

19 July 2006

Screening report

Croatia

Chapter 17 – Economic and monetary policy

Date of screening meetings:

Explanatory meeting: 16 February 2006

Bilateral meeting: 9 March 2006

I. CHAPTER CONTENT

The *acquis* in the area of economic and monetary policy contains specific rules requiring the independence of central banks in Member States, prohibiting direct financing of the public sector by the central banks and prohibiting privileged access of the public sector to financial institutions. Member States are expected to co-ordinate their economic policies and are subject to the Stability and Growth Pact on fiscal surveillance. New Member States are also committed to complying with the criteria laid down in the Treaty in order to be able to adopt the euro in due course after accession. Until then, they will participate in the Economic and Monetary Union as a Member State with a derogation from the use of the euro and shall treat their exchange rates as a matter of common concern.

The *acquis* in the area of economic and monetary policy is governed by Art. 4 and Title VII (Art. 98 to 124) of the EC Treaty, and by relevant implementing legislation. Treaty provisions related to the adoption of the euro do not apply to Member States with a temporary derogation as defined in Art. 122 (1) and (3) of the EC Treaty.

The *acquis* consists mainly of Treaty provisions and protocols, regulations and decisions that do not require transposition into national legislation. Nonetheless, as indicated in Article 109 of the EC Treaty, each Member State shall ensure that its national legislation including the statutes of its central bank is compatible with the EC Treaty and the Statute of the European System of Central Banks (ESCB).

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part is notably based on the information provided by Croatia at the screening meeting of 9 March 2006. Croatia accepts the *acquis* under this chapter. It does not anticipate any problems to implement the *acquis* by the date of accession.

II.a. Monetary policy

The primary objective of the HNB, as defined in Article 3.1-2 of the Law on the HNB, is to achieve and to maintain price stability. The HNB shall moreover support the economic policy of the Republic of Croatia without prejudice to its primary objective. However, this provision does not take the ESCB's secondary objective into account.

On *central bank independence* Article 53 of the Croatian Constitution mentions that the HNB is only independent in its operations and is responsible to the Parliament. According to Article 2 of the Law on the HNB, the Parliament is in charge of adopting the HNB's statute. The Law on the HNB stipulates that the central bank shall neither take nor seek instructions from the ruling bodies of the Republic of Croatia or the European Union or from any other body. Finally, in pursuing its primary objective, the central bank is independent in the choice of policy instruments and measures. However, Articles 264 and 266 of the General Act on Public Administration (GAPA) allows for the Croatian government under certain circumstances, e.g. in cases of economic disturbances, to revoke or cancel a decision made by the central bank.

Article 59 of the Law on the HNB offers the possibility to the HNB's Governor of describing, and of explaining the reasons for, the monetary policy to be pursued by the

central bank during the following year. Since reporting obligations on monetary policy should only be carried out ex-post, the Croatian authorities have committed themselves to amend Article 59.

With respect to personal independence, the Law on the HNB protects its Council members from various forms of political interference. However, Article 42 gives the Parliament the possibility of dismissing a Council member if it considers that misconduct in the exercise of a member's office results in a permanent and significant departure from the primary objective of the HNB. The Croatian authorities acknowledge that this provision should be removed. A right of judicial review exists for the members of the HNB Council.

Croatia's authorities consider that the HNB is financially independent, since its profits are determined exclusively by its monetary and exchange rate policy and since the central bank decides independently on the allocation of its profits. Furthermore, the central bank may not give guarantees to other bodies nor is it responsible for losses of any such bodies. However, in Articles 52 and 53, unrealised gains and losses enter into the calculation of the surplus and shortfall between the HNB income and expenditure.

With regard to the *prohibition of monetary financing of the public sector* Article 36 of the HNB Law prohibits monetary financing of the "Republic of Croatia". Therefore, in order to align the provision concerned with the acquis in this area, the Croatian authorities intend to broaden the scope of the public sector definition to all public bodies in general. Article 53 of the Law on the HNB involves a form of monetary financing by permitting the Croatian government to cover those shortfalls between income and expenditure of the HNB that are larger than general reserves of the HNB by issuing bonds. The Croatian authorities intend to adjust this provision in line with the acquis. In Article 10.3 of the HNB Law, the "lender of last resort" function contains the necessary safeguard preventing that the HNB might eventually end up bearing financial costs which are in principle to be borne by the state.

