

# **Monetary policy in Croatia - the challenge of slowing down the lending boom**

Vedran Šošić, Research Department, Croatian National Bank

## **Monetary policy framework in Croatia**

Despite a prolonged period of macroeconomic stability (during the last decade, average inflation rate was kept below 2.5%), high unofficial “euroization” remains one of the most striking features of the monetary policy environment in Croatia. Foreign currency deposits in Croatia comprise close to 90% of total deposits, while two-thirds of broad money is denominated in foreign currency. The “euroization” phenomenon is the most important single factor affecting the choice of the monetary policy framework. Due to implied adverse impact of large swings in exchange rate arising from such high “euroization”, the central bank puts high emphasis on the goal of exchange rate stability<sup>1</sup>. However, there is no pre-commitment on behalf of the central bank to defend certain exchange rate level and therefore movements that are believed to be in accordance with “fundamentals” are tolerated. The main channel of the money creation is foreign exchange intervention. Intervention needed in order to stabilize the exchange rate often results in excess liquidity due to the magnitude of capital inflows. The resulting excess liquidity in the banking system is usually sterilized with the issuance of CNB bills. This type of policy is sometimes referred to as “quasi-currency-board”. Exchange rate is managed, but without an explicit band, while international reserves are kept at a higher level than money supply (currently approximately 30%) – an attempt to use both credibility arising from the exchange rate stability and flexibility by accommodating certain exchange rate fluctuations.

## **Current monetary policy challenges**

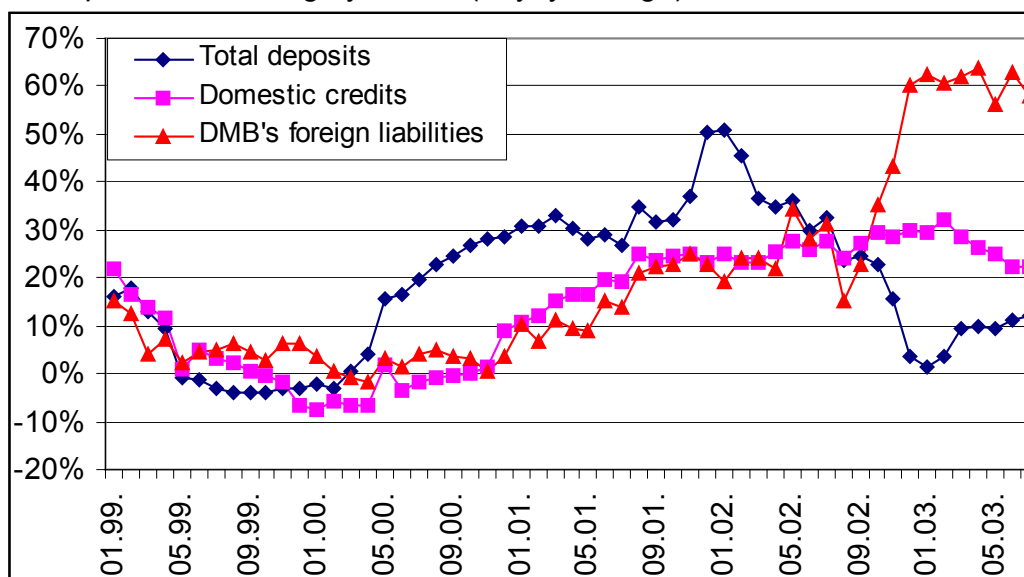
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<sup>1</sup> Primary goal of monetary policy is price stability. Due to highly “euroized” environment and implied relationship between exchange rate and prices, this goal feeds into the task of keeping the exchange rate stable. Although recent research shows that spillover effects from exchange rate fluctuations into price movements are weak in Croatia, this might be precisely because of the policy success, or narrow range within which the exchange rate has been kept.

Commercial banks initiated lending boom during 2001. This lending boom boosted consumption and investment, but it also significantly increased imports so current account deficit almost doubled in 2002 (reaching 7.1% of GDP) compared to 2001. The use of foreign sources of capital for financing domestic lending increased external debt, which reached 68% of GDP at the end of 2002, an increase of about 10 percentage points over the previous year. Finally, although the share of non-performing loans is still low, it is extremely hard to determine the real quality of the banking assets during the period of the lending boom.

There were several causes of the lending boom. The lending expansion was first initiated by the strong inflow of foreign currency deposits into the banking system after the end of the 1998/99 banking crises. The deposit inflow culminated in the last quarter of 2001, during the euro-changeover period, when foreign currency deposits grew by almost 2 billion euros. After the changeover, deposit inflows dried-up, but commercial banks didn't want to give up the fighting for market shares. In order to be able to continue strong lending activity, many commercial banks turned to foreign financing. Since in 1999/2000 some of the major foreign players entered Croatian banking market, they had no trouble finding sources of finance abroad.

Graph 1: Deposit and lending dynamics (% yoy change)



Source: Croatian National Bank

## **Implemented policy measures**

First round of policy measures implemented consisted of direct measures as well as prudential measure. These measures included credit restrictions and minimum liquidity restrictions. Banks whose risk assets grew “excessively”, defined as more than 4% per quarter, are required to purchase low-yield CNB bills (0.5% interest rate) twice the amount of excess growth. This instrument directly aims at slowing down the lending boom. The second measure introduced required banks to hold liquid foreign exchange assets equal to at least 35% of their total foreign exchange liabilities. The goal of this measure was to make foreign borrowing more difficult. In addition to these macroeconomic measures, there was an additional prudential measure requiring fast-growing banks (growth rate above 20%) to form additional reserves (0,1% of risk assets).

It seems that measures implemented by the national bank managed to somewhat slow down the lending boom. However, external debt still keeps rising. Also, the one additional reason to be wary of the economic developments is the question of monetary statistics reliability. In addition to the first attempts of commercial banks to sell parts of their assets and thereby decrease their growth rate, which were quickly sanctioned, they soon started to use additional channels to extend loans (e.g. leasing companies they own). This banking strategy helps development of other financial intermediaries, but it distorts the real picture of the lending dynamics.

Because of the above-mentioned reasons, the central bank decided to implement an additional measure. This measure pertains to increase of the domestic currency share of the required reserve from 25% to 35%. It is expected of that measure to mop-up the excess liquidity in the banking system and further decelerate lending growth.

In case all these measures do not contribute significantly to slowing down the lending growth and growth of external indebtedness, central bank is considering tightening the

monetary policy stance even further. This will be brought about by increase of the rate of required reserves. Also, an introduction of capital controls is being considered.

Although IMF suggested central bank to raise interest rates, there are several reasons why central bank decided not to do so. The first reason pertains to the monetary transmission mechanism, which is based on the foreign exchange market. In the environment of the structural excess liquidity in the banking system, which is the net creditor of the central bank, commercial banks use central bank facilities mostly to manage their excess liquidity. Therefore, it is unclear whether increase of the interest rates on CNB bills would make sources of finance more expensive and feed into other interest rates. Secondly, since the rate on CNB bills is around 2.5%, while lending rates are still within the 8-10% range, the rate should probably be increased substantially in order to make banks switch from lending to private sector into the CNB bills. Moreover, increasing the interest rates, while interest rates around the world remain depressed, might trigger even more capital inflows. Finally, raising the interest rates would increase the costs of servicing debt for the Ministry of finance.