

The Impact of Bank Ownership on Balance of Payments Through the Income Account in Croatia

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Abstract

High foreign participation in the banking sector and the increasing level of balance of payments deficit characterize the Croatian economy. This paper examines the relationship between bank ownership and balance of payments in Croatia. The market structure of the banking sector has undergone significant changes in many countries over the past ten years. These changes are consequences of a number of factors and processes such as financial deregulation, the establishment of the European Monetary Union and globalization which started in the 1980s, and to which banks have to adapt. The change of bank ownership structure from state ownership to foreign-bank ownership is particularly important in Croatia. Between 1996 and 2003, the share of assets held by foreign banks increased drastically. In 2003 more than 90 percent of the banking sector's total assets were foreign-owned. At the same time, balance of payment deficit was steadily increasing. During this time, Croatia has had a consistent current account deficit largely reflecting the balance of goods account due to the increasing imports, especially consumers' products. In this poster presentation we try to answer the question whether bank ownership structure in Croatia might have an impact on the balance of payments.

Keywords: banking sector, ownership structure, balance of payments

JEL Classification: G21, H62

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1 Introduction

The Croatian banking system is characterised by a high degree of foreign ownership. The wave of foreign bank entry is a characteristic of all transition countries with the dynamic of this change being the only difference, but overall all of the countries in transition were faced with similar problems. In most of the transition countries, banks were predominantly state owned towards the end of the 1980s. The banks in question were large state owned banks that approved loans to specific sectors of state interest. The loans in question were primarily loans given to state firms that were unable to pay their debts, so the losses of the banks accumulated. Since the state determined the loan seekers, banks were not in the position to assess risks, so a fair amount of the credits would not be returned and the state would eventually write them off. Firms were the main sector credited by banks, while the population and products accumulated savings and services that were not used in developing that particular sector¹. Since a number of banks in that period began to fail, it became essential that banks were market-oriented, restructured and transferred to private ownership. Liberalisation of the banking system began in 1993 in Croatia with the adoption of the Act on Banks and Savings banks.

The main purpose of this paper is to point out the connection between the consolidated balance of banks and the balance of payments² and to provide guidelines for the analysis on the connection between banks in Croatia and the current account deficit. The focus of the analysis will lie in the influence of foreign banks on the current account deficit because there is a large disproportion between large banks, most of which are foreign owned and small banks. This paper will not look at whether the situation would be different if the largest banks remained domestically owned, as is the case in Slovenia but rather the situation in which 91 percent of the assets of the banking system are in foreign ownership. This paper only analyses the influence of banks on the income account of balance of payments. On the other hand, there will be some points made about the possible impact of the banks on the current account deficit through goods accounts.

¹ See Keren, M. and Ofer, G. (2002).

² The balance of payments of the Republic of Croatia is composed in accordance with the methodology recommended by the International Monetary Fund (*International Monetary Fund: Balance of Payments Manual, fifth edition, 1993*) in national currency (HRK) and in US dollars (USD). It is composed of two accounts; accounts of current transactions (which is composed of four accounts: goods, services, income and current transfers) and capital transaction accounts (which is composed of the following accounts: direct investments, portfolio investments and other investments).

The paper consists of five chapters. A chapter on the changes in the structure of bank ownership and the analysis of consolidated balance of banks follows the first introductory chapter. An analysis of the current account balance of payments is made in the third chapter. In the fourth chapter, the connection between the consolidated balance of banks in Croatia and the current account balance of payments is described and attempts are made to estimate if and to what measure Croatian banks contribute to the balance of payments deficit increase through the income account. In this part of the paper, banks' commitments toward foreign banks and non-residents will be especially analysed, in other words foreign liabilities of banks as a statement that has an influence on the balance of payments. This will be followed by a conclusion and recommendations for further research.

