



Managing financial FDI: Croatia

Abstract

As part of its integration into the international and regional economy, Croatia experienced very large inflows of financial FDI. The foreign ownership of banks jumped from 7 percent in 1998 to 90 percent in 2002, remaining around this level since. Credit grew especially for households. Between 2000 and 2008 household loans grew at an annual average of 23 percent. But with rule-based macroprudential measures, Croatia managed the boom and subsequent crisis of 2008 relatively well. Between 2008 and 2010 banks enjoyed the highest average bank regulatory capital to risk-weighted assets in the region. The ratio of nonperforming loans to total loans was around 7 percent. What lies behind this performance? Croatia successfully implemented rule-based macroprudential policies. The exchange rate regime largely ruled out the use of monetary policy. Compared to Poland, the country's record of economic growth, prior to the crisis, was also less favorable. Large structural budget deficits reduced the potential for fiscal policy. Croatia's formal prudential policy framework may have made up for weaknesses in macroeconomic management. This approach is not without drawbacks. It is difficult to limit credit expansion effectively and tailor policies to different sectors without creating distortions in the market: limiting bank credit hampered the expansion of small banks but excluding them from regulation would be considered discriminatory against other players on the market.

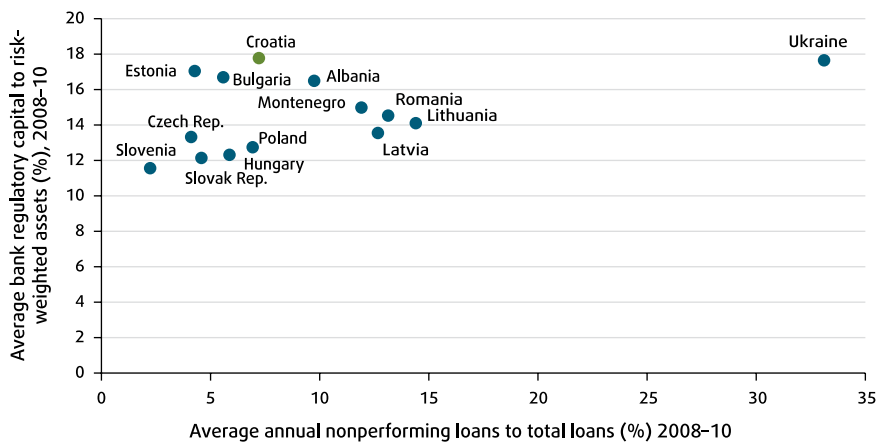
In the last two decades, Croatia experienced significant financial foreign direct investment (FDI). Foreign ownership of banks jumped from 7 percent in 1998 to 90 percent in 2002, remaining around this level since. Credit grew, especially for households. Household loans grew at an annual average of 23 percent from 2000 to 2008.¹ Croatia managed the boom and subsequent crisis of 2008 relatively well. Between 2008 and 2010 banks enjoyed the highest average bank regulatory capital to risk-weighted assets in the region (figure 6). At the same time, the ratio of nonperforming loans to total loans stood at around 7 percent. These results are particularly impressive given country's limited room for macroeconomic maneuver. The exchange rate-regime—a tightly managed float to the euro—restrained the usefulness of monetary policy while the prospective accession to the EU ruled out any direct capital controls. This country benchmark discusses how Croatia managed its large financial FDI inflows.

Active policies, measureable results

There are several measures that allowed Croatian authorities to manage its large financial flows.

First, Croatian authorities limited lending. Beginning in 2003, regulations were put in place that aimed at restraining credit growth once it surpassed a certain threshold.² Because banks circumvented these restrictions by, among other means, transferring credit risks to foreign parents, in July 2004 the authorities introduced marginal reserve requirement (MRR). With MRR, banks were obliged to make additional noninterest deposits to the Croatian Central Bank when their foreign liabilities increased above June 2004 levels. Initially set at 24 percent, the MRR was raised over the years, to 72 percent in 2008.³ Moreover, in 2007 the regulations limiting credit from 2003 were reintroduced with some amendments. The new rules worked better because they addressed off-balance sheet items, thus limiting possible loopholes banks used to avoid credit growth restrictions.⁴ The credit growth limitations were lifted in November 2009.⁵

Figure 6: Average annual bank regulatory capital to risk-weighted assets (%) 2008–10 and average annual ratio of nonperforming loans to total loans (%) in selected Europe and Central Asia countries



Source: IMF WEO and FSI.

