



CROATIAN NATIONAL BANK

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Konrad Adenauer Stiftung  
Economic Policy Debate, Zagreb, 2 October 2013  
“EU Membership – Challenges for the  
Croatian Economy”

**A Tale of Two Policies:  
Monetary and Fiscal**

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# Monetary Policy

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## □ Facts

- high level of Euroization
- high penetration of foreign banks (that can refinance with mother banks)

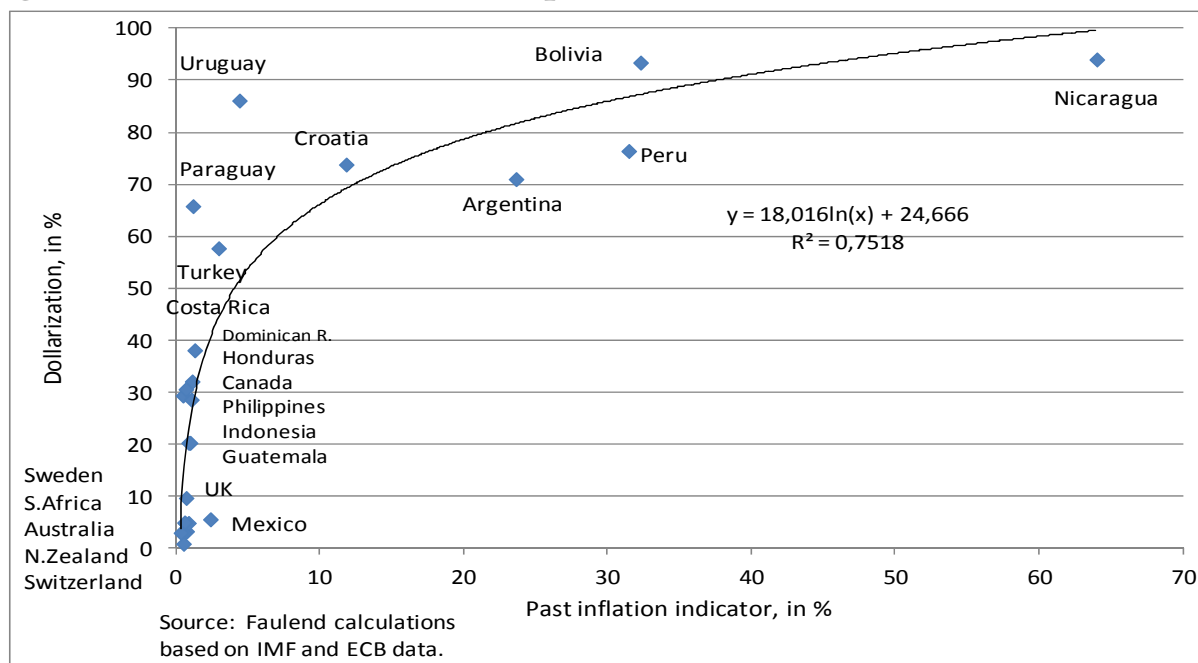
## □ Consequences

- need to keep exchange rate stable
- limited control of price of credit supply – impaired interest rate channel

# Currency Substitution (Euro(Dollar)ization)

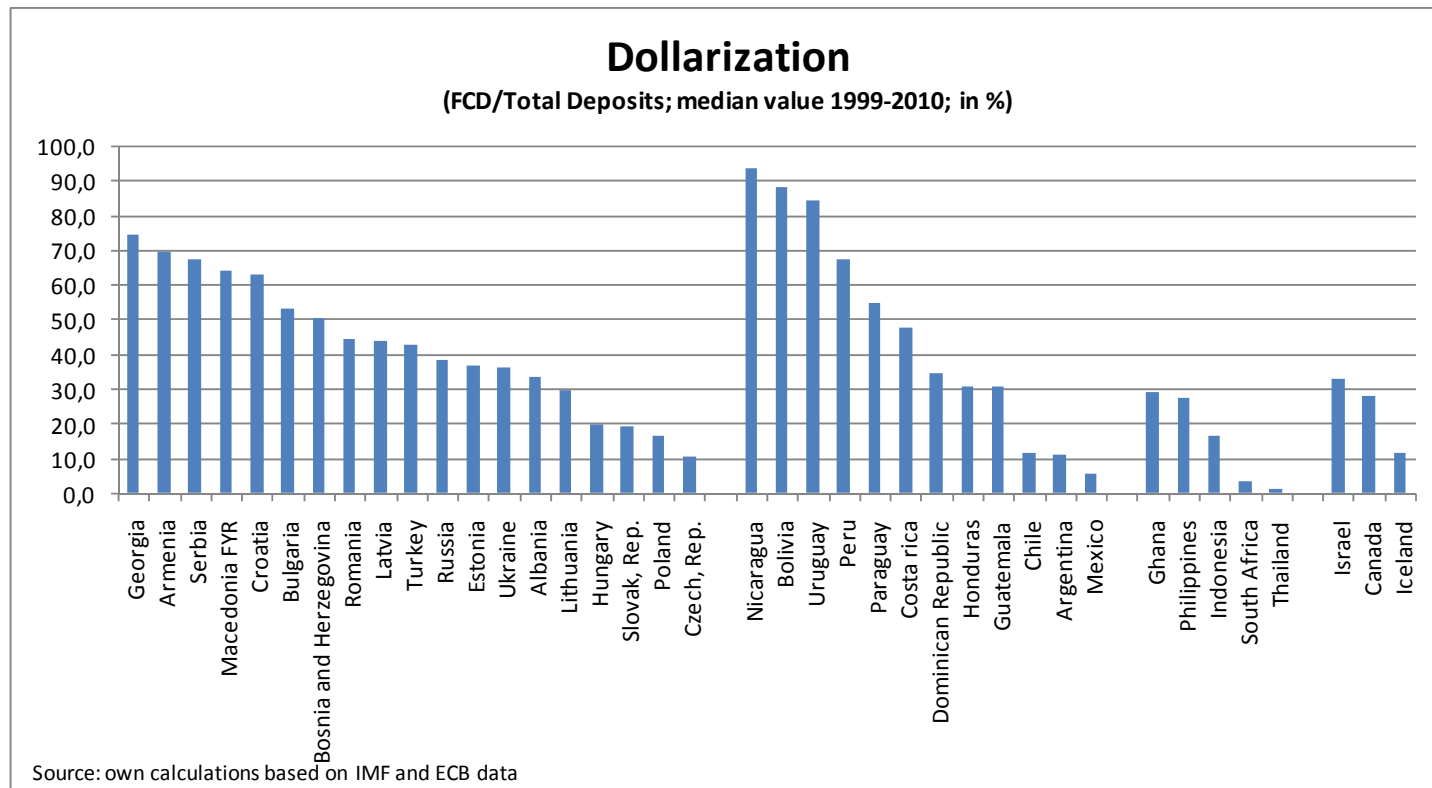
- A phenomenon which in principle appears as a consequence of past monetary instabilities
  - high inflation and devaluations lead to substitution of domestic currency with foreign one, (there are also other push factors (remittances, tourism..))

Roots of  
Dollarization –  
Monetary  
Instability



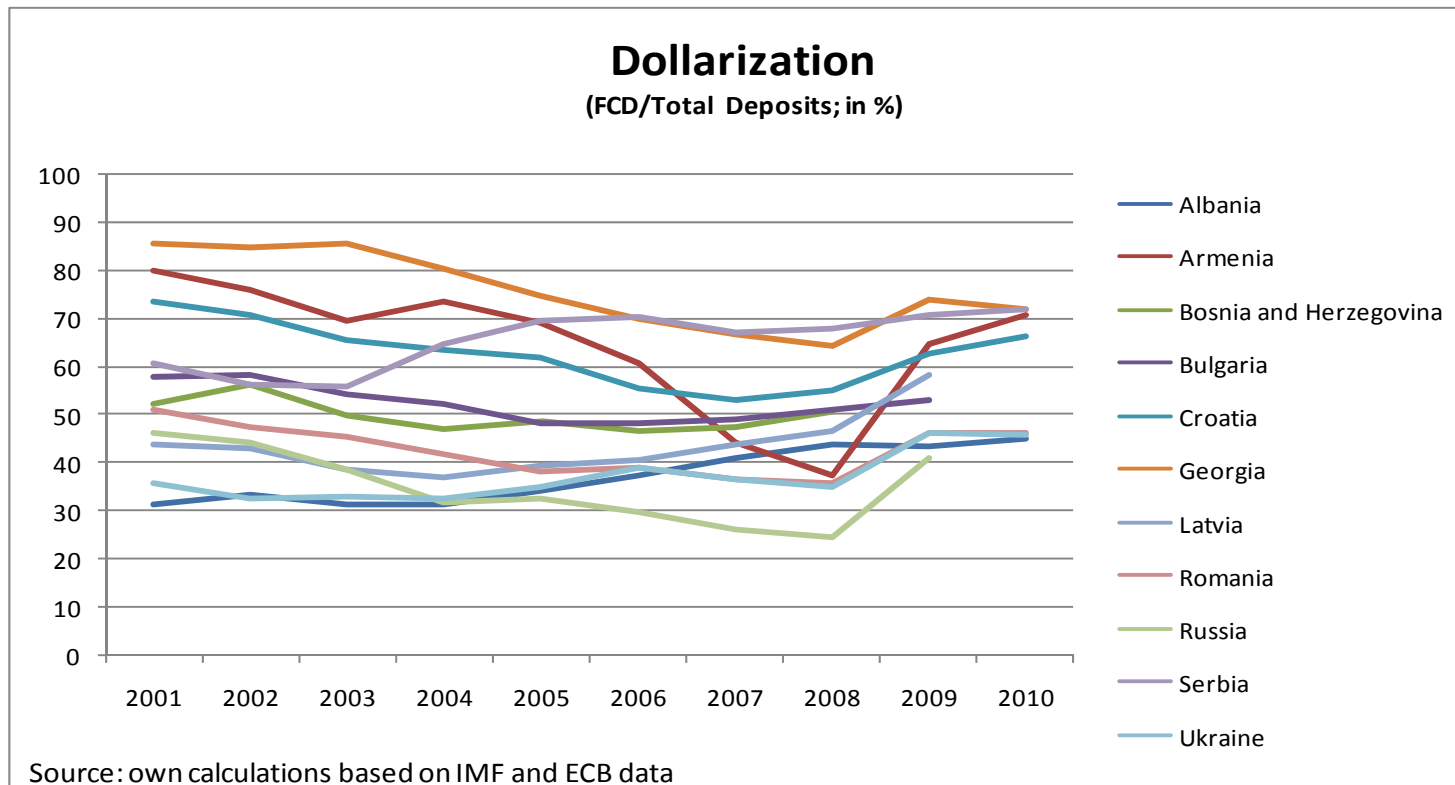
- Poor past monetary policy creates constraints for the current monetary policy – path dependent behaviour

