

Monetary Policy versus Structural Reforms: The Case of Croatia

Dubravko Radošević and Neven Vidaković*

Abstract:

Over the course of the recession during the last six years, central bank officials in Croatia have on numerous occasions stated there is a strong need for structural reforms in Croatia and that there is no need for monetary policy reforms. This short paper investigates why the CNB is only demanding fiscal reforms (i.e. internal devaluation) and is not offering any monetary reforms (conventional or unconventional monetary policy responses). Over the course of the last 15 years CNB has caused several structural changes that lead to financial instability. This paper reviews three main structural changes initiated by the monetary policy of the central bank, i.e. structural changes of: credit policy of the banking system, development in the external indebtedness and central bank independence. The modern monetary theories and new central bank strategies imposed new views on central bank policy measures. We suggest several financial sector and central banking reforms in Croatia, including accession of Croatia to SSM, the first pillar of EU banking union.

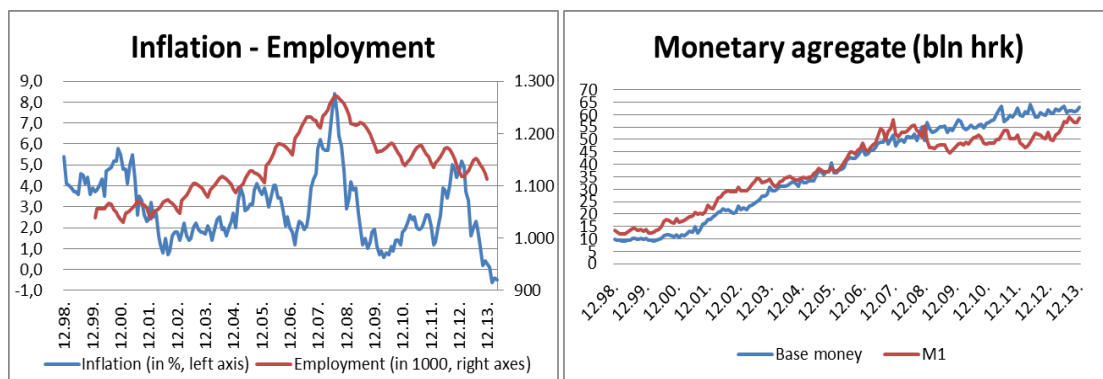
1. Introduction

Over the course of the last six years in Croatia there have been three key macroeconomic developments: (1) Croatian economy is in recession, i.e. stagdeflation (stagnation and deflation) or, better to say, “secular stagnation” – the persistent underuse of potential resources in Croatia. (2) Banking industry is stable, but NPL are increasing adding to the inherent financial instability (high public and unsustainable external debt, with currency mismatch in all sectors of national economy), and (3) there is a constant need for structural reforms, recessionary dynamics and capital outflows (foreign banks branches deleveraging) are contributing to sharp disinflation that is now transformed into deflationary pressures. One of the main proponents of the economic reforms which are absolutely mandatory for the economy’s successful recovery has been the

* Dr. Dubravko Radošević, Senior Research Associate at the Institute of Economics, Zagreb and Assistant Professor, University of Zagreb, Croatia. Dr. Neven Vidaković, professor at Effectus University College for Law and Finance, Zagreb, Croatia.

Croatian national bank (CNB). Representatives of the central bank since the start of the crisis in September 2008 have on numerous occasions clearly and explicitly stated there is a need for structural reforms and all those structural reforms have to be made on the fiscal side (fiscal consolidation, i.e. austerity strategy). Basically, government and central bank since 2008 started with strategy of internal devaluation, without taking into account downward nominal rigidity of wages. Wage deflation was the main policy instrument after the crisis started. Representatives of CNB have never, not even once, to the knowledge of the authors stated that there is a need for any kind of monetary reforms which will be led by the central bank. As a matter of fact the representatives of the central bank have repeatedly stated there is a strong need to stay the course in terms of deflationary monetary policy¹. Basically, central bank is asking two successive coalition Governments (former center-right and current center-left Government) to proceed with internal devaluation strategy (i.e. wage deflation and fiscal deflation policies), instead of changes in relative prices through counter-cyclical monetary policy, implementing non-standard monetary policy measures. Wage deflation policy was unsuccessful, deepening recession and causing economic depression in Croatia², and central bank policy stance on the need for structural reforms could be considered as a “blame game”, between central bank and Government of Croatia.

