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Spillovers of the Crisis: How Different Is Croatia?

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1. Overview

Central and Eastern Europe, a region which had been a recipient of massive capital inflows from Western Europe during the last twenty years, has been hit hard by the current global financial and economic crisis. After the collapse of Lehman Brothers it faced soaring risk premia and falling demand for its exports. The sharp downturn in real economic activity was accompanied by problems in the banking sector in some countries and the need for international official financial assistance.

The purpose of this paper is to explain why Croatia is one of the countries that have so far managed to cope with the crisis relatively well. The second section describes the causes of capital inflows and various measures adopted by the Hrvatska Narodna Banka (HNB) to slow them down, and stresses that it was almost an impossible mission for the HNB. The third section explains how these measures ensured the continued normal functioning of the Croatian banking system in the period of economic distress and suggests that avoiding the exchange rate and banking crisis was the key reason why the current decline in real economic activity is less pronounced than in peer countries. The fourth part admits that such policy is not without risks, particularly given that international competitiveness has been in decline for the last several years.

2. Main Features of HNB Policy after Obtaining EU Candidate Status

Since 2000, Croatia has significantly improved its political relations with the international community. Better political relations helped finalize negotiations on joining the World Trade Organization in 2001 and contributed to the signing of the Stability and Association Agreement with the European Union (EU) in 2002. Political integration was followed by higher foreign capital inflows to Croatia.

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When Croatia obtained the candidate status for EU membership in 2005, inflows intensified even further.

Foreign owned local banks were the main players moving foreign capital into Croatia. Their owners are major foreign banks that operate in the region, and most of them came to Croatia around 2000. They encouraged their local subsidiaries to increase domestic lending and financed the lending by foreign borrowing from other banks belonging to the same banking group. Making a profit on the difference between domestic and foreign interest rates has been the main motive of foreign banks' business in Croatia. Namely, while foreign interest rates fell to historically low levels in 2001 and remained there for several years, interest rates in Croatia have been much higher than abroad. Furthermore, the expectation that the nominal exchange rate would remain stable also supported capital inflows. Although the primary goal of the HNB is price stability, tight management of the nominal exchange rate of the Croatian kuna (HRK) against the euro has been the main feature of HNB monetary policy since 1993 and it has also proven to be successful in controlling inflation. This is a result of the fact that Croatia is a small open economy with a high degree of euroization (about 2/3 of bank deposits are in foreign currency).

Although capital inflows are considered positive, there were rising concerns within the central bank that Croatia receives, in the short run, too much of what is otherwise a good thing. Such concerns were supported by the fact that, on the one hand, the speed of economic growth was similar to other countries in the region, while on the other hand external vulnerabilities were materializing much faster. This was partly due to the fact that most of the new bank loans were granted to households, i.e. for consumption. The HNB recognized such trends as the seeds of future crisis, and decided to act. However, it had to do so within the following constraints: 1) the room for independent monetary policy was limited due to the exchange rate regime, 2) despite the HNB's legal power to impose capital controls, this was not possible due to the EU accession efforts, and 3) the cooperation with fiscal authorities was limited due to the large structural problems in the government budget. Therefore, the HNB's response to capital inflows was a combination of soft monetary policy and the adoption of various administrative and prudential measures. Such measures were introduced already in 2003, and were changed and gradually tightened afterwards. The choice of particular measures and changes in those measures over time were not simple and smooth processes because banks always tried to find ways to arbitrage them.

In 2003 the HNB introduced a speed limit to bank lending and a rule on minimum retained earnings if bank lending exceeds a certain threshold. The speed limit was set as the annual growth of banks' domestic credits of 16%. As the penalty for breaching it was high, banks formally met the limit, and the rate of growth of banks' credits to the non-government sector fell from 28.7% in 2002 to 11.8% in 2003. Because of the banks' attempts at arbitrage, the rate of growth of total domestic credits in the economy as a whole declined by much less. Banks actually adjusted to the limit by: 1) selling a part of their loan portfolio to affiliated Croatian leasing companies, securing the funding by borrowing abroad from the mother bank or other banks within the same banking group; and 2) selling the credit risk to the mother bank; under the accepted accounting standards banks can remove such loans from the balance sheet. The latter operation should had been recorded by statistics as foreign direct lending to non-bank clients (using the local bank credit office expertise), but it was not captured by statistics in 2003. The other measure adopted by the HNB was the requirement for fast-growing banks to retain a portion of earnings for three years. The purpose of such a requirement is to provide a cushion against possible deterioration of newly granted credits in the future.