..., cont.



- ❑ Quite widespread, particularly among transition economies

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- ❑ Posses feature of strong persistence, and it is practically irreversible once it becomes deeply entrenched

# When Euroization Becomes a Constraint for Monetary Policy?

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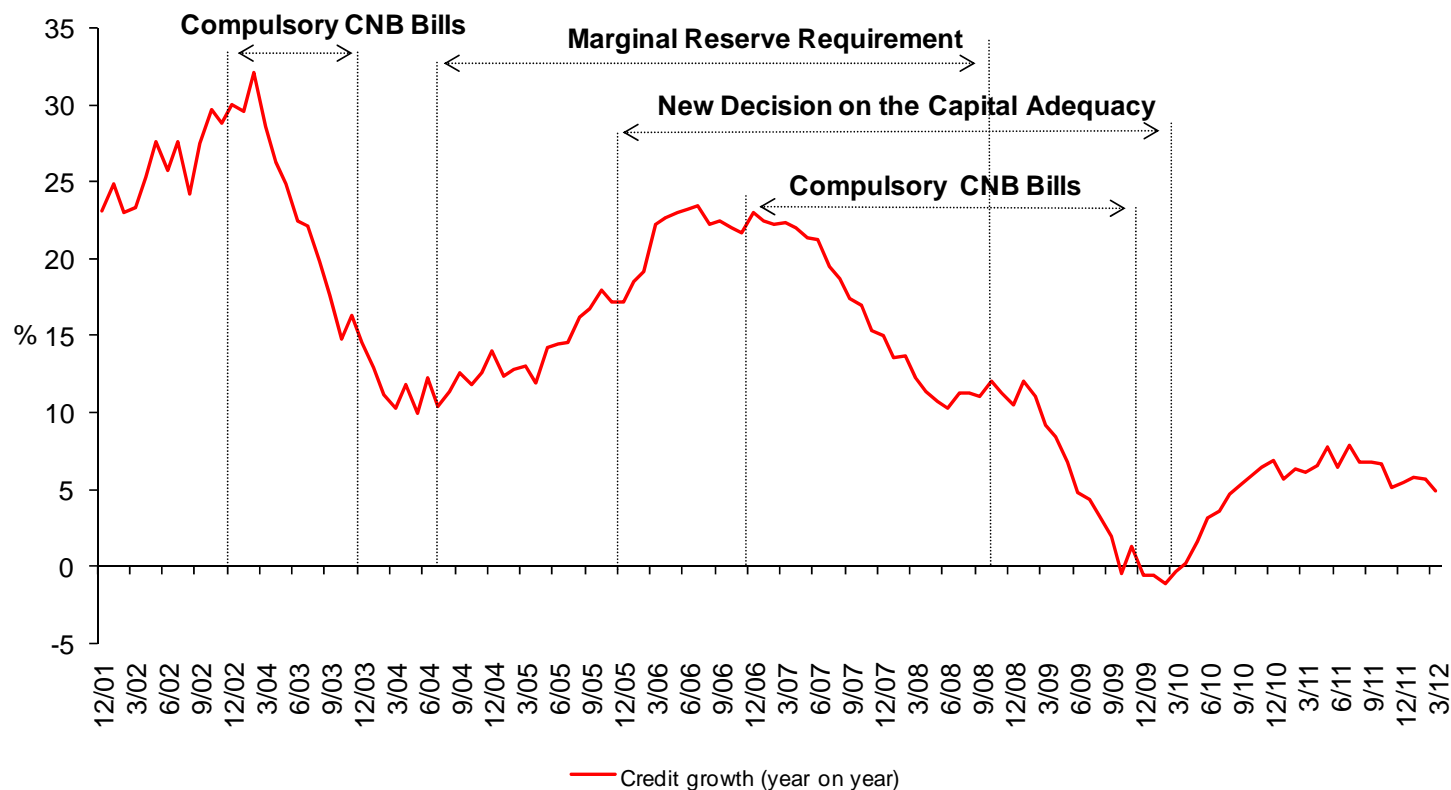
- ❑ Once it reaches very high levels ( $> 50\%$ ) and it becomes deeply entrenched
  - under assumption of significant size and importance of banks intermediation
- ❑ Credit euroization more problematic than deposit dollarization
  - in practice (and in principle) both credit and deposit euroization are about the same (due to regulatory rules that request banks to maintain balanced f/x positions)
  - research finds that deposit euroization causes credit euroization
  - there are exceptions of course, for instance Hungary, where credit euroization is 2-3 times higher than deposit euroization

## ... and Why?

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- ❑ Currency portfolio shifts
  - even minor exchange rate instability could lead to switching from domestic to foreign currency (high sensitivity of economic agents to exchange rate)
- ❑ Pass-through on inflation
  - depreciation leads to inflation
- ❑ Balance sheet effect - most important!
  - because at high levels of euroization exchange rate devaluation has recessionary impact on the economy - similarity with Fischer's "Debt-Deflation Phenomenon" (Calvo)
- ❑ Financial system instability due to increased credit risk (i.e.Chf)
  - ⇒ **therefore, exchange rate stability is of utmost importance in countries with high euro(dollar)ization**
- ❑ Which reduces degrees of freedom of monetary policy

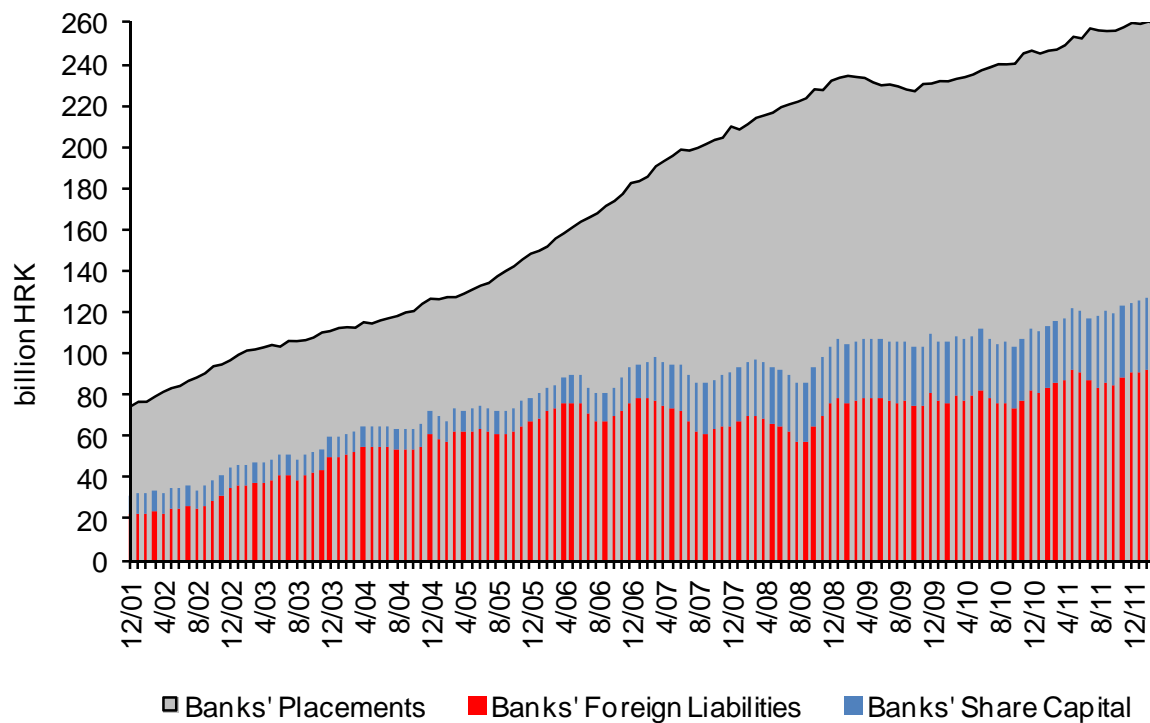
# Good times: countercyclical monetary policy