Graphs 1 & 2: Inflation, employment and monetary aggregates



Source: CNB and Croatian statistical institute

¹ The data on the declared policy positions of the two central bank governors, former Željko Rohatinski and current Boris Vujčić, can be found on the CNB's web site (www.hnb.hr), which contains many speeches and presentations. Some of those speeches and presentations are referenced in this paper. We used for our research also CNB official documents: annual reports, monthly bulletins and reports on financial stability, as well IMF staff reports on Article IV. Consultations with the Republic of Croatia, quarterly reports of Vienna Initiative 2.0, and various research papers and statistics of European central bank and Bank for International Settlements.

² We have to emphasize that a group of Croatian heterodox/post-Keynesian economists in 2011 have predicted economic depression in Croatia, if and when fiscal deflation policy will be continued, without any substantial changes in procyclical monetary policy of the central bank (see: Baletić Zvonimir and Družić Gordan, editors (2011): *Iz recesije u depresiju*, Hrvatska akademija znanosti i umjetnosti, Zagreb).

As we can see from Graphs 1 & 2 during the recession CNB has managed to maintain low inflation, well below the inflation target of close to 2 percent yoy that is now translated into deflation, at the cost of high unemployment. Deflation risk in Croatia is very high in 2014, and central bank underestimated the severe negative effects of persistent and too low inflation rate. In February, March and April there was a deflation in Croatia. Also, since the start of recession, banking sector has been extremely liquid since base money is greater than M1, which indicates strong liquidity of the banks, but accompanied with the credit crunch and deleveraging due to the balance-sheet recession (there are, also, key elements of paradox-of-thrift recession).

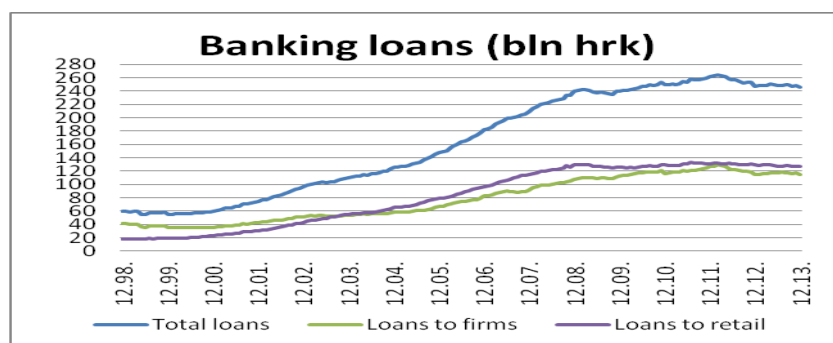
This paper answers a simple question: why there is a need for reforms only on the fiscal side and not on the monetary side? Not to keep the readers in suspense, we will answer this question immediately: because over the course of the last 15 years central bank has undertaken several structural changes, that had substantial influence on medium and long - term economic development. By structural changes, not structural reforms, we mean the changes in the structure of some key elements of the market economy that lead to severe macroeconomic imbalances. In order to keep this paper short and to the point we shall review only three structural changes (basically, macroeconomic imbalances) we perceive as the most significant and those are: (a) structural changes in sectoral distribution of banks' loans, (b) in the level and composition of external debt, and (c) the role of the independent central bank in the market economy.

2. Structural changes in sectoral distribution of banks' loans

Over the course of several years there were structural changes of the bank's balance sheet. Initially, banks' loans were predominantly given to corporate sector of national economy, but over time Croatian banking sector has moved towards giving loans to retail. From corporate lending (financing production and exports in manufacturing sector), commercial banks moved to lending to retail (financing consumption and imports). In December 1999 the percentage of loans to companies was 64% of commercial loans, in December 2008 the percentage was 45%. In the same time period, the percentage of loans to households was 35% in December 1999, while in December 2008 it was 54%. This simple data clearly shows there was a change in the structure of banks' loans portfolio. Why? In the boom-years 2000 – 2008, Croatian economy was kept afloat not by new investments, but by consumption bubble based on increasingly unsustainable leverage. There was also a significant change in the currency structure of loans

(implicit euroisation was fully implemented by the central bank, aiming at early adoption of euro, removing thus devaluation risk), leading to currency mismatches and unstable economy. While up to 2000 almost all loans were in euro or Kuna, at the end of 2010 about 22% of all loans were in Swiss francs. Absence of credible and efficient macroprudential policy of the central bank (for instance, dynamic provisioning targeted to curb the growth of particular groups of loans, such as foreign – exchange denominated loans) resulted in a fragile financial system. There were some measures that could be considered as cyclical capital ratio requirements, but we have to take into account fact that CNB has not yet finished in- depth supervision of banks' balance - sheets, so called, Asset Quality Review (AQR), applying new ECB methodology. In a nutshell, several countries in European Union, Croatia included, have relied on a 'debt-led consumption boom' type of development in the face of low investment in the capital stock and redistribution at the expense of labor incomes, making use of the increasing potential for wealth-based and debt-financed consumption generated by the dominance of finance.

