The Development of the Croatian Banking Sector since Independence

Stephan Barisitz[1])

1 Introduction

Like other elements of structural reform, banking reform in independent Croatia has proceeded relatively slowly, compared to the most advanced central European countries. The delicate geopolitical situation of the country, its involvement in wars on its own territory and in Bosnia in the first half of the 1990s, authoritarian political tendencies and Croatia's long-standing political isolation from the EU are not likely to have created an atmosphere conducive to structural reform. But the Croatian government did opt for a radical macroeconomic stabilization program in 1993 that met with impressive success for a number of years and remains an important element of the economic strategy of the authorities even today (status: November 2000). The fact that Croatia did not keep up the momentum of reforms by failing to sufficiently spread them to the structural and institutional spheres even after the most preoccupying security problems had been overcome caused the country to fall back in the ranks of reforming transition economies. The pivotal relationship of macrostructural links and their effect on a country's economic performance is vividly illustrated by the eventful history of Croatia's banking sector during the last decade, featuring repeated banking crises and rehabilitation efforts.

This study attempts to trace and analyze the development of banking in Croatia since the demise of the former socialist Yugoslavia and Croatian independence (1991). Following a chronological structure, chapters 2–9 offer an overview of historic evolutions and interrelationships. Specifically, the development of legal foundations, banking supervision, banks' major sources of assets, liabilities, earnings and related changes, bank restructuring, rehabilitation programs and the role of foreign banks and FDI are analyzed. Chapter 10 gives a brief summary and focuses on some conclusions and recommendations.

2 Socialist Yugoslav Origins

In the former Socialist Federative Republic of Yugoslavia (SFRY) a two-tier banking system had already existed since the early 1960s. Its creation was connected with a number of decentralizing measures which put an end to the central planning system in Yugoslavia, as it had been copied from the USSR after World War II. At the time, two-tier banking consolidated the economic system of workers' self-management or "market socialism" of Yugoslav flavor. Workers' self-management was based on decentralized planning and "social ownership" of the means of production, a term not clearly defined and denoting neither state nor private ownership. Pervasive price controls existed. Workers' collectives and elected directors were the most important decision-making bodies in firms. However, the communist party authorities often intervened in decision making, particularly at a local level,

1 *Foreign Research Division, Economic Analysis and Research Section, OeNB.* *The standard disclaimer applies.* *The author is thankful for valuable comments made by Hermine Vidovic (WIIW), Thomas Nowotny (OeNB), Kurt Pribil (OeNB) and Doris Ritzberger-Grünwald (OeNB). The author also wishes to thank Hermine Vidovic and Thomas Nowotny for materials provided and is grateful to Andreas Nader (OeNB) for statistical support.*

where political and economic elites typically tended to intermingle. The National Bank of Yugoslavia (NBY, central bank) in Belgrade had branches in all constituent republics, including Croatia, and most commercial banks specialized in certain regions.

The Law on Principles of the Credit and Banking System, adopted in 1977, provided the detailed legal framework for banking in socialist Yugoslavia. Although commercial banks were also socially owned, they were managed by a "bank assembly," consisting of the "founders" of the bank as well as of representatives of the staff. The bank assembly elected a director. Commercial banks could be founded by state institutions, enterprises or social organizations. Founders were represented in the assembly according to the amount of their capital participation, whereas the staff representation could not take more than 10% of votes. Therefore, in contrast to firms, credit institutions were strongly influenced by their outside founders.[1]) Typically, most banks were founded by a number of enterprises and organizations, at times including some public participation; their most important assignment was to supply credits on the most favorable (cheapest) terms to founder enterprises (connected lending). Some of them have also been strongly connected to regional or national political hierarchies.

Given regional specialization and some cartel agreements on the level of interest rates on household deposits, competition was limited and banks would mainly procure funds from the local population. A major part of these funds consisted of foreign exchange deposits (mostly denominated in Deutsche mark) stemming from earnings from tourism and remittances of "guest workers" living abroad.[2]) The foreign currency was then surrendered to the NBY, which in return supplied the commercial banks with the equivalent amount in Yugoslav dinars (YUD) and the right to purchase foreign exchange from federal authorities. Owing to the dominating incentives for bank behavior and to possibilities of political interference, commercial banks' credit decisions often did not correspond to market criteria. In case the banks ran into financial difficulties, the central bank would normally act as a lender of last resort. Apart from very small private firms, enterprises usually also faced soft budget constraints; if necessary, they would be bailed out by banks or republican or federal state authorities.

This system was prone to recurring bouts of repressed and open inflation. During most of the 1980s, roughly 20 banks were active on Croatian territory, two of which served the whole constituent republic while the rest served in largely non-overlapping regional areas. In the second half of the decade, when some timid reform measures were begun and prices were partly freed, open inflation gathered momentum. In February 1989 a new federal banking law was passed; it liberalized the establishment and activity of credit institutions and required existing banks to "corporatize" themselves, i.e. turn themselves into limited liability companies or joint stock companies with the founders and staff becoming owners/shareholders. Because there

1 *Leipold (1980), p. 181.*

2 *Former Yugoslavia was more open to the West than other former socialist countries, so people could more or less freely travel to the West, and tourism in Yugoslavia (especially on the Adriatic coast) was more developed.*

Table 1

Overview: Economic Indicators Croatia

	Real GDP[1][2]	Unemployment rate	Industrial production[2]	CPI[3]	Current account[1]	Trade balance	Total official reserves minus gold	Budget surplus/deficit[4]	Gross debt in convertible currencies	Exchange rate[5]	Interest rate[6]
	percentage change over previous year	*period average*	*percentage change over previous year*		*USD million*	*USD million*	*USD million, end of period*	*in % of GDP*	*USD million*	*period average*	*%*
1990	– 7.1	×	–11.3	+ 127.4	×	×	×	×	×	×	×
1991	–21.1	×	–28.5	+ 244.2	×	×	×	×	2,823	×	×
1992	–11.7	15.5	–14.6	+11,703.7	×	×	166.8	×	2,713	×	1,889.4
1993	– 8.0	14.6	– 5.9	+ 1,133.1	623.0	295.3	617.3	×	2,638	325.16	34.5
1994	+ 5.9	14.8	– 2.7	+ 2.4	853.4	327.1	1,409.5	+1.6	3,020	190.49	8.5
1995	+ 6.8	15.1	+ 0.3	+ 4.6	–1,441.5	–2,243.8	1,895.7	–0.9	3,809	192.76	8.5
1996	+ 6.0	15.9	+ 3.1	+ 3.7	–1,091.3	–2,113.7	2,314.0	–0.5	5,308	194.83	6.5
1997	+ 6.5	17.6	+ 6.8	+ 5.0	–2,325.1	–3,194.4	2,539.1	–1.3	7,452	200.05	5.9
1998	+ 2.5	18.1	+ 3.7	+ 5.3	–1,530.4	–2,236.4	2,815.7	+0.7	9,588	194.57	5.9
1999	– 0.3	19.1	– 1.4	+ 3.8	–1,522.6	–2,022.9	3,025.0	–1.9	9,925	13.20	7.9
1999											
January	×	18.6	– 4.1	+ 3.4	×	– 226.1	2,611.6	×	×	13.64	5.9
February	×	18.6	– 5.2	+ 3.3	×	– 264.2	2,397.0	×	×	13.37	5.9
March	– 1.5	18.8	– 3.6	+ 3.3	– 562.0	– 213.9	2,451.0	×	×	13.17	7.9
April	×	18.8	– 3.0	+ 3.2	×	– 311.4	2,413.3	×	×	13.18	7.9
May	×	18.7	– 2.6	+ 3.2	×	– 297.5	2,583.0	×	×	13.18	7.9
June	– 1.1	18.6	– 1.8	+ 2.9	– 578.9	– 405.7	2,609.8	×	×	13.18	7.9
July	×	18.8	– 2.0	+ 4.6	×	– 333.6	2,755.0	×	×	13.14	7.9
August	×	18.8	– 2.8	+ 4.5	×	– 175.7	2,847.6	×	×	13.20	7.9
September	– 1.0	19.3	– 2.8	+ 4.2	421.3	– 254.0	2,816.0	×	×	13.13	7.9
October	×	19.7	– 2.3	+ 4.2	×	– 327.3	2,994.6	×	×	13.10	7.9
November	×	20.0	– 2.1	+ 3.5	×	– 398.0	2,825.6	×	×	13.08	7.9
December	– 0.3	20.4	– 1.4	+ 3.8	– 802.9	– 298.8	3,025.0	×	×	13.06	7.9
2000											
January	×	20.9	– 0.7	+ 3.9	×	– 107.4	2,852.8	×	×	13.00	7.9
February	×	21.1	+ 3.5	+ 3.9	×	– 200.7	2,807.8	×	×	12.97	7.9
March	+ 4.0	21.3	+ 3.7	+ 3.9	– 428.3	– 302.3	2,925.1	×	×	12.95	7.9
April	×	21.3	+ 1.5	+ 4.3	×	– 227.9	2,942.7	×	×	12.95	5.9
May	×	21.0	+ 1.4	+ 4.2	×	– 301.4	3,100.8	×	×	12.97	5.9
June	+ 3.8	20.5	+ 2.9	+ 5.7	– 282.3	– 379.0	3,236.8	×	×	13.05	5.9
July	×	20.6	+ 2.6	+ 5.4	×	– 344.7	3,511.3	×	×	13.17	5.9
August	×	20.8	+ 3.2	+ 5.8	×	. .	3,424.9	×	×	13.24	5.9