Source: CNB

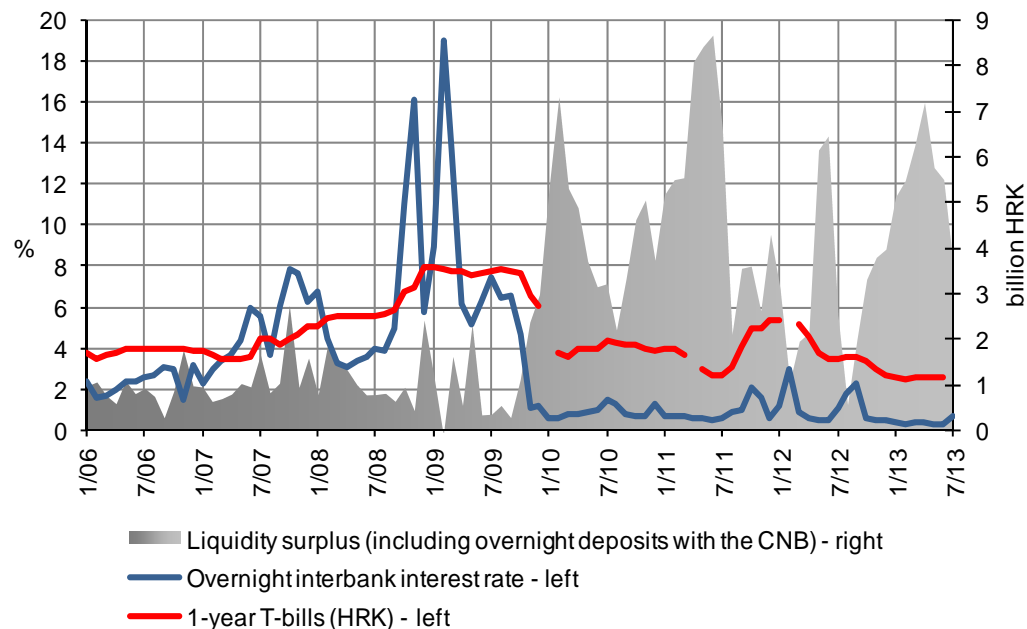
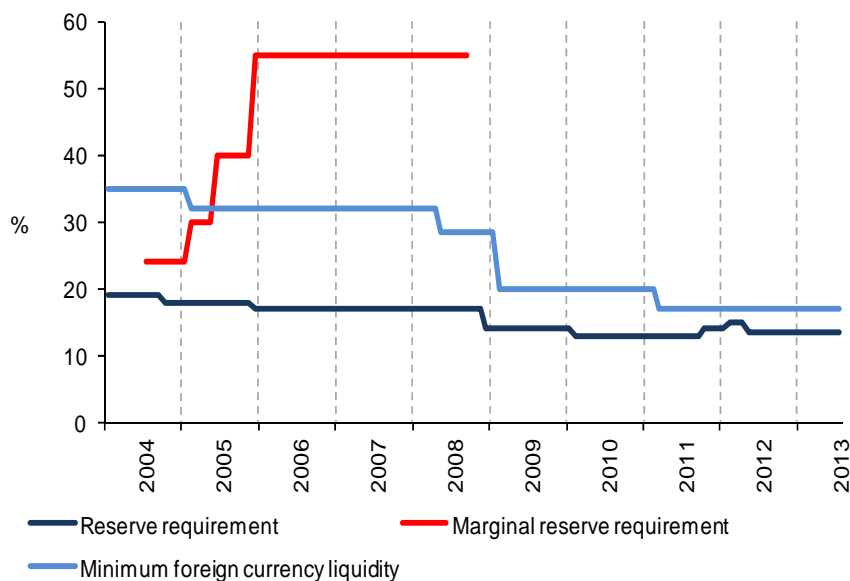


## ...curbing down build-up of vulnerabilities...



Source: CNB

# Bad times: countercyclical monetary policy response



Shaded area represents periods when banks' credit growth was regulated with compulsory CNB bills.

Source: CNB.

Sources: MF and CNB.

## ...cont...

- ❑ Reserve requirements changes
  - abolishment of marginal reserve requirement in October 2008
  - RR rate cut from 17% to 13,5%
- ❑ Other Monetary and Prudential Measure Changes
  - decrease of minimum required amount of fc claims (from 28.5% - 25% - 20% and finally to 17% of banks' total foreign liabilities)
  - increase of the allowed open foreign currency position of the banks from 20% to 30% of regulatory capital
- ❑ Counter-cyclical intervention equal to aprox. 12% of the GDP, huge structural liquidity surplus
- ❑ Special lending program, syndicated loans with HBOR (prior to the Funding for lending (BoE))

# Risk sharing credit schemes in place from 2010

## Special lending model 2012 (in billion HRK)

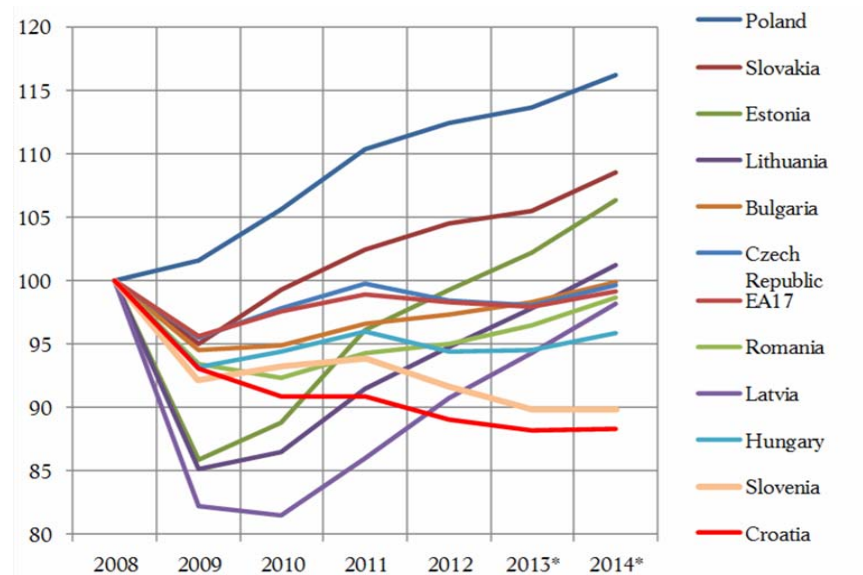
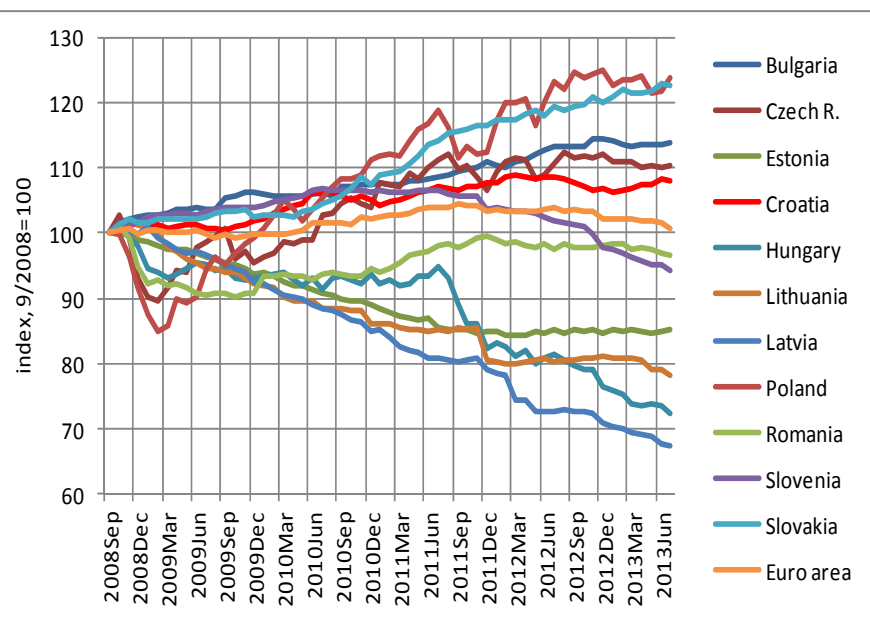
		HBOR funds approved in auctions	Banks' funds	Total lending potential = HBOR (50% ) + banks (50% )
<b>Total lending potential</b>		<b>3,4</b>	<b>3,4</b>	<b>6,8</b>
Approved <b>until end-April 2013</b>	8 auctions	<b>3,4</b>	<b>3,4</b>	<b>6,8</b>
Amounts of loans disbursed to final users <b>until end-August 2013</b>		<b>1,4</b>	<b>1,4</b>	<b>2,9</b>
Average interest rate (Special lending model)				<b>3,75</b>
Average market interest rate on long- term corporate loans ( <b>July 2013</b> )				<b>5,58</b>

