



HRVATSKA NARODNA BANKA

University College Effectus
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Features and challenges of the monetary policy of the Republic of Croatia

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What can the central banks do?

- ❑ The tasks before the central banks and the expectations placed upon them are different today than before the financial crisis: today, the central banks are not only responsible for price stability but for financial stability as well
- ❑ In response to the financial crisis, the central banks started pursuing expansionary monetary policies, using conventional and unconventional measures, but economic growth remained slow and inflation low
- ❑ Against such a background, the risks of expansionary monetary policies are rising
- ❑ Monetary policy, either conventional or unconventional, is not a substitute for structural reforms and fiscal policy

Restrictions to monetary policy in Croatia

1. High euroisation of deposits and placements
2. RC being a small and open economy with a high share of exports and imports in GDP (approximately 50%)
3. Large external debt of all the sectors (risk to financial stability)
4. High import dependence of the economy

Restrictions to monetary policy: high euroisation

- Croatia is a highly euroised economy
- Euroisation/dollarisation means the use of foreign currency for payments, price calculations, savings and/or lending
- The most frequent causes of euroisation:
 - history of high inflation
 - other reasons: proximity of large economies, the level of openness of the domestic economy, transfers, quality of institutions, network externalities
 - that what is called the original sin— impossibility of borrowing in the domestic currency abroad
- There is a difference between euroisation of deposits and euroisation of placements

Deep-rooted euroisation of deposits in the Republic of Croatia

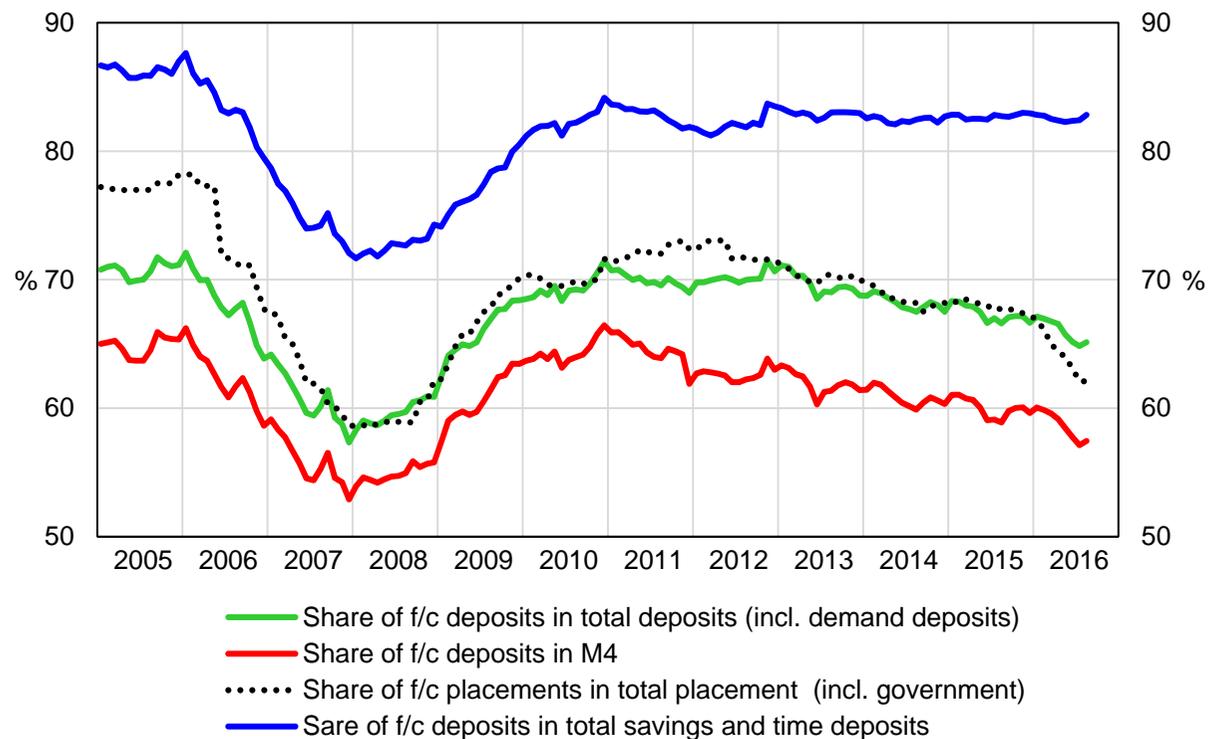
In the past 20 years, euroisation of savings and time deposits in the Republic of Croatia stood at 80% \pm 8% despite:

1. the stability of the exchange rate of the kuna against the German mark and later, since 1999, against the euro
2. the measures taken by the CNB to ensure financial stability
3. highly capitalised and stable banking system
4. constantly higher interest rates on kuna deposits than on foreign currency deposits

In the Republic of Croatia, euroisation of deposits causes euroisation of placements

- Foreign currency deposits provide the biggest source of lending for the banks
- To protect their savers and owners from losses, the banks have to achieve a match between liabilities (sources – mostly foreign currency deposits) and assets (placements – mostly loans)
- This is why a large share of loans is granted in kuna with a currency clause – the banks disburse such loans in kuna and the debtors pay them off also in kuna, but the amount of obligation is linked to exchange rate developments, most often the euro

High euroisation of deposits and placements



Note: Foreign currency deposits include kuna deposits with a currency clause and foreign currency placements include kuna placements with a currency clause.

Source: CNB.

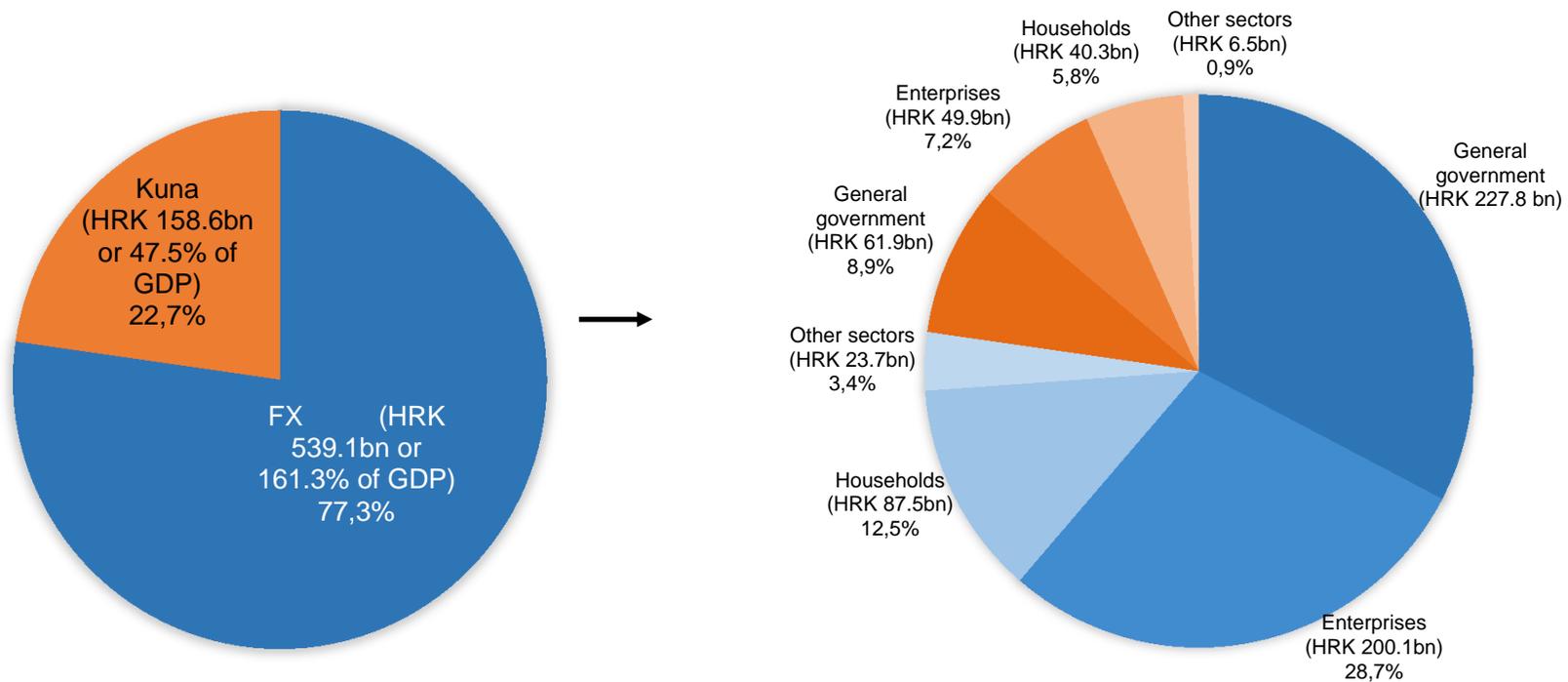
Restrictions to monetary policy: Croatia – a small and open economy

