cash (official gazette *Narodne novine*, No. 22/2002).

This Decision set forth the establishment of cash centers in the existing operating units of the FINA for supplying banks with cash. Their number is to be reduced by the end of the current year (probably 22). The transfer of funds from the settlement account with the CLVPS to the cash account is a condition that the bank has to meet in order to withdraw the cash in the cash center. The funds kept in this account are an integral part of the bank settlement account.

At the same time, Croatian Post was deprived of the right to build cash reserves in the case that there is no cover in the account, and the obligation to finance Croatian Post with cash reserves was taken over by Hrvatska poštanska banka.

This phase of the payment system reform was considered the most challenging for both the payment transaction agents (banks and the CNB) and the payments system participants. The numerous changes that were introduced include:

- payment system participants' accounts with the FINA were closed and corresponding accounts were opened with banks. More than 300,000 payment system participants had their accounts with the FINA.
- a new method of designing the giro account in the payment system was introduced within the procedure of opening business entities' accounts with banks. All deposit accounts for government budget revenues, obligatory contributions and revenues for financing other public needs were changed accordingly.

Finally, we would like to note that all the activities carried out in the course of national payment system reform can be considered very satisfactory, especially with respect to the time-limits for the implementation of the new Law on the National Payment System.

Some problems arose, mostly related to the closing of participants' accounts held with the FINA and the transfer of the funds in these accounts to a bank account, so the CNB supplied each bank with recommendations on how to overcome these problems. These recommendations enabled the banks to quickly solve the problem transactions.

In addition, it was considered that the closure of such a large number of accounts of business entities would pose a certain risk to the functioning of the whole system. Therefore, the time-limit for closing accounts held with the FINA was extended in consultation with the Ministry of Finance. This also reduced the pressure on the banks.

Although the course of payment system reform has been judged satisfactory so far, one should bear in mind that this is the first time that banks perform payment operations and they need time to adjust.

5

International Relations

5.1 Relations between the Republic of Croatia and the International Monetary Fund (IMF)

Co-operation with the International Monetary Fund concerning information exchange and IMF support for the Republic of Croatia's economic and financial policy continued during 2001. Within the framework of this co-operation, numerous contacts were made with experts from the International Monetary Fund, both through this institution's representation office and through repeated IMF visits to Croatia.

In addition to the regular annual consultation related to Article IV of the Articles of Agreement of the IMF held in March 2001, there were especially intensive contacts with the IMF related to preparations for and implementation of a new Stand-By Arrangement, which was approved on 19 March 2001.

In 2001, in contrast to previous years, representatives of the Croatian National Bank (Governor and Deputy Governor), acting in the name of the Republic of Croatia, directly participated in the work of IMF management bodies, mostly through voting without meeting. The regular Annual Meeting of the Board of Governors of the International Monetary Fund and the World Bank, which was to be held in Washington at end-September 2001, was first postponed and then cancelled owing to the security situation related to terrorist attacks on the USA on 11 September 2001. The need to formulate a joint economic policy and respond to circumstances arising from the September events in the USA led to the decision to hold the meeting of the International Monetary Fund and the Development Committee of the World Bank in Ottawa on 17 November 2001. Representatives of the Croatian National Bank did not participate in the meeting because its topics and the number of participants were limited. Following existing practices, executive directors of the IMF Dutch Constituency and the World Bank represented the interests of the Republic of Croatia at the meeting.

In addition to direct voting, the interests of the Republic of Croatia in the IMF continued to be represented through the IMF Constituency which, together with Croatia, includes 11 countries and is headed by Mr. J. de Beaufort Wijnholds, the Dutch representative, as the Executive Director. In mid-2001, pursuant to the Constituency's operating rules, the Croatian National Bank appointed its representative, Mr. Michael Faulend, to the position of Assistant to the Executive Director of the IMF Dutch Constituency for a two-year period.

5.1.1 Stand-By Arrangement

The Executive Board of the IMF approved a 14-month arrangement in the amount of SDR 200m on 19 March 2001, which expires on 18 May 2002. In view of Croatia's relatively high level of international reserves, favorable balance of payments outlook and good standing in the international capital markets, this arrangement was concluded as "precautionary", i.e. the funds approved are not purchased but may be used if the need arises.

Under the arrangement, the Republic of Croatia committed itself to cut the budget deficit, while maintaining price stability based on the stable exchange rate of the domestic currency. The economic program for 2001 included, among others, a reduction in the consolidated central government deficit and structural reforms aimed at economic liberalization, restructuring and privatization.

In November 2001, the Executive Board of the IMF stated that, despite certain difficulties, Croatia's economic indicators were generally favorable and approved the content of the documents submitted to the IMF, thus confirming the completion of the first review under the arrangement.

Negotiations on the second review under the arrangement began at end-November 2001. At that time, a letter of intent was written that describes the economic policies the Croatian authorities intend to pursue during the remaining period of the arrangement. The letter emphasized that the program objectives for 2001 relating to economic growth, inflation and international reserves had been exceeded.

At its session held on 29 March 2002, the Executive Board of the IMF adopted the content of the documents submitted to the IMF, thus confirming the completion of the second, and final, review under the arrangement.

It should be noted that this was the first arrangement with the IMF that was completed successfully and within the programmed period.

All documents relating to the stand-by arrangement have been regularly published on the web sites of the CNB and IMF, in line with the IMF projects aimed at increasing the transparency of its activities and the activities of its member countries.

5.1.2 Financial Sector Assessment Program

In their joint effort to strengthen the structure of the international financial system, the IMF and the World Bank launched a project in 1999 entitled the Financial Sector Assessment Program (FSAP). The purpose of this program is to assess the financial sectors of member countries, to enable the early detection of weaknesses in their financial systems, to ensure co-ordinated and efficacious dialogue with the national governments and to identify the development and technical assistance needs of member countries. The Republic of Croatia applied to join the project in November 2000. The preliminary FSAP mission visited Croatia in April 2001, followed by the main mission in September 2001. The mission emphasized the successful maintenance of macroeconomic and banking sector stability but also the need to further improve the supervision of all parts of the financial sector and to implement appropriate structural reforms. The mission's final report is expected to be released in 2002.

5.1.3 Contribution of the Republic of Croatia to Financing the Initiative to Reduce Poverty

Within the IMF and World Bank activities, the CNB joined the initiative of these two institutions aimed at reducing poverty – the HIPC initiative (Heavily Indebted Poor Countries) and the Poverty Reduction and Growth Facility (PRGS). The IMF and the World Bank conduct operations aimed at poverty reduction and growth increase in 77 of the poorest countries in the world. The basic condition for receiving the PRGF is low income per capita and the suitability for receiving International Development Association (IDA) facilities under very favorable conditions, which means a per capita income under USD 885 in 1999. The basic conditions for the HIPC status are: a) suitability for receiving IDA and PRGF facilities; b) unsustainable public debt even after the activation of traditional debt reduction mechanisms; and c) implementation of strategies aimed at poverty reduction and sustainable economic growth.

At the IMF's request, and in accordance with the Resolutions of the Government of the Republic of Croatia of 28 June 1996 and 7 October 1999, the Croatian contribution consists of an interest-free loan of SDR 519,161, the amount allocated to the SCA-2 Account. The funds in this account, opened by the IMF for the purpose of financing the HIPC Initiative, are collected from the member countries that paid increased charges and fees on the IMF financial facilities or that received reduced interest on their deposits with the IMF. The agreement on an interest-free loan maturing in 18 years was signed by the IMF and the CNB, which is authorized to conduct all operations and transactions in the name of the Republic of Croatia under the IMF Articles of Association. It came into force on 9 April 2001.

5.1.4 Technical Assistance of the International Monetary Fund

In 2001, several meetings with IMF representatives were held at the Croatian National Bank in connection with technical assistance in the areas of accounting, monetary and financial statistics, Special Data Dissemination Standard and monetary policy instruments.

In addition, as in the previous years, the IMF provided technical assistance to other institutions in the Republic of Croatia.

5.1.5 Financial Transactions

As the fiscal agent of the Republic of Croatia and a depository of the International Monetary Fund, the Croatian National Bank keeps the deposit accounts of the International Monetary Fund and regularly services the obligations based on the arrangements that the Republic of Croatia has concluded with the IMF: the Systemic Transformation Facility (STF), SDR 130.80m, approved in 1994 simultaneously with the stand-by arrangement, and the Extended Fund Facility (EFF), SDR 353.16m, approved in 1997. During 2001, SDR 5.35m in interest was paid on these arrangements: the principal payments on the STF and EFF arrangements were SDR 21.80m and SDR 2.39m respectively, with an additional SDR 0.5m paid in charges on the stand-by arrangement. As a member of the Special Drawing Rights Department (of the IMF), Croatia has regularly repaid its obligations based on the inherited obligations related to the allocation of the special drawing rights. During 2001, SDR 1.70m was paid on this basis.

Since the Republic of Croatia's admission as an IMF member, all its obligations towards the IMF have been regularly fulfilled in accordance with existing legal provisions.

Balance on 31 December 2001		
GENERAL RESOURCES ACCOUNT	SDR (million)	% Quota
Quota	365.10	100.00
IMF holdings	462.17	126.59
SDR DEPARTMENT	SDR (million)	% net cum. al.
Net cumulative allocation	44.21	100.00
Holdings of Croatia	85.49	193.40
LIABILITIES PAID IN 2001	SDR (million)	–
Repayment of principal – STF arrangement	21.80	–
Repayment of principal – EFF arrangement	2.39	–
Interest payments on all arrangements	5.35	–
Charges on the stand-by arrangement	0.50	–
SDR Department membership fee	0.01	–
Net cumulative allocation costs	1.70	–

Note: The value of special drawing rights (SDRs) is the weighted average of the basket of leading world currencies, which is revised every five years. As of 1 January 2001, the currency basket is composed of the American dollar (45%), the euro (29%), the Japanese yen (15%) and the pound sterling (11%).