## Government credit schemes - model A and A+ (2010-2012, in billion HRK)

		HBOR funds approved in auctions	Banks' funds	Total lending potential = HBOR (40% ) + banks (60% )
<b>Total</b>	14 auctions	<b>2,2</b>	<b>3,4</b>	<b>5,6</b>
Amounts of loans disbursed to final users (February 2010 until end- August 2012)		<b>2,0</b>	<b>3,0</b>	<b>5,0</b>
Growth of total bank loans to enterprises (February 2010 until end- August 2012)			<b>17,9</b>	
Average interest rate (Model A and A+)				<b>4,49</b>
Average market interest rate on long- term corporate loans				<b>6,69</b>

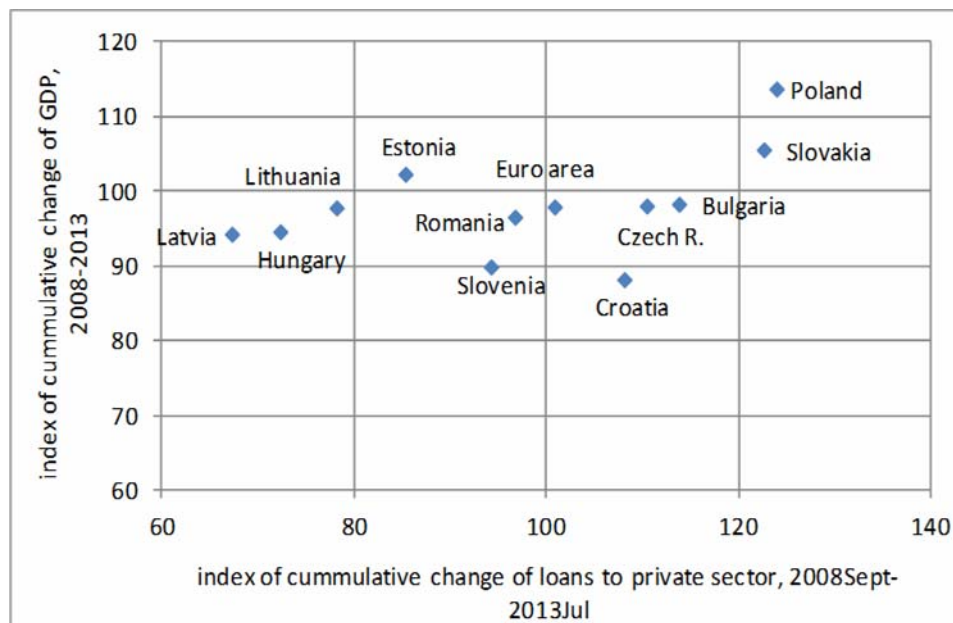
Source: CNB.

# But is it really credit that creates GDP growth?



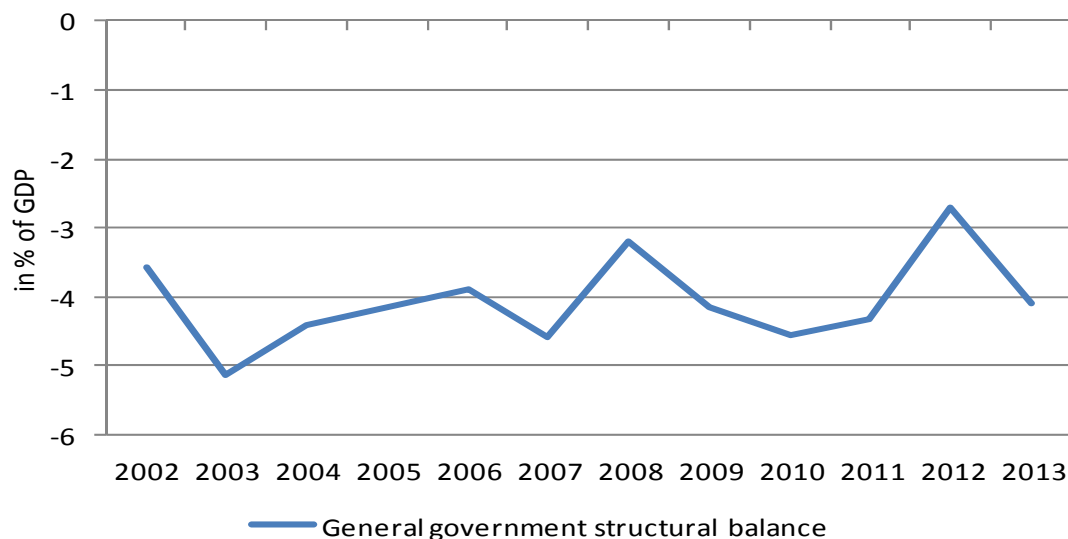
Sources: ECB; CNB

# ...or are we barking at the wrong tree?...



# Fiscal policy

- ❑ When monetary policy is constrained by high level of currency substitution (euroization), fiscal policy should be the main countercyclical policy tool
- ❑ However, that requires fiscal discipline in good times, of which, in Croatia, there was none:



# Financial crisis significantly worsened fiscal positions in most EU countries

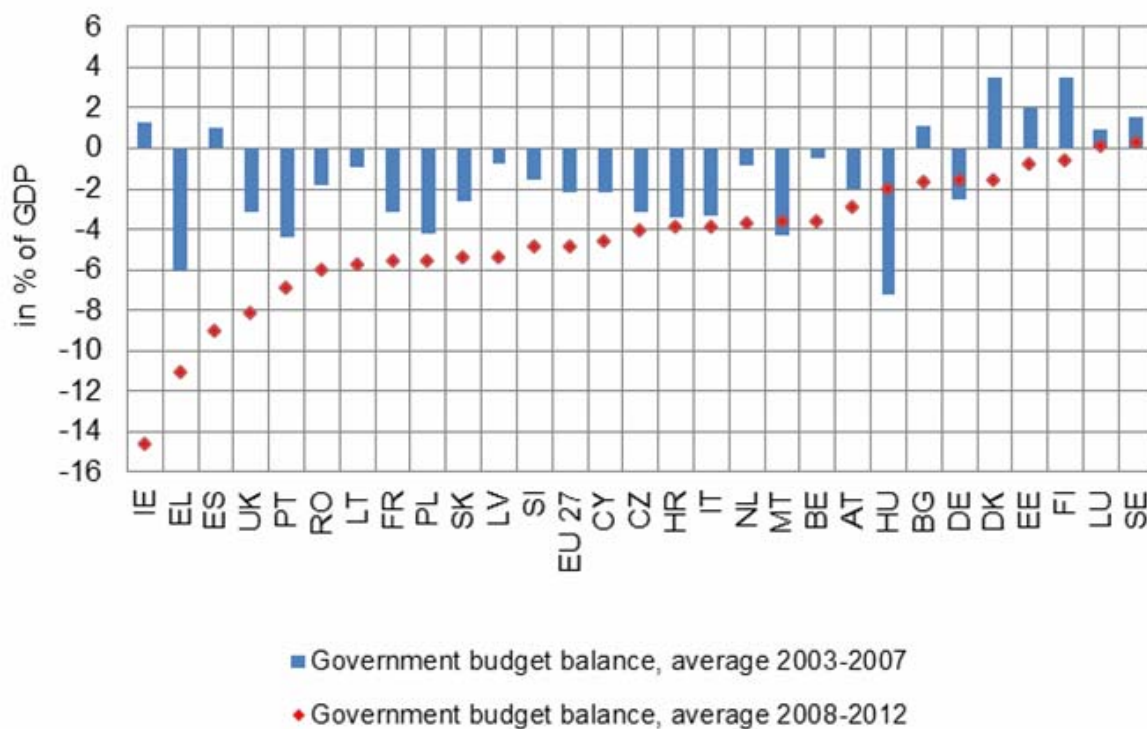
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- ❑ Operation of automatic fiscal stabilizers
- ❑ Implementation of fiscal stimulus packages by some countries
- ❑ Significant cost of banking sector bail out programs