Concerning the *prohibition of privileged access of public authorities to financial institutions* Croatia presented a series of acts concerning various financial institutions. Croatia presented instances where current provisions are not in line with the acquis and indicated roughly time-frames towards full alignment. Mention was notably made of the following provisions:

- Article 123 of the Insurance Act, which obliges insurance undertakings to invest not less than 50% of their mathematical reserves in securities issued by the government, the central bank and the Croatian Bank for Reconstruction and Development. Croatia will abolish this restriction before EU accession;
- Article 71 of the Mandatory and Voluntary Pension Funds Act, which obliges pension funds to invest not less than 50% of the fund's assets in long-term debt securities issued by the government and the central bank. This act will be amended by the end of 2006 in order to comply with the rules for chapter 17 by the date of accession;

- Article 10 of the Savings and Loan Cooperatives Act, which stipulates that available funds may be invested exclusively in government securities. Croatia plans to remove this provision by implementing a new Act in the course of 2006;
- Article 17 of the Deposit Insurance Act, which states that the Deposit Insurance Fund may invest its assets only in short-term securities issued by the government and the central bank as well as in long-term securities issued by the government. Croatia intends to remove this restriction by changing the relevant Act during 2007;
- The Act on the Croatian War Veterans and their Family Members Fund, which includes some provisions which may give rise to privileged access by the public authorities. This Act will be amended in the course of 2006.

Other legal acts, such as the Banking Act, the Law on Investment funds, the Act on the Croatian Bank for Reconstruction and Development as well as Croatian tax legislation do not seem to include any provision establishing privileged access by the public sector to financial institutions.

With view to the *integration of the central bank into the ESCB* the Croatian authorities acknowledge that it is necessary to complement the Law on the HNB with the necessary provisions ensuring integration of the HNB into the ESCB and notably reflecting its subordination to the guidelines and instructions of the ESCB and ECB as from the date of euro adoption.

II.b. Economic policy

In the area of economic policy co-ordination and fiscal policy existing Croatian legislation does not contain any provisions that are non-compliant with the *acquis* provisions. Croatia participates in pre-accession economic policy co-ordination by submitting on an annual basis Pre-accession Economic Programmes and fiscal notifications. The medium-term fiscal framework adopted by the Government as well as the Budget Act set objectives in line with *acquis* reference values.

Pursuant to the Government's Economic and Fiscal Policy Guidelines 2006-2008 Croatia has started in 2006 with the implementation of the ESA 95 methodology for the purpose of statistical reporting to the EU within the framework of fiscal surveillance. As regards Articles 100 and 119 of the EC Treaty, the Croatian Act on the Conclusion and Implementation of International Treaties regulates the receipt of foreign assistance and allows for financial assistance from abroad.

III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTATION CAPACITY

Croatia has reached a satisfactory level of alignment with the *acquis*. However, increased efforts have to be made to ensure full Central Bank independence, in particular with respect to its institutional and financial independence.

As noted in the Commission's Progress Report of November 2005, Croatia can be regarded as a functioning market economy. This is an important requirement for the negotiations in this chapter."

III.a. Monetary policy

In Articles 3.1-2 of the Law on the HNB, the Bank's primary objective is to achieve and to maintain price stability, while the secondary objective refers to the economic policy of the Republic of Croatia. However, from the date of the introduction of the euro in Croatia the secondary objective should refer to the general economic policies in the Community and take precedence over the current national economic objective.

Concerning *independence of the central bank* the provisions in the Croatian legislation (Constitution, Law on the HNB) provide for a partially independent central bank. Several provisions are not compliant and should therefore be adjusted. The Statute of the HNB should be amended accordingly.

As concerns institutional independence Articles 264 and 266 of the GAPAA, which allow for annulling or repealing of HNB decisions by the government, are clearly incompatible with the EC acquis on central bank independence. In fact, the GAPAA provisions seem to apply to any administrative decision, including HNB decisions in monetary matters. Moreover, Art 266 speaks about eliminating "economic disturbances", which might be of a macroeconomic magnitude and could result from an HNB decision on monetary policy. These provisions of the GAPAA have to be amended in order to secure the independence of the Croatian Central Bank.

Furthermore, the principle of "responsibility" vis-à-vis the Parliament in Article 53 of Croatia's Constitution¹ appears to be problematic, since it covers all central bank tasks, including decision-making on monetary policy, the competence for which is transferred to the ECB after euro adoption. This is further illustrated by the (equally problematic) possibilities for the Parliament of interfering with the HNB's monetary policy tasks in several articles of the Law on the HNB: Articles 42.1 (dismissal by the Parliament of a member of the HNB Council on monetary policy grounds), 58.1 (possibility for the Parliament of drawing "special" conclusions) and 59.1b (possibility for the Parliament of obtaining ex-ante information/reporting from the HNB Governor): see *infra*. In parallel, the scope of the HNB's independence is explicitly limited to "its work" (operational independence), which, in the current context, further confirms that the HNB is not totally independent. Indeed, the interaction between allowing for independence only in the HNB's work on the one hand, and making the HNB responsible vis-à-vis the Croatian Parliament on the other hand, clearly implies that the role attributed by the Croatian Constitution to the Parliament clearly affects the central bank's independence. The present wording of Art 53 of the Constitution is therefore not compatible with the EC Treaty and the ESCB Statute and should be adjusted.