5.2 Activities of the CNB concerning the Relations between the Republic of Croatia and International Development Banks – the World Bank Group (IBRD, IFC, IDA, MIGA), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IDB)

a) The following laws regulate the Republic of Croatia's membership in the World Bank Group, European Bank for Reconstruction and Development and Inter-American Development Bank: the Law on Accepting Membership of the Republic of Croatia in the International Monetary Fund and Other International Financial Organizations on the Basis of Succession (official gazette *Narodne novine*, No. 89/1992), the Law on Accepting Membership of the Republic of Croatia in the European Bank for Reconstruction and Development (official gazette *Narodne novine*, No. 25/1993) and the Law on Accepting Membership of the Republic of Croatia in the Inter-American Development Bank (official gazette *Narodne novine*, No. 94/1993). Under these laws, the Ministry of Finance of the Republic of Croatia is the competent authority for co-operation with the World Bank Group, the European Bank for Reconstruction and Development and the Inter-American Development Bank, and is authorized to perform all operations and transactions in the name of the Republic of Croatia that are permissible under these institutions' articles of association. The Croatian National Bank is the depository, i.e. it keeps all deposit accounts owned by these international financial organizations, in the name and on behalf of these financial institutions, and performs financial transactions with these organizations as the payment agent of the state – the Republic of Croatia. During 2001, the Croatian National Bank regularly executed payments for shares for which the Republic of Croatia assumed obligation according to the repayment plan accepted by each international financial organization.

Payments Executed in 2001 on the Basis of Membership of the Republic of Croatia in International Financial Organizations

Name	Amount paid and currency		Balance of promissory notes issued by the Ministry of Finance	
EBRD	EUR	369,000.00	EUR	738,000.00
IDB	a) HRK	1,440,443.67	USD	253,333.00
			(Ordinary capital)	
	b) EUR	205,886.50	DEM[a]	1,583,219.00
			(Fund for special operations – FSO notes)	
IBRD			HRK	89,622,398.73
IDA			HRK	437,666.65
MIGA			USD	202,334.00

[a] Notes are cashed in euro.

b) The use and repayment of the funds pursuant to the Agreement signed on 4 June 1997 between the Republic of Croatia (Ministry of Finance) and the International Bank for Reconstruction and Development on the Enterprise and Financial Sector Adjustment Loan (EFSAL) of DEM 160m (official gazette *Narodne novine*, No. 17/1997, "International Agreements") have been made through a special account at the Croatian National Bank. The loan was used in entirety on 18 December 2001 when the second loan tranche of EUR 40,903,350.49 (DEM 80m) was disbursed.

c) An Agreement between the Republic of Croatia (Ministry of Finance) and the International Bank for Reconstruction and Development on the Structural Adjustment Loan (SAL) (official gazette *Narodne novine*, No. 2, 6 February 2002, "International Agreements") was signed on 5 December 2001. Under the Agreement, the International Bank for Reconstruction and Development approved a USD 202m loan to the Republic of Croatia to support the implementation of economic reforms in Croatia. The repayment term of the loan is 10 years, and the use – withdrawal of funds – is executed through a special account at the CNB. The first tranche of USD 102m was withdrawn on 13 February 2002, and the second tranche depends on the fulfillment of the terms stipulated in the Agreement.

5.3 Relations between the Croatian National Bank and the Bank for International Settlements (BIS)

5.3.1 Membership of the Croatian National Bank in the Bank for International Settlements

Following a series of unsuccessful negotiations on the distribution of the former SFRY's assets held at the BIS, due to lack of co-operation on the Yugoslav side, the Croatian National Bank and the central banks of Bosnia and Herzegovina, Slovenia and Macedonia gained full membership in the BIS in mid-1997 in accordance with a separate decision of the BIS. The decision stipulated that membership was to be based on the subscription of 10 "symbolic" shares, for which USD 122,940.00 was paid. It was agreed that the BIS would repurchase these symbolic shares after the resolution of the succession process. The process of accepting membership in the BIS was regulated by the Decision of the CNB Council made in May 1997 (official gazette *Narodne novine*, No. 54, 27 May 1997).

The issue of the distribution of assets (foreign exchange reserves, gold and shares) which the BIS kept in the name of the former National Bank of Yugoslavia again became topical after the political changes in the Federal Republic of Yugoslavia at end-2000. In this regard, delegations of the five successor states held several meetings at the end of 2000 and the beginning of 2001. The Agreement between the five successor states was initialed at a meeting in Brussels on 10 April 2001. It was later annexed to the Agreement on Succession Issues, which was initialed in May 2001 and signed on 29 June 2001 in Vienna. Under the Agreement, Croatia was entitled to 28.49% of the former SFRY's assets held at the BIS.

On the basis of the above-stated and related comments sent to the BIS by relevant institutions/central banks of the successor states, a resolution was reached at the Extraordinary General Meeting of the BIS on 11 June 2001 which cancelled 8,000 shares of the former National Bank of Yugoslavia (NBY) in the BIS capital. At the same time, a corresponding number of new shares were issued to the central banks of Croatia, Bosnia and Herzegovina, Slovenia, Macedonia and Yugoslavia. The resolution also called for the cancellation of ten symbolic shares previously issued to the central banks of Croatia, Bosnia and Herzegovina, Slovenia and Macedonia.

At its meeting on 4 July 2001, the CNB Council reached the Decision on the Croatian National Bank Membership in the Bank for International Settlements (BIS), Basle. In accordance with the resolution of the Extraordinary General Meeting of the BIS, the decision regulated the continuance of the CNB membership in the BIS by taking over a 28.49% stake (or 2,280 shares) in the total shares of the former NBY in the BIS capital. As previously agreed, the ten symbolic shares were returned to the BIS, which returned to the Croatian National Bank the amount it paid in 1997.

The Republic of Croatia also became entitled to a 28.49% stake in the other assets of the former NBY kept at the BIS, comprising gold and foreign exchange. Pursuant to the Croatian government's Decision on the acceptance of the distribution of the former NBY's assets held at the BIS, which was reached in 1996, these assets (13.127 tons of bullion and USD 8.32m of foreign exchange deposits) were included in the international reserves of the Republic of Croatia on 13 June 2001.

5.3.2 Regular Activities of the Croatian National Bank within the Co-operation with the Bank for International Settlements

In addition to the regular Annual General Meeting and the extraordinary General Meeting on 11 June 2001, an Extraordinary General Meeting of the BIS was held on 8 January 2001 at which a decision was reached that all BIS shares held by private shareholders be repurchased against payment of compensation of CHF 16,000 for each share.

The Governor and other members of the CNB management participated in the work of these meetings and the regular meetings of central bank governors from the BIS member countries, where a number of topical issues in the area of international banking and finance were discussed.

The Croatian National Bank participated in the activities of the Bank for International Settlements aimed at co-ordinating technical assistance provided by the G-10 central banks to the central banks in Central and Eastern Europe. Several bilateral contacts were made, and various forms of technical assistance were agreed on in principle.

Furthermore, CNB representatives participated in the work of regional groups of the Basle Committee on Banking Supervision and the Committee on Payment and Settlement Systems.

A separate and important form of co-operation between the CNB and BIS has been established in the area of international reserves management.

5.4 Co-operation between the Croatian National Bank and Other International Institutions

The Croatian National Bank co-operated with other international financial institutions as well. For instance, representatives of the Japan Center for International Finance (JCIF) and the Institute for International Finance (IIF) visited Croatia again this year in July and November 2001 respectively.

The aim of these visits was to acquire information on Croatia's economic and political situation and to prepare the corresponding reports. These visits and reports are important for Croatia because of the high reputation these institutions and their reports have among the leading Japanese and world banks and funds.

5.5 Activities of the CNB concerning Relations between the Republic of Croatia and the European Union

After the negotiations on the Stabilisation and Association Agreement formally opened in November 2000, representatives of the Croatian National Bank, within their jurisdictions, took part in the work of technical task forces with the aim of providing technical support to the Negotiating Team of the Republic of Croatia. Of the nine technical task forces (I – General political and technical-legal issues; II – Regional co-operation; III – Free movement of goods; IV – Free movement of workers, services and capital; V – Legal harmonization; VI – Co-operation in justice and home affairs; VII – Co-operation policies; VIII – Financial co-operation; IX – Agriculture and fisheries), CNB representatives contributed to the work of task forces IV, VII and VIII. The Ministry for European

Integration was appointed co-ordinator for relations with the European Union at the level of the Republic of Croatia.

The Stabilisation and Association Agreement between the Republic of Croatia and the European Union was initialed in Brussels on 14 May 2001 and signed by the Croatian government in Luxembourg on 29 October 2001. The Agreement will enter into force following its ratification by the Croatian Parliament, the European Parliament and the parliaments of all EU member countries. The Agreement was ratified by the Croatian Parliament and European Parliament on 5 December and 12 December 2001 respectively. Austria, which ratified the Agreement on 21 February 2002, was the first EU member country to do so.

Under the Agreement, one of the main tasks of Croatia is to approximate its legislation to the EU regulations. Even before the Agreement was signed, the CNB strove to incorporate relevant EU regulations concerning its field of competence and always requested the opinion of European Commission experts when preparing draft legislation. Such an opinion was also requested at the beginning of 2001 when the new Law on the Croatian National Bank was enacted.

Representatives of the Bilateral Relations Division of the European Central Bank visited the Croatian National Bank at end-April 2001. They held an economic workshop on the organization and functioning of the European Central Bank as the head institution of the European System of Central Banks.

5.6 International Payment Operations

The scope and dynamics of international payment operations continued growing in 2001. Orders for payments abroad and receivables from abroad were executed daily, both for the purposes of the CNB and the Ministry of Finance (nostro and loro remittances). The inflows to the Croatian National Bank from abroad (loro remittances) resulted from the sale of coins and commemorative coin editions.

International payment operations for the purposes of the Croatian National Bank included a continuous monitoring of international standards related to banking (International Chamber of Commerce – ICC, Incoterms, ISO, etc.).