Source: national data, IMF, WIIW, EBRD.
[1]) Subannual: quarterly data.
[2]) 1999, 2000: cumulated periods.
[3]) Annual data: Dec. to Dec.; 1999, 2000: inflation over corresponding month of previous year.
[4]) General government.
[5]) ATS for 100 HRK; as of 1999: EUR for 100 HRK
[6]) Official CNB discount rate; end of period.

was frequently a large number of founders, the shares were often widely scattered, which meant weak power and control of owners. New private banks also entered the market.

Basic market-oriented banking supervision regulations were issued, such as limits on lending to individual borrowers, capital adequacy, credit risk assessment and provisioning for bad loans. But the NBY lacked the means to effectively enforce many of these provisions, especially the above-mentioned limits. The futile macroeconomic stabilization effort of 1990[1]) was not accompanied by any meaningful attempt at restructuring banks or enterprises. In August 1990 the Yugoslav parliament passed an amendment to the constitution of the SFRY which abolished workers' self-management and provided for transition to a capitalist market economy. Given the mounting

1 *The so-called Marković program, named after its initiator, the last federal prime minister Ante Marković.*

centrifugal political tendencies and the unraveling of the socialist Yugoslav state structures during these years, it is unclear what immediate practical effect the latter measure had.

3 The Early Years of Independence: "Linear Rehabilitation" of Banks

After Croatia gained independence in the fall of 1991,[1]) the country immediately lost control of parts of its territory as a consequence of military action. Croatia then remained subject to military tensions and warfare on its own territory and in adjacent parts of former Yugoslavia until 1995. During this time, the new government in Zagreb only controlled about two thirds of the territory of the republic.[2]) In areas directly touched by hostilities, rival ethnic groups were often expelled, fixed assets of banks or banks' customers were destroyed or became inaccessible, and operations of credit institutions were frequently forced to shut down when the towns in which they were located were occupied. Apart from the negative economic effects of the wars and disintegration of former Yugoslavia, the above-mentioned persistent security problem put big strains on the overall economic development of the country and also constituted a drag on banking reforms.

Soon after independence, the former branch of the National Bank of Yugoslavia in Zagreb became the National Bank of Croatia, called Croatian National Bank (CNB, Hrvatska Narodna banka) since 1997.[3]) The establishment of the CNB was regulated in a government ordinance issued in December 1991 and in the Law on the Croatian National Bank, enacted in November 1992. Following the model of the German Bundesbank, the law provides for an independent central bank, which is, however, accountable to parliament. The CNB is in charge of bank licensing, banking regulation and banking supervision, including in certain cases the revocation of licenses. The currency reform of December 1991 replaced the Yugoslav dinar with the Croatian dinar (HRD), to be replaced, in its turn, by a permanent currency after an improvement of the economic situation. At the time of Croatian independence (fall of 1991) there were 26 commercial banks in the country. They consisted of 20 "old" credit institutions, the two largest of which (Privredna banka, Zagrebačka banka) operated nationwide and 18 of which were medium-sized regional banks, and six new private ones active in Zagreb.

In order to take stock of the banking system inherited from former Yugoslavia, the Croatian authorities in cooperation with the auditing firm Coopers & Lybrand prepared an analysis of the quality of bank assets according to 1989 data. The results indicated that at the time, the bad assets were twice the size of bank capital. Drawing from these results and its own inquiries, the CNB noted in its 1991 Annual Report that at the end of 1990 five banks were solvent, ten banks were solvent with problems in

1 Croatia was internationally recognized during the first months of 1992.

2 The former so-called "Republic of Serb Krajina" remained outside the control of the state.

3 In order to avoid confusion, the central bank of the republic will henceforth be called by its current name, "Croatian National Bank" even if it is dealt with in reference to times before 1997.

connection with the settlement of claims, eleven banks were technically insolvent and two banks seriously technically insolvent. Yet even in this relatively somber analysis, claims on the NBY relating to transfers of foreign exchange from citizens' bank deposits to Belgrade were entered as "high quality" bank assets. These claims reportedly amounted to about USD 3.2 billion in the second half of 1991 and comprised the bulk of households' savings, or around 50% of total bank assets. With the dissolution of former Yugoslavia, the NBY stopped honoring these claims and simply seized the foreign exchange. So commercial banks were in fact stripped of most of their hard currency assets, and were left with partly dubious loans extended to enterprises in domestic currency and sizeable liabilities in foreign exchange. The problem of insolvency grew drastically and spread. Still before the NBY's refusal, a part of foreign savings had been withdrawn and transferred to bank accounts abroad or hoarded.[1])

Pent-up demand and price liberalization, the strong contraction of economic activity,[2]) major macroeconomic and structural imbalances inherited from socialism as well as the absence of any strong stabilization measures during the first years of independence triggered very high inflation, keeping in mind that price rises had been high in former Yugoslavia as well. Annual retail price inflation (December to December) rose from 240% in 1991 to over 11,000% in 1992 (table 1). During the first ten months of 1993, the monthly inflation rate was 28% on the average. This loss of internal value was accompanied by negative real interest rates and precipitated an even stronger depreciation of the Croatian dinar, thereby increasing the burden of liabilities to depositors. Currency substitution – foreign currencies, especially the Deutsche mark, replaced the Croatian dinar in everyday transactions – gathered momentum. Given the relatively liberal framework of bank licensing and supervision stemming from the former Yugoslav banking law of 1989, and given the emergence of new sources of earning money partly linked to the unstable macroeconomic situation (e.g. currency arbitrage transactions, speculation and foreign trade financing), the total number of banks increased substantially to 43 at end-1993 (table 2).

Despite this proliferation of credit institutions, the widespread insolvency and fragility of the banking sector, particularly of "old" banks, demanded urgent attention. The authorities decided to attack two major structural problems inherited from the socialist past. One problem was linked to enterprise debtors who were victims of the economic calamities brought about by the collapse of former Yugoslavia and of the ineffective use of credit resources stemming from lending decisions taken in the socialist era. Many of these debtors had become delinquent. Therefore the government in 1991 and 1992 issued so-called "big bonds" to large socially-owned companies in an amount equivalent to about USD 1 billion. In exchange, the government took (additional) equity in the enterprises. With these securities the enterprises repaid banks the nominal value of their overdue obligations. The bonds were issued for a term of 20 years and were indexed to the

1 *Jankov (2000), p. 3.*

2 *On the whole, Croatian GDP is estimated to have contracted by about one third from 1989 to 1993.*

producer price index. However, since they paid no interest and were not tradable, they did not provide banks with new liquidity.

The other problem related to the unserviceable foreign currency deposits. In 1992 the government of Croatia assumed responsibility for the respective claims (amounting to about USD 3 billion) against the NBY. Since the newly independent Croatian state had few foreign exchange reserves, it issued to the banks domestic currency-denominated "counterpart bonds" indexed to the Deutsche mark. In order to prevent the withdrawal of the deposits from the banking system, which would have precipitated the failure of banks, these deposits were blocked for a period of three years (until July 1995) and thereafter unfrozen at the minimum rate of 20 semiannual installments. The bonds bear 5% interest and are payable semiannually. Individuals have, however, been allowed to buy back their blocked deposits at a 30% discount or to swap them for government bonds, which could be used to purchase socially-owned apartments or firms. While this has met with some interest, the bulk of foreign currency deposits remained frozen (until the beginning of the unblocking process).[1])

These two measures were called "linear rehabilitation" measures, since they were not geared to specific banks but aimed at doing away with particular economy-wide problems by giving every bank securities in an amount proportional to its nonperforming claims. This was done in a static manner, in some respects resembling a bookkeeping operation to clean up balance sheets. Thus, linear rehabilitation at once and formally solved the problem of insolvency and decapitalization of many banks, which were relieved of a financial burden and given new room to maneuver. Claims on government came to represent almost half of total banking assets at end-1993. Yet the bonds placed in banks' portfolios did not provide them with sufficient liquidity and only earned below-market yields; customary rehabilitation measures or substantial restructuring, like changes in management or bank ownership, curbs on granting credits to dubious debtors, and in the last instance, bank bankruptcy, were not implemented or envisaged. In fact, two interest groups continued to hold sway over many banks: large debtors and politicians. Since basic incentives remained unaltered, linear rehabilitation lacked a dynamic impact on credit institutions' behavior. Overall, soft budget constraints continued to operate in the real as well as the financial sector, and imprudent lending practices (particularly to owner-enterprises) persisted.