Characteristics of small open economies:

- ❑ A high share of exports and imports in GDP (in the Republic of Croatia, approximately 50% of GDP)
- ❑ Global price takers
- ❑ They do not affect global trade and capital flows
- ❑ As a rule, they may not borrow on the international market in own currency
- ❑ Large exposure to supply shocks (e.g. oil or raw materials prices) and demand shocks (e.g. tourism)
- ❑ Large exposure to changes in the direction and volume of foreign capital flows, which are as a rule procyclical

Restrictions to monetary policy: high external debt of non-monetary sectors

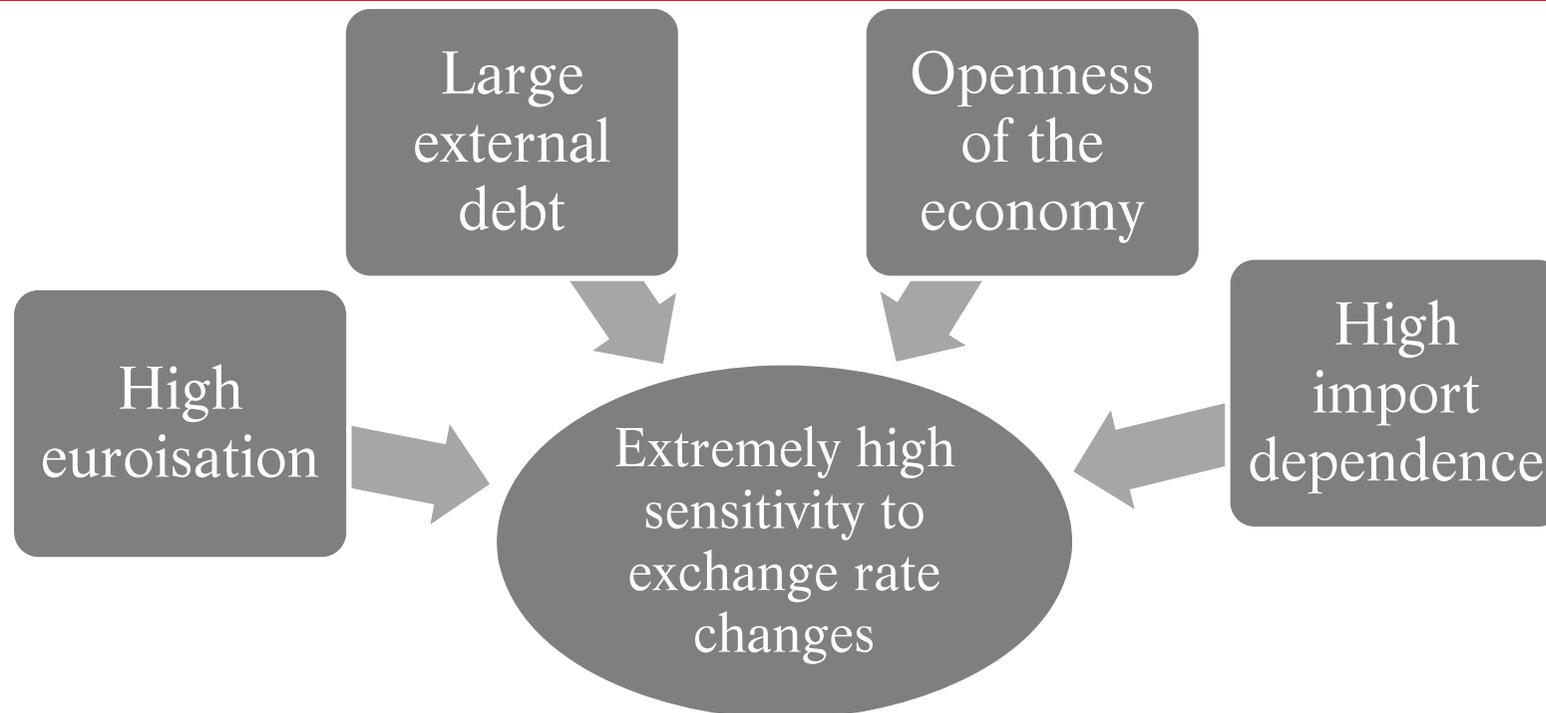
Total debt of non-monetary sectors as at 31 December 2015



Note: Total domestic and external debt of all sectors of the economy as at 31 December 2015, except debt of the CNB and other monetary financial institutions. The external debt also includes the debt in kuna with a currency clause.

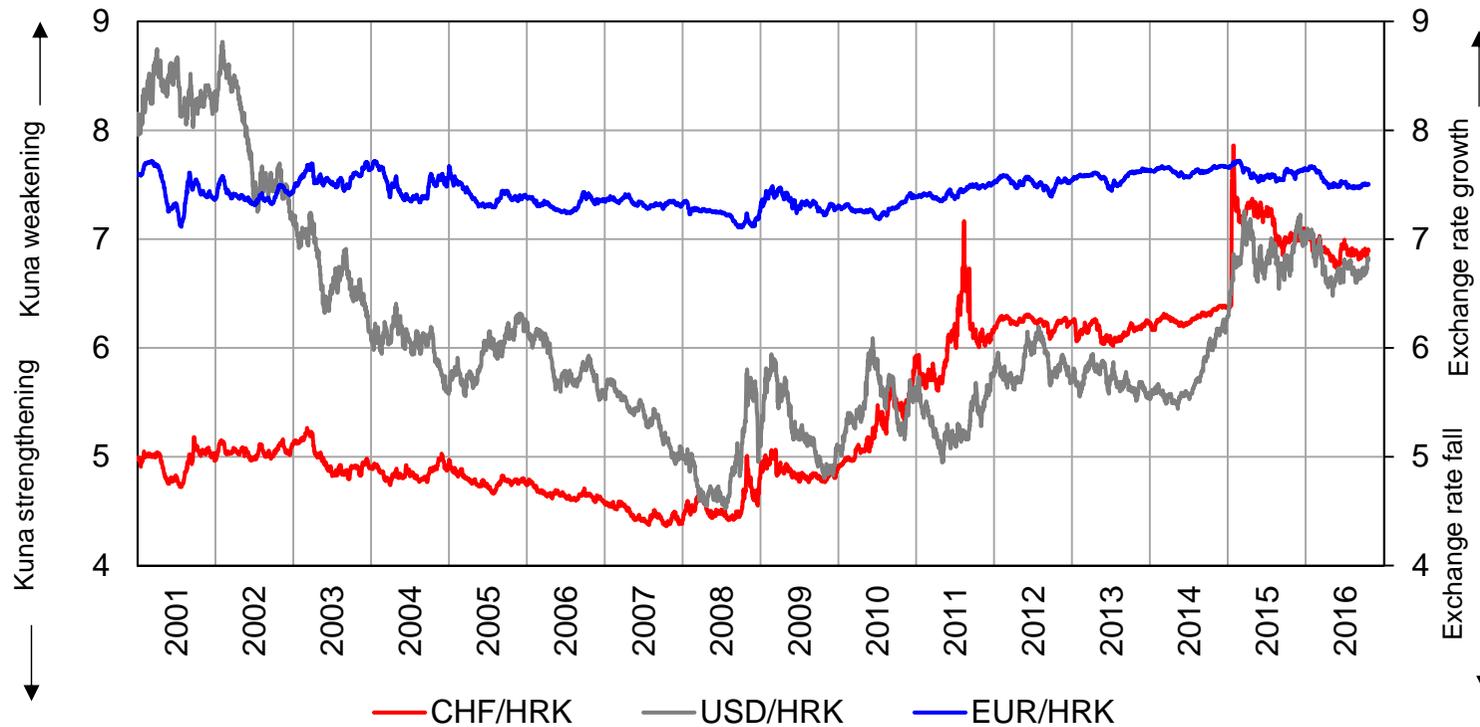
Source: CNB.