Related to the changes in SWIFT standards, SWIFT message MT 100 – *Customer Transfer* – has been replaced under the new standards by message MT 103 – *Single Customer Credit Transfer*. The Croatian National Bank started using this message for international payments in May 2001 and was the first bank in Croatia to do so.

5.7 Correspondent Relations with Foreign Banks and Other Financial Institutions

The Croatian National bank monitors economic, financial and political developments in certain countries and regions of special interest for both the Croatian banking system and the economy as a whole.

In 2001, special attention was paid to the candidate countries for EU membership in the first round and to their banking systems. The monitoring of developments in these countries was considered significant for comparison of their economic indicators with those of the Republic of Croatia and for comparing the status of Croatia with the status of these countries as potential EU members. In addition, certain banking groups operating in the Republic of Croatia operate also in other Central European countries, which gives added importance to the analysis of corresponding banking systems.

The collection and monitoring of data, which is divided into four groups, is implemented at two levels, the credit-investment standing of countries (with emphasis on the OECD countries) and the credit-investment standing of financial institutions.

The first group comprises banks (commercial and investment) that are business partners or potential business partners of the Croatian National Bank. These financial institutions receive special attention because monitoring their credit risk, i.e. the risk that their credit standing deteriorates, is an essential part of the whole risk management system. This risk is one of the elements used in determining the international reserves management policy. In addition to monitoring particular financial institutions, developments of the related banking and financial system, as well as economic and political developments are monitored. Lists are prepared containing financial institutions and countries fulfilling the CNB criteria for mutual co-operation.

The second group comprises countries and banks that fulfil the criteria pursuant to the Decision on the Reserve Requirements (official gazette *Narodne novine*, Nos. 44/2001, 77/2001, 87/2001 and 100/2001). It includes countries and banks with which the Republic of Croatia, i.e. Croatian commercial banks, have established good and developed co-operation.

The third group comprises transition countries, especially those that are candidates for EU membership and also those included in the Stability Pact, i.e. the countries in the "Balkan" region (Albania, Bosnia and Herzegovina, Macedonia, FR Yugoslavia), which, according to the international community and financial institutions, includes Croatia. The latter countries are especially important because Croatian banks and companies have re-established business co-operation with some of them. The CNB also monitors global banks and companies that increase their exposure to risky markets by operating in the region, thus directly exposing their Croatian business partners to this risk.

The fourth group comprises all other countries and their banking sectors that the Croatian National Bank monitors for its own purposes or at the request of the Croatian government and its ministries and the Croatian Parliament and its committees, or for the purposes of co-operation with the Croatian Bank for Reconstruction and Development (CBRD).

The Croatian National Bank participates in the work of the Interministerial Committee for Export Insurance (ICEI) of the Croatian Bank for Reconstruction and Development. The government of the Republic of Croatia enacted the Decree on the Interministerial Committee for Export Insurance on 27 August 1998 (official gazette *Narodne novine*, No. 115/1998). The Decree established the ICEI, determined its tasks, and authorized the CBRD to conclude agreements with domestic exporters in the name and for the account of the Republic of Croatia. The ICEI comprises one representative from each of the following institutions: the Ministry of Finance, the Ministry of the Economy, the Ministry of Foreign Affairs, the Ministry of Agriculture and Forestry, the Croatian Chamber of Commerce and the Croatian National Bank. The CNB prepares materials and assesses the credit standing of countries and foreign banks for the purposes of the ICEI.

Multiple sources of data are used in preparing the relevant reports – reports by internationally recognized credit rating agencies, financial institutions' annual and other periodical reports, specialized magazines, reports and comments by international financial institutions, the CNB's archive, and other relevant sources.

5.8 Credit and Financial Relations and Succession Issues

The Croatian National Bank participates in resolving various issues related to the succession of the states of the former SFRY.

The provisions of Annex C to the Agreement on the Succession Issues, which was signed in Vienna on 29 June 2001, defined the basic assumptions for the distribution of the financial assets and liabilities of the former SFRY. The Committee on the Distribution of the Financial Assets and Liabilities referred to in Annex C to the Agreement on the Succession Issues was established soon afterwards to determine the actual balance of assets and liabilities. CNB employees were engaged in gathering and reconciling data presented by representatives of the National Bank of Yugoslavia, and in preparing information material for the Committee members. Special attention was paid to establishing contacts and the exchange of information with competent bodies and institutions of the other successor states of the former SFRY. CNB employees were appointed to the Task Force for clearing of the former SFRY's successor states, which has continuously worked on reconciling the balances in the clearing accounts of the former NBY with the former Soviet Union, German Democratic Republic, Czechoslovakia, Albania and Egypt.

Because of the increased interest of Croatian commercial banks, contacts were maintained with the competent financial bodies of the former SFRY's successor states (Banking Agency of the Federation of Bosnia and Herzegovina, Banking Agency of Republika Srpska, Central Bank of Bosnia and Herzegovina, and National Bank of the Republic of Macedonia). Contacts were established with the National Bank of Yugoslavia and the Central Bank of Montenegro.

In March 2001, the Croatian National Bank and the Ministry of Finance established a Commission for granting approvals to settle refinanced obligations arising from foreign credit relations prior to maturity pursuant to Article 18, paragraph 3 of the Foreign Credit Relations Act (official gazette *Narodne novine*, No. 43/1996).

As the debtor/guarantor for rescheduled loans, the government is keenly interested in these decisions. Therefore, the Ministry of Finance's representative has veto power on all decisions made by the Commission.

Over the last year, representatives of the CNB performed numerous specific activities related to participation in the work of intergovernmental commissions and committees of the Ministry of Finance, the Ministry for European Integration, the Croatian Chamber of Commerce and other government bodies.

6

Currency Department Operations

During 2001, the Croatian National Bank, through the regular operations of its Currency Department, received printed cash from the manufacturer, supplied cash to branches of the Institute for Payment Transactions, withdrew and processed banknotes and destroyed worn out banknotes withdrawn from circulation. In addition to the basic operations of the Currency Department, the CNB issued commemorative coins and provided expert evaluation of suspicious kuna banknotes.

6.1 Movements in Cash

On 31 December 2001, there were 74.9 million kuna banknotes, valued at HRK 8.8bn, outside the vault of the Croatian National Bank and the Institute for Payment Transactions.

In comparison with late 2000, the quantity of banknotes outside the vault of the Croatian National Bank and the Institute for Payment Transactions rose by 13.3%, while the total value of banknotes outside the vault rose by 39.6%.

On 31 December 2001, there were 769 million kuna and lipa coins, valued at HRK 0.378bn, outside the vault of the Croatian National Bank and the Institute for Payment Transactions.

In late December 2001, there was also HRK 0.123bn worth of kuna and lipa banknotes and coins in the treasuries of the Croatian Post, in addition to HRK 0.539bn in the vaults of banks. The total value of currency in circulation in late 2001 thus stood at HRK 8.5bn.

Compared with the end of 2000, the quantity of coins outside the vault of the Croatian National Bank and the Institute for Payment Transactions was 11.2% higher, while their value was 12.8% higher.

During 2001, the average amount of banknotes and coins was 17 banknotes and 171 coins per each citizen of Croatia.

In 2001, the Currency Department received 29.4 million banknotes, worth HRK 2bn, from the Institute for Payment Transactions.

In 2001, the banknote sorting system processed 31.7 million banknotes. Of the total amount, 70.66%, or 22.4 million banknotes, worth HRK 1.14bn, were destroyed, as they did not meet the quality standards set for banknotes in circulation.

According to the latest data, the renewal index (destroyed banknotes / circulation x 100) was 29.9.

6.2 Commemorative Coins

During 2001, the Croatian National Bank issued 1000 numismatic sets of kuna and lipa coins, with “2001" marking the year of minting, as well as 1000 numismatic sets of 25 kuna commemorative circulation coins.

The value of counterfeits identified over 2001 was HRK 124,870.00. In comparison with 2000, this value declined by 17.6%.

Most counterfeits were 100 kuna banknotes. Out of 1,096 identified counterfeits, 411 were in this denomination, or 38%. An analysis of the received counterfeits showed that they were mainly produced by means of computers and printed on color printers.

7

Financial Statements of the Croatian National Bank

Pursuant to the provision referred to in Article 56 of the Law on the Croatian National Bank and in accordance with the accounting regulations and International Accounting Standards, the Croatian National Bank compiles financial statements for each financial year. The financial statements of the Croatian National Bank for 2001 are the following:

- income statement,
- balance sheet,
- statement of changes in capital,
- cash flow statement,
- notes to the financial statements and an overview of major accounting policies.

These statements show the difference between income and expenditures, the balance and sources of funds, changes in capital and the structure of cash inflows and outflows.

The financial statements are audited by independent external auditors, in compliance with the auditing regulations and International Auditing Standards.

7.1 Income Statement

Table 7.1 Income Statement
in HRK

Item	2001	2000
I Net operating income	792,383,740.21	449,818,412.83
II Net gain or loss from balance sheet items value adjustment with changes in the exchange rate and market prices	–244,372,968.40	288,416,323.90
III Net administrative expenses and depreciation	–180,670,833.85	–163,005,867.99
IV Special reserves	59,539,918.37	69,400,464.06
Surplus of income over expenditures (I+II+III+IV)	426,879,856.33	644,629,332.80

7.1.1 Income and Expenditures

Interest Income

a) Interest Income from Foreign Currency Denominated Financial Assets

Interest accrued from foreign currency denominated financial assets is accounted for as income of the Croatian National Bank in kuna equivalent. In 2001, this was the most important item in the total income of the Croatian National Bank, standing at HRK 1,524.7m and accounting for 85.78% of total income.

Interest income from securities rose in 2001 due to increased investments in government bonds, while other income decreased owing to lowered financial market interest rates.