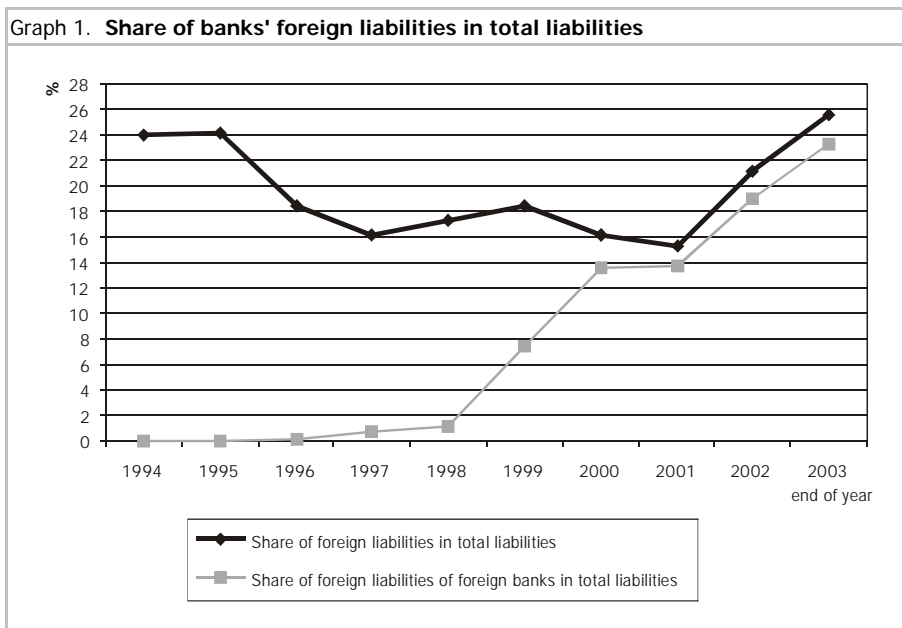
2 The Banking System of Croatia

The first foreign bank entered the market in 1994. Foreign banks achieved a higher growth of shares in total assets in 1998 and 1999. The portion of assets of domestic owned banks in total assets of the banking system fell from 78.4 percent in 1996 to 3.5 percent in 2003.³ By the end of 2003, almost 91 percent of the banking system's assets were foreign owned.

Data from the consolidated balance of banks at the end of 2003 indicate that banks accumulate 25.6 percent of total assets from non-residents (21.2 percent at the end of 2002).

From graph 1 it is evident that from 1997 onward, the Croatian banks were using a significant amount of funds from foreign sources but that percentage drastically decreased in 1997. The reason for that was the decrease of foreign liabilities, i.e. the decrease in the amount of loans accepted by foreign banks in mid 1997. The structure of banks' foreign liabilities was dominated by foreign liabilities in foreign currency and 77.35 percent of foreign liabilities comprised of the banks' commitments towards foreign banks. The share of foreign liabilities in the banking system's total liabilities statement oscillated significantly between 1994 and 2003.

³ *Changes such as the conversion of some banks to savings banks during 2001 influenced that increase in the assets of domestic owned banks, but not a significant change of its share in the assets.*