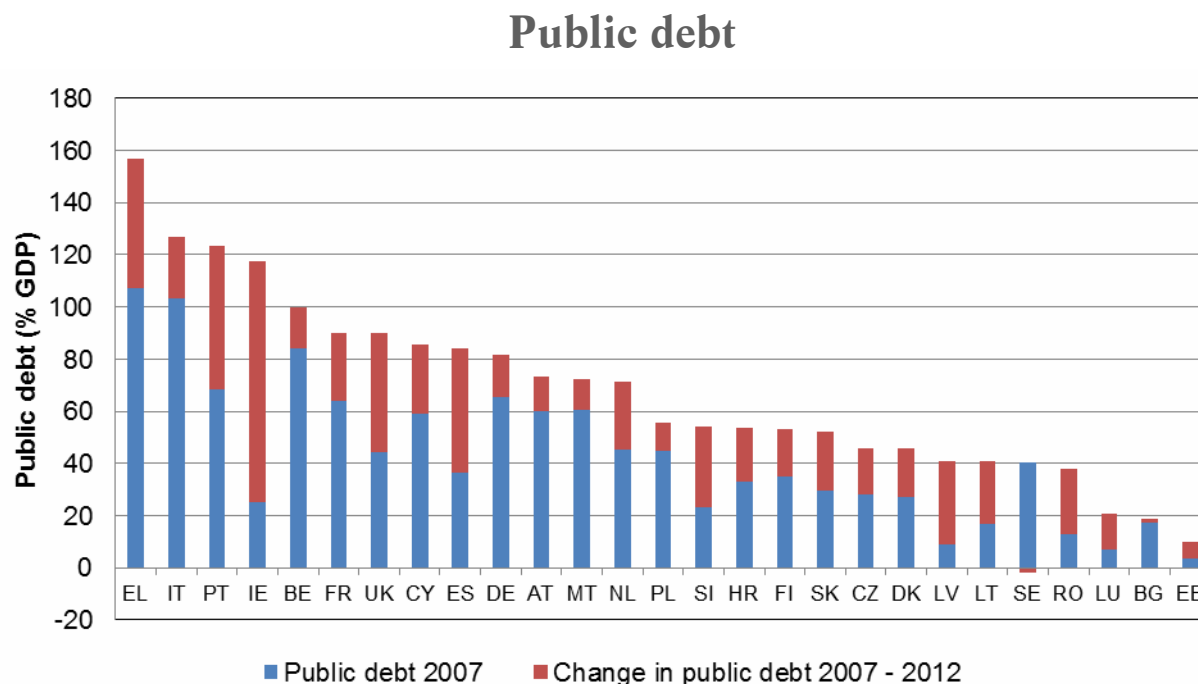
# Fiscal position in EU countries before and after the crisis

## Government budget balance



Sources: Eurostat, CNB.

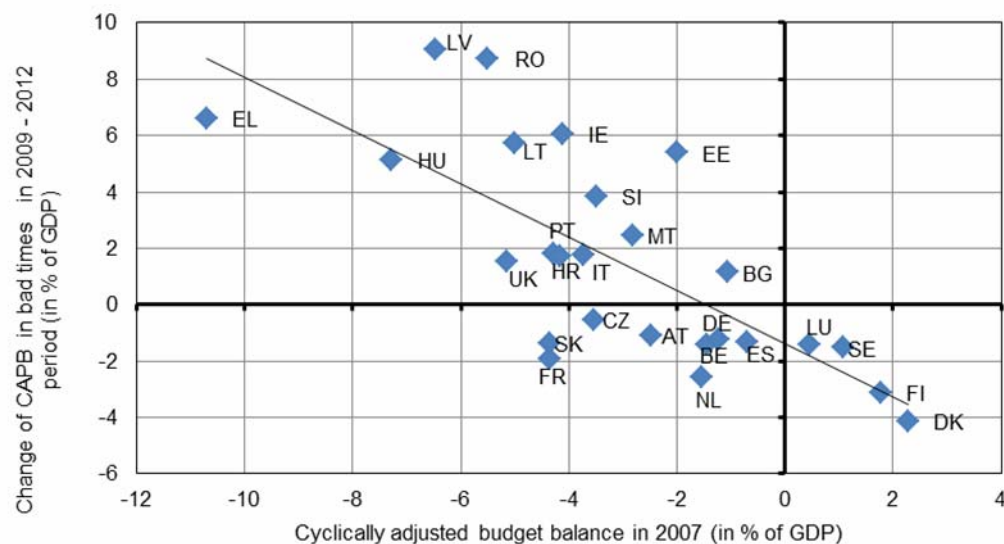
# Fiscal position in EU countries before and after the crisis



Sources: Eurostat, CNB.

# Countercyclicality: Fiscal stance

- Countries with better fiscal positions before the crisis were able to adopt expansionary fiscal policies during downturn
- Others had to implement significant consolidation measures



Note: CAPB - Cyclically adjusted primary balance.

Bad times are defined as a period when output gap was negative or sharply decreasing.

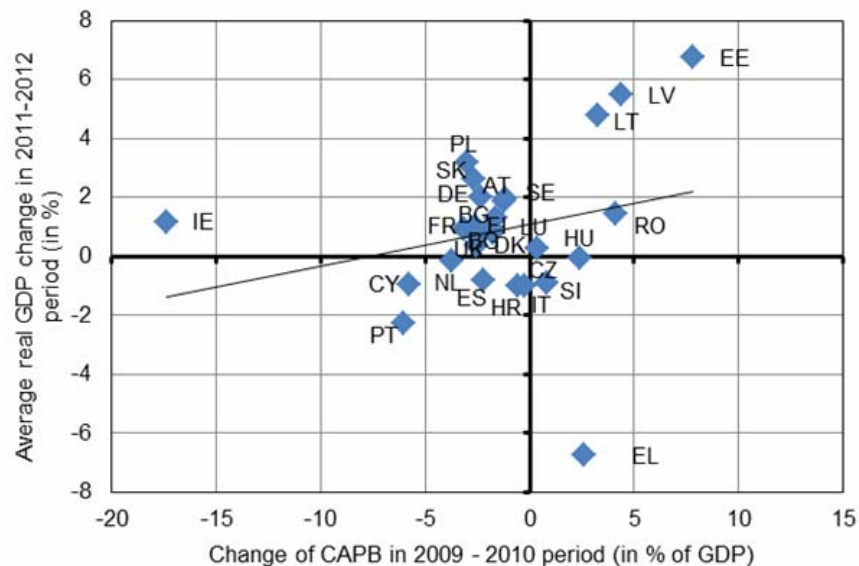
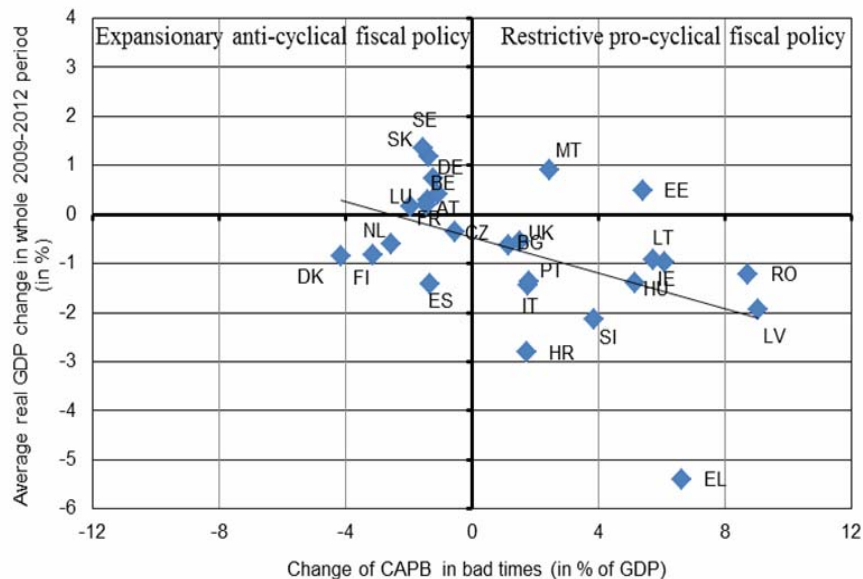
Sources: Eurostat, CNB.

# How was this reflected in economic performance?

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- Economic performance was better in countries which had anti - cyclical fiscal policies in bad times
- However, some countries with strong fiscal adjustment immediately after the onset of financial crisis show strong recovery in recent years.

# How was this reflected in economic performance?



Note: CAPB - Cyclically adjusted primary balance.

Bad times are defined as a period when output gap was negative or sharply decreasing.

Sources: Eurostat, CNB.