Exchange rate dependence sets the course of the monetary policy



In such conditions, the CNB achieves its objective (price stability) by maintaining the stability of the nominal exchange rate of the kuna against the euro

Stable, but not fixed nominal exchange rate



Source: CNB.

What does the CNB do?

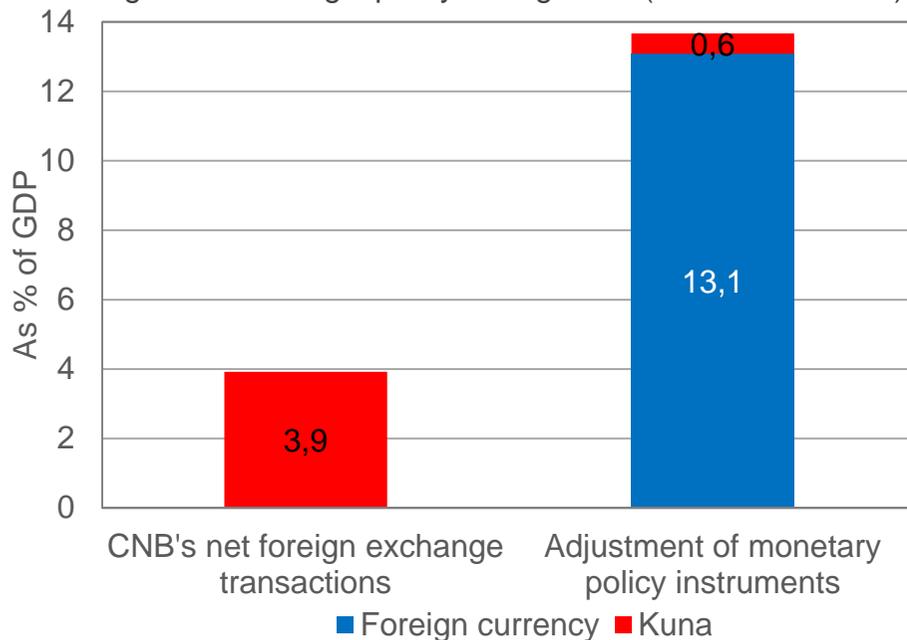
- Pre-crisis period
 - The highly restrictive nature of the monetary policy was achieved by raising the regulatory burden placed upon the banks - countercyclical action
 - The basis for action since 2008
- Highly expansionary monetary policy since the beginning of the crisis
 - Reduction of regulatory burden and release of liquidity reserves
 - Recently strengthened additionally by regular and structural repo operations
- Continuous: the policy of discouraging euroisation by imposing higher relative regulatory cost and encouraging kuna lending, maintaining at the same time the stability of the exchange rate
- Results: improved financing conditions, lower interest rates and costs for all the sectors, while maintaining financial stability

The expansionary orientation of monetary policy, exercised by the CNB over years, set to continue in the future

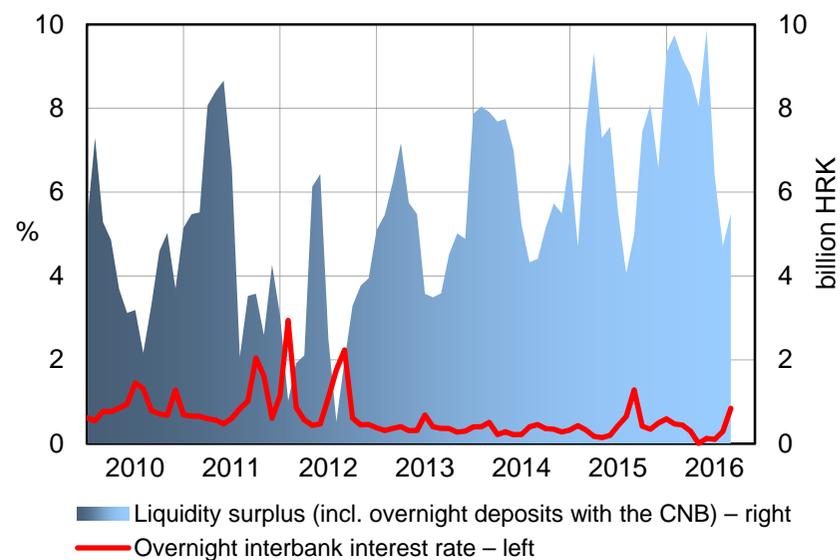
*Strong countercyclical response of the CNB
– the liquidity created from October 2008 to
September 2016*

Bank liquidity and overnight interbank interest rate

Creating and releasing liquidity during crisis (10/2008 - 9/2016)



Source: CNB.

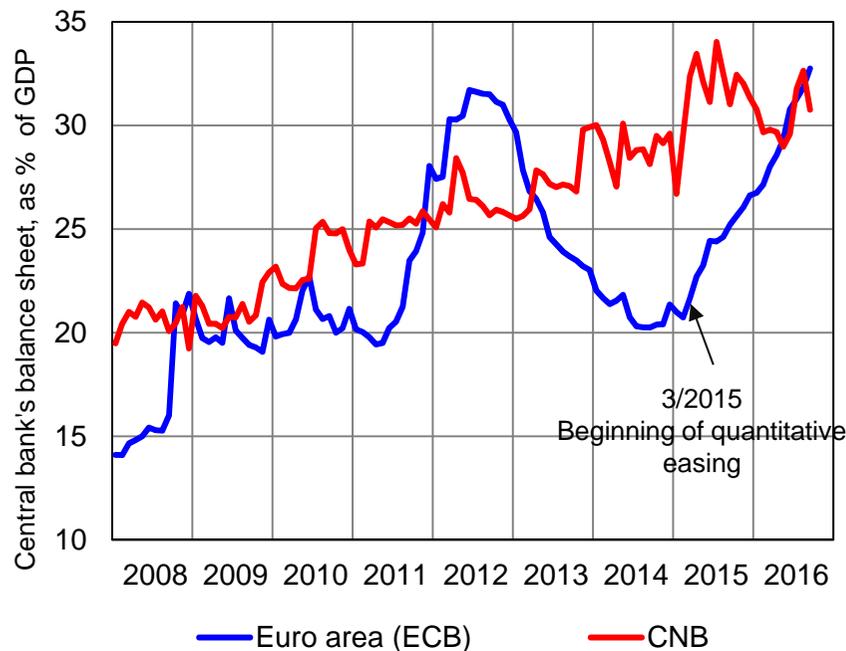


Note: Excess liquidity is the difference between the balance in the banks' settlement accounts with the CNB and the amount which the banks have to maintain in these accounts based on the calculation of reserve requirements.

Source: CNB.