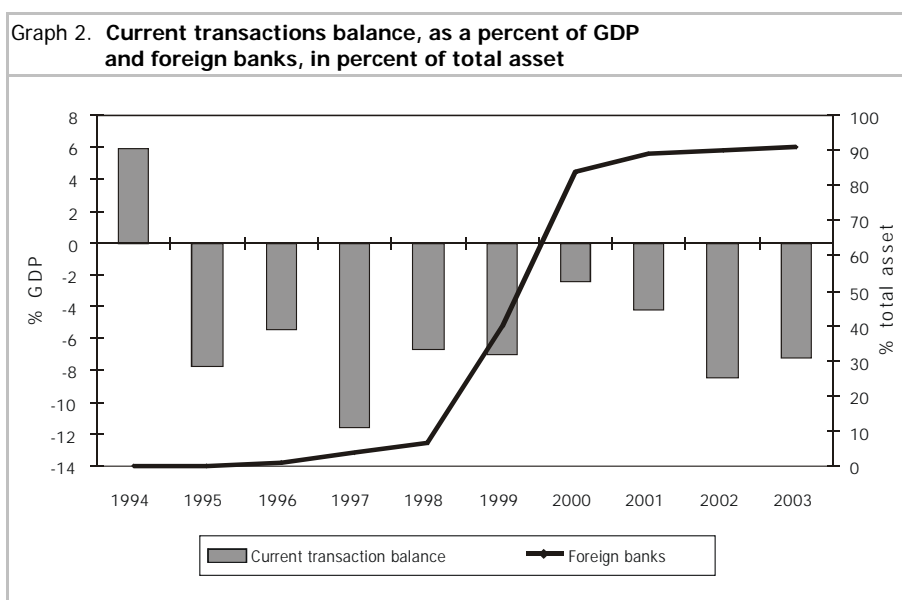


Source: Croatian National Bank.

In 2002 indebtedness to foreign sources began to increase drastically and Croatian banks started using significant funds from foreign sources (mostly loans from foreign banks). Since some data is lacking due to non-reporting of relevant data by banks for this analysis in their annual reports, an estimation of the share of foreign banks' liabilities in the total liabilities of the banking system was made. An estimation of the movement of the share of foreign liabilities of foreign banks in the total liabilities was made on the assumption that the foreign banks' share in particular segments of liabilities was estimated on the basis of the foreign banks' share in the total assets of the banking system. Since the share of foreign owned banks' assets was growing during the observed time period, it is expected that the share of foreign liabilities of foreign banks in the total liabilities will tend to grow.

3 Analysis of the Current Account Balance of Payments in the Republic of Croatia from 1994 to 2003

During the last nine years Croatia has recorded a continued deficit in current account transactions. The deficit is a result of the exchange of goods of Croatia with foreign countries. In the observed period the exchange balance was positive only in 1994. The surplus in 1994 was a result of the decrease in domestic demand during the war. The largest recorded current account transactions deficit was in 1997, 2002 and 2003 (see graph 2).



Source: Central Bureau of Statistics, Croatian National Bank.

In the observed period between 1994 and 2003, the annual growth rates of imports were higher than growth rates of exports (in almost all of the years). Besides the constant deficit on the goods account, was a constant deficit recorded on the income account⁴. In 1998, a significant deficit increase has been recorded (compared with the deficit growth rate achieved during the period between 1995 and 1998).

⁴ The income account includes data from the foreign payments statistics on compensation of employees, payments on the basis of interest, income from foreign direct and portfolio investment ect., see Croatian National Bank: Annual Reports Statistics.

In the 1997, the current account deficit reached its peak of USD 2.3bn or almost 12 percent of GDP. This was the biggest current account deficit ever recorded. In the next three years it decreased mainly due to a modest decline of imports, as a result of a downward trend in consumption (partially due to the decreasing credit expansion), banking crisis, restrictive measures of monetary policy and external factors, such as Asian and Russian crises. Besides these factors, several foreign policy events⁵ were behind positive movements of Croatian exports. In 2000 the deficit was decreased by HRK 11.3bn or by USD 1.9bn. With share of 2.4 percent of GDP it was the lowest in the whole period in question. However, it should be pointed out that deficit would have been even smaller had Croatia registered deterioration of its income account from 1998, mainly caused by increased interest payments on external debt, which had been growing since 1996. Income deficit amounted to USD 406.7 million in 2000, which represents a rise of about USD 287 million since 1997.

In the following years further deterioration of the current account were recorded. In the year 2002 it peaked at USD 1.92bn (HRK 5.28bn) or 8.5 percent GDP, and parallel to increases in the merchandise trade deficit that reached USD 5.2bn. One of the factors that contributed to this movement was the greater demand for goods (and consequently imports) and credit expansion, as well as increasing level of foreign debt. After 2002, resources for the financing of demand for commercial banks credits had been found in foreign sources. This situation motivated the Croatian National Bank to take some restrictive measures in order to slow down the expansion of foreign debt, which was registered in the capital account and which became a significant source of financing for the current account deficit.