Table 7.2 Interest Income from Foreign Currency Denominated Financial Assets
in HRK

Item	2001	2000
Interest on foreign exchange deposits	912,035,427.20	1,014,403,274.15
Interest on securities	566,049,414.44	230,768,120.78
Interest on IMF SDRs	46,689,200.04	61,509,846.99
Total	1,524,774,041.68	1,306,681,241.92

b) Interest Income from Kuna Financial Assets

In 2001, interest income from kuna financial assets fell substantially compared with the previous year, accounting for 23.58% of income generated in 2000 and 1.02% of total income. This was the result of a low bank demand for secondary liquidity sources due the high liquidity of the banking system in 2001, and a parallel reduction in interest rates. In addition, certain types of loans, e.g. short-term loans to the government and intervention loans, were no longer extended in 2001, in line with the ban imposed on them by the new regulations.

The largest shares in the HRK 15.8m interest income from loans to financial institutions were accounted for by interest on Lombard loans amounting to HRK 6.3m and interest on liquidity loans amounting to HRK 5.7m.

Table 7.3 Interest Income from Kuna Financial Assets
in HRK

Item	2001	2000
Interest on loans to the Republic of Croatia	0.00	4,577,118.59
Interest on loans to financial institutions	15,884,683.12	57,515,423.39
Other interest income	2,284,244.53	15,249,918.66
Total	18,168,927.65	77,342,460.64

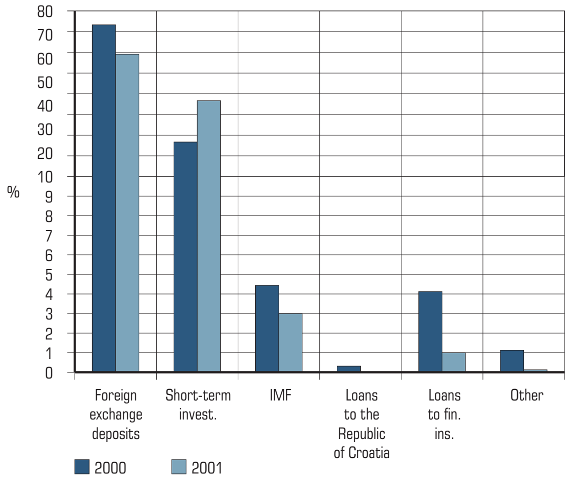
Other interest income, amounting to HRK 2.2m, comprised the following: penalty interest on unpaid interest on liquidity and intervention loans, remuneration on unallocated and unmaintained kuna reserve requirements and penalty interest on overdue remuneration on unallocated and unmaintained reserve requirements.

Other Net Operating Income

Income from dividend amounted to HRK 3.9bn, while net income from trading in securities amounted to HRK 16.3m. Income derived from succession to part of the assets of the former SFRY, amounting to HRK 18.8m, significantly increased other income.

Figure 7.1

Trends in the Shares of Different Types of Interest Income



Interest Expense

a) Interest Expense for Foreign Currency Denominated Financial Liabilities

The growth of interest expense for issued foreign exchange CNB bills was the result of the increased purchase of CNB bills in late 2001 related to improved foreign exchange liquidity.

The reduction in the reserve requirement rate, from 23.5% to 22% and subsequently to 19%, and the fall in the money market interest rates, resulted in reduced expenses for interest paid on foreign exchange reserve requirements. In addition, as from September 2001, 20% (25% from November) of the foreign exchange portion of reserve requirements has been included in the kuna reserve requirements and effected in kuna.

Table 7.4 Interest Expense for Foreign Currency Denominated Financial Liabilities
in HRK

Item	2001	2000
Interest expense for issued foreign exchange CNB bills	92,780,733.45	80,842,283.02
Interest expense for banks and savings banks' foreign exchange reserve requirements	249,884,762.75	297,600,197.93
Interest on financial arrangements with the IMF	67,667,781.45	76,514,711.10
Interest on foreign exchange repo deposits	17,406,510.85	26,508,798.51
Total	427,739,788.50	481,465,990.56

b) Interest Expense for Kuna Financial Liabilities

In 2001, the Croatian National Bank incurred expenses of HRK 201.6m for interest paid on issued kuna CNB bills, 11.32% over 2000. This was due to a higher average balance of purchased CNB bills and slightly lowered interest rates.

In 2001, the Croatian National Bank interest expense for remuneration paid on kuna reserve requirements was HRK 167.1m, 70.7% of this expense in 2000. This was primarily due to the reduced remuneration rate rather than the lowered reserve requirement rate.

Table 7.5 Interest Expense for Kuna Financial Liabilities
in HRK

Item	2001	2000
Interest expense for issued kuna CNB bills	201,646,318.69	181,140,530.76
Interest expense for banks and savings banks' kuna reserve requirements	167,054,850.97	236,268,385.44
Total	368,701,169.66	417,408,916.20

Operating Expenses

Operating expenses contain employee and administrative expenses, depreciation expenses for the fixed assets of the Croatian National Bank and doubtful debt value adjustments.

Table 7.6 Operating Expenses
in HRK

Item	2001	2000
Employee expenses	117,390,865.24	111,617,626.08
Administrative expenses	49,182,566.43	48,244,741.29
Depreciation	22,994,662.94	15,878,093.18
Total	189,568,094.61	175,740,460.55

a) Employee Expenses

Employee expenses in 2001 stood at HRK 117.4m. This included gross salaries, gross compensation and contributions on salaries. Salaries were paid in accordance with the Statute of the Croatian National Bank and the Rulebook on Salaries and other Employee Income in the Croatian National Bank. The Rulebook provides for the level of salaries and adjustments in salaries to be determined by the Council of the Croatian National Bank.

Employee expenses accounted for 8.69% of the total expenditures of the Croatian National Bank.

Table 7.7 Employee Expenses
in HRK

Item	2001	2000
Employee net salaries	50,700,337.47	45,435,246.71
Contributions on salaries	16,933,905.38	15,801,079.62
Tax and surtax	15,457,876.81	15,796,492.72
Total gross salaries	83,092,119.66	77,032,819.05
Gross employee compensation	18,154,467.07	18,144,701.52
Contributions on salaries and compensation	16,129,218.89	16,440,105.51
Other contributions	15,059.62	–
Total	117,390,865.24	111,617,626.08

b) Administrative Expenses

In 2001, administrative expenses stood at HRK 49.1m. The largest item in these expenses comprised other services provided by outside sources, i.e. security services, amounting to HRK 3.8m, in addition to expenses for insurance services (HRK 1.4m), research and payment system, as well as renting and other occupancy expenses.

Amounting to HRK 10.1m, repairs and maintenance expenses included expenses for regular and investment maintenance of premises, office and information equipment, plants, vehicles and other tangible assets.

Expenses for professional services amounted to HRK 6.2m. This comprised expenses for Reuters and Bloomberg information services, software for international financial operations of the Croatian National Bank and SWIFT, HRK 3.0m expenses for using SWIFT for the operations conducted by the Croatian National Bank as the central bank in the Croatian Large Value Payment System, as well as expenses for consultancy services and lawyers.

Table 7.8 Administrative Expenses
in HRK

Item	2001	2000
Stationery and office supplies	2,259,745.51	1,876,936.99
Telecommunications and postal services	3,496,240.47	3,218,185.67
Training, seminars, conferences, education and research	1,320,118.32	1,340,804.74
Professional service fees	6,237,138.69	4,978,378.21
Other services provided by outside sources	14,870,520.51	14,350,886.46
Transport	1,635,335.82	1,461,900.19
Publications and subscriptions expenses	2,322,453.32	2,562,463.17
Repairs and maintenance	10,149,956.19	10,368,457.45
Expenses from write-off and sale of fixed assets	82,007.94	138,627.33
Other employee related expenses	525,283.32	470,224.33
Other expenses	6,283,766.34	7,477,876.75
Total	49,182,566.43	48,244,741.29

c) Depreciation

In 2001, expenses for the depreciation of the Croatian National Bank fixed assets, calculated using the linear method, were HRK 22.9m.

In 2000, in accordance with International Accounting Standard 16, HRK 5.9m of depreciation expenses for the revaluation of premises was debited to revaluation reserves and the remaining amount to current year expenses.

The expenses for printing notes and minting coins are accounted in the Croatian National Bank balance sheet as fixed assets. On the income statement, total expenses are not debited annually but depreciated, expenses for minting coins over five years and expenses for printing banknotes over two years, and transferred to expenditures in monthly statements. In accordance with Article 51 of the Rulebook on Classifying Fixed and Intangible Assets, Liabilities and Claims, Calculating Depreciation and Writing-Off Small Inventory of the Croatian National Bank, the annual rates of coins and banknotes' depreciation are 20% and 50% respectively.

Value Adjustments

Pursuant to the Governor's Decision on the Provisioning Policy of the Croatian National Bank for Loans Extended to Banks, of 30 July 1999, banks faced with financial difficulties which can negatively affect timely interest payments and principal repayments of loans granted by the Croatian National Bank, which are not covered by first-rate instruments of collateral, must set aside special reserves for identified losses.

Accordingly, in 2001 these provisions, i.e. value adjustments made for bad loans and interest, amounted to HRK 5.1m, accounting for 0.38% of total expenditures.

Value adjustments made for bad and doubtful loans and interest in the current year were debited directly to the Croatian National Bank expenditures, while the collected amount of HRK 66.8m was credited to the CNB income.

Table 7.9 Value Adjustment Expenses for Doubtful Debts
in HRK

Item	2001	2000
Loans		
New value adjustments	4,056,472.04	5,608,990.61
Collected amount	–64,391,689.08	–44,822,611.75
Accrued interest		
New value adjustments	1,015,343.31	1,888,085.06
Collected amount	–2,469,161.60	–32,074,927.98
Written-off amount	11,668.73	–
Provisions for litigation costs	2,237,448.23	0.00
Total	–59,539,918.37	–69,400,464.06

7.1.2 Allocation of Surplus of Income over Expenditures

The Croatian National Bank generates income from its operations, incurs expenditures and determines a surplus of income over expenditures or shortfall between income and expenditures.