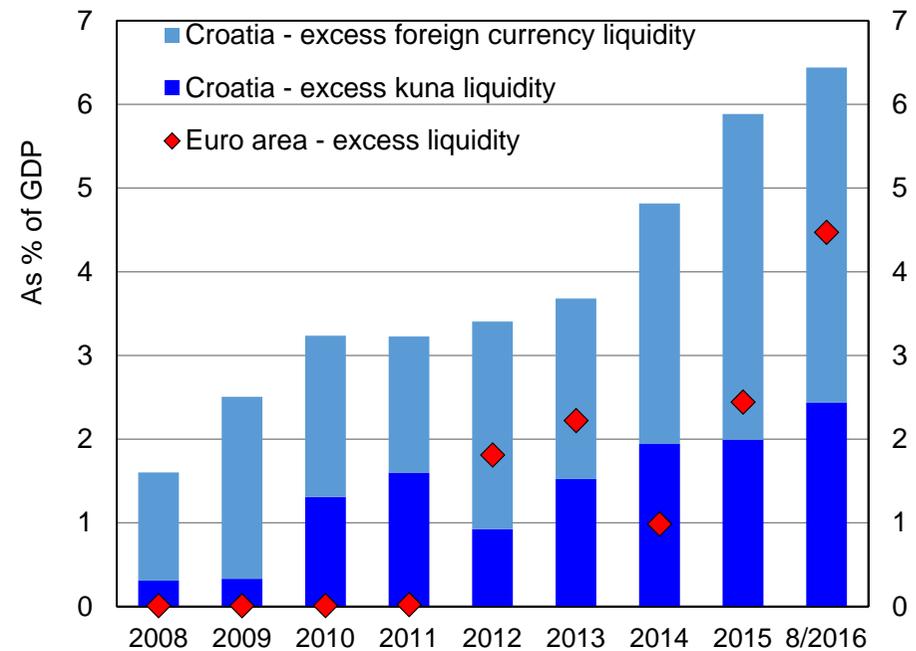
The scope of the expansionary character of the monetary policy in effect does not differ from that in the euro area; what sets them apart are the channels and instruments used

Growth in ECB and CNB balance sheets



Sources: CBS, ECB, Eurostat, CNB.

Excess liquidity - RC in relation to the euro area



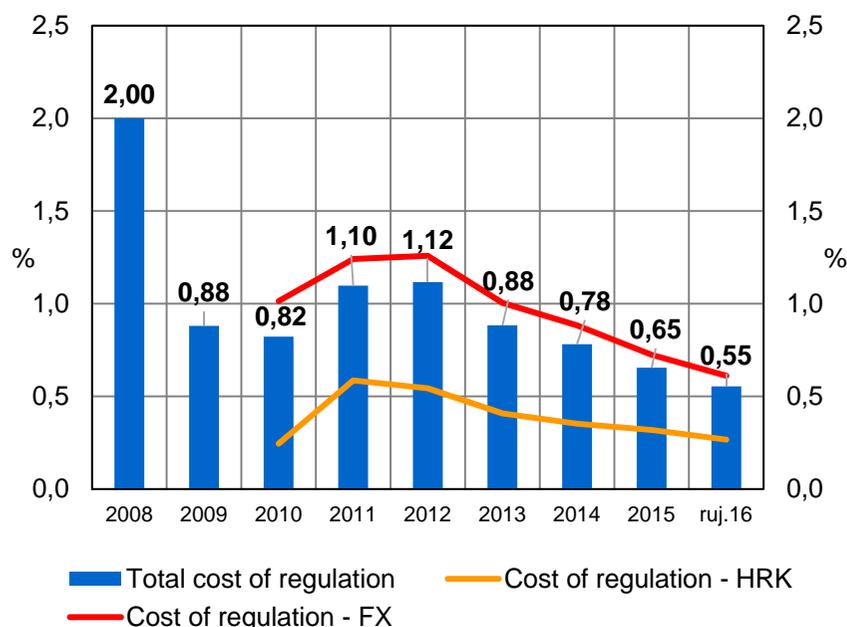
Note: Excess liquidity in the euro area is the excess of reserves over regulatory reserve requirements.

Sources: ECB, Eurostat, CNB.

Easing of CNB's regulatory requirements continued into 2016

Considerable reduction in regulatory costs for the banks...

...by easing all forms of reserve requirements



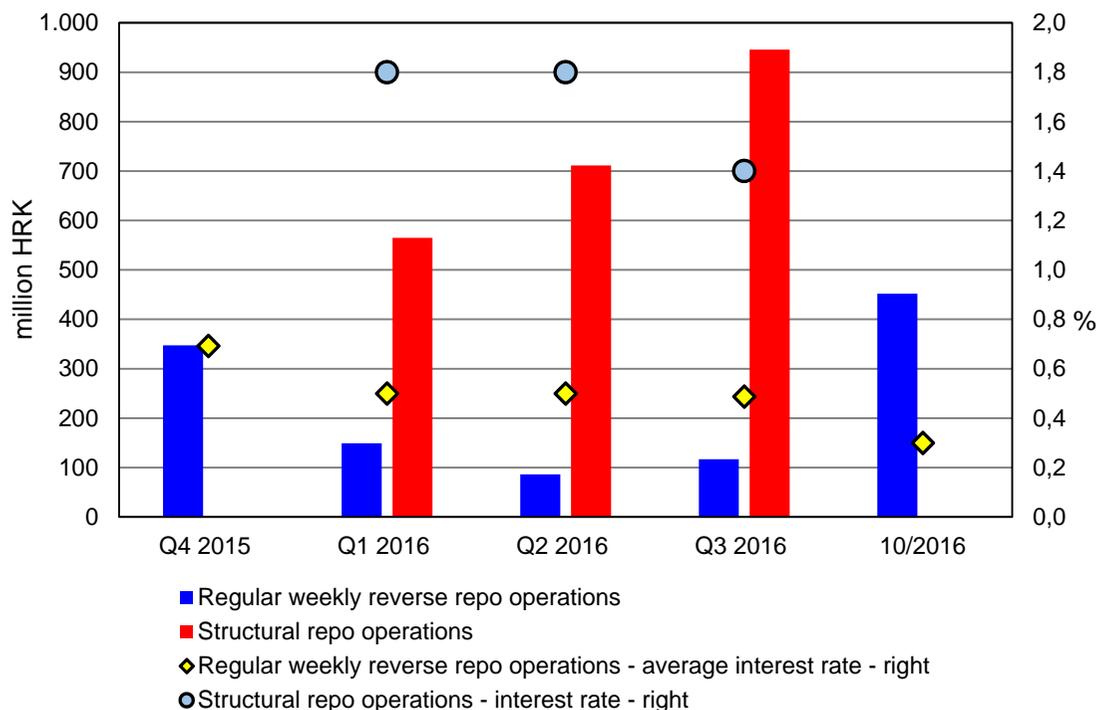
Note: The cost of regulation is estimated as the weighted difference between the smallest required return on placements and the nominal cost of the sources of bank financing, with the amount of funds that the banks cannot place due to regulatory requirements being factored in.

Source: CNB calculation.

Note: Monetary policy indicator = the assets of credit institutions held for regulatory purposes / the liabilities of credit institutions. The assets of credit institutions held for regulatory purposes (less excess liquidity) include the calculated reserve requirements in kuna, the allocated reserve requirement in foreign currency, the marginal reserve requirement, CNB bills and the minimum required foreign currency claims.

Source: CNB calculation.