Similar movements continued in 2003 and resulted in a record merchandise trade deficit of USD 7.9 billion, and the current account deficit of USD 2.04 billion (HRK 53.25 billion) or 7.2 percent of GDP. Besides the negative impact of a negative balance in goods account, a surplus of expenditures over revenues recorded in the current account was also strongly affected by the growth in net outflows from the income account, which almost entirely resulted from increased expenditures incurred on the basis of reinvested profit from equity investments.

⁵ *EU lifted quantitative restrictions on certain Croatian exports, the Stability Pact and accession to the WTO.*

Data relating to last year show that a strong growth in goods imports, which marked the year 2002, was not curbed. A rise in banks' loans together with an increased credit activity of the leasing companies helped to maintain the purchasing power of the Croatian citizens at a relatively high level.⁶

4 The Impact of Foreign Banks on the Current Account Balance of Payments

In 1995, the deficit of the balance of payments goods account was compensated with the surplus of services and current transfers accounts. Since 1995 until the present, a surplus on these accounts was not enough to cover the deficit on the goods account. Therefore, financing of the continuous current account deficit is covered with capital and financial transactions, that is, with the inflow of direct foreign investments and indebtedness of all sectors abroad. In the observed time period Croatia therefore became a net capital importer due to total domestic savings being lower than total investments.

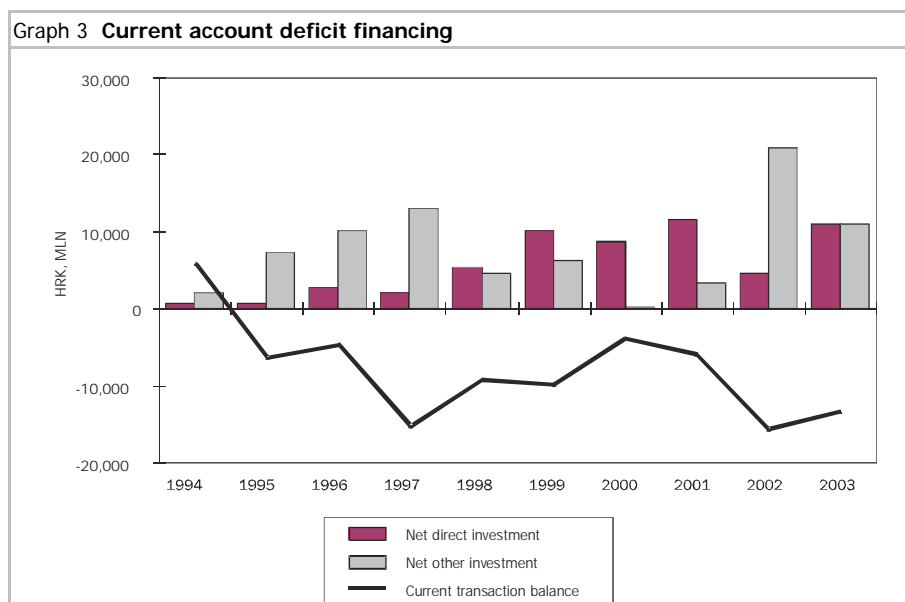
Namely, in 1995, after the war, Croatian economy began its recovery with the decrease in domestic consumption and surplus of balance of payments current account. This also resulted in the GDP growth due to domestic demand, consumption and investment. During 1995 and 1996, a source of finance became the non-indebted capital (from official sources and repatriated foreign savings of citizens, that is, foreign currency payments).