Bank privatization got off to a slow start at the beginning of the 1990s. Apart from the issuing of new shares (capital increases), banks were usually privatized indirectly, i.e. through privatization of their shareholders, mostly socially-owned enterprises.[2]) In order to make enterprise privatization legally possible, in a first step enterprises were *de jure* nationalized, then shares were sold by the Croatian Privatization Fund. This was often a gradual process, dominated by MEBOs (management and employee buyouts), given the power staff traditionally held in firms formerly subject to workers' self-

1 *Van Elkan (1998), p. 6 to 7.*

2 *Another way of privatizing banks was through "case-by-case rehabilitation," involving the cancellation of (part of) shareholders' capital and its takeover by the state (see below).*

management. While politically understandable, MEBOs did not provide privatized enterprises with new capital or know-how. Moreover, company managers often remained the same persons. As a result, the ownership composition of almost all the "old" banks has constantly changed, being determined by privatization of their enterprise owners. But this in itself did not give a strong impetus to restructuring. Before 1993, no "old" bank was more than 50% privately owned.

4 The Stabilization Program (1993) and New Legislation

In 1993 inflation, having become a chronic phenomenon, persisted even in the absence of significant fiscal deficits. In the context of an accommodative monetary policy, widespread indexation prevailed and, notwithstanding the loss of hard currency deposits to Belgrade and capital flight, currency substitution expanded throughout the economy.

In October 1993 the authorities embarked on an ambitious stabilization program which consisted of two major elements: first, restrictive monetary, fiscal and incomes policies and (after an initial devaluation) a strong orientation of the exchange rate of the Croatian currency to the Deutsche mark as a nominal anchor in the formal framework of a managed float in order to achieve rapid disinflation; also, curtailment of CNB-refinancing of credit institutions; and second, implementation of major structural adjustments in the economy, including stepping up the privatization process, demonopolizing parts of the economy, restructuring loss-making industries (such as shipbuilding) and rehabilitating the banking sector. Whereas the first plank of the program was carried out with impressive results, the second plank has been much more difficult, and its realization has turned out to be a protracted matter. In fact, in a number of areas structural reforms have still not been concluded or have remained at an early stage. Indexation was discontinued and the authorities succeeded in quickly cutting galloping inflation to almost zero. In a few months, inflationary expectations were broken. In May 1994 the Croatian dinar (HRD) was replaced by the Croatian kuna (HRK) as a permanent currency at a ratio of HRD 1,000 for HRK 1. In 1994, annual inflation slowed to about 2% (Dec. to Dec.), and in the following years remained stable at a moderate level (4 to 5%). Economic growth reappeared in 1994 and remained robust until 1997 (table 1).

The success of the stabilization program substantially improved the macroeconomic environment for banking activity. Real interest rates turned positive and, as economic confidence slowly returned, capital flight diminished and hard currency that had been kept abroad or stashed away started to flow back into the banking system. As a result of this capital inflow, the stock of new foreign currency deposits (i.e. deposits that were established after 1991 and whose withdrawal was not blocked) expanded from USD 820 million at end-1993 to USD 4.0 billion (68% of all deposits) at end-1996. This fueled a strong expansion in lending. At the same time, given the stabilization of prices and of the exchange rate and the return of confidence in the Croatian currency, reverse currency substitution was observed.

The legal framework for banking was also improved. The new Banks and Savings Banks Act (October 1993) rendered legislation more compatible

Table 2

Number and Size of Commercial Banks[1]) and Savings Banks in Croatia

Period	Total number of commercial banks	Commercial banks graded according to their assets		Total number of savings banks	Savings banks graded according to their assets	
		Less than HRK 1 billion	HRK 1 billion and over		Less than HRK 100 million	HRK 100 million and over
Dec. 1993	43	35	8	0	0	0
Dec. 1994	50	40	10	33	31	2
Dec. 1995	53	42	11	21	20	1
Dec. 1996	57	42	15	22	21	1
Dec. 1997	60	41	19	33	30	3
Dec. 1998	60	37	23	33	29	4
Dec. 1999	53	34	19	30	26	4
Aug. 2000	50	32	18	30	26	4

Source: CNB.
[1]) Reporting deposit money banks as defined by the CNB.

with that of a capitalist market economy. The law, modeled on the German *Kreditwesengesetz* (Banking Act), set a number of prudential standards which did not exist before 1993. To give an example, the minimum capital adequacy ratio was set at 8% of risk-weighted assets in accordance with international standards.[1]) Lending to shareholders and single borrowers was restricted to certain shares of liable capital. Lending to members of management or supervisory boards required the approval of both bodies, but there were no quantitative limits on loan size. The law allowed for three types of credit institutions: banks with a "full license" (requiring minimum capital equivalent to DEM 15 million), banks with a "limited license" (minimum capital of DEM 5 million) and savings banks (minimum capital of DEM 1 million). Branches of foreign banks had to satisfy a minimum capital requirement of DEM 2.5 million. The scope of business was defined for universal banks, but banks with a limited license were not permitted to engage in international banking business and savings banks in addition were not allowed to accept enterprise deposits. Remaining limitations on private and foreign ownership of credit institutions were removed.

All banks operating at the time the law was enacted were asked to bring their operations into line with the law by the end of 1995. Licensing remained a relatively easy hurdle to pass, since one of the goals of the law was to foster competition and break some still existing regional monopolies. In December 1994, the total number of banks in Croatia increased to 50, 24 of which were "new" private banks. While most of them kept the focus of their activities in the nation's capital, some started to penetrate the regions. Some limited further competition was induced by the (formal) entry of savings banks into the market. While in 1993, according to official data, there had been none, in December 1994 the country disposed of 33 savings banks. Most of them had apparently operated in the informal sector until 1994. But

1 *However, reported capital adequacy ratios depend on accounting standards and on classification rules used to assign assets to risk categories. In this respect, Croatian implementation guidelines did not uniformly conform to international standards and/or have not always been consistently applied.*

these entities were quite small, their activities locally focused, and their assets together did not exceed 2% of the assets of all credit institutions. Notwithstanding the proliferation of banks, concentration remained high. The share of total assets of the two "old" banks operating nationwide continued to amount to around 55% of total assets through 1995.

5 Banking Problems in the Mid-1990s

Although the macroeconomic situation and the general legislative framework improved, a significant part of the banking sector still faced considerable financial difficulties resulting from continuing regional military hostilities, the accumulation of nonperforming loans, the reduction of central bank refinancing, and restrained liquidity reflecting a sizeable fraction of assets in the form of nontradable government debt.[1]) The financial needs of banks in difficulty drove up interest rates on the interbank money market, enabling other credit institutions to earn high interest rate margins on liquidity supplied by the repatriation of foreign savings. Rising interbank rates had repercussions on interest rates economy-wide. Average quarterly interbank rates and credit rates rose above 25% (on an annual basis) at end-1995 and stayed at a high level in the first half of 1996 (chart 1).

In order to tackle some of these problems, strengthen legal sanctions against loss-making banks and protect depositors, the Law on Bank Rehabilitation and Restructuring (June 1994) was adopted and the State Agency for Bank Rehabilitation and Deposit Insurance (BRA, the Agency) established. According to the law, banks with losses in excess of 50% of capital are obliged to submit to the rehabilitation and restructuring process. A bank can voluntarily choose to undergo this process if its losses are less than the 50% threshold. The CNB then has to conduct a feasibility study of the bank and recommend to the government whether rehabilitation is desirable. If the government approves, existing shareholders' equity is written off against losses (or suspended), the bank's management may be dismissed, new capital provided and governance authority and ownership partially or fully transferred to the BRA (the state).