Total income in 2001 was HRK 1,777.6m, while expenditures were HRK 1,350.7m. The surplus of income over expenditures was thus HRK 426.9m. This surplus level was primarily generated by income from interest on funds deposited abroad, amounting to HRK 1,524.8m, whose share in total income was 85.78%.

Table 7.10 Allocation of Surplus of Income over Expenditures
in HRK

Item	2001	2000
Surplus of income over expenditures	426,879,856.33	644,629,332.80
Shortfall between income and expenditures	–	–
Surplus allocated to general reserves	85,375,971.27	288,416,323.90
Shortfall covered from general reserves	–	–
Surplus allocated to the government budget	341,503,885.06	356,213,008.90
Shortfall covered from the government budget	–	–

Pursuant to Article 53 of the Law on the Croatian National Bank, the surplus of income over expenditures is allocated to general reserves, in the amount determined by the Council of the Croatian National Bank. This amount should neither exceed 20% of the surplus of income over expenditures nor fall below net profit from value adjustment of balance sheet items to changes in the exchange rate and market prices. The remaining surplus of income over expenditures, after the allocation to general reserves, is extraordinary revenue to the government budget.

The Croatian National Bank covers any shortfall between income and expenditures from general reserves. Should these reserves prove insufficient, the shortfall is covered from the government budget.

Consequently, 20% of the 2001 surplus of income over expenditures, amounting to HRK 85.4m, was transferred to general reserves, and the remaining HRK 341.5m to the government budget.

7.2 Balance Sheet

7.2.1 Assets

Cash and Deposits with Other Banks

These assets of the Croatian National Bank comprise cash in the cashier's office, foreign currency cash in vault, foreign exchange deposits with central and commercial non-resident correspondent banks, and SDR holdings with the IMF available for daily operations of the Croatian National Bank (their balance on 31 December 2001 was HRK 902.4m).

Table 7.11 Balance Sheet of the Croatian National Bank on 31 December 2001/2000
in HRK

Item	2001	2000
Assets		
Cash and deposits with other banks	11,919,326,939.80	2,720,735,608.95
Receivables from other banks	25,522,156,956.39	21,002,123,964.26
Short-term investments	12,829,300,398.16	6,545,691,350.23
Loans	34,687,212.56	348,271,862.80
Long-term investments	3,861,933,123.29	3,888,610,144.44
Accrued interest and other assets	94,530,080.66	109,421,528.33
Fixed assets	350,701,329.95	333,786,905.95
IPT – issued banknotes and coins	8,092,691,996.96	6,429,462,655.38
Total assets	62,705,328,037.77	41,378,104,020.34
Liabilities		
Banknotes and coins outside the CNB vault	9,046,164,284.87	7,168,994,943.29
CNB bills	6,377,295,063.88	4,356,127,821.32
Liabilities to domestic banks	14,674,327,249.89	10,203,204,939.03
Liabilities to the government and government agencies	1,854,704,744.96	1,158,020,653.75
Liabilities to foreign entities	5,415,164,447.97	5,508,596,010.41
Accrued interest and other liabilities	19,525,932,948.56	8,331,314,654.28
Total liabilities	56,893,588,740.13	36,726,259,022.08
Capital		
Paid-in capital	2,500,000,000.00	0.00
Reserves	3,311,739,297.64	4,651,844,998.26
Total capital	5,811,739,297.64	4,651,844,998.26
TOTAL CAPITAL AND LIABILITIES	62,705,328,037.77	41,378,104,020.34

Note: There is a HRK 22.7bn difference between the Croatian National Bank balance sheet as it stood on 31 December 2001 (trial balance sheet) and that compiled for the purposes of monetary statistics (monetary authorities accounts). In the monetary authorities accounts, accounts are classified to show the inflows of the reserve money on the asset side, and its sectoral distribution and outflows, i.e. sterilization, on the liabilities side. Certain active items from the trial balance sheet are transferred to the liabilities of the monetary authorities accounts and vice versa, which affects the total balance sheet sum. The most different are CNB's transit and settlement accounts recording all transactions in banks and government institutions' accounts held with the CNB, as well as cash transactions. These are accounts comprised by sub-account 298 (totaling HRK 19bn) on the trial balance sheet asset side and by sub-account 482 on its liabilities side (a total of about HRK 19bn). Their net amount is shown in the monetary authorities accounts within the remaining liabilities.

Receivables from Other Banks

Time foreign exchange deposits with foreign correspondent banks (central and commercial) account for the largest share in the investment structure of total international reserves of the Republic of Croatia, managed by the Croatian National Bank and recorded in the CNB balance sheet.

Table 7.12 Receivables from Other Banks
in HRK

Item	2001	2000
Placements to foreign central banks	1,407,993,238.82	989,243,200.21
Placements to foreign commercial banks	24,097,589,615.08	19,997,695,474.20
Placements to domestic commercial banks	16,574,102.49	15,185,289.85
Total	25,522,156,956.39	21,002,123,964.26

Time deposits held with commercial banks having a minimum AA– rating amount to HRK 24,097.5m in kuna equivalent. Although this amount rose in absolute terms compared with the previous year, the share of these deposits in total reserves decreased, in contrast with the enlarged share of government securities (in comparison with the previous year, investments in government securities went up by 8.25%). This resulted in the improved liquidity of reserves and mitigated credit risk.

The share of reverse repo agreements in international reserves was 4.54% larger than in the previous year. By means of these high-quality instruments, CNB deposits with commercial banks are collateralized by first-class government bonds, which results in a strengthened security of placement of total international reserves.

Short-Term Investments

Increased investments in bonds and certificates of deposits in 2001 compared with 2000 resulted from the changed structure of international reserves. This included investing a part of the foreign exchange reserve requirements in bonds, which was not done in 2000.

The securities' portfolio largely comprises government bonds of the Federal Republic of Germany and the United States. The remaining bonds are issued by renowned European financial and government institutions, as well as by international financial institutions – the World Bank and the International Bank for Reconstruction and Development.

Table 7.13 Short-Term Investments
in HRK

Item	2001	2000
EUR-denominated securities	7,540,669,145.65	3,929,277,299.07
USD-denominated securities	4,437,945,273.63	2,389,477,115.44
Certificates of deposits	850,685,978.88	226,936,935.72
Total	12,829,300,398.16	6,545,691,350.23

Loans

On 31 December 2001, the balance of loans granted to banks and savings banks stood at HRK 228.3m, accounting for only 37.91% of their balance on 31 December 2000. There was less use of secondary liquidity sources due to the pronounced liquidity that characterized the banking system through most of 2001.

Table 7.14 Loan Balance
in HRK

Item	2001	2000
Loans granted to domestic banks		
Lombard loans	0.00	0.00
Repo loans	0.00	299,629,365.00
Intervention loans	111,713,693.97	142,645,974.77
Liquidity loans	34,500,000.00	34,500,000.00
Bridging loans	82,083,074.46	125,436,294.62
Total balance of loans granted to banks and savings banks	228,296,768.43	602,211,634.39
Other loans and receivables from loans to employees	864,440.76	869,442.08
Gross loan amount	229,161,209.19	603,081,076.47
(minus) special value adjustments	–194,473,996.63	–254,809,213.67
Total	34,687,212.56	348,271,862.80

Changes in value adjustments	2001	2000
Balance on 1 January	254,809,213.67	294,022,834.81
New value adjustments	4,056,472.04	5,608,990.61
Collected amount	–64,391,689.08	–44,822,611.75
Balance on 31 December	194,473,996.63	254,809,213.67

Long-Term Investments

Long-term investments comprised the subscription to the International Monetary Fund, amounting to HRK 3,830.6m, and subscriptions to international financial and other institutions (shares of the Bank for International Settlements in Basle and SWIFT shares, totaling HRK 23.1m), while the remaining HRK 8.1m constitutes the initial capital of the Croatian National Bank in the Croatian Monetary Institute.

Table 7.15 Long-Term Investments
in HRK

Item	2001	2000
IMF subscription	3,830,754,942.91	3,879,547,187.36
Subscriptions to other international financial institutions	23,123,883.58	1,008,660.28
Investments in domestic companies	8,054,296.80	8,054,296.80
Total	3,861,933,123.29	3,888,610,144.44

Accrued Interest and Other Assets

The most important items in accrued interest, totaling HRK 151.5m, were the following: interest on foreign exchange deposits with non-resident correspondent banks, amounting to HRK 60.3m; interest on loans granted to banks and savings banks, amounting to HRK 20.6m; kuna remuneration for unallocated foreign exchange reserve requirements, amounting to HRK 20.4m; and kuna remuneration for unmaintained foreign exchange reserve requirements, amounting to HRK 45.8m.

Table 7.16 Accrued Interest and Other Assets
in HRK

Item	2001	2000
Accrued interest	151,506,245.01	167,312,114.89
Gold and other precious metals	1,475,658.85	1,269,619.62
Numismatics	12,274,437.81	13,895,617.67
Other assets	4,554,940.72	3,679,196.17
Gross accrued interest and other assets	169,811,282.39	186,156,548.35
(minus) interest value adjustment	–75,281,201.73	–76,735,020.02
Total	94,530,080.66	109,421,528.33

Changes in value adjustments	2001	2000
Balance on 1 January	76,735,020.02	106,921,862.94
New value adjustments	1,015,343.31	1,888,085.06
Collected amounts	–2,469,161.60	–32,074,927.98
Balance on 31 December	75,281,201.73	76,735,020.02

Fixed Tangible and Intangible Assets

On 31 December 2001, the tangible and intangible assets of the Croatian National Bank stood at HRK 350.7m, an increase of 5.06% in comparison with 2000. Land and premises was the most important item, accounting for 73.1% of these assets, followed by banknotes and coins, whose share was 15.1%. Other assets, e.g. computers, furniture, equipment, motor vehicles, construction in progress and software for information systems and subsystems, accounted for the remaining 11.9% share.

The fixed assets of the Croatian National Bank are neither subject to a mortgage nor to a fiduciary relationship.