The speed limit regulation was discontinued in 2004 and replaced by other measures believed to be better. The important new measure introduced in July 2004 was the marginal reserve requirement, which required banks to make additional non-interest bearing deposits with the HNB if their foreign liabilities increased above their value recorded at end-June 2004. The marginal required reserve rate was set in July 2004 at 24%. The rate was later gradually increased, reaching 55% at the end of 2005. Throughout that period, the HNB was also active in refining the regulation and closing all loopholes found by banks. For instance, marginal required reserves were also later applied to increases in liabilities to affiliated leasing companies, to off-balance sheet items related to the selling of credit risk and to debt securities issued. The latter were included because some banks started issuing debt securities by placing them privately with the mother bank. Prior to that, bank debt securities were not issued at all.

Marginal required reserves came in addition to the regular required reserves and the minimum foreign exchange liquidity requirement. Taken together, these three requirements reached their peak at the end of 2005, and – although there were some minor variations in the minimum foreign exchange liquidity requirement – remained there until October 2008. Banks were required to place 72% of the increase in foreign liabilities with the HNB, or in liquid foreign assets, while the remaining 28% was disposable for lending to clients (see table 1). In spite of extremely high reserve requirements, banks' domestic lending increased again. The annual rate of growth of banks' domestic credits was at 22.3% in 2005 and 23.9% in 2006. However, in 2006 banks' foreign liabilities started to decline because foreign borrowing as the source of banks' funds for domestic lending was replaced by raising new equity capital. At this time, incoming cash transfers from mother banks for the purpose of raising bank equity capital tripled relative to the previous three years' average.

Table 1: Required Reserves Set by the HNB

Source of financing	Disposable for lending		Cost of financing (%)		Break even average interest rate (BEAIR)	
	2007	2009	2007	2009	2007	2009
Foreign liabilities						
HRK (100)	28	86	4,30%	5,87%	15,04%	6,73%
HRK indexed to FX (100)	28	66	4,30%	5,87%	15,04%	7,76%
FX (100)	28	69,5	4,30%	5,87%	14,67%	7,51%
Household deposits						
HRK (100)	83	86	2,80%	6,65%	3,27%	7,65%
HRK indexed to FX (100)	51	66	4,21%	5,09%	5,70%	6,58%
FX (100)	56,1	68,1	2,87%	4,97%	2,82%	6,23%
Average interest rate on new placements			8,69%	9,76%		

Source: HNB.