A new deposit insurance scheme covers savings deposits of individuals and is administered by the BRA. It is financed through premiums levied on credit institutions.[2]) In the event that a bank entered bankruptcy, the BRA was at first authorized to pay to insured depositors 100% of the first HRK 30,000 (or foreign exchange equivalent) and 75% of deposits between HRK 30,000 and HRK 50,000. From July 1, 1998, the maximum coverage was increased to HRK 100,000 (approximately USD 16,000), and the graduated system was abolished. Premiums are levied at a rate of 0.2% of insured deposits per quarter. All premiums are paid – and the Agency's investments are held – in local currency, while about three quarters of insured deposits are denominated in foreign currencies. Insurance applies to all eligible

1 *From 1993 to 1996 the government did not pay interest and only partially paid principal on "counterpart bonds" in cash. Instead, it serviced this debt by issuing new securities.*

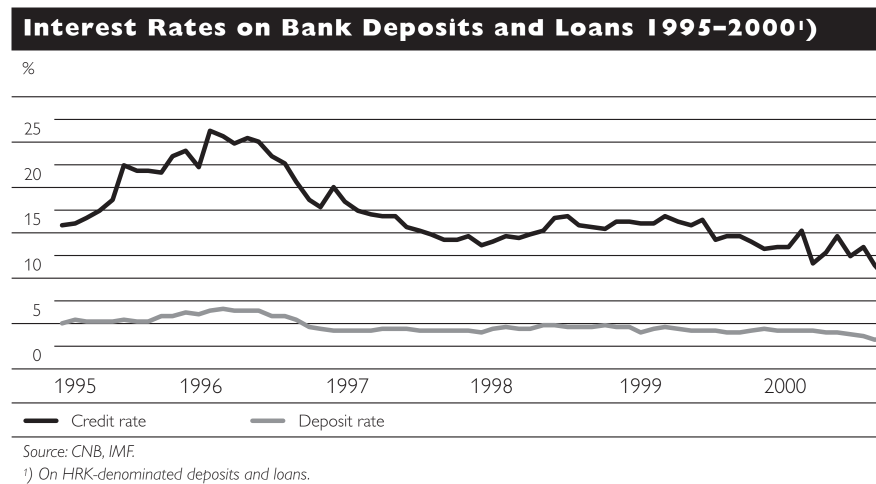
2 *Although the law was enacted in 1994, the scheme did not become operational at that time, because the Ministry of Finance did not specify the insured amount per deposit until 1997.*

accounts regardless of the financial soundness of the bank holding the deposits.

The rehabilitation process according to the law involves three stages: The first is financial restructuring, which comprises the write-down of bad loans against loss provisions and capital and, if these are insufficient, against bonds issued by the BRA. Further BRA bonds may be issued to provide initial capital for the bank. The loans are transferred to the BRA for workout. The second stage consists of operational restructuring, which involves the draft and implementation of a recovery plan for the bank, usually including measures to improve operating efficiency and risk assessment capabilities. The third stage is privatization of the state's share to investors that are not also major debtors of the bank.[1]) Since, in contrast to linear rehabilitation, this process focuses on the economic situation of individual credit institutions, it can be termed "case-by-case rehabilitation."

Chart 1

Interest Rates on Bank Deposits and Loans 1995–2000[1])



Source: CNB, IMF.
[1]) On HRK-denominated deposits and loans.

6 "Case-by-Case Rehabilitation" Measures

Although the above-mentioned reform laws had been enacted in 1993 and 1994, substantial bank rehabilitation measures according to the procedures outlined did not start until the fall of 1995. Certainly, in the preceding years the attention of the authorities with respect to economic policy had been focused on assuring the success of the Stabilization Program. Moreover, the long-lasting military standoff and conflict that had affected the country throughout the first half of the 1990s came to an end with the war in the summer of 1995,[2]) after which the Croatian authorities resumed control of almost the entire territory of the republic.[3])

Four "old" banks (one with nationwide operations, and three big regional banks), which together accounted for 46% of total banking sector assets at end-1995, were selected for the rehabilitation process as stipulated by the

1 *Van Elkan (1998), p. 8.*
2 *The reconquest of the "Krajina."*
3 *The last part of the "Krajina," Eastern Slavonia, was reclaimed through negotiations in 1997.*

1994 bank rehabilitation law. The four banks were: Privredna banka (in terms of assets the largest commercial bank in Croatia until its restructuring, headquartered in Zagreb), Riječka banka and Splitska banka (the two largest regional commercial banks, from Rijeka and Split/Dalmatia respectively), Slavonska banka (the fifth largest regional commercial bank, from Osijek/Slavonia). Thus, the restructuring exercise applied to four out of the seven largest credit institutions.

The least troubled of the four banks and the first to enter the rehabilitation process was Slavonska banka, and it did so voluntarily in October 1995. The BRA injected liquidity into the bank by purchasing a part of its "big bonds" (with a discount) and granted a short-term credit. The Agency acquired a minority share (35%) of the bank's equity, giving it veto power on the bank's supervisory board. The existing management team was retained, and Slavonska banka took the obligation to reduce its loans to large borrowers and owners as well as enterprise stakes it had acquired through debt-equity swaps to the limits stipulated by law. The second phase of rehabilitation, which was drafted by the bank and approved by the BRA, was largely completed in 1997, and the state's share was successfully sold to the EBRD and Kärntner Landes- und Hypothekenbank (of Austria) in 1998.

Riječka and Splitska banka entered into obligatory rehabilitation in April 1996. Riječka banka reportedly was saddled with 1.4 times more bad credits than capital; in Splitska banka, this relationship was 2.3. The sum of bad loans of both credit institutions accounted for about 6% of the total volume of loans of the banking sector in mid-1996.[1]) The two banks' entire capital was wiped out in the process of writing off the credits; the BRA became the sole owner of both banks, government bonds were placed in their portfolios and new management teams were installed. Operational restructuring of the banks has made considerable progress. The state partially divested its equity holdings in 1997. During the first half of the year, former private sector shareholders who were not debtors of the banks and had a good record of creditworthiness were allowed to acquire a quarter of the banks' shares at concessional prices. As a result, the state's share in Riječka banka declined to 75%, while its share in Splitska banka only fell to 88%, since not enough former shareholders met the conditions for the transaction. In the spring of 2000, majority shares in both banks were sold to strategic foreign investors: Bayrische Landesbank (Germany) bought a 59% stake in Riječka banka for USD 76 million, and UnoCredito Italiano secured a 63% holding in Splitska banka for USD 57 million.

The obligatory rehabilitation procedure for Privredna banka started in December 1996. This institution held a very large amount of bad credits that exceeded its capital by a factor of about 2.7; in November 1996, Privredna banka's bad loans made up about a quarter of all loans of the banking sector.[2]) Almost all capital was written off in the first phase. After recapitalization through bonds and an injection of liquidity, the BRA had an ownership stake of 90%. Furthermore, there was a turnover of the bank's management.

1 *Jankov (2000), p. 4.*

2 *Ibid.*

Operational restructuring was complicated and took about three years. The authorities then privatized Privredna banka through sale to a foreign strategic investor. In December 1999 Banca Commerciale Italiana paid EUR 301 million (about the same amount in U.S. dollars at the time) for a 66% stake in the bank.

Rehabilitation of the four credit institutions had a strong effect on outstanding bank credit and government debt. In 1996 loans to enterprises with a face value of about HRK 2 billion were written off from Riječka banka and Splitska banka, and a further HRK 4 billion in credits were written off the books of Privredna banka; this was the equivalent of around one fifth of the stock of credit to enterprises at end-1995. Government bonds were issued and cash payments made to recapitalize the four banks; they totaled HRK 3.2 billion (about 4% of GDP). The bonds have a maturity of 10 years and carry an interest rate of 6%; both amortization and interest are due semi-annually. Since these bonds (like the "counterpart bonds") were indexed to the Deutsche mark, they increased the exposure of the state to exchange rate movements. But foreign exchange revenues from the above-mentioned privatizations (mostly in euro) eased this constraint.

The most obvious initial consequence of the rehabilitation of the four banks was a decline in the level of interest rates. The restructuring of these banks' assets, their receipt of bonds yielding greater liquidity than had been the case in the framework of linear rehabilitation and the injection of cash caused the liquidity situation of the four banks to improve dramatically. As a result, pressures on interbank interest rates eased markedly already in mid-1996, contributing to a general decline in interest rate levels. Moreover, the expansion of banks' deposit-taking and lending activities resumed. However, some deterioration of loan portfolios reportedly occurred in 1997 and 1998, notably in Slavonska banka. More generally, in connection with continuing shortcomings in accounting practices, the CNB estimated that the banking sector failed to make provisions for dubious assets amounting to HRK 2.9 billion (or about 30% of liable capital) in 1996.

Zagrebačka banka (the largest credit institution of the country since the rehabilitation of Privredna banka) has been relatively well managed. Its major clients have been private export companies in good financial condition. Zagrebačka banka has therefore been able to restructure on its own. It was the first Croatian bank to get an international credit rating, and in mid-1996 it floated about 25% of its capital on the London Stock Exchange. As of the beginning of 1998, about a third of the bank's capital was owned by foreigners. At end-1996, 48 banks (out of a total of 57) were majority privately owned (i.e. more than half of their shares were held by privately owned firms). These private and privatized credit institutions accounted for 60% of the assets of the banking sector. 20 banks, all licensed after 1991, were entirely in private ownership.