In 2016, the expansionary character of the monetary policy was further boosted by structural repo operations



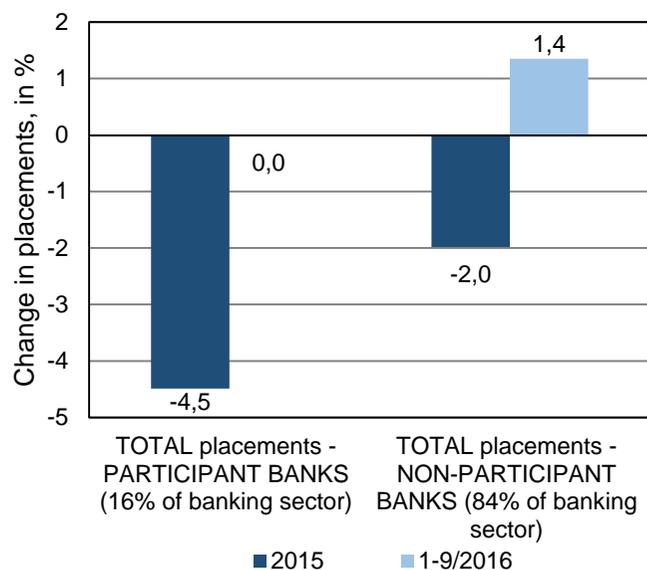
- Three auctions held so far; the total amount placed stands at almost HRK 1bn
- The aim is to ensure to the banks longer-term sources of kuna liquidity (the maturity of operations is four years)
- Low interest rate; 1.8% at the first auction, then cut to 1.4%
- The structural repo operations contribute to the lowering of the kuna yield curve on medium/longer maturities, the development of the domestic market for kuna government securities and encouraging the banks to increase kuna lending
- In addition to structural operations, the CNB supports the system's kuna liquidity by regular weekly operations.

Note: The amount of and the interest rate used for regular weekly repo are period averages, while the amount of and the interest rate used for structural repo operations are the amounts and rates achieved at an auction. Data for October 2016, as at and including 26 October.

Source: CNB.

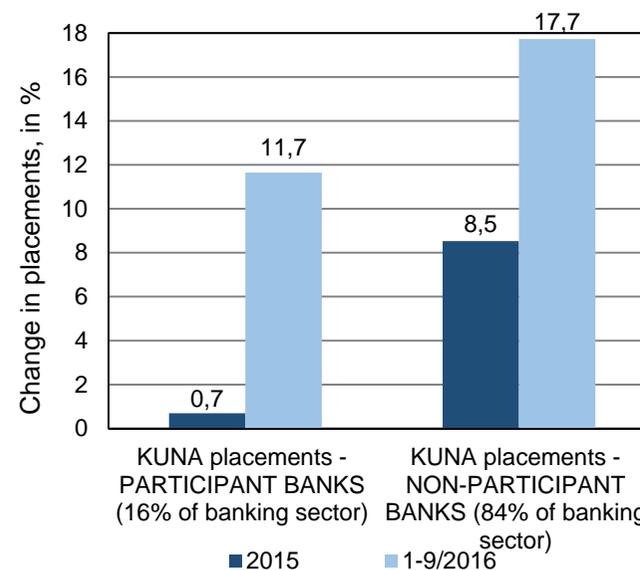
The banks that participated in structural repo operations were able to halt the fall in lending

Total lending



Note: Placements mean bank placements to other domestic sectors (government excluded).
Source: CNB.

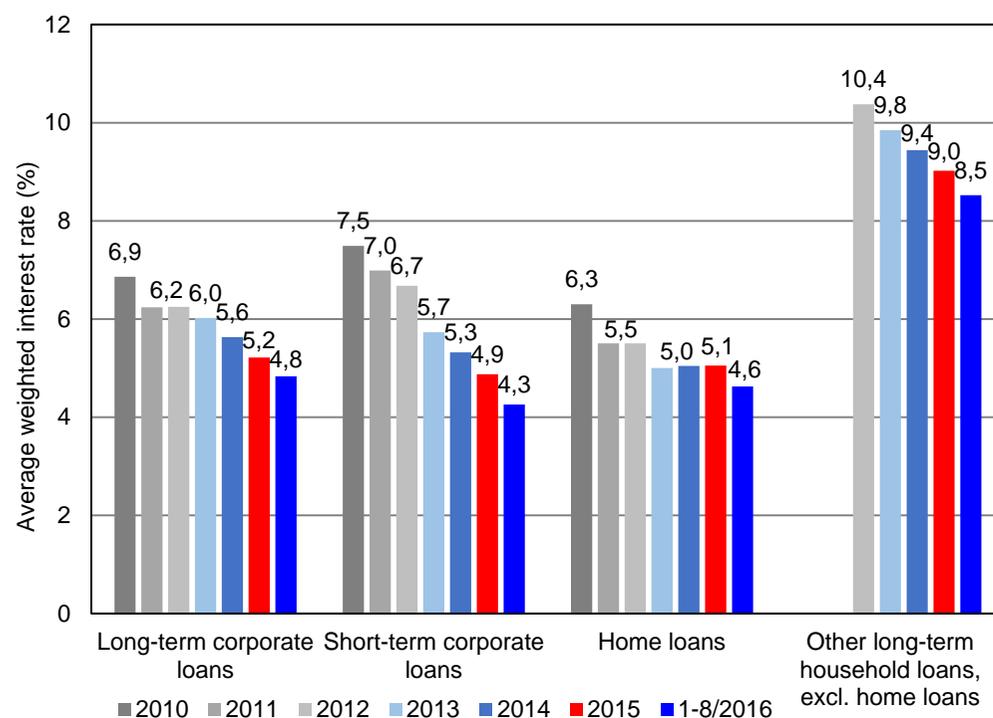
Participant banks increased kuna loans, in contrast with the previous year



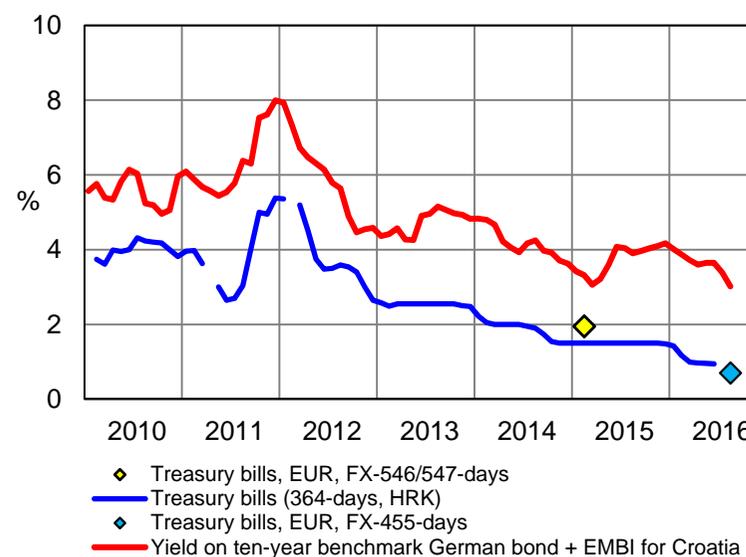
Note: Placements mean bank placements to other domestic sectors (government excluded).
Source: CNB.

Financing conditions are improving steadily

Interest rates on bank loans



Costs of government borrowing



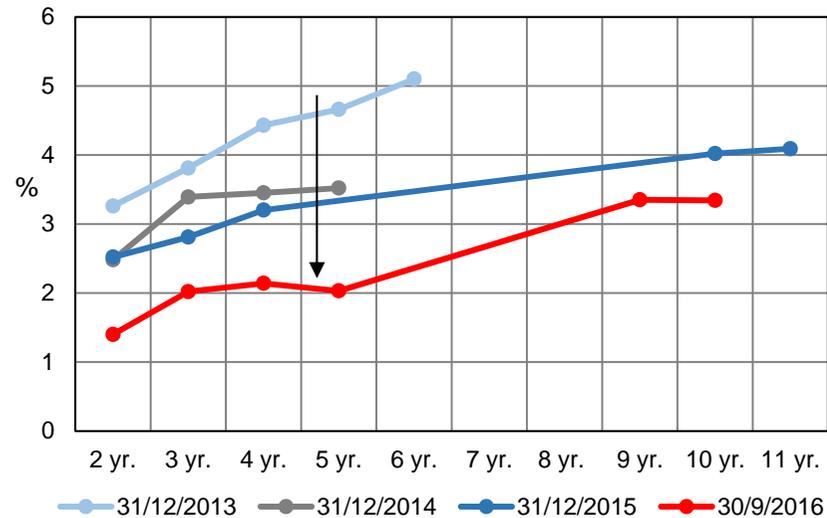
* Interest rates on home loans for 2015 and from January – August 2016 are interest rates on new loans, i.e. excluding renegotiated loans. All other data relate to new transactions which include new and renegotiated loans.
Source: CNB.