In the 1997 and 1998 current accounts deficit was mainly financed with the borrowings from non-residents of all sectors. Favourable judgement of the Croatian credit worthiness by international institutions contributed to this and made it possible for Croatia to access international sources under favourable conditions. In 1998, foreign direct investments became a main source of financing for the current account deficit. Between 1999 and 2001, net direct investments completely covered the current account deficit, mainly because of the increase of investment in the banking sector and telecommunications. Capital revenue coupled with restructuring and bank privatisation caused the increase in deposits. All of this accelerated the credit expansion. Untenable expansion of private consumption and investments in the years when the highest level of current account deficit was recorded (in the year 1997, 2002 and 2003) was financed with a strong credit growth and rise in public consumption. After a few years of having a high deficit levels

⁶ See *Croatian National Bank, Annual Report 2003*.

and strong increase in external debt, the Croatian National Bank undertook restrictive measures. These measures resulted in a decrease of the current account deficit. In all three observed years (1997, 2002 and 2003) high deficit growth was recorded on the item consumer goods in the merchandise trade. In addition, the growing domestic demand was accompanied by inadequate and insufficient production of certain goods.

In the 2002 net direct investments decreased significantly compared to previous years. This is in part a result of lower income (lack of privatisation of big companies), and in part a result of higher expenditures (domestic investments abroad). In the same year, the current account deficit was partly financed by other investments. Other investments reached a higher level than the total amount of direct investments⁷. Share of borrowing from non-residents in other investments was very high, especially on item deposits from physical and legal entities in Croatian banks. The reason for such a high level of these deposits is the higher interest rates level in Croatian banks than in other countries, where the headquarters of these banks are situated. Within the other mentioned investments, international indebtedness played an important role as well as deposits of non-residents in Croatian banks because of the higher interest rates in Croatia than in the countries where the banks' owners are situated.



Source: Croatian National Bank, Croatian Bureau of Statistics.

⁷ Other investments were in 2002 1.83 bn USD or 13.6 bn HRK higher than net direct investments.

To ascertain the impact of foreign banks on the balance of payment current account deficit, three main bank data are considered - foreign banks' aggregate profit after taxes, interest payments on debt and data from consolidated bank accounts (table 1).

	Foreign banks' aggregate net profit	Net assets/liabilities to non-residents, only foreign banks	Interest payments on debt	Total payments on debt	Total surplus/deficit of balance of payments current account	Foreign banks contributions to deficit of balance of payments current account
	HRK, mln	HRK, mln	HRK, mln	HRK, mln	HRK, mln	percent
1994	0.00	6.05	0.44	0.44	5,735.60	0.00
1995	-9.75	11.71	0.89	0.89	-6,266.00	0.01
1996	12.74	-0.81	0.00	12.74	-4,671.20	0.27
1997	121.44	-95.37	0.00	121.44	-15,184.90	0.80
1998	112.52	227.73	10.03	122.55	-9,239.20	1.33
1999	496.61	1,918.82	70.68	567.29	-9,953.00	5.70
2000	1,587.71	-1,598.44	0.00	1,587.71	-3,894.00	40.77
2001	759.75	-9,780.35	0.00	759.75	-6,052.70	12.55
2002	1,874.34	8,155.66	325.61	2,199.95	-15,676.60	14.03
2003	2,290.37	13,239.73	375.68	2,666.05	-13,320.30	20.01

Source: author's calculation based on the figures from Financial agency and Croatian national bank.

In this part of the article, the main assumption is that foreign banks take all their net profit (profit after taxes) out of the country. As a consequence, the profit together with interest payment on debt results in a negative influence on balance of payments. Net profits figures are incomplete because the data about operating banks in Croatia vary according to different sources. In the article we used data from the Financial agency because data from the Croatian National Bank on individual banks is not available and relevant. The next item used in the analysis is the difference between foreign assets and liabilities (variation between claims on non-residents and liabilities to non-residents). Due to the unavailability of data on individual banks in the Croatian National Bank, this data needs to be estimated. Data about the total amount of a bank's credits can be found in the bank's balance sheet, but amount of credit received from non-residents cannot be calculated. Therefore, the estimation is made with the assumption that the share of the foreign banks in every item of the banks' accounts liabilities is estimated by the share of foreign banks in total assets of banking system. The third factor included in the analysis is interest paid by foreign banks on borrowing from non-residents. Annual Euribor is used as the referent interest rate, but increased for 0.5 percent annually, which is used as an estimated extra interest rate that Croatian banks pay because of their credit rating. The

total payment on debt item is calculated as the sum of aggregate net profit and interest payments. At the end of the analysis we calculated the total contribution of foreign banks to the balance of payments current account deficit.