7.2.2 Liabilities

Banknotes and Coins

As shown by accounting records, on 31 December 2001, the total balance of banknotes and coins outside the CNB vault was HRK 9,046.1m. This included HRK 8,092.6m put into circulation through the Institute for Payment Transactions, HRK 414.7m put into circulation directly by selling domestic cash to non-resident correspondent banks and HRK 538.8m kept at the vaults of banks.

CNB Bills

Table 7.17 CNB Bills
in HRK

Item	2001	2000
Nominal value of kuna CNB bills	3,485,800,000.00	2,586,900,000.00
Discount (in kuna)	(21,904,925.31)	(43,509,580.00)
Nominal value of foreign exchange CNB bills	2,921,321,119.45	1,831,879,710.60
Discount (in foreign currency)	(7,921,130.26)	(19,142,309.28)
Total	6,377,295,063.88	4,356,127,821.32

Kuna CNB bills were considerably modified in 2001. At the beginning of the year, their maturity terms were 35, 91 and 182 days, but from February they were 35, 70 and 105 days. In addition, auctions were held with lower frequency, with a view to stimulating the development of the secondary market. Standing at HRK 2.9bn, the average monthly balance of CNB bills rose by 38% compared with HRK 2.1bn in 2000. This resulted from growing sterilization needs, accounted for by the improved liquidity of the banking system.

Liabilities to Domestic Banks

Allocated reserve requirements of banks and other financial institutions are accounted for as Croatian National Bank liabilities to commercial banks and other financial institutions. Kuna reserve requirements rose in 2001, due to the increased calculation base of reserve requirements and the fact that, from September 2001 on, foreign exchange reserve requirements were partially allocated in kuna.

Table 7.18 Liabilities to Domestic Banks
in HRK

Item	2001	2000
Kuna reserve requirements	6,289,510,636.53	4,080,073,860.81
Foreign exchange reserve requirements	5,696,517,850.26	5,490,533,353.40
Deposits of banks in bankruptcy and liquidation	127,340,258.21	164,964,394.76
Other deposits of banks and savings banks	2,560,958,504.89	467,633,330.06
Total	14,674,327,249.89	10,203,204,939.03

The conversion of 12 currencies of EMU member states into the euro brought about an increase in foreign exchange household deposits. The calculation base of reserve requirements was therefore increased, which led to a growth in the foreign exchange reserve requirements. Other deposits, amounting to HRK 2,560.9m, comprised commercial banks and savings banks' funds in the Croatian Large Value Payment System, i.e. in settlement accounts.

Liabilities to the Government and Government Agencies

The deposits of the Republic of Croatia and its agencies were accounted on the liability side of the Croatian National Bank balance sheet, in the total amount of HRK 1,854.7m. The deposits of the Republic of Croatia, standing at HRK 1,376.6m, accounted for 74.2% of these funds. The remaining HRK 478.0m were deposits of the Croatian Pension Insurance Institute, deposits of other government agencies as well as court-mandated deposits and those made pursuant to legal provisions.

Liabilities to Foreign Entities

Kuna promissory notes are related to the Republic of Croatia's membership in the International Monetary Fund. Their value equals that of the long-term investments in the subscription to the International Monetary Fund. Issued by the Ministry of Finance on the basis of approved financial arrangements with the International Monetary Fund, they are repaid in special drawing rights according to the repayment schedule of the International Monetary Fund.

Table 7.19 Liabilities to Foreign Entities
in HRK

Item	2001	2000
International Monetary Fund:		
– kuna promissory notes	3,819,391,798.13	3,868,039,310.44
– kuna promissory notes payable in foreign exchange	1,020,156,929.25	1,290,273,908.30
– other accounts	9,599,595.27	9,721,865.11
Foreign banks and other financial institutions	566,016,125.32	340,560,926.56
Total	5,415,164,447.97	5,508,596,010.41

Accrued Interest and Other Liabilities

Interest payable amounted to HRK 25.5m. The most important items are: interest on resident banks' foreign exchange deposits, amounting to HRK 8.6m; interest based on the financial arrangements concluded between the International Monetary Fund and the Republic of Croatia, amounting to HRK 5.3m; and interest on banks and savings banks' kuna deposits, amounting to HRK 10.6m.

Table 7.20 Accrued Interest and Other Liabilities
in HRK

Item	2001	2000
Interest payable	25,485,443.60	30,731,994.12
Liabilities to employees	4,626,623.83	4,436,165.36
Taxes and contributions	4,267,969.27	4,004,710.25
Liabilities arising from the surplus of income over expenditures	341,503,885.06	233,226,254.62
Liabilities to the Ministry of Finance	7,580,750.02	8,152,941.56
Liabilities to suppliers	2,901,274.81	2,573,613.97
Other liabilities	3,152,632.63	1,946,701.36
Liabilities to the IPT and CLVPS	19,136,414,369.34	8,046,242,273.04
Total	19,525,932,948.56	8,331,314,654.28

Provisions for litigation costs, amounting to HRK 2.2m, constituted the most important item in other liabilities.

Liabilities to the Institute for Payment Transactions and the Croatian Large Value Payment System comprise two settlement accounts recording all primary issue transactions of the Croatian National Bank conducted through the domestic payment system.

7.3 Changes in Capital

The total capital of the Croatian National Bank amounts to HRK 5,811.7m. This comprises paid-in capital amounting to HRK 2,500.0m and general reserves amounting to HRK 3,311.7m. The new Law on the Croatian National Bank, which came into effect in April 2001, stipulated the capital of the Croatian National Bank at HRK 2.5bn. HRK 2,500m was transferred to paid-in capital from the existent reserves of the Croatian National Bank. This capital can be neither transferred nor used as collateral.

The residual reserves at the disposal the Croatian National Bank on the day the new Law came into effect were allocated to general reserves. The HRK 1.08bn increase in general reserves over the year derived from the division of assets held in the name of the former SFRY in the books of the Bank for International Settlements in Basle. Based on this division, the Croatian National Bank was allocated a part of monetary gold, international reserves and shares.

On 31 December 2001, the Croatian National Bank fixed asset revaluation reserves stood at HRK 232.7m.

Of the 2001 surplus of income over expenditures, HRK 85.4m was allocated to general reserves, pursuant to the provision of Article 53 of the Law on the Croatian National Bank.

7.4 Cash Flow

In 2001, the Croatian National Bank started compiling a cash flow statement in accordance with International Accounting Standards 1 and 7 and by means of the direct method. By providing data on changes in the financial position, the cash flow statement exemplifies changes in the structure of the assets, liabilities and capital of the Croatian National Bank. The 2001 cash flow statement shows cash inflows and outflows in the period from 1 January to 31 December 2001, as well as the cash balance at the beginning and end of the period.

Table 7.21 Cash Flow in the Period from 1 January to 31 December 2001
in HRK

1.		CASH FLOW FROM OPERATING ACTIVITIES	
I.		Net cash flow from operating activities	543,156,246.03
2.		CASH FLOW FROM INVESTMENT ACTIVITIES	
II.		Net cash flow from investment activities	–9,916,748,266.54
3.		CASH FLOW FROM FINANCIAL ACTIVITIES	
III.		Net cash flow from financial activities	9,126,550,915.44
IV.		Exchange rate effect	32,557,218.62
		NET CASH FLOW FROM OVERALL ACTIVITIES	–214,483,886.45
	A	Cash balance at the beginning of the year (1 January 2001)	1,102,673,215.99
	B	Cash balance at the end of the year (31 December 2001)	888,189,329.54
		NET REDUCTION IN CASH	–214,483,886.45

The Croatian National Bank cash flows are classified according to the following types of activities:

1. operational activities – comprising inflows (outflows) from kuna and foreign exchange interest and other inflows (outflows) from regular operational activities;

2. investment activities – comprising inflows (outflows) from foreign exchange deposits, investments and receivables, kuna loans to financial institutions and the purchase of tangible assets;

3. financial activities – comprising inflows and outflows of currency in circulation, inflows (outflows) from CNB bills, kuna and foreign exchange liabilities, kuna deposits of the government and financial institutions and the stipulated allocation of the surplus of income over expenditures to the government budget.

7.5 Treasury Inventory System and Off-Balance Sheet Statement

7.5.1 Treasury Inventory System

The treasury inventory system consists of bookkeeping records that the Croatian National Bank has kept since 1999 following the example of other central banks. Its chief aim is to provide comprehensive accounting records of cash outside circulation, held in the Croatian National Bank vault and with the Institute for Payment Transactions.

Table 7.22 Treasury Inventory System
in HRK

Item	2001	2000
Cash (kuna and HRD/Croatian dinars):		
– non-issued banknotes and coins in the Croatian National Bank vault (kuna)	61.552.723.737,00	63.476.982.955,00
– banknotes and coins (Croatian dinars)	1.769.814.011,23	1.788.464.553,23
– receivables from the IPT for given cash (kuna)	16.765.806.472,33	15.876.565.057,06
– cash (kuna) issued directly by the Croatian National Bank	953.472.287,91	739.532.287,91
– damaged and worn-out cash (kuna) in the Croatian National Bank vault	1.825.604.137,03	1.672.633.559,30
Custody securities accounts	641.774.822,84	403.032.442,08
Records on transactions related to former Yugoslavia	579.917.773,82	587.168.868,90
Post-bankruptcy interest calculation	726.999.541,13	583.327.402,30
Other records	119.514.089,94	118.096.363,00
Total	84.935.626.873,23	85.245.803.488,78

7.5.2 Off-Balance Sheet Statement

Off-balance sheet records comprise commitments of the Croatian National Bank related to repo agreements and received collaterals. Foreign exchange debt securities are used as collateral in repo agreements concluded with non-resident correspondent banks. Collaterals received from resident banks are classified by their type (CNB bills, treasury bills, promissory notes of the Republic of Croatia, foreign currency denominated collaterals and other receivables received as collateral) and by the banks that concluded a repo agreement with the CNB.