# Could we wait for fiscal adjustment (lower fiscal multiplier)? No!

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- ❑ Interest rate – growth differential is unfavorable
- ❑ To reverse public debt growth path fiscal adjustment is needed
- ❑ The more it is postponed the larger adjustment will be needed

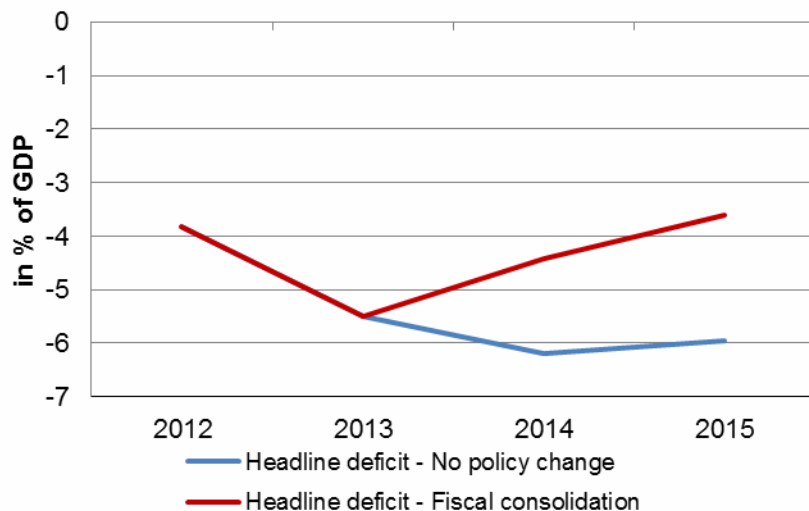
# Hypotetical fiscal projections

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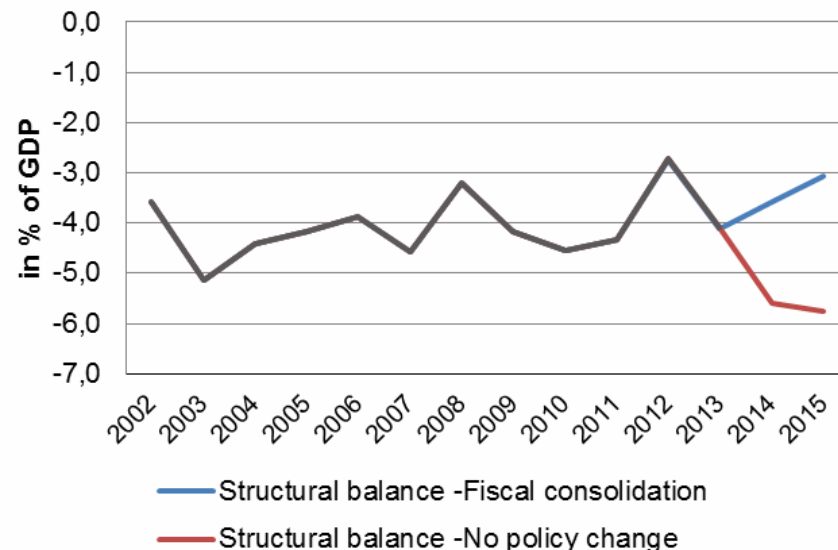
- Without additional fiscal measures headline deficit will in next two years fluctuate around 6,0% of GDP.
- Structural fiscal adjustment of 0,5% of GDP per year could decrease it to around 3,5% in 2015.
- Public debt will still be above 60% of GDP.

# Hypothetical fiscal projection with and without EDP (0.5 pc in structural terms)

## Headline deficit



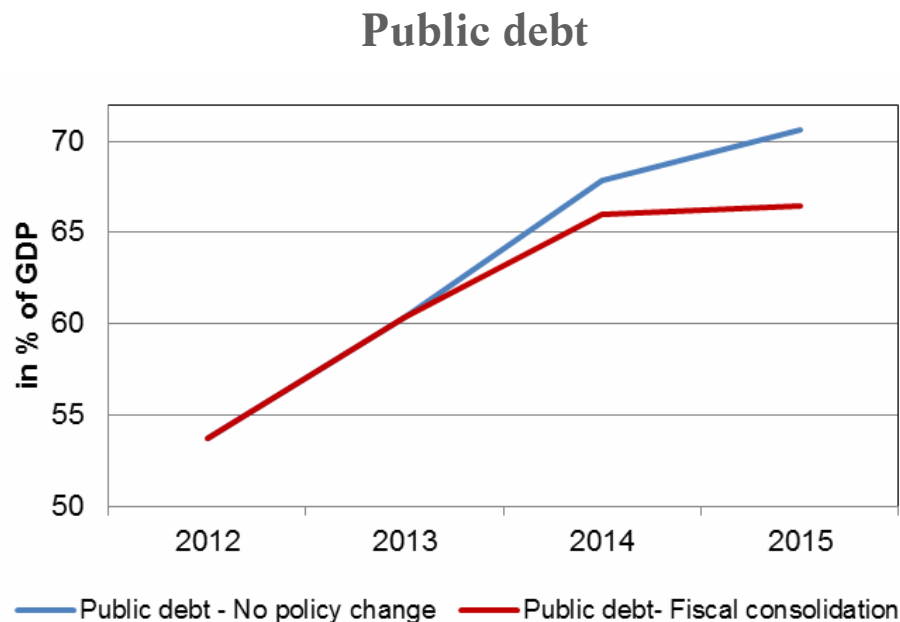
## Structural balance



Sources: MOF, CNB.

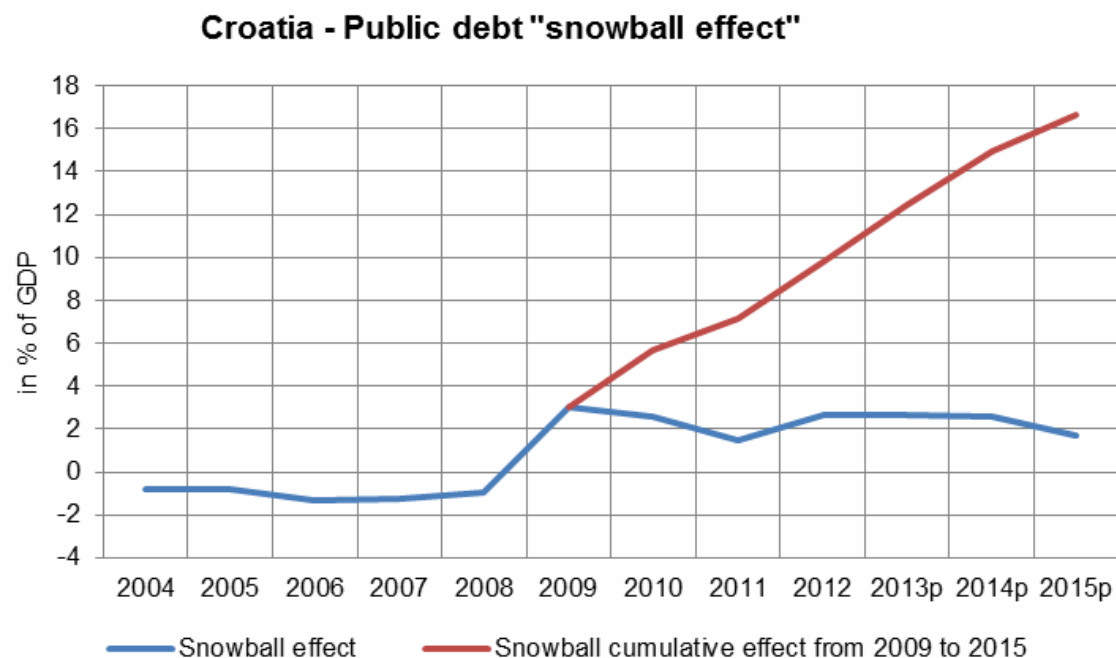


# Hypothetical fiscal projection with and without EDP - Croatia



Sources: MOF, CNB.

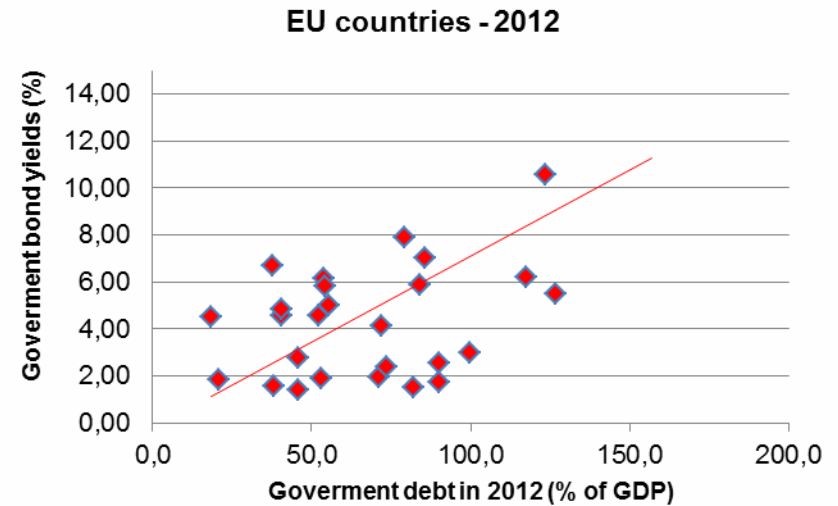
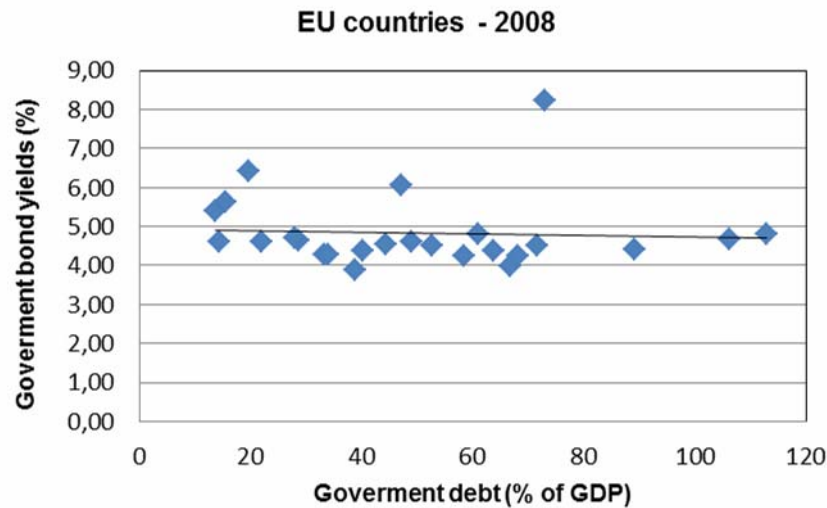
# Croatia – public debt „snowball effect”



Note: Since 2008 HAC is excluded from general government.