7 Persisting Structural Shortcomings of Banking Activities

In 1998 the total number of banks in Croatia amounted to 60, the highest number so far (table 2). This quite large number for an economy of 4.8 million inhabitants indicated considerable potential for consolidation and was bound to weaken the capacity of the CNB to adequately monitor all credit institutions. On the other hand, the relatively liberal approach to licensing probably enhanced competition, as outlined below. But the sector remained highly concentrated, with the two largest banks of the socialist period (the privatized Zagrebačka banka, and the largely state-owned Privredna banka) still dominating the market and accounting for about 42% of total assets, 35% of deposits and 30% of the capital of the banking sector. The three medium-sized banks rehabilitated in 1995–96[1]) (Slavonska, Riječka, Splitska) made up 17% of total assets. Five rapidly expanding small to medium-sized banks, consisting of some former regional and some "new" private banks, accounted for 12%, while the remaining 50 banks accounted for 29% of total assets.

Foreign-owned banks slowly consolidated their foothold in Croatia and started to trigger more competition. The share of majority foreign-owned banks in total assets of the sector increased to 4% at end-1997 and 7% at end-1998. In 1998 there were still 33 savings banks with comparatively modest resources.[2]) The first foreign banks to enter Croatia were Austrians (RZB/Raiffeisen-Zentralbank Austria at the beginning of 1995, then BankAustria in 1996). Other early entrants were Germany's Hypo-Vereinsbank, Société Générale, BNP-Dresdner Bank and Cassa di Risparmio di Trieste.

The years following the adoption of the Stabilization Program and the end of military hostilities witnessed a strong economic expansion in Croatia accompanied by a stable exchange rate and one of the lowest inflation rates of all transition countries. One of the major factors stimulating this expansion was strong capital inflows, which mainly consisted of the repatriation of foreign currency resources and deposits. This certainly reflected enhanced confidence in the domestic banking sector. Foreign currency deposits with Croatian banks rose to around USD 4.9 billion at end-1997 and peaked at USD 6.1 billion at end-1998 before declining somewhat in 1999. Foreign currency deposits came to around 80% of total bank deposits, which is among the highest comparable shares in the entire region.

This inflow as well as credits taken up abroad and strong increases in real wages fueled rapid growth of lending and a "catching-up process" in domestic consumption, which triggered a substantial deterioration of the current account. Croatia's current account balance turned negative in 1995, and the deficit quickly grew to 11.6% of GDP in 1997 (see also table 1). Since most of the credits extended on the basis of the foreign exchange inflow were in domestic currency, the entire banking sector's open foreign exchange position (i.e. the ratio of foreign currency liabilities to foreign currency assets)

1 Besides Privredna banka.

2 Their total assets in comparison to commercial banks' assets did not exceed 1%.

grew from 135% at end-1995 to 231% in December 1998 (table 3).[1]) However, it must be added that the bulk of the Croatian kuna credits granted were indexed to the Deutsche mark (currency clause). By doing this, banks substituted credit risk for foreign exchange risk. Despite the anti-inflationary success of the authorities, the Deutsche mark continued to constitute a *de facto* dual currency in Croatia.

A number of "aggressive risk-taking banks"[2]) (which, apart from some privatized former regional banks, mostly consisted of "new" private banks predominantly located in Zagreb) outperformed other banks in attracting foreign currency deposits by offering high interest rates. Many of them then lent the money on to other banks or enterprises, likewise demanding high lending rates. Loans to households (e.g. real estate and automobile purchase credits) expanded strongly, albeit from a low base. They grew from a share of 9% of total bank credits at end-1993 to 26% at end-1997. The above-mentioned credit institutions, unencumbered by a legacy of nonperforming loans or low-liquidity assets, quickly gained market share,[3]) but their behavior raised concerns about the riskiness of their lending. Notwithstanding the improved framework of banking supervision according the law of 1993, elements of related party lending, single client exposure, inadequate provisioning, and political interference in banking decisions reportedly resurfaced. Some banks showed irresponsible management of their depositors' money, sometimes even accompanied by irregularities and criminal activities, like money laundering.[4])

A number of factors brought problems to a head. After the bulk of foreign savings had apparently been repatriated, the inflow of foreign exchange leveled off in 1998. Some problems started to emerge in the repayment of credits based on these inflows. The Asian financial crisis of the fall of 1997 and the Russian crisis a year later narrowed foreign borrowing opportunities for emerging economies, including Croatia and its banking sector, and increased foreign investors' nervousness. Given the strong deterioration of the external balances, the authorities decided to tighten fiscal and monetary policies. The latter measures were also aimed at protecting the stability of the exchange rate.

This further exacerbated the situation of high risk-taking banks. After remaining stable at a level of about 10% for almost two years, interbank rates were driven up to about 15% in the spring of 1998. Continuing institutional weaknesses related to the persistent degree of nontransparency stemming from the failure to consistently apply international accounting standards, to the lack of a clear market exit mechanism for banks provided for by legislation, and to the still modest experience and insufficient human capital in

1 *Own calculations based on CNB data. Calculations exclude households' blocked foreign exchange deposits and counterpart bonds (domestic currency-denominated, but linked to the Deutsche mark) issued for blocked deposits.*

2 *See description in Babič, Jurković and Šonje (1999), p. 23, p. 28.*

3 *An indication of developments can be taken from the fact that the number of credit institutions with assets between HRK 1 million and HRK 10 million, which the CNB defines as medium-sized banks, increased from 6 in 1993 to 21 in 1998.*

4 *As stated in the lecture of Marko Škreb, former Governor of the CNB, at the OeNB on May 21, 1999. Report on the Lecture by Marko Škreb, p. 103.*

the area of banking supervision in the CNB. These shortcomings have probably prevented the CNB from intervening earlier in the evolving new crisis. Up to a point, the fact that all banks that had so far encountered difficulties had been rescued by the state contributed to a moral hazard problem affecting banks' behavior. The bankruptcy system for enterprises had also proved to be relatively ineffective. Since some drawbacks of the existing banking and bankruptcy laws had become evident, the authorities made preparations to overhaul the legislation. The expansion of lending activity of high risk-taking banks contributed to the growth of the share of private banks in total assets and capital of the banking sector (to 67% and 74% respectively by end-1997).

Table 3

Commercial Banks' Open Foreign Exchange Position[1])

	Dec. 1993	Dec. 1994	Dec. 1995	Dec. 1996	Dec. 1997	Dec. 1998	Dec. 1999	Aug. 2000
	HRK million							
Commercial banks' foreign currency assets								
Reserves	–	–	–	–	–	1,668	4,635	5,651
Foreign assets	6,192	7,047	9,279	12,526	16,168	12,743	12,353	18,674
Claims on central government and funds	967	1,252	1,866	1,843	1,971	1,893	959	1,650
Claims on other domestic sectors (enterprises, households, local government)	10,139	10,094	11,050	8,087	8,443	9,087	7,063	6,757
Total foreign currency assets	17,298	18,393	22,195	22,456	26,582	25,391	25,010	32,732
Commercial banks' foreign currency liabilities								
Foreign currency deposits	5,412	8,783	14,099	21,818	31,278	37,791	36,966	43,370
Foreign liabilities	11,971	13,101	15,108	12,381	13,540	15,878	17,027	17,283
Central government and funds' deposits	316	158	265	136	4,488	4,265	2 559	2,857
Restricted deposits	325	433	416	641	939	498	610	606
Total foreign currency liabilities	18,024	22,475	29,888	34,976	50,245	58,612	57,162	64,116
	%							
Open foreign exchange position (foreign currency liabilities as %age of foreign currency assets)[1])	104.2	122.2	134.7	155.7	189.0	230.8	228.6	195.7

Source: CNB Bulletins September 2000 (no. 52), October 2000 (no. 53) and own calculations based on data provided in these Bulletins.
[1]) Excluding households' blocked foreign exchange deposits and "counterpart bonds" (domestic currency-denominated, but linked to the DEM/EUR) issued for blocked deposits.