Table 7.23 Off-Balance Sheet Statement
in HRK

Item	2001	2000
Commitments arising from reverse repo agreements	9,282,965,528.79	5,591,536,824.72
Commitments arising from repo agreements	–515,902,100.00	–326,213,760.00
CNB bills received as collateral	1,843,346.25	0.00
Other collaterals received from resident banks	552,347,445.34	1,041,871,509.74
Total	9,321,254,220.38	6,307,194,574.46

Management and Internal Organization of the Croatian National Bank

Management of the Croatian National Bank

MEMBERS OF THE COUNCIL OF THE CROATIAN NATIONAL BANK

Chairman of the Council
Željko Rohatinski

Boris Vujčić
Relja Martić
Tomislav Presečan
Čedo Maletić
Adolf Matejka

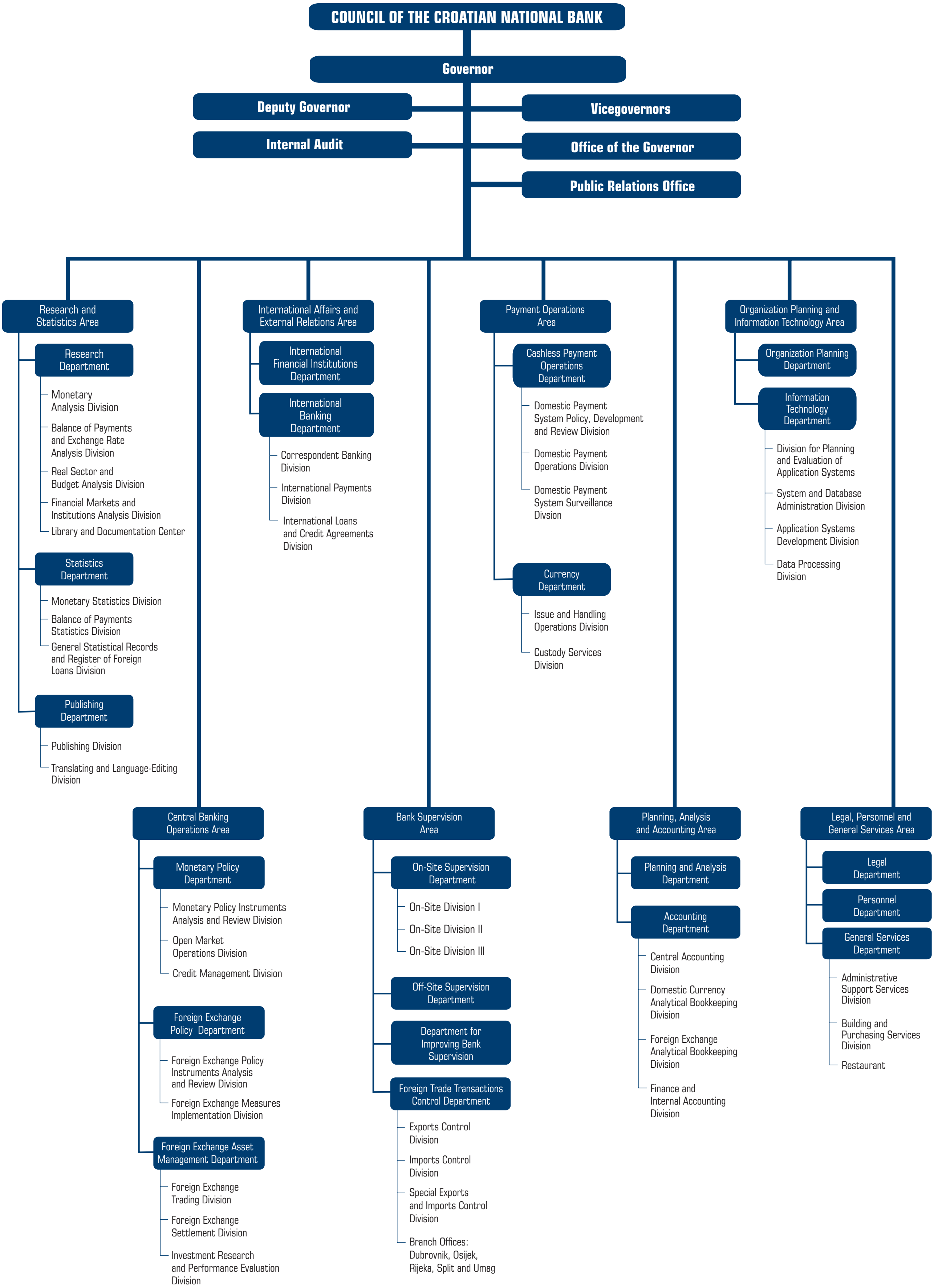
Mate Babić
Alen Belullo
Božidar Jelčić
Branimir Lokin
Damir Novotny
Silvije Orsag
Sandra Švaljek
Branko Vukmir

MANAGEMENT OF THE CROATIAN NATIONAL BANK

Željko Rohatinski, Governor
Boris Vujčić, Deputy Governor
Relja Martić, Vicegovernor
Tomislav Presečan, Vicegovernor
Čedo Maletić, Vicegovernor
Adolf Matejka, Vicegovernor

EXECUTIVE DIRECTORS

Research and Statistics Area – **Ljubinko Jankov**
Central Banking Operations Area – **Irena Kovačec**
International Affairs and External Relations Area – **Jadranka Granić**
Bank Supervision Area – **Marija Mijatović-Jakšić**
Planning, Analysis and Accounting Area –
Payment Operations Area –
Organization Planning and Information Technology Area – **Petar Ćurković**
Legal, Personnel and General Services Area –


COUNCIL OF THE CROATIAN NATIONAL BANK
Governor
Deputy Governor
Vicegovernors
Internal Audit
Office of the Governor
Public Relations Office
Research and Statistics Area
Research Department
Monetary Analysis Division
Balance of Payments and Exchange Rate Analysis Division
Real Sector and Budget Analysis Division
Financial Markets and Institutions Analysis Division
Library and Documentation Center
Statistics Department
Monetary Statistics Division
Balance of Payments Statistics Division
General Statistical Records and Register of Foreign Loans Division
Publishing Department
Publishing Division
Translating and Language-Editing Division
International Affairs and External Relations Area
International Financial Institutions Department
International Banking Department
Correspondent Banking Division
International Payments Division
International Loans and Credit Agreements Division
Payment Operations Area
Cashless Payment Operations Department
Domestic Payment System Policy, Development and Review Division
Domestic Payment Operations Division
Domestic Payment System Surveillance Division
Currency Department
Issue and Handling Operations Division
Custody Services Division
Organization Planning and Information Technology Area
Organization Planning Department
Information Technology Department
Division for Planning and Evaluation of Application Systems
System and Database Administration Division
Application Systems Development Division
Data Processing Division
Central Banking Operations Area
Monetary Policy Department
Monetary Policy Instruments Analysis and Review Division
Open Market Operations Division
Credit Management Division
Foreign Exchange Policy Department
Foreign Exchange Policy Instruments Analysis and Review Division
Foreign Exchange Measures Implementation Division
Foreign Exchange Asset Management Department
Foreign Exchange Trading Division
Foreign Exchange Settlement Division
Investment Research and Performance Evaluation Division
Bank Supervision Area
On-Site Supervision Department
On-Site Division I
On-Site Division II
On-Site Division III
Off-Site Supervision Department
Department for Improving Bank Supervision
Foreign Trade Transactions Control Department
Exports Control Division
Imports Control Division
Special Exports and Imports Control Division
Branch Offices: Dubrovnik, Osijek, Rijeka, Split and Umag
Planning, Analysis and Accounting Area
Planning and Analysis Department
Accounting Department
Central Accounting Division
Domestic Currency Analytical Bookkeeping Division
Foreign Exchange Analytical Bookkeeping Division
Finance and Internal Accounting Division
Legal, Personnel and General Services Area
Legal Department
Personnel Department
General Services Department
Administrative Support Services Division
Building and Purchasing Services Division
Restaurant

List of Banking Institutions

31 December 2001

LICENSED BANKS

BRODSKO-POSAVSKA BANKA d.d.[1]
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35000 Slavonski Brod

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Smičiklasova 23
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SWIFT: TSBZ HR 22

CENTAR BANKA d.d.[1]
Jurišićeva 3
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Phone: + 385 1 /4803-444
Fax: + 385 1/4803-441
Tlx: 21707
SWIFT: CBZG HR 2X

CONVEST BANKA d.d.[1]
Gajeva 33
10000 Zagreb

Phone: + 385 1/4922-333
Fax: + 385 1/4819-153
SWIFT: CNVT HR 22

CREDO BANKA d.d.[1]
Zrinsko-Frankopanska 58
21000 Split

Phone: + 385 21/380-655
Fax: + 385 21/380-660
SWIFT: CDBS HR 22

CROATIA BANKA d.d.[1]
Kvaternikov trg 9
10000 Zagreb

Phone: + 385 1/2391-111
Fax: + 385 1/2391-470
SWIFT: CROA HR 2X

DALMATINSKA BANKA d.d.[1]
Marka Oreškovića 3
23000 Zadar

Phone: + 385 23/201-500
Fax: + 385 23/201-774
Tlx: 27224 dbk zd rh
SWIFT: DBZD HR 2X
Reuters: DBZH

DRESDNER BANK CROATIA d.d.[1]
Gajeva 1
10000 Zagreb

Phone: + 385 1/4866-777
Fax: + 385 1/4866-779
Tlx: 22230 dres hr
SWIFT: DRES HR 2X

DUBROVAČKA BANKA d.d.[1]
Put Republike 9
20000 Dubrovnik

Phone: + 385 20/356-333
Fax: + 385 20/356-778
Tlx: 27540 hrvdubank
27592 hrvdubank
SWIFT: DUBA HR 2X

ERSTE & STEIERMÄRKISCHE BANK d.d.[1]
Varšavska 3-5
10000 Zagreb

Phone: + 385 1/4561-999
Fax: + 385 1/4561-900
SWIFT: ESBC HR 22

GOSPODARSKO KREDITNA BANKA d.d.[1]
Draškovićeva 58
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Phone: + 385 1/4802-666
Fax: + 385 1/4802-571
Tlx: 22404 ccb zg hr
SWIFT: CCBZ HR 2X