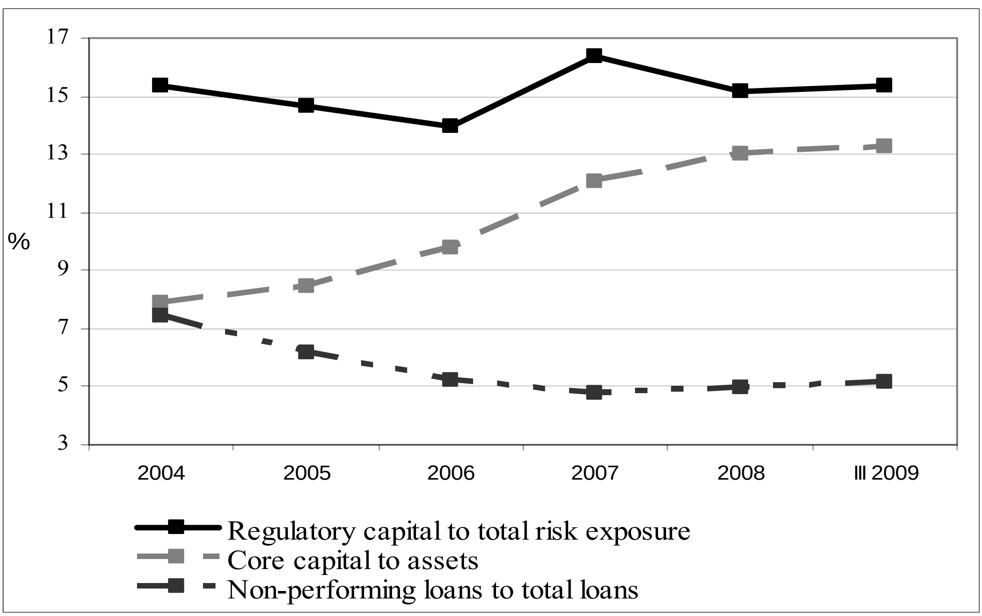
Furthermore, according to a survey of bank managers, changes in capital adequacy regulation also contributed to the increase in bank equity capital. As of mid 2006, risk weights applied to bank loans in foreign exchange or loans in kuna indexed to foreign currency, granted to un-hedged clients, have been higher than those required by Basel II. Applying such higher risk weights to a substantial part of bank assets (almost all households' loans are unhedged) caused a fall in banks' capital adequacy ratio by two percentage points.

Raising banks' reserve and capital adequacy requirements failed to weaken capital inflows. In 2005 and 2006, total domestic lending in the economy as a whole grew even higher than bank lending (24.6 vis-à-vis 23.1 annually), due to fast growth of direct foreign lending to non-bank enterprises. Creditors of non-bank clients were the same foreign banking groups. To discontinue such trends in domestic lending and the buildup of external vulnerabilities, the HNB decided to employ the speed limit to bank lending again in 2007. The regulation was prepared more carefully than in 2003, covering the selling of credit portfolio and credit risk. Loans granted by local bank affiliates were covered by the limit as well. The speed limit was set as the annual growth of bank lending of 12%. Penalties for breaching the limit were high, causing the annual growth of bank lending to fall to 15.3% in 2007. As bank lending is an important source of household credit, limiting it caused a significant decline in the growth rate of overall household credit, which fell from 23.5% in 2006 to 19.2% in 2007. On the other hand, the growth rate of credit to enterprises remained at 25%, because borrowing from domestic banks was replaced by foreign borrowing.

The speed limit was successful in restricting household credit, so the HNB employs it even today, although it is no longer binding. However, due to its obvious drawbacks, the HNB has also considered revoking the speed limit in the future, with the exit provided by linking bank capital adequacy with credit growth.

Such a link was incorporated in the capital adequacy regulation at the beginning of 2008. According to it, banks growing at 12% annually have to satisfy a minimum capital adequacy rate of 12%, while banks growing faster than that face higher capital adequacy requirements. The HNB also tried to link the additional capital adequacy requirement negatively with the growth of core deposits. In addition, other supervisory regulation was also tightened prior to the crisis; weights used in the calculation of risk weighted assets were increased, as were the minimum retained earnings ratios for fast growing banks. Higher risk weights applied to bank loans in foreign exchange, as well as those in kuna indexed to foreign currency granted to unhedged clients, caused a decline in the banks' capital adequacy similar to that in 2006 and forced banks to raise more equity capital (see chart 1). Consequently, by the end of September 2008 the ratio of banks' core capital to total assets reached almost the same value as bank capital adequacy, which was quite unique and high.

Chart 1: Capital Adequacy Ratios



Source: HNB.

Looking back at the period preceding the global crisis from the point of view of a small transition country that has just started the accession process to the European Union, it turns out that it was extremely difficult to control the volume of capital imports. Due to the exchange rate regime, capital inflows forced the HNB to operate like a currency board and to build large international reserves. Various administrative and supervisory measures had to provide a cushion and slow down the buildup of external vulnerabilities. Applying such measures, the HNB managed, for the most part, to alter the structure of debt capital inflows – bank foreign borrowing from mother banks was replaced by enterprises' non-guaranteed direct foreign borrowing from the same creditors. This, in turn, altered personal consumption and private investments as more credit was provided to non-financial enterprises than to households. On the other hand, the cushion was provided by the high capital adequacy and high liquid assets held mostly in foreign currency, ensuring the soundness of domestic banks.