The reference to "operational autonomy and independence" and to the principle of "responsibility" in Article 2.2 of the Law on the HNB qualifies and therefore weakens the

¹ Article 53 of Croatia's Constitution reads as follows: "*The Croatian National Bank shall be the central bank of the Republic of Croatia. The status, rights and obligations of the Croatian National Bank shall be regulated by law. The Croatian National Bank shall be independent in its work and shall be responsible to the Croatian Parliament*".

HNB's independence. Over and above the comments already made on Article 53 of the Constitution, Article 2 of the HNB Law should reflect the wording of Article 108 EC as closely as possible. More generally, the provisions relating to the responsibility (Law on the HNB) and accountability (Article 1 of the Statute of the HNB) vis-à-vis the Parliament in the articles dealing with the HNB's independence appear to curtail central bank independence.

In Article 3.1 of the Law on the HNB, term "within the powers granted" (by the Parliament) creates uncertainty about the scope of the obligation for the HNB to achieve and maintain price stability. Article 5.1 of the Law on the HNB, which promotes the co-operation between the HNB and the government (and other government bodies), could influence or constrain the HNB's field of activity and, ultimately, its independence. It is also redundant in the light of the provisions of Article 3.2 and should preferably be removed. Alternatively, it should be made clear that the considered co-operation is allowed to the extent that it does not prejudice the HNB's independence in the pursuit of its objectives and the performance of its tasks.

In Article 58.1, the scope and content of the "special" conclusions to be drawn by the Parliament on the basis of the information provided by the HNB should be clarified, so as to avoid that they could constitute interference of the Parliament within the HNB's exclusive tasks and independence. In Article 59.1 b), the possibility for the HNB of reporting ex-ante to the Parliament on its future monetary policy is contrary to Article 108 of the EC Treaty, as it could either be interpreted as the seeking of instructions or, alternatively, could open the possibility for the Parliament of influencing the content of the central bank's policies. Reporting obligations for the HNB on monetary policy issues should therefore have a strictly ex-post character.

On financial independence Articles 52 and 53 provide for unrealised gains and losses (i.e. gains/losses resulting from the revaluation/depreciation of assets and reserves) to enter into the calculation of the surplus or shortfall between the income and expenditures, instead of being transferred to a Revaluation Reserve. If the Revaluation Reserve is not sufficient, the remaining loss should ultimately be reflected in the profit and loss account of the HNB and should be covered, if possible, by the general reserve of the Bank, and as a last resort, by the State budget.

Regarding personal independence provisions of Article 42.1 concerning grounds for dismissal should not be too specific and should closely reflect the wording of Article 14.2 ESCB/ECB. Any other ground for dismissal should be removed. This is particularly relevant for the possibility granted to the Parliament of dismissing a member of the HNB Council in case of misconduct having led to a permanent and significant departure from the primary objective of the HNB.

On the *prohibition of monetary financing of the public sector* some alignment with the EU acquis still has to be made, notably concerning provisions under Article 53 of the Law on the HNB on possible coverage of a shortfall between income and expenditures of the central bank by public debt securities.

Concerning *privileged access of public authorities to financial institutions*, a series of provisions subsist (in five different Laws or Acts – see supra under Section II) which give

or may give rise to privileged access by the public authorities or bodies to financial institutions.

It is necessary to ensure the HNB's integration into the ESCB and to reflect its subordination to the guidelines and instructions of the ESCB and ECB as from the date of the introduction of the euro in Croatia, even though such amendments need only enter into force by the date at which the country actually adopts the euro.

The main incompatibilities in this area are related to the absence of reference to the HNB as an integral part of the ESCB and to its subordination to the ECB's legal acts (Articles 2 and 38.2). They are notably also related to:

- the definition of monetary policy: Articles 4.1, 8.1, 12, 35, 36.3, 38.3;
- the conduct of foreign exchange policy and operations: Articles 8.2, 8.5, 15.1-2, 35;
- the holding and managing of foreign reserves: Articles 4.1, 16-17, 38.3;
- the right to authorise the issue of banknotes and the volume of coins: Articles 4.1, 38.3;
- the definition of the monetary unit: Articles 8.5, 19-24;
- the monetary functions, operations and instruments of the ESCB: Articles 4.1, 8.2, 9, 10, 11, 12, 13, 14, 38.3;
- the imposition of sanctions: Article 65;
- the financial provisions of the ESCB: Articles 56 (accounting rules), 57 (auditing);
- other issues: Articles 4.1 (payment systems), 5.2 (consultation of the ECB), 6 (participation of the HNB in international organisations), 30 and 32 (payment systems), 38.3 (participation of the HNB in international organisations), 49 (professional secrecy), 62 (statistical role of the ECB and the EC Council).

III.b. Economic policy

Croatia is already to some extent experienced in participating in the field of economic policy co-ordination through the production of Pre-accession Economic Programmes and fiscal notification. It has been implementing an economic policy aimed at creating the conditions for long-term macroeconomic stability and promoting integration and convergence with the EU. Croatian legislation in this area does not contain any provisions that are not aligned with the *acquis* provisions.