Sources: Eurostat, CNB.

# Sovereign risk assessments by markets in EU



Sources: Eurostat, CNB.

# Rating sensitivity – Croatia

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- ❑ positive pressure on rating:
  - fiscal reform (*Fitch Ratings*)
  - deficit and debt reduction (*Fitch Ratings, S&P, Moody's*)
  - restoration of economic growth (*Fitch Ratings, S&P, Moody's*)
  
- structural reforms (*Fitch Ratings*)
  - ❑ state privatizations (*S&P*)
  - ❑ reforms of the business climate (*S&P*)
  - ❑ labor law amendments (*S&P*)
  - ❑ planned pension reforms (*S&P*)

Sources: Fitch Ratings, Standard & Poor's, Moody's

# Anti-cyclical fiscal policy – lost opportunity

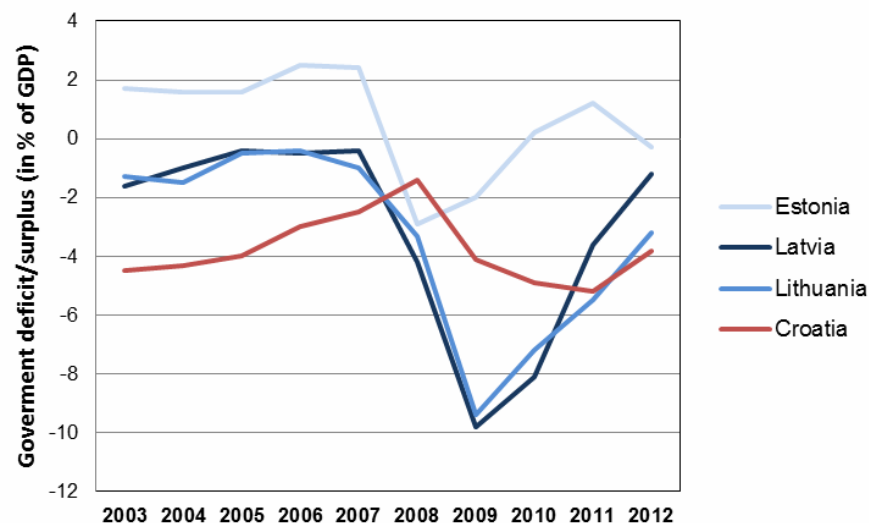
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- ❑ So, immediate fiscal consolidation is necessary, in order to prevent further worsening of fiscal position, negative feedback loop (higher interest rates – higher debt – higher interest rates -snowball effect)
- ❑ If postponed it will only result in a need for stronger adjustment later, as was the case so far. If the fiscal policy was anti-cyclical in good times, deficit/debt would have been lower and fiscal policy could have been used to help restore growth after the crisis
- ❑ Also, if the fiscal consolidation started immediately, like in Baltic countries, that would have reduced the risk and debt and helped faster recovery
- ❑ No gain in delaying fiscal consolidation!

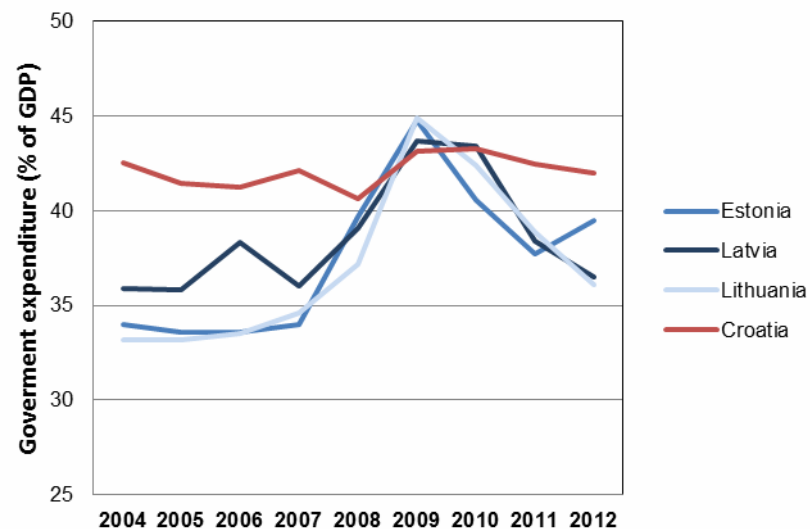
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- However, there is something more important than fiscal and monetary policy
  - Namely, recovery of growth is possible even under the fiscal consolidation and without credit

# Baltic countries – Croatia comparison

## Government budget balance



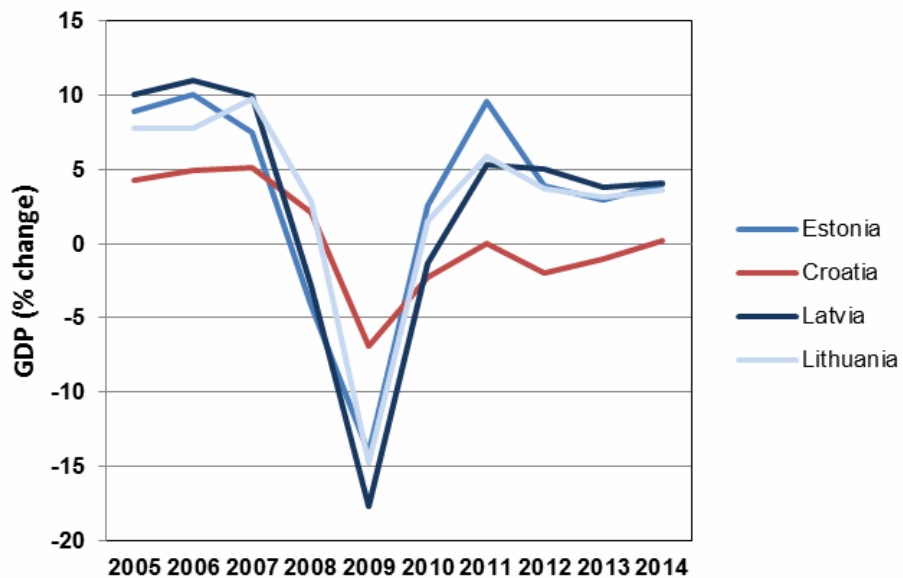
## Government expenditure



Sources: Eurostat, CNB.

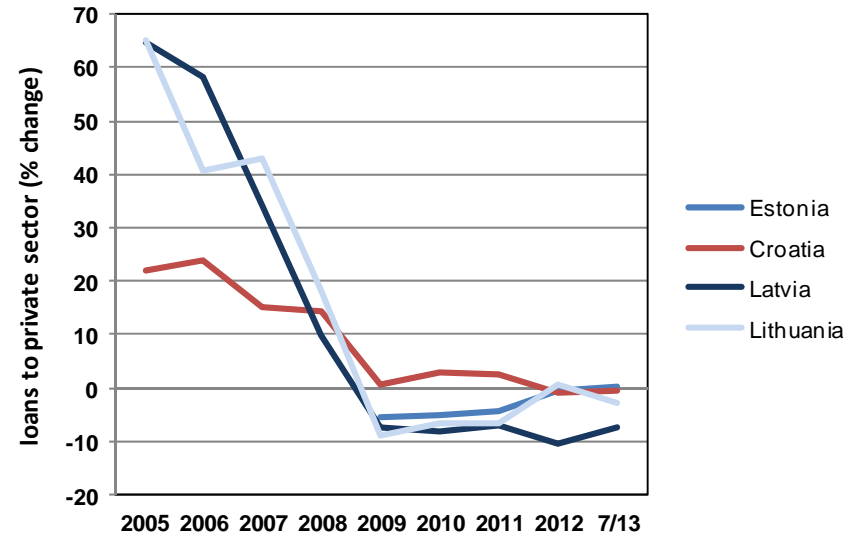
# Baltic countries – Croatia comparison

## GDP growth rate



Sources: Eurostat, CNB.