3. The Monetary Policy Response to the Global Financial Crisis

The bankruptcy of Lehman Brothers in September 2008 shook Europe. International capital flows to Central and Eastern Europe were suddenly viewed as extremely risky and the profitability of banking groups engaged in such transactions started to be questioned by their investors. The future trend of capital inflows to Croatia also became uncertain. In addition, expectations of future exports were revised downwards substantially due to rapidly declining foreign demand. The Croatian government was unprepared for the crisis; the budget was, until April 2009, based on unrealistic real growth projections, while the government's foreign currency debt obligations due in the coming period were high. Rumors of possible problems in mother banks caused an immediate reaction of Croatian depositors. In October 2008 they started withdrawing their funds from local banks, hoarding the withdrawn foreign currency cash mostly under mattresses. Although withdrawals had stopped already by the end of October 2008, they caused capital outflows in the amount of 2% of GDP in the last quarter of 2008[2].

When the crisis started, the appreciation pressures that had previously been a common feature of the foreign exchange market were replaced by depreciation pressures. These exchange rate pressures were successfully contained. The HNB acted by providing liquidity in foreign and tightening liquidity in domestic currency. It did this mostly by lowering required reserves in foreign currency, i.e. it avoided large direct market interventions. As it was in fact only repaying banks' required reserve deposits, its net international reserves did not decline. On the other hand, banks regulatory costs fell substantially (see table 1).

Defending the exchange rate was extremely complex due to the very large financial needs of the government. The required reserve reduction that took place

[2] In October the Government reacted quickly by raising the maximum insured deposit amount from HRK 100,000 to HRK 400,000, while the CNB provided foreign currency liquidity by revoking the marginal reserve requirement.

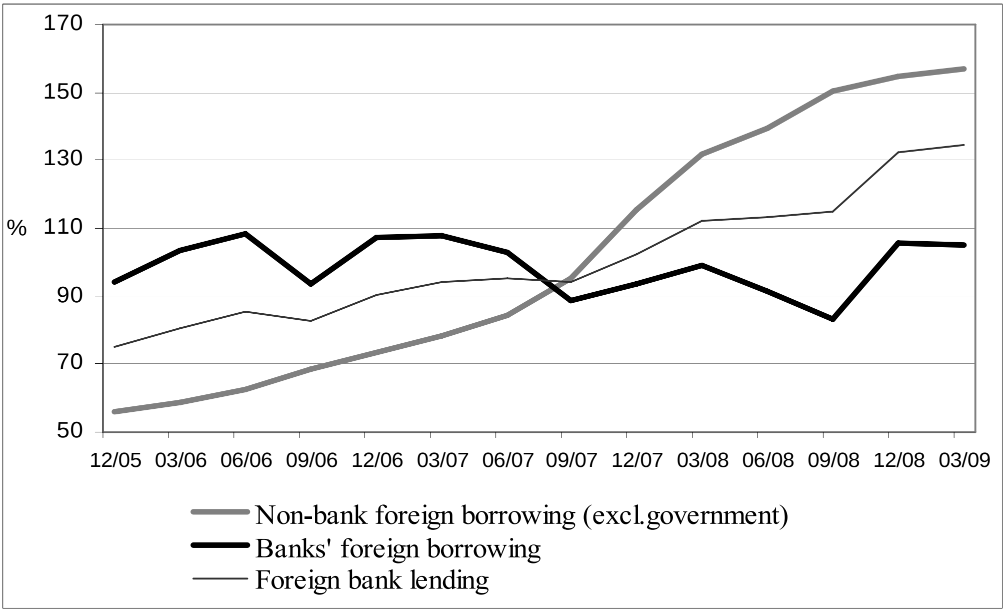
from October 2008 to March 2009 was sometimes implicitly conditioned by granting new credit to the Croatian government. In fact, it turns out that within the same period an increase in banks' net claims on the government amounted to about 50% of funds freed by the reduction and 25% of the value of deposit withdrawals in October. In addition to providing foreign currency liquidity to banks by lowering required reserves, the HNB also tightened banks' liquidity in HRK, resulting in double digit overnight interbank lending rates as opposed to single digit ones prior to the crisis. The rates were extremely volatile and even reached 40% on a daily basis. However, the increase in lending rates to banks' clients was moderate due to lower regulatory costs (less than one percentage point), as well as the fact that the interbank market is not an important source of funds.