Second, the authorities closely monitored the foreign currency positions of banks and reacted accordingly to events in the market. Foreign currency liquidity requirements were adopted in 2003. To avoid possible runs on deposits denominated in foreign currencies, banks were required to maintain higher liquidity standards for those liabilities. To circumvent the stricter rules, banks started to offer deposits in local currency but indexed to foreign currencies. Croatian regulators amended the rules in 2006 and foreign currency deposits as well as those indexed to foreign currencies were subject to stricter liquidity requirements. The limits on banks' net open foreign exchange positions became stricter in the boom years.⁶

Third, the authorities amended rules on capital adequacy ratios. Starting in January 2008, capital adequacy ratios were linked to credit growth and founding sources of individual banks. For example, banks growing at 12 percent would have to comply with a capital adequacy ratio of 12 percent. The higher the credit growth, the greater was the minimum capital adequacy ratio requirement.

Fourth, authorities managed the risks in the banking sector, especially in case of loans denominated or indexed to foreign currencies. Setting clear rules was crucial as foreign denominated loans were substantial in Croatian economy. In the fourth quarter of 2006 nearly three-quarters of all bank credit to the private sector was denominated or indexed to foreign currencies, mostly the euro (54 percent). Since June 2006 banks that granted loans indexed in foreign currency to unhedged borrowers have had to apply higher risk weights. Consequently, home mortgage loan that would qualify for 50 percent risk weight would have to be increased to 75 percent for an unhedged borrower. These risk weights were raised gradually up to 100 and 150 percent respectively in January 2008.

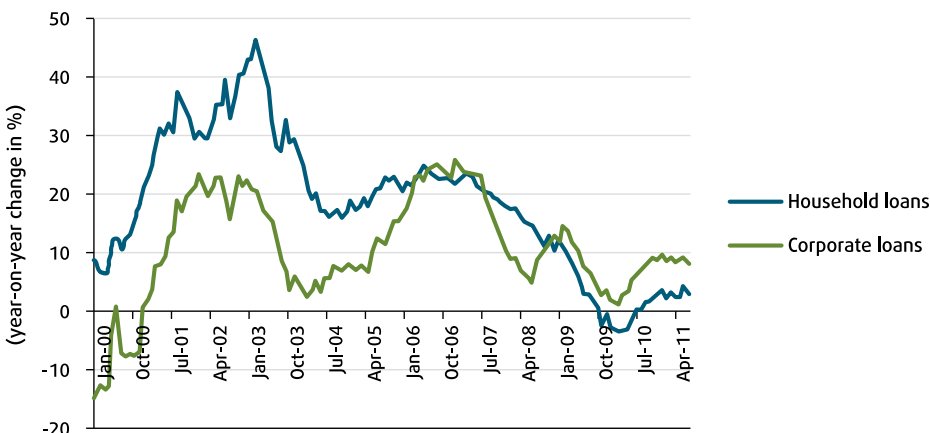
The policy and its risks

Despite efforts to restrain lending, the availability of credit in the economy remained high (figure 7). And although restrictions did hamper credit growth in the economy, they entailed certain costs



(Kraft and Galac 2011). Credit limits pushed banks to use unofficial channels, deteriorating the system's transparency. They also effectively discouraged rapid growth of small banks. Finally, credit restrictions may have limited domestic credit growth, but at the same time banks were able to offset this decrease by an increase in foreign debt (Galac 2010).

Figure 7: Growth of household loans and corporate loans in Croatia, 2000-11



Source: Croatian National Bank.

What are the broader lessons of Croatia's experience in managing its financial sector? Croatia may represent the case of the successful implementation of rule-based macroprudential policies. Croatia's formal prudential policy framework may have made up for the exchange rate regime that mostly ruled out the use of monetary policy. Compared to Poland, the country's record of economic growth, prior to the crisis, was also less favorable. Large structural budget deficits reduced the potential for fiscal policy. Croatia's formal prudential policy framework may have made up for weaknesses in macroeconomic management. This approach is not without drawbacks. It is difficult to limit credit expansion effectively and tailor policies to different sectors without creating distortions in the market. Restrictions on bank credit, for example, hampered the expansion of small banks.

Sources

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Notes

- In the respective period, corporate loans grew by an unweighted average of 12 percent. Estimates are based on year-on-year change in household loans (monthly data). Source: Croatian National Bank.
- When bank lending exceeded certain level, a bank was obliged to purchase Croatian Central Bank bills that paid only 0.5 percent interest.
- When in 2008 MRR stood at 72 percent, banks had to deposit 72 percent of surplus in foreign liabilities at the central bank, while the remaining 28 percent could be used for credit expansion. MRR was abandoned in October 2008.
- To avoid credit limits from 2003, banks used leasing companies, encouraging clients to take leases instead of loans. Another possibility for banks was to refer clients to parent banks abroad. While the regulation from 2007 captured banks' use of leasing companies, it failed to control cooperation with parent banks.
- The Croatian National Bank kept credit growth restrictions in place to avoid depreciation of local currency when the crisis of 2008 hit.
- In April 2003 authorities set the maximum open positions to 20 percent.