8 The New Banking Crisis of 1998 to 1999, First Bankruptcies and Measures of the Monetary Authorities

The underlying insolvency of several banks became apparent in the course of 1998, when the gains in market shares of the "aggressive banks" abruptly came to an end. In February, a struggle among owners of the fifth largest bank, Dubrovačka banka, led to rumors about the bank's financial difficulties and triggered a run on deposits. Dubrovačka banka (based in Dubrovnik) belonged to the former network of regional banks. It was privatized in 1994 with the sale of a large stake to a businessman with strong political connections attempting to consolidate an important position in the hotel industry of the Dalmatian region. The bank had inherited some problems of the past (comparable to those of the rehabilitated banks of the mid-1990s) as well as engaged in aggressive risk taking. After suffering severe liquidity bottlenecks, Dubrovačka banka received emergency liquidity support from the CNB and was subjected to rehabilitation procedures (corresponding to the

rehabilitation law of 1994), including a write-off of shareholders' equity and a turnover of management.[1])

The failure of Dubrovačka banka undermined confidence and resulted in a withdrawal of deposits from other credit institutions. Reverse currency substitution stopped and gave way to opposite tendencies. By mid-1998, the liquidity position of the sixth largest bank, Glumina banka, had also seriously deteriorated. Although the bank requested CNB support, the monetary authorities, in a break with the past, did not recommend deeply insolvent Glumina banka for rehabilitation. In contrast to Dubrovačka banka, which served a specific region, Glumina banka had its headquarters and main operations in the capital of Zagreb, where the banking sector was already relatively highly developed and where there was more competition. While an improved legal framework was in preparation, several other banks experienced serious liquidity problems and some stopped meeting their obligations. The CNB stepped up its provision of exceptional liquidity assistance.[2])

To prepare for interventions after the expected adoption of the new banking law, the CNB commissioned two audit firms to examine the 1997 financial accounts of 12 banks and bring them into line with international accounting standards. The new Banking Law was enacted in December 1998.[3]) It strengthened the central bank's regulatory and enforcement powers and clarified and facilitated bankruptcy procedures. In particular, it established the institution of a temporary administrator in the event of the insolvency of a bank. The temporary administrator is empowered to take control of the respective bank's assets and is assigned the task of developing and recommending to the CNB a strategy for solving the bank's problems. The new law also raised minimum initial capital requirements, increased the capital adequacy ratio to 10% and reduced maximum exposure limits to single clients, and shareholders and related parties. The category of savings banks was abolished, and all such institutions are obliged to meet the criteria for commercial banks by end-2001.[4]) Enterprise bankruptcy legislation was amended in March 1999 to strengthen creditors' rights and accelerate procedures.

Equipped with its new powers, the CNB began to implement a number of measures to address individual weaknesses of the identified problem banks. The latter accounted for approximately 15% to 20% of total assets of the banking sector in 1998. The first type of problem banks solely consisted of Croatia banka. This was the country's twelfth largest credit institution, the closure of which, however, was viewed by the CNB to pose a systemic risk. In February 1999 the monetary authorities appointed a temporary administrator and supplied continuous liquidity support. Following CNB recommendations, the government in September 1999 decided to rehabilitate the bank and issued government bonds for its recapitalization.

1 *It became the fourth bank out of the top five (measured by assets at the beginning of 1998) to undergo rehabilitation.*

2 *Lönnberg and Maggi (1999), p. 37.*

3 *This law replaced the Banks and Savings Banks Act (of 1993).*

4 *Lönnberg and Maggi (1999), p. 37.*

The second type of problem bank comprised 14 commercial and savings banks deemed to be insolvent. These institutions together made up around 8% of total banking assets. The CNB appointed temporary administrators for all of these banks and filed requests to the commercial courts for bankruptcy proceedings against ten banks. In 1998 and 1999 the courts decided to initiate such proceedings against eight institutions, among them (the abovementioned) Glumina, Gradska, Ilirija, Komercijalna, Neretvansko-gospodarska and Županjska banka. Temporary administrators in the six remaining banks were instructed to take action aimed at improving the collection of their claims, cutting operating costs and preparing opportunities for possible mergers with sound credit institutions.

In the third instance, the CNB took preventive measures with respect to small banks that were weak, but still solvent. Individual supervisory agreements between the banks and the monetary authorities were concluded. By end-1999, all credit institutions concerned were implementing remedial actions mandated by the CNB, regardless of the difficult macroeconomic environment. The banking crisis itself had compounded the dampening effects of the fiscal and monetary tightening on growth. Real GDP growth fell to 2.5% in 1998. While the current account deficit fell to 7.1% of GDP in 1998, this was by no means yet reassuring.

In 1999 the Kosovo war (March to June) further aggravated the economic situation by substantially reducing Croatia's tourism receipts. The country suffered a mild recession that year (GDP: –0.3%) and ended up with a current account gap about the same size as in 1998. Inflation was slightly higher in 1998 (5.3%) than before. During the half year that followed the Russian financial crisis (of August 1998), the real exchange rate of the Croatian kuna to the Deutsche mark depreciated by about 8%, but recovered somewhat afterwards. This depreciation may have added to some credit losses suffered with respect to Deutsche mark-indexed loans. In 1998 and 1999, total CNB cash injections into problem banks amounted to HRK 1.8 billion (1.3% of 1999 GDP), issues of government securities for bank recapitalization came to HRK 2.7 billion (1.9% of GDP).[1]) Since the resources of the BRA for reimbursing depositors of banks undergoing bankruptcy proceedings were not (yet) sufficient, the government introduced a major revision to the budget in mid-1999 to include means for paying out a third of insured deposits in 1999. Total spending to reimburse insured deposits is estimated at about 2% of GDP.[2]) Due to the takeover of assets of rehabilitated banks by the BRA (the state) and the exit of a number of bankrupt private institutions, the share of private banks in total assets and capital of the banking sector temporarily declined to 59% and 64%, respectively, in mid-1999. The share of majority foreign-owned banks increased to 9% of assets and to 15% of capital.

By the end of 1999, the most immediate problems of the crisis appeared to have been overcome and public confidence at least partly restored. Although the Croatian public had been unaccustomed to the fact that banks

1 *Lönnberg and Maggi (1999), p. 38.*

2 *Report on the Lecture by Marko Škreb (1999), p. 102.*

can go bankrupt, by and large it calmly accepted the restructuring measures. Money that had been withdrawn from Croatian kuna as well as foreign exchange deposits in banks that were not subject to bankruptcy procedures started to flow back in mid-1999. Reverse currency substitution returned.[1]) In 2000, foreign exchange deposits in the banking system reached new record levels. The closure of some problem banks favorably influenced supply and demand on the interbank market, thus reducing interest rates. The bankruptcies may also have sent a signal to the banking sector in general, breaking or weakening expectations of future bailouts and thereby reining in moral hazard problems. But the multiplicity of claims on strained budgetary resources has given rise to concern.

Ljubinko Jankov estimated total fiscal expenditure, or, more precisely debt issuing, for the rehabilitation of banks in Croatia during the period from 1991 to mid-1998 at around 31% of annual GDP.[2]) This debt build-up consists of: First, government-issued bonds ("big bonds" and "counterpart bonds") in 1991–92 for the "linear rehabilitation" of banks: 22.6% of GDP; second, bonds issued in lieu of cash in 1993–96 to service liabilities related to counterpart bonds: 1.2% of GDP; third, securities issued in 1996 for the rehabilitation of Riječka banka, Splitska banka and Privredna banka: 6.1% of GDP; and fourth, bonds issued for the restructuring of Dubrovačka banka in the amount of 0.8% of GDP. If one disregarded just mentioned expenditures in connection with Dubrovačka banka and instead took earlier data on issues of government liabilities with respect to all bank rehabilitation measures in 1998 and 1999 (Lönnberg and Maggi: 1.9% of GDP), one would arrive at an estimate of total cumulative indebtedness for bank rehabilitation in 1991–99 of 32% (or roughly a third) of gross domestic product.

This is regarded as high in comparison with central European countries as well as in an international comparison.[3]) But it covers neither expenditures for the settlement of insured deposits in bankrupt banks, nor the sizeable cash injections repeatedly carried out by the CNB, nor does it take into account the costs of the banking crises borne by other actors and sectors of the economy (e.g. depositors, enterprises, regions). Liabilities acquired by the government of Croatia in connection with bank rehabilitation came to the equivalent of USD 4.3 billion and made up about 95% of total (domestic and foreign) government debt in 1992. The latter amounted to around a quarter of GDP. Until 1998 debt due to bank rehabilitation grew to USD 5.6 billion, but in relative terms declined to half of total government debt, which had grown slightly to 26% of GDP. The servicing of debts for bank rehabilitation has been a considerable burden for the national budget, especially since 1996.

1 *After the local currency share of broad money had declined to 31% in March 1999, it climbed back to 35% in October 1999.*

2 *Jankov (2000), p. 7.*

3 *Jankov (2000) p. 7–8; see also international comparisons in Šonje and Vujčić (1999), p. 11 to 12.*

9 Current Structural Adjustment Efforts and FDI

The year 2000 (as of November) has seen a confluence of largely positive macroeconomic changes and strong, very favorable structural changes, improving the overall situation of the banking sector. But it is not yet clear whether the adjustments have produced the critical mass needed to bring about a "breakthrough" on the path of the Croatian banking sector to a developed market-oriented institution.