From the data shown in table 1, it is noticeable that the contribution of the factors included in analysis of the balance of payments current account deficit is high after the year 2000. The highest level of foreign bank contribution was reached in 2000 when foreign banks for the first time achieved high net profit levels. Until 1995, contribution of foreign banks to the balance of payments current account deficit was near zero. Up until that year, only one foreign bank was active in Croatia and in 1995 that foreign bank suffered losses. Shareholders of that foreign bank financed the loss, not the government. Therefore the banks' losses did not contribute to the current account balance deficit payments. High level of net profit had a negative influence on the current account balance deficit payments in the year 2002 and 2003. At the end of 2003 total contribution of foreign banks through income account amounted to 20.29 percent of current account balance deficit payments.

5 Conclusion and Recommendations for Further Research

Similarly to other transition countries, Croatia was and still is on its way toward a market-oriented economy. During that period it was important that banks were oriented towards the market, restructured and transferred to private ownership. In recent years, judging by the share of capital assets, it is clear that the Croatian banking system is predominantly foreign owned. Parallel to the expansion of foreign banks on the domestic market another matter of debate is the current account balance deficit. The aim of this paper was drawing a connection between the two. The largest contributor to the deficit in question (based on indicators and hypotheses) is the point when foreign banks achieved a high level of profit for the first time in 2000. However, it is noticeable that banks indirectly contributed to the expansion of the current account deficit. The structural problems on the supply side, low savings and favourable interest rates enabled credit expansion of banks. This raises the question of whether domestic banks would act the same way. Considering the fact that a bank is above all a profit institution, they would.

It should not be ignored that apart from the mentioned contributor to the current account balance deficit, there are other contributors that have not been observed such as

repatriated profit and indebtedness of registered banks that have a negative and positive influence on the banks' balance of payments. One of the most negative aspects mentioned is the high growth of bank crediting in Croatia. The amounts of approved loans to an individual sector are the incentives to growth of personal consumption and investment and in the Croatian case, to imports as well. The fact remains that until foreign banks entered, the Croatian market for consumer loans was undeveloped; accessibility to capital for investing into the economy increased and that crediting growth is the most frequent way of achieving expansion of banks and their market share. Loans to firms dominate the loan structure from 1994 to 2003, but in 2003 the sector changed and for the first time the population had more loans granted than firms⁸.

Therefore, it can be concluded that from the time of entry of foreign banks into Croatia until the present when they are still strengthening their marketing positions, the main agitator for achieving a larger market share through crediting is increasing population crediting. This is linked to the growth of personal consumption and imports into Croatia. The analysis of the population loan structure shown confirms the thesis that banks in Croatia initiate personal consumption of the population through crediting. 11.2 percent of total loans in the first trimester of 2003 were credits for automobiles, therefore, imported goods. The remaining loans (48.1 percent of total loans), that are the most important statement, consist mostly of unspecified loans that influence consumption. All of this contributes to the deficit growth of the current account balance.

Continuing the current account deficit entails a capital inflow the balance of payments capital account, but these inflows have to be maintained through current income account that grows larger each year. Even though foreign owners of banks have opted for reinvesting profit in Croatia until now, it can be expected that in the future there will be a repatriation of profit, which will influence the current transaction account even more. These conclusions raise the question of long-term sustainability of this situation; the solution lies in higher savings, improving and restructuring the supply side of the Croatian economy and directing new funds into profitable investments.

⁸ *During all the period, credits to the population have bigger growth rates than credits to the enterprises. In 2003 the first mentioned rose by 21.7percent yoy while the credits to the enterprises rose by 2.13percent.*

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