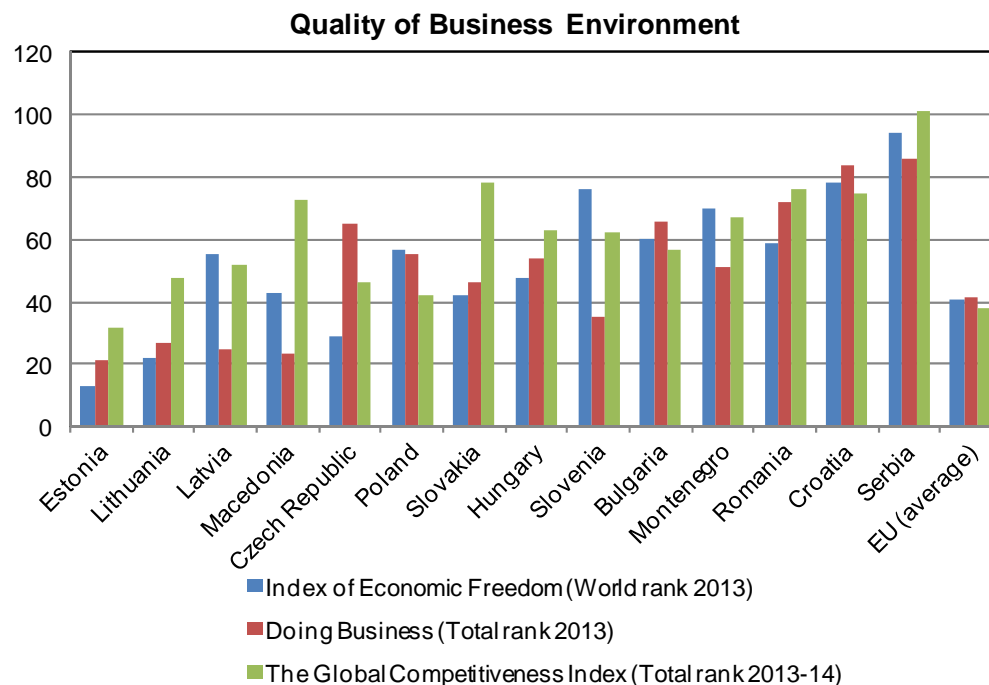
## Credit growth



Sources: ECB, CNB.

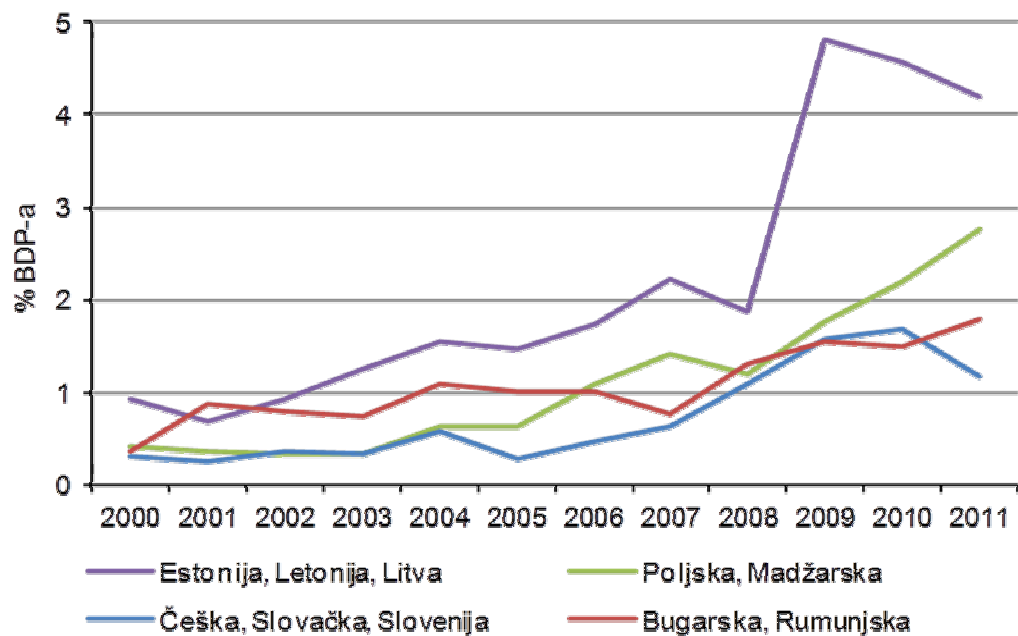


# If its not credit, nor fiscal, what can bring growth back: sorry for being boring, but its the...:



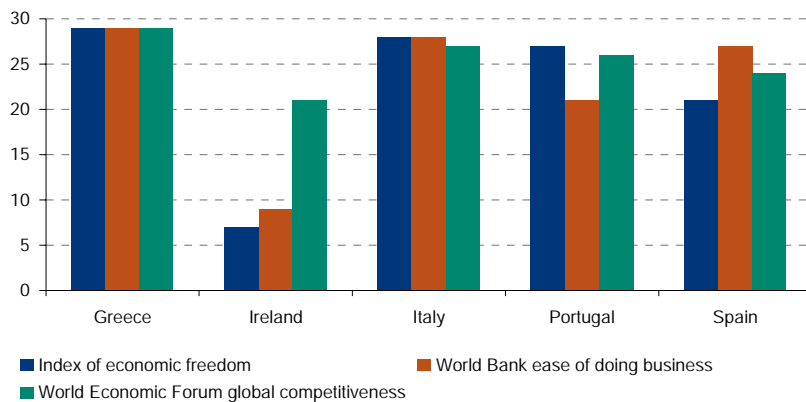
Sources: WB, Heritage Foundation, CNB

# Those with best business environment are also those with highest EU funds absorption

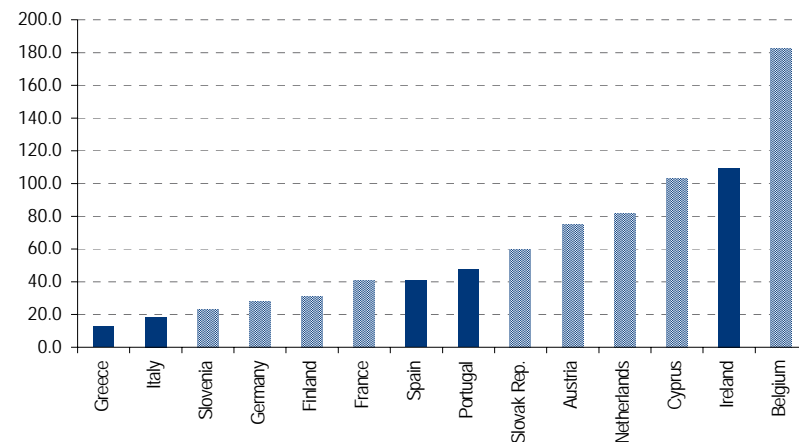


# ...lessons from the eurozone...

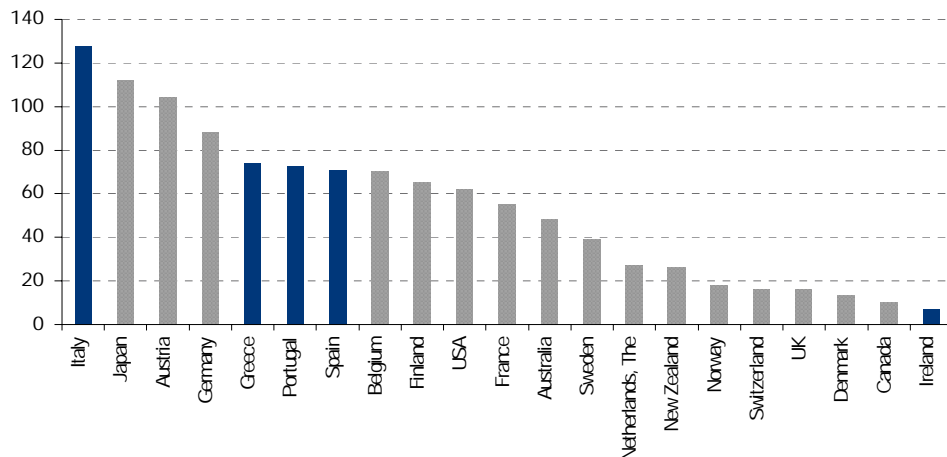
Structural rigidities in the Eurozone periphery (latest ranking in 29 advanced economies)



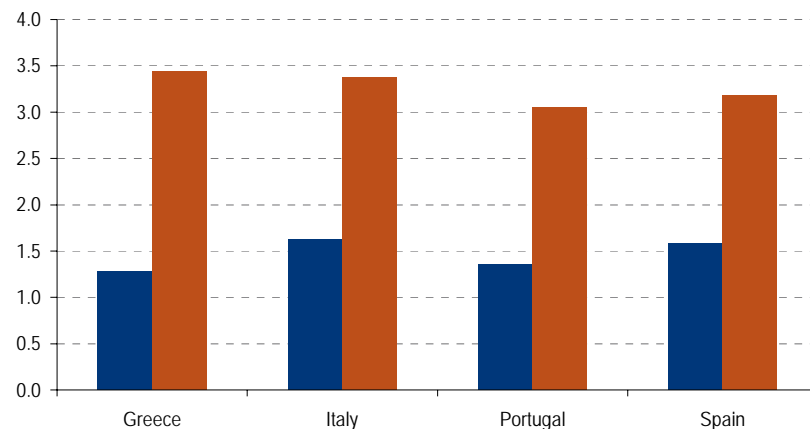
Stock of FDI inflows (in percent of GDP, 2009)



Ease of paying taxes



Increase in potential growth from reforms



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**Thank you!**