After confidence had returned in the wake of the latest banking crisis, internal demand recovered, spurring the growth of consumption as well as investment. Exports were stimulated by economic expansion in all major external markets (the EU as well as central and eastern Europe). In contrast to the preceding year, which had been marked by the Kosovo war, the summer of 2000 featured a strong rebound of tourism revenues. In the first semester of 2000, GDP grew by about 4% (over the corresponding period of 1999); independent experts expect growth for the whole year to be in the range of 2% to 4%. The current account deficit is expected to decline to about 4% to 5% of GDP, mainly financed by FDI linked to privatization. But due to structural problems with extrabudgetary funds (health system, pensions) and the tax system, the fiscal situation is likely to deteriorate. Rising international oil prices have been the primary source of increasing inflation, which came to 7.1% (year on year) in September 2000, one of the highest levels since adoption of the Stabilization Program in 1993.

The elections that resulted in the change of presidency and government at the beginning of 2000 brought about an improvement of the domestic political situation as well as of political relations between Croatia and the EU and made it possible for the country to start overcoming its international isolation. Negotiations on a Stabilization and Association Agreement with the European Union are to start in the fall of 2000. In mid-2000 Croatia became a member of the WTO. But the political change (so far) has not entailed a major adjustment of the economic policy strategy of the authorities, nor has the change at the helm of the CNB (July 2000). After a few months of discussions, the authorities decided they would continue to adhere to the basic principles laid out in the previous administration's Stabilization Program (of 1993). The Croatian kuna has remained oriented toward the euro/Deutsche mark as a *de facto* nominal anchor. Under its new governor, the CNB continued to conduct a tight monetary policy and to oppose any substantial devaluation (or appreciation) of the Croatian kuna.[1])

However, some experts and politicians (including the main economic advisor of the president) have contended that the Croatian kuna is overvalued by about 30% to 40% and have spoken out in favor of a strong devaluation to boost export competitiveness and stimulate industrial production. They also feel that monetary policy should be relaxed. As pointed out above, given the considerable indirect foreign currency exposure of banks, a substantial devaluation could create serious problems for a large part of the banking sector and trigger renewed capital flight.

1 In the summer months of 2000 the CNB repeatedly intervened to prevent the Croatian kuna from appreciating too strongly against the euro.

After the banking crisis of 1998–99 had been overcome, there was a spate of transactions featuring foreign strategic investors purchasing stakes in leading Croatian banks, most of which had been rehabilitated in preceding years. These purchases substantially altered the ownership structure of the Croatian banking sector and turned Croatia from one of the laggards to one of the front runners with respect to foreign participation in transition economies' banking sectors. As mentioned earlier, Banca Commerciale Italiana in December 1999 paid about USD 300 million for a 66% stake in Privredna banka, the second largest bank in the country. Under its new owner, Privredna banka has already launched extensive marketing campaigns in the corporate as well as the retail sector to recoup terrain lost in recent years.

In April 2000, Unocredito Italiano bought 51% of Splitska banka (the third largest bank) for USD 46 million. The new majority owner undertook to issue additional shares, increasing the bank's capital by about USD 10 million and raising Unocredito's stake to 63%. In May, Germany's Bayerische Landesbank secured a 59.9% holding in Riječka banka (the fourth bank) for USD 76 million. The foreign investor acquired a 33.7% stake in the bank from the BRA for USD 41 million and agreed to increase the capital of the bank through a share issue. The German insurer Allianz raised its share in Zagrebačka banka to 10%. According to statements from its management board, Zagrebačka banka was then looking for a "top international bank" to join Allianz as a core strategic shareholder. In 1999 Bankers Trust Company acquired a large stake in Zagrebačka. In mid-2000 foreigners, owned 63% of Zagrebačka banka. The Ministry of Finance, perhaps somewhat euphorically, claimed that the entry of some major West European banks "has put an end to the weakness of the financial services sector in Croatia."[1]) Competition has certainly been enhanced. The still existing lack of competition in some regions will probably soon be a thing of the past, because new foreign-owned players can be expected to move into hitherto relatively "protected" regional territories. The two banks remaining in state hands, Dubrovačka banka and Croatia banka, are slated for privatization in the coming months (table 4).

The takeover of larger banks appears to be complemented by some long-awaited tendencies toward consolidation of medium and small-sized banks. FDI is partly involved in these processes, too. Thus, Erste Bank and Steiermärkische Bank und Sparkasse (both of Austria) announced their intention to merge three small regional credit institutions of their own (Bjelovarska banka, Čakovečka banka and Trgovačka banka) into one unit. On September 1, 2000, Bjelovarska banka took over the other two banks and has since operated under the name Erste & Steiermärkische Bank. Zagrebačka banka recently acquired Varaždinska banka (the seventh largest bank), further strengthening the former's position as the largest credit institution in the country. In the first quarter of 2000 the CNB appointed temporary administrators to two small insolvent regional banks, Istarska banka (of Istria) and Cibalae banka, and initiated bankruptcy proceedings. Bankruptcy proceed-

1 *Norton (2000), p. 66. See also Tibbitts (2000), p. 12.*

ings were also launched against three other small credit institutions that had been identified as problem banks during the crisis of 1998–99 (Agroobrtnička banka, Hrvatska gospodarska banka, Promdei banka). But the decision on Istarska banka triggered strong political resistance from some members of the government. Subsequently the CNB revised its decision, and the government partially recapitalized Istarska banka by issuing bonds.

Evidently, despite the strengthening of its authority through the new Banking Law, the central bank has not become immune to political interference. On the other hand, currently a new draft central bank law aimed at increasing and safeguarding the independence of the monetary authorities is being debated.[1]) As a result of stricter licensing procedures, of bankruptcies in 1999 and 2000 and of some mergers, the total number of banks in Croatia fell to 53 at end-1999 and to 50 in August 2000. The number of savings banks declined to 30. Concentration, while diminishing slightly since the mid-1990s, has remained high and has probably grown again lately owing to recent transactions and consolidations. In mid-1999, the two largest banks accounted for over 45% of total assets and for almost 40% of total capital of the banking sector. The five largest credit institutions accounted for over 60% of all assets and half of all capital. After the privatizations and takeovers of some of the largest banks by foreign strategic investors in 1999–2000, the share of the private sector in the total assets of the banking system is reported to have increased to about 90%, the bulk of which is owned by foreigners (table 4). The improved overall health of the banking system and increased competition caused interest rates to drop to the lowest levels for years in mid-2000 (chart 1).

The banking sector's open foreign currency position (foreign exchange liabilities as a percentage of foreign exchange assets), as measured above, declined to 196% in August 2000 (table 3). As most loans are still indexed, banks' indirect exposure to Croatian kuna depreciation remains substantial. Given the tightening of banking supervision by the CNB[2]) supported by an improved legal framework embodied in the new Banking Law and given the recent exit of bankrupt institutions, banks that remained solvent adopted a more prudent lending policy. They also probably adjusted their portfolios in a prudential response to previous excess lending. However, the introduction of a dose of hard budget constraints in the banking sector seems to have prompted many banks to go further and start shying away from granting credits to firms, because enterprise bankruptcy regulations and, in particular, creditors' rights apparently remain insufficiently enforced in Croatia. Besides, many large enterprises are highly indebted.

1 *This would replace the above-mentioned Law on the Croatian National Bank (of November 1992). The draft law is reported to provide for observance of central banking standards of the EU, from institutional and personal independence to defining the primary goal – the achievement and preservation of price stability. See: South East Europe (2000). See also Vidovic (2000b), p. 6.*

2 *Among other measures, reserve requirements have been strongly increased.*

Table 4

Croatia's Top Ten Banks

Largest Croatian Commercial Banks as Measured by Net Assets as of End-1999

Rank	Credit institution	Net assets	Index of net assets 1999/97	Major foreign investor (year of purchase)[1]	Share of all foreign investors in capital[1]
		HRK million			*in %*
1	Zagrebačka banka	25,101	1.18	Bankers Trust Company (1999)	64
2	Privredna banka	15,744	1.03	Banca Commerciale Italiana (1999)	66
3	Splitska banka	7,436	1.05	Unocredito Italiano (2000)	63
4	Riječka banka	6,139	1.22	Bayrische Landesbank (2000)	60
5	Dubrovačka banka	3,667	0.81	–	–
6	Raiffeisenbank	2,947	2.03	RZB (Raiffeisen-Zentralbank) (1995)	100
7	Varaždinska banka	2,628	1.13	Bankers Trust Company (2000)	62
8	Slavonska banka	2,481	0.95	Kärntner Landes- und Hypothekenbank (1998)	72
9	Hypo Alpe-Adria-Bank	2,242	2.04[2])	Kärntner Landes- und Hypothekenbank (1996)	100
10	Dalmatinska banka	2,227	0.92	Regent Pacific Fund (2000)	44

Source: Norton (2000 a), p. 65; information provided by the CNB as well as by Velimir Šonje and Raiffeisenbank Zagreb.
[1]) Information on ownership structure as of September 2000.
[2]) Index 1999–98.