Sources: CNB, MoF.

Falling yield curves on government bonds of all maturities

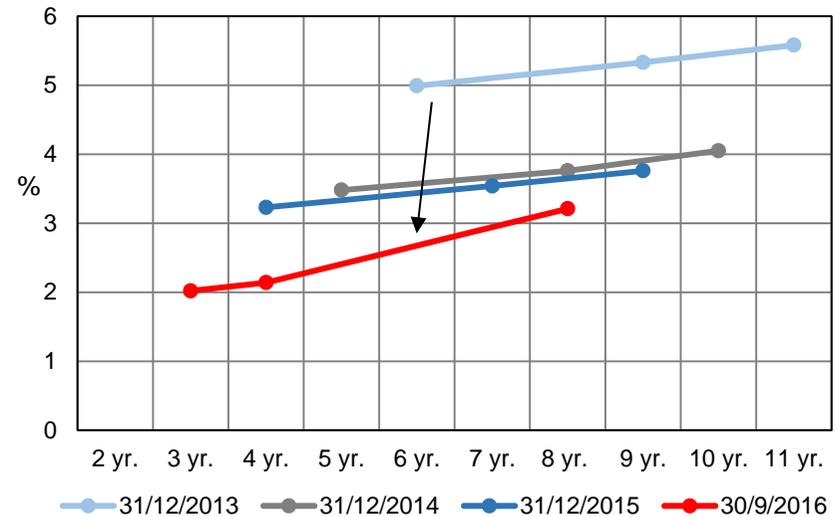
Yield to maturity on RC bonds

In kuna without a currency clause



Source: CNB.

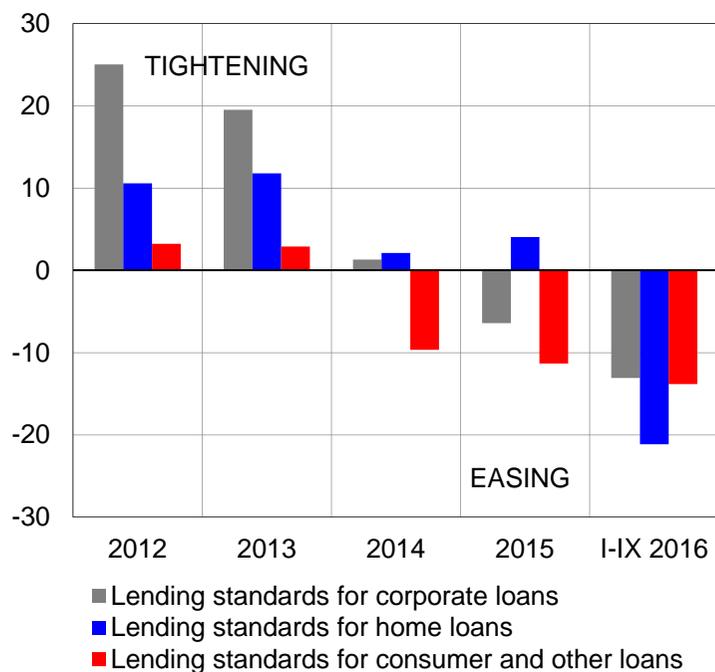
In kuna with a currency clause in euro



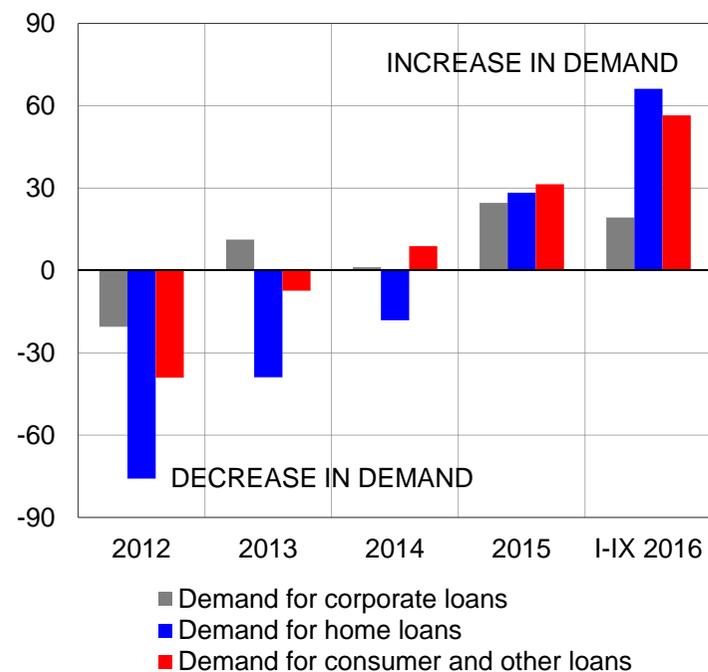
Source: CNB.

Favourable developments in credit supply and demand

Easing of bank lending standards...



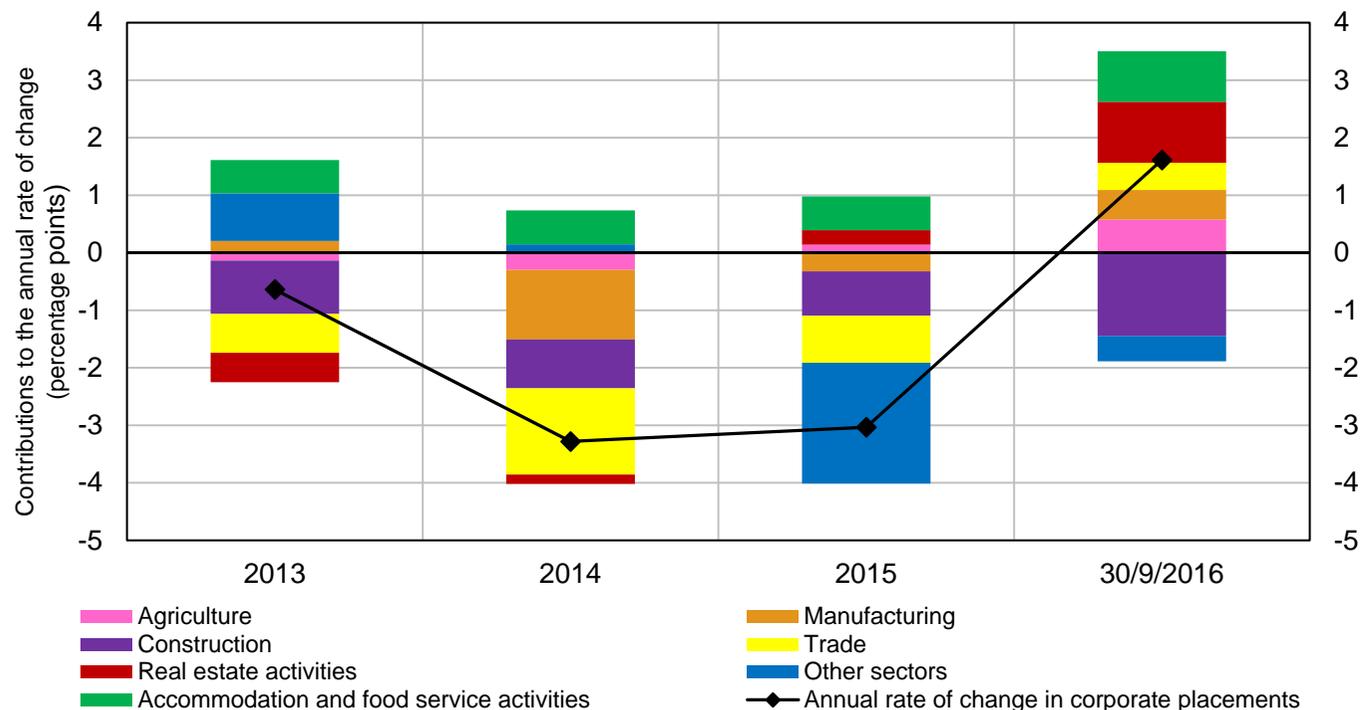
...with a concomitant rise in credit demand



Note: Data show annual averages of net percentages of banks' responses weighted by shares in the respective loan group.
 Source: Bank Lending Survey, CNB.