HRVATSKA POŠTANSKA BANKA d.d.[1]
Jurišićeva 4
10000 Zagreb

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Fax: + 385 1/4810-791
SWIFT: HPBZ HR 2X

HVB BANK CROATIA d.d.[1]
Jurišićeva 2
10000 Zagreb

Phone: + 385 1/4800-777
Fax: + 385 1/4800-890
SWIFT: BACX HR 22

HYPO ALPE-ADRIA-BANK d.d.[1]
Koturaška 47
10000 Zagreb

Phone: + 385 1/6103-666
Fax: + 385 1/6103-555
SWIFT: KLHB HR 22

HYPOBANKA d.d.[2]
Vodovodna 20a
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Fax: + 385 1/3643-687
Tlx: 21621 hipzg rh
SWIFT: HYZA HR 22

IMEX BANKA d.d.[1]
Tolstojeva 6
21000 Split

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Tlx: 26191
SWIFT: IMXX HR 22

ISTARSKA BANKA d.d.[1]
Dalmatinova 4
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Fax: + 385 52/527-400
Tlx: 24746, 24716 ibpu rh
SWIFT: IBPU HR 2X

ISTARSKA KREDITNA BANKA UMAG d.d.[1]
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Fax: + 385 52/741-275
Tlx: 24745 ikb rh
SWIFT: ISKB HR 2X

JADRANSKA BANKA d.d.[1]
Ante Starčevića 4
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Phone:+ 385 22/242-101
Fax: + 385 22/335-881
Tlx: 27435, 27 346 jbs rh
SWIFT: JADR HR 2X

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47000 Karlovac

Phone: + 385 47/611-540
Fax: + 385 47/614-206
Tlx: 23742 kb ka rh
SWIFT: KALC HR 2X

KREDITNA ZAGREB d.d.[1]
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10000 Zagreb

Phone: + 385 1/6167-333
Fax: + 385 1/6116-466
Tlx: 21197 krez zg rh
SWIFT: KREZ HR 2X

KVARNER BANKA d.d.[1]
Jadranski trg 4/I
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Fax: + 385 51/353-566
Tlx: 24564 kbri hr
SWIFT: KVRB HR 22

MEĐIMURSKA BANKA d.d.[1]
Valenta Morandinija 37
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Tlx: 23251 banka rh
SWIFT: MBCK HR 2X

NAVA BANKA d.d.[2]
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Fax: + 385 1/3656-700
SWIFT: NAVB HR 22

PARTNER BANKA d.d.[1]
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10000 Zagreb

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Fax: + 385 1/4602-289
Tlx: 21212 parbaz rh
SWIFT: PAZG HR 2X

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Tlx: 28550 kb slp rh
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SWIFT: SPRM HR 22

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Reuters: PBZH

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Tlx: 21137 rba zg rh
SWIFT: RZBH HR 2X

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Fax: + 385 51/211-093
Tlx: 24 161
SWIFT: ADRI HR 2X

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Fax: + 385 51/330-525
Tlx: 24 143 bankom rh
SWIFT: RBRI HR 2X
Reuters: RBRH

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Fax: + 385 1/3361-523
Tlx: 21811 samba rh
SWIFT: SMBR HR 22

SISAČKA BANKA d.d.[1]
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44000 Sisak

Phone: + 385 44/549-100
Fax: + 385 44/549-101
Tlx: 23645 sbdd sk rh
SWIFT: SSKB HR 2X

SLATINSKA BANKA d.d.[1]
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33520 Slatina

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Fax: + 358 33/551-566
Tlx: 28277 slatb rh
SWIFT: SBSL HR 2X

SLAVONSKA BANKA d.d.[1]
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31000 OSIJEK

Phone: + 385 31/231-231
Fax: + 385 31/201-039
Tlx: 28235, 28090 banka rh
SWIFT: SLBO HR 2X

SPLITSKA BANKA d.d.[1]
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Phone: + 385 21/312-777
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Tlx: 26252 st bank rh
SWIFT: SPLI HR 2X

ŠTEDBANKA d.d.[1]
Slavonska avenija 3
10000 Zagreb

Phone: 385 1/6306-666
Fax: 385 1/6187-015
SWIFT: STED HR 22

VARAŽDINSKA BANKA d.d.[1]
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Fax: + 385 42/400-112
Tlx: 23224 banka rh
SWIFT: VBDD HR 2X
Reuters: VBVH

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10000 Zagreb

Phone: + 385 1/4801-300
Fax: + 385 1/4801-365
SWIFT: VBCR HR 22

ZAGREBAČKA BANKA d.d.[1]
Paromlinska 2
10000 Zagreb

Phone: + 385 1/6104-000
Fax: + 385 1/6110-555
Tlx: 21462 zaba rh
SWIFT: ZABA HR 2X
Reuters: ZBZH

BRANCHES OF FOREIGN BANKS

BAYERISCHE HYPO–UND VEREINSBANK AG
Glavna podružnica Zagreb[1,4]
Ul. Alexandera von Humboldta 4
10000 Zagreb

Phone: +385 1/6159-206, 6159-198
Fax: + 385 1/6159-197

REPRESENTATIVE OFFICES OF FOREIGN BANKS

1. **BANK FÜR KÄRNTEN UND STEIERMARK AG**, Zagreb
2. **CASSA DI RISPARMIO DI UDINE E PORDENONE S.p.A.**, Zagreb
3. **COMMERZBANK AKTIENGESELLSCHAFT**, Zagreb
4. **DEUTSCHE BANK AG**, Zagreb
5. **KREDITNA BANKA d.d. TUZLA**, Zagreb
6. **LHB INTERNATIONALE HANDELSBANK AG**, Zagreb

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1 Licensed banks in accordance with Article 37 of the Banking Law (full authorization).
2 Licensed banks in accordance with Article 36 of the Banking Law (medium authorization).
3 Licensed banks in accordance with Article 37 of the Banking Law (limited authorization).
4 The request for the branch to be deleted from the Register of Companies as of December 31, 2001 was submitted to the Commercial Court on 28 December 2001.

LICENSED SAVINGS BANKS

BANICA CREDO ŠTEDIONICA d.d.[1]
Matice hrvatske 1
21000 Split

Phone: + 385 21/314-488
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GOSPODARSKA ŠTEDIONICA d.d.[1]
Stjepana Radića 2
10216 Vrbovec

Phone: + 385 1/2792-888
Fax: + 385 1/72792-855

KRAPINSKA ŠTEDIONICA d.d.
Gajeva 2
49230 Krapina

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ŠTEDIONICA MORE d.d.[1]
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ŠTEDIONICA SONIC d.d.[1]
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1 Operating license includes the collection of household foreign exchange savings and exchange operations.

List of abbreviations and symbols

al.	– allocation
BIS	– Bank for International Settlements
bn	– billion
c.i.f.	– cost, insurance and freight
CBRD	– Croatian Bank for Reconstruction and development
CBS	– Central Bureau of Statistics
CEFTA	– Central European Free Trade Agreement
CESI	– Central European Stock Index
CEI	– Croatian Employment Institute
CIHI	– Croatian Institute for Health Insurance
CLVPS	– Croatian Large Value Payment System
CNB	– Croatian National Bank
CPI	– consumer price index
CPII	– Croatian Pension Insurance Institute
cum.	– cumulative
dep.	– deposits
DMB	– deposit money bank
dom.	– domestic
EBRD	– European Bank for Reconstruction and Development
ECB	– European Central Bank
EFF	– Extended Fund Facility
EFSAL	– Enterprise and Financial Sector Adjustment Loan
EMU	– European Monetary Union
EU	– European Union
EURIBOR	– Euro Interbank Offered Rate
excl.	– excluding
fin.	– financial
FINA	– Financial Agency
FDI	– foreign direct investment
f.o.b.	– free on board
f/c	– foreign currency
FSAP	– Financial Sector Assessment Program
GDP	– gross domestic product
HICP	– harmonized index of consumer prices
HIPC	– Heavily Indebted Poor Countries
IBRD	– International Bank for Reconstruction and Development
ICEI	– Interministerial Committee for Export Insurance
IDA	– International Development Association
IDB	– Inter-American Development Bank
IFC	– International Finance Corporation
IIF	– Institute for International Finance
ILO	– International Labor Organization
IMF	– International Monetary Fund
ins.	– institution
invest.	– investment
IPT	– Institute for Payment Transactions
JCIF	– Japanese Center for International Finance
m	– million
MIGA	– Multilateral Investment Guarantee Agency
MoF	– Ministry of Finance
NCEA	– National Classification of Economic Activities
NCS	– National Clearing System
NDA	– net domestic assets
NFA	– net foreign assets
OECD	– Organization for Economic Co-operation and Development
OPEC	– Organization of Petroleum Exporting Countries
o/w	– of which
PPI	– producer price index
PRGS	– Poverty Reduction and Growth Facility
RPI	– retail price index
RR	– reserve requirement
SDR	– special drawing rights
STF	– Systemic Transformation Facility
URBEA	– Unified Register of Business Entities' Accounts
VSM	– Varaždin Securities Market
ZIBOR	– Zagreb Interbank Offered Rate
ZMM	– Zagreb Money Market
ZSE	– Zagreb Stock Exchange

Abbreviations for currencies

HRK	– Croatian kuna
ATS	– Austrian schilling
FRF	– French franc
DEM	– German mark
CHF	– Swiss franc
GBP	– pound sterling
ITL	– Italian lira
USD	– US dollar
SIT	– Slovenian tolar
EUR	– euro
JPY	– Japanese yen

Symbols

–	– no entry
....	– data not available
0	– value is less than 0.5 of the unit of measure being used
ø	– average
a, b, c,...	– indicates a note beneath the table and figure
*	– corrected data
( )	– incomplete or insufficiently verified data