10 Summary and Conclusions

10.1 Summary

The eventful history of the Croatian banking sector since the onset of transition can be divided into four periods, each of which – except the last – ended with a banking crisis and/or rehabilitation measures. But each period witnessed some qualitative improvements in the situation and partly also in the behavior of banks over the previous period.

The *first period* comprised the early years of independence and brought about major upheavals for the banking business. The collapse of the traditional system of workers' self-management and of former socialist Yugoslavia, economic disintegration and dislocation, the ongoing wars of Yugoslav succession, the new government's loss of control of parts of the country's territory and the confiscation of the bulk of Croatian households' savings in foreign exchange by the National Bank of Yugoslavia (Belgrade) inflicted great losses and hampered the transition of the country's banking system to a market-oriented one.

Among the only profitable activities for credit institutions in the hyperinflationary environment of the early 1990s were currency arbitrage transactions and other speculative activities. In order to reactivate the banking and enterprise sectors, the authorities decided to carry out "linear rehabilitation" measures to bail out insolvent firms that had become victims of ineffective lending decisions taken in the socialist era and to reimburse depositors and banks for foreign exchange deposits seized by the NBY. Government securities called "big bonds" were transferred to enterprises in order to repay bank loans and "counterpart bonds" were placed in banks' portfolios. But "linear rehabilitation" was only a one-off measure that was not accompanied by any major changes in incentives, and soft budget constraints continued to operate.

The *second period* was ushered in by the authorities' adoption of the Stabilization Program in the fall of 1993. Monetary and fiscal policies were tightened and the Croatian currency was in fact linked to the Deutsche mark within the formal framework of a managed float. A new banking law was adopted that rendered legislation more compatible with that of a capitalist market economy. Inflation was brought down quickly and for a number of years featured among the lowest of all transition economies. A robust economic recovery set in. Capital and foreign currency that had been transferred abroad during the years of upheaval and instability started to flow back.

On the other hand, a significant portion of the banking sector still faced considerable financial difficulties resulting from continuing regional military hostilities and the accumulation of nonperforming loans. A bank rehabilitation law was enacted in 1994, and an agency for bank rehabilitation and deposit insurance was created. After the military conflict had come to an end and the macroeconomic situation had been stabilized, the authorities decided to rehabilitate four relatively big troubled banks, which together accounted for almost half of total banking sector assets ("case-by-case rehabilitations"). The managements of three of the four institutions were dismissed and the shareholders lost their capital. The recapitalization measures were onerous and featured the massive issuing of government bonds.

The *third period* was at first characterized by continued economic expansion that was largely driven by a catching-up process in domestic consumption fueled by the return of foreign currency savings, by credits taken up abroad and by strong wage increases. This triggered a substantial deterioration of the current account, led to a considerable widening of the banking sector's open foreign exchange position and thus increased the sector's vulnerability to a depreciation of the kuna. In this context, a number of rapidly expanding small to medium-sized private banks outperformed other banks in attracting foreign currency deposits by offering high interest rates. Since they did not engage in prudent lending and thus took high risks, they soon encountered problems regarding the repayment of such loans. These were exacerbated by the effects of the international financial crises of 1997–98, which cut access to foreign credits, and by the authorities' decision to tighten macroeconomic policies in reaction to the deterioration of external balances.

The underlying insolvency of several banks became apparent in the course of 1998. Whereas two medium-sized banks were rehabilitated the traditional way, a number of other problem banks only received limited liquidity assistance from the CNB, which waited for the enactment of a new banking law at end-1998. This new law strengthened the supervision authority of the CNB and, in particular, facilitated bank bankruptcy procedures. On request of the central bank, the commercial courts initiated bankruptcy proceedings in 1998–2000 in at least 11 cases. These restructuring measures were carried out under difficult economic conditions that were further aggravated by the impact of the Kosovo war on Croatia (loss of foreign exchange revenues from tourism in 1999). A major revision to the

budget of 1999 had to be introduced to supplement the means of the deposit insurance agency for paying out insured deposits of bankrupt banks. Total cumulative government debt issuing for bank rehabilitation in Croatia in 1991–99 has been estimated to amount to about a third of annual GDP, which is high in an international comparison.

The *fourth period* started in 2000 and was introduced by a confluence of positive macroeconomic and structural changes, improving the overall situation of the banking sector. The change of presidency and government at the beginning of 2000 brought about an improvement of the political environment and has made it possible for the country to overcome its isolation from the EU. Despite the change at the helm of the CNB in mid-2000, (so far) the authorities have not planned any major adjustment of the economic policy strategy inherited from the previous administration (as laid down in the Stabilization Program of 1993).

After the banking crisis of 1998–99 had been overcome, there was a spate of transactions in which foreign strategic investors purchased stakes in leading Croatian credit institutions, most of which had been rehabilitated in preceding years. These transactions are believed to have increased the share of the private sector in total assets of the banking system to about 90%; the bulk of these assets is owned by foreigners. Croatia has thus turned from one of the laggards to one of the front runners with respect to foreign participation in transition economies' banking sectors. On the other hand, the introduction of a dose of hard budget constraints in the banking sector seems to have prompted many credit institutions to become very cautious in lending to firms, given that creditors' rights remain insufficiently enforced in Croatia.

10.2 Some Remaining Challenges

After various reform "waves" and structural adjustments over more than a decade of transition, with changes accelerating during the last two years, the Croatian banking sector has seen its efficiency and competitiveness substantially improve. Still, there are some important remaining challenges with respect to banking sector development in Croatia:

– A strong effort to relaunch or accelerate reforms in the real sector is needed, since banking sector reforms cannot be successful if they are not accompanied by enterprise reforms. Hard budget constraints need to spread from banking to the enterprise sector, and creditors' rights need to be enforced. This would appear to be the only way to create a sustainable basis for reactivating commercial bank lending. It would ensure a more efficient allocation of credit than in the past and create incentives for efficiency-enhancing investment. A new initiative in this direction may already have started: The government recently pledged to accelerate the sale or liquidation of 1,850 firms in which the state continues to hold stakes. About half of these enterprises are assumed to be insolvent. Bankruptcy proceedings have reportedly begun.[1]) On the other hand, accelerated restructuring in industry is bound to tempo-

1 *Vidovic (2000a), p. 40.*

rarily drive up the already high unemployment rate and create additional social hardship.

– As mentioned earlier, banks' indirect foreign currency exposure remains high. As long as the population stays strongly attached to hard currency deposits and the euro/Deutsche mark remains a *de facto* dual currency in Croatia – notwithstanding the commendable Croatian kuna inflation record over a number of years – there is little the authorities can do to reduce the exposure, short of partially or fully abandoning the Croatian kuna and opting for a currency board or outright euroization. Since the CNB and the government do not seem to favor these alternatives (currently), the best overall strategy would appear to be sound macroeconomic and structural policies.
– Notwithstanding recent bankruptcies and mergers and acquisitions, some of the remaining smaller banks will need to find a market niche or merge to achieve a viable size. Given the FDI-induced increase in competition, further exits of smaller banks from the market can be expected. If properly managed, though, such institutions' failure need not undermine depositors' confidence. Croatia is still "overbanked"; the average Croatian assets-per-employee ratio is reported to be USD 650,000, well below the USD 5 million seen in developed markets.[1])
– The current deposit insurance scheme has two shortcomings. It is vulnerable to exchange rate movements, because the BRA's (the deposit insurance agency's) right to invest its revenues in foreign currency assets is restricted. Further, contributions paid to the BRA are independent of the financial soundness of the respective credit institutions. A reform of the deposit insurance scheme, which is reportedly under preparation, should address these two problems.[2])

If the new government capitalizes on existing political goodwill and on the current favorable macroeconomic situation, it could reinvigorate structural reform of the real economy. Together with FDI and in-depth bank restructuring efforts by new strategic foreign investors, this could put Croatia's banking sector on track to catching up with its advanced central European neighbors. Such structural catching up would help the country meet further preconditions for catching up in European integration.

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1 *Economist Intelligence Unit (2000).*
2 *See discussion in Lönnberg and Maggi (1999), p. 43 to 44.*

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