A growing number of activities is witnessing credit growth

In 2016, there was an increase in lending to agriculture, manufacturing, trade, the real estate sector and tourism

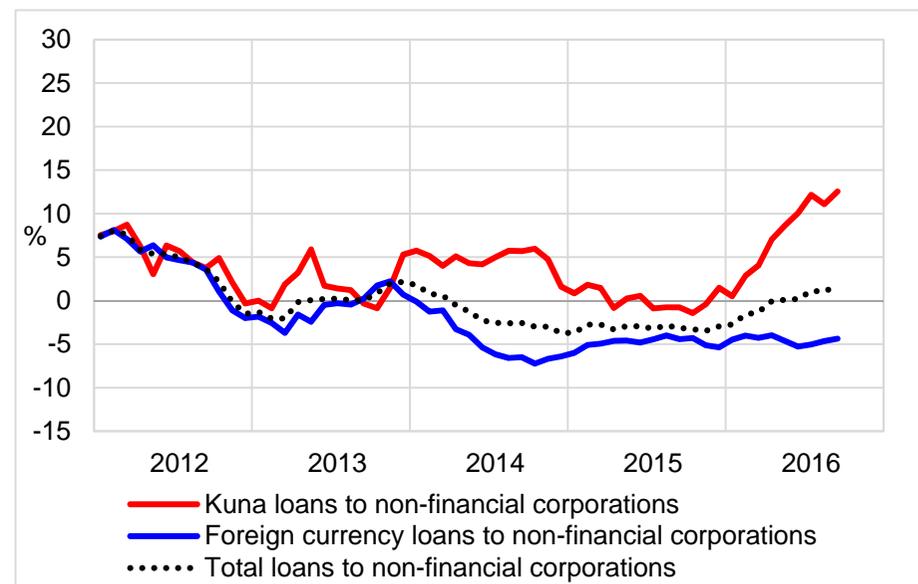
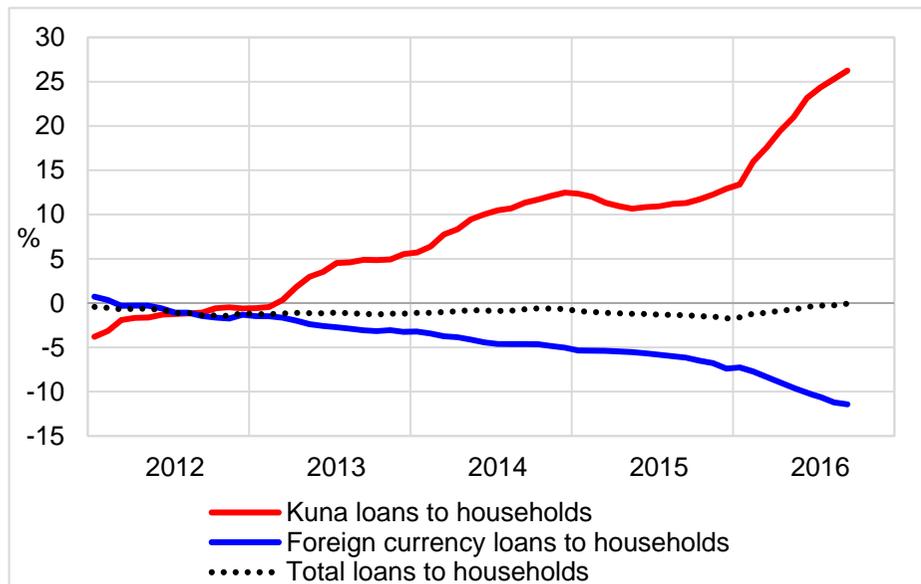


Note: Transaction-based data.
Source: CNB.

Increased kuna lending spurred placement recovery...

*A jump in kuna placements to
households...*

...and enterprises

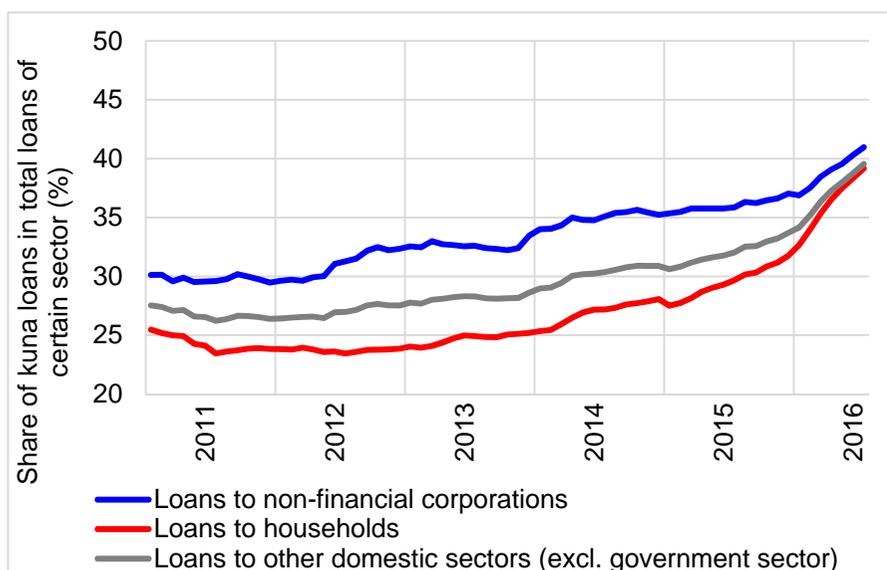


Note: Transaction-based annual rates of change.
Source: CNB.

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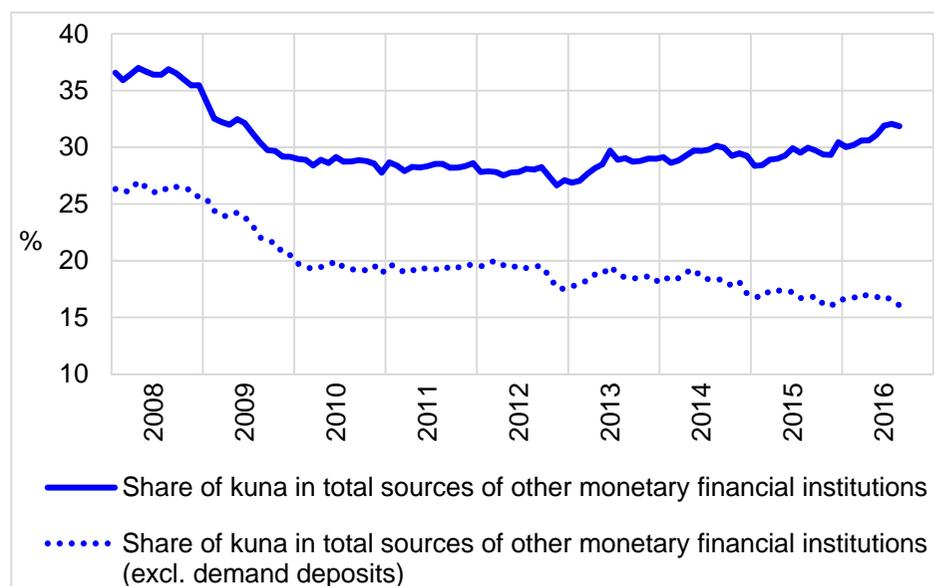
...and is also connected with gradual deposit deeuroisation

Credit deeuroisation



Source: CNB.