Although the money and foreign exchange markets stabilized as of March 2009, it is still early to judge the impact of the global financial crisis on Croatia. Based on the evidence of the last two quarters, it seems that there are some important positive trends: capital inflows to Croatia have continued, the banking system has remained stable, and the decline in real economic activity has been moderate relative to peer countries.

After the crisis had started, capital inflows continued as a result of a huge increase in domestic banks' foreign debt. The stock of non-bank enterprises' debt increased moderately as well (see chart 2). This indicates that, thanks to earlier measures of the HNB, banks were well prepared for the crisis and had the opportunity to borrow abroad as much as was needed during the peak of the crisis. The total bank domestic lending rate continued its rapid growth. As new loans were mostly granted to the government, there was a sharp increase in banks' net claims on the government, while domestic bank credit to the private sector stagnated for the first time since September 2000, due to demand rather than supply factors.

HNB policies aimed at maintaining exchange rate stability have also preserved the stability of the banking system. Banks remained profitable and loan loss reserves low (see chart 1). As the HNB sets limits on banks' foreign currency exposure, banks are not directly exposed to foreign currency risk. However, since their clients are unhedged, the stability of the exchange rate is of crucial importance for banks. According to bank reports to the HNB, more than 90% of banks' claims in foreign currency, or claims in HRK indexed to foreign currency, are unhedged. Therefore the materialization of their clients' exchange rate risk could seriously lower the quality of banks' credit and provoke large losses. In addition, the large foreign debt of enterprises amplifies the exchange rate risk.

Chart 2: Foreign Debt Stocks to Medium Term 2005 – 2008 Average



Source: HNB.

In general, the need to protect the exchange rate in bad times also means that the HNB monetary policy framework does not allow for the use of countercyclical monetary policy. Such a limitation of the HNB monetary policy framework has not proven to be important in this crisis. The fact that Croatia has been handling the crisis without having to clean the mess in its banking system ensures a less severe decline in real economic activity.

4. Challenges for the Future

The HNB policy of exchange rate stability is a long term concept. Building adequate official and bank reserves in good times has enabled the HNB to anchor expectations even in bad times, as well as to ensure the stability of the banking system. Although the HNB was willing to spend part of its international reserves in the crisis period, it was aware that they are not infinite, so it tightened monetary policy in order not to lose reserves in the future. In a longer-term perspective, the implementation of monetary policy will depend on future capital flows. If they continue to finance the current account deficit, there will be room for softer monetary policy; the less sufficient they are for the financing of the current account deficit, the tighter monetary policy will be.

The HNB policy of maintaining a stable nominal exchange rate of the kuna against the euro also means that the exchange rate is not used as a tool for the improvement of international competitiveness. The Croatian economy faces a number of structural weaknesses: low total factor productivity, low labor participation, a smaller share of goods exports in GDP than in peer countries, etc. Although the Croatian government tried to launch structural reforms to address some of these weaknesses, international competitiveness measured by relative unit labor costs started to worsen after Croatia became an EU candidate (see the HNB Bulletin No 141). This presents a challenge for the implementation of economic policy in the long run. This trend in international competitiveness should be reversed by launching more structural reforms that increase the economy's long run growth potential.

The HNB has not questioned its exchange rate and monetary policy regime because of the changing international environment. In spite of low inflation since 1993, the moderate real appreciation of the HRK as well as regulatory banking costs which continuously favor deposits in HRK, financial euroization has not declined in the period prior to the crisis. During the crisis it has even increased further. Therefore, the main reasons for the existing exchange rate and monetary policy regime remain unchanged. Whether such a policy will continue to be as successful as it has been in the past remains to be seen.