Deposit deeuroisation



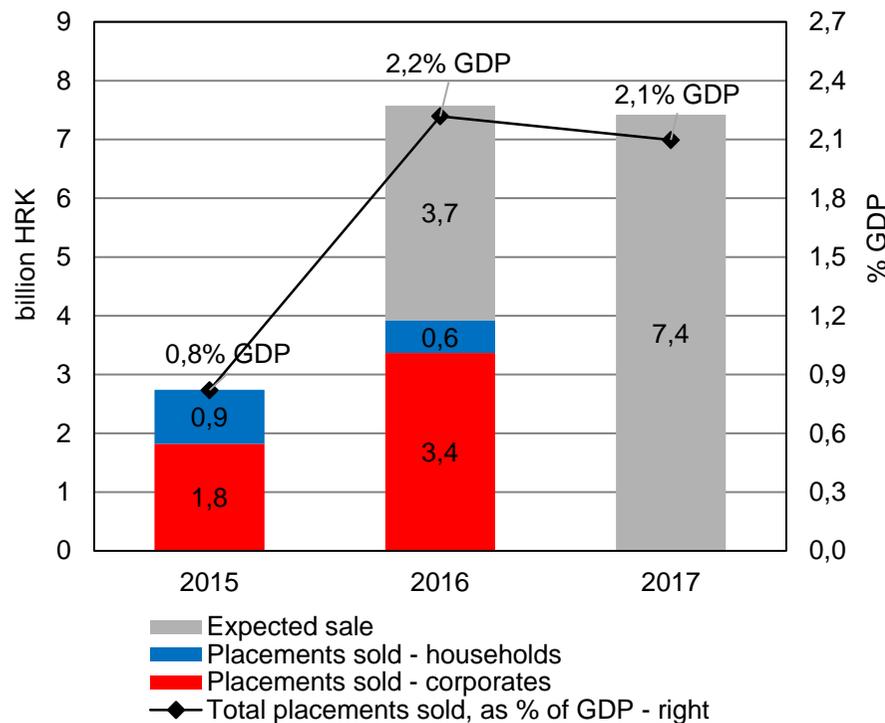
Note: The sources include demand deposits, savings and time kuna and foreign currency deposits and foreign liabilities of banks.

Source: CNB.

The banks stepped up their efforts to clean their balance sheets, writing off and selling their placements

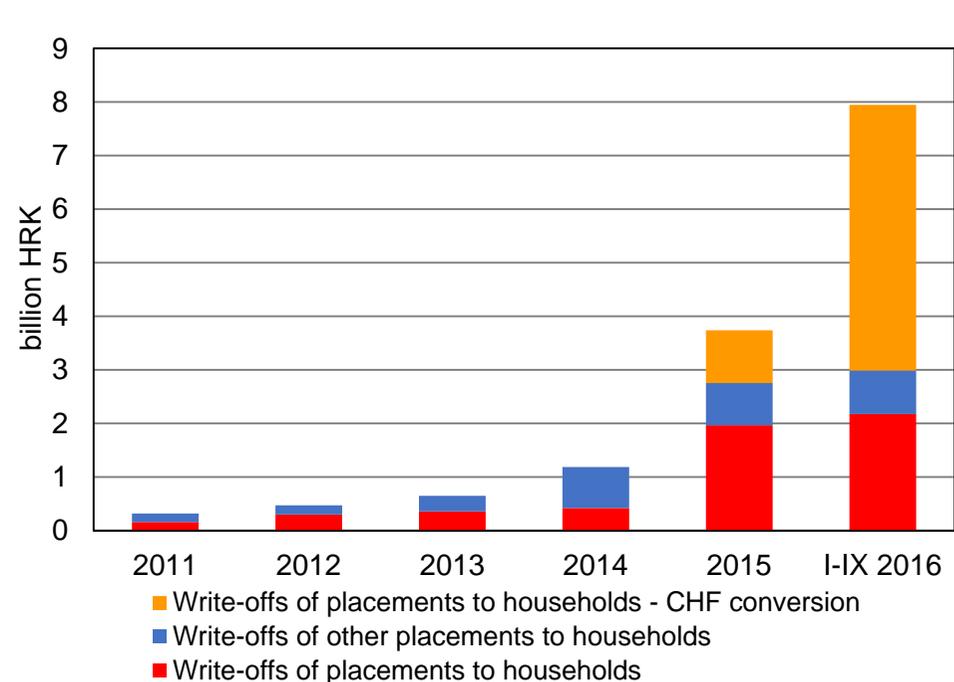
Visible increase in the sale and write-off of bank placements, particularly placements to enterprises

Sale of placements



Note: The sales made in 2016 relate to the first half of the year. The expected sale of placements are estimated based on announcements of large banks. Source: CNB.

Write-offs of placements

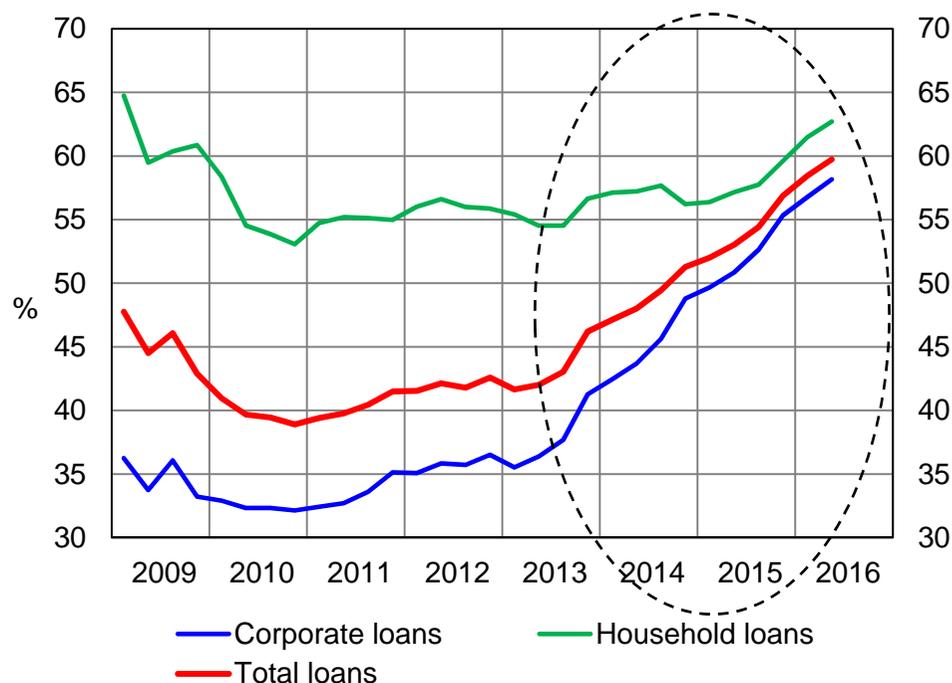


Note: The estimated amounts of write-offs associated with Brush 1 and Brush 2 projects are not included in the data. Source: CNB.

...partly also driven by prudential measures of the CNB aimed at increasing provisions for non-performing placements

- The standards for the coverage of non-performing placements by provisions were tightened in 2013
 - Banks failing to actively address the issue of NPLs are obligated to gradually increase provisions for such placements, irrespective of their coverage by collateral

Coverage of non-performing loans by provisions (%)



Source: CNB.

The CNB continues to ensure high banking system liquidity

- The CNB will continue to pursue an expansionary policy of maintaining high monetary system liquidity by structural repo operations, regular operations and foreign exchange transactions, if necessary
- Such a policy contributes to the improvement in the domestic financing conditions and provides support to the recovery in domestic credit activity
- This is what the CNB can do and what it can exert influence on under the circumstances, taking into account the stability of the exchange rate of the domestic currency and total financial stability of the system
- However, increased competitiveness of the domestic economy, based on structural reforms and exports growth, concomitant with the containment of macroeconomic imbalances and further consolidation of public finances, must be the basis for a stronger economic recovery

Thank you for your attention!