Graphs 3: Sectoral distribution of loans in Croatia



Source: CNB and Croatian statistical institute

The changes in the sectoral distribution of banks' loans were never addressed by the central bank; however CNB did twice implement measures to decrease the rate of total credit growth. The first measure was in 2004 and the second was in 2007. However both of these measures (applying linear and quantitative monetary control instruments) did not address the sectoral distribution of loans, only the growth rates of credit in the whole economy, but after the asset bubble has already been accumulated. As a matter of fact, when asked will there be any measures to address sectoral distribution of loans former governor explicitly stated: no³. Similar thing occurred with the loans in Swiss francs, which should have been considered as "toxic

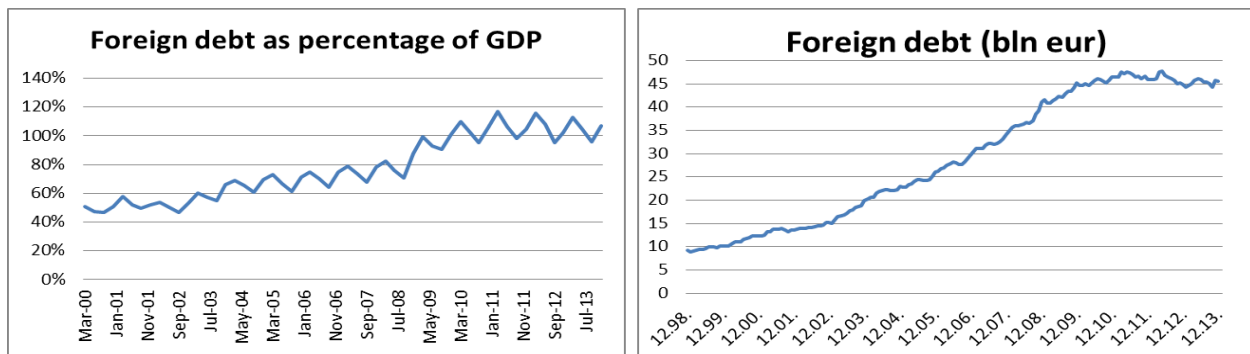
³ Speech of the CNB Governor, as presented at the Conference of Croatian Association of Exporters, Zagreb; 7th of November, 2008. Full speech is available at www.hnb.com.

asset” from the beginning. CNB published a paper in which it stated those loans have a currency risk; however CNB never acted on the change in the currency structure of loans with appropriate macro-prudential measures, leading to further increase of FX risk in banking industry.

3. Structural changes in the level and composition of external debt

CNB has also in the time period 2000 – 2008 managed to execute a structural changes of capital account of the balance-of-payment. The changes in the foreign debt were both in the level and in the structure of foreign debt. At the end of 2000 Croatian external debt was 10, 1 bln euros, which could be considered as sustainable level of external indebtedness. At the end of 2009 total foreign debt was 45, 2 bln euros or 101% of GDP. Clearly there is an increase of foreign debt in terms of size versus the economy. Croatia is now in “external debt trap”. However it is important to address the change in the structure of foreign debt in terms in credit distribution. At the end of 1999 “other domestic sectors” had only 34% of foreign debt, while at the end of 2009 this increased to 46%.

Graphs 4 & 5: External debt and GDP



Source: CNB and Croatian statistical institute

The explanation for this is clear and simple. Capital controls of the central bank imposed on external borrowing were circumvented by private commercial banks, which are Croatian branches/subsidiaries of EU cross –border banking groups. Commercial banks redirected their corporate clients in Croatia to borrow abroad directly at their parent banks, evading thus capital controls of CNB. But, central bank was not willing to extend capital controls on direct external borrowing of corporate sector, which we explain as regulatory capture, contributing to excessive increase of external debt. As we can see, the monetary policy instruments mentioned in the

previous chapter regarding the excessive credit growth has had the effect on increase of external debt. The central bank was aware that once the domestic credit stops in small open economy with free flow of capital, firms will go abroad to obtain the needed funding. Therefore the measure to limit domestic credit growth has had consequences on increase of foreign debt, thus creating a structural change in the composition of the foreign debt. This is a clear demonstration how monetary policy measures of central bank imposed on participants in the market economy can have influence on other real variables and can cause long term structural imbalances in a small open economy. This is the main reason why Croatia is now under EU surveillance, implementing Macroeconomic Imbalance Procedure (MIP) in 2014, after country report on Croatia under Alert Mechanism Report (ARM) in 2013 gave us reliable signaling device for potentially harmful imbalances and loss of competitiveness (net international investment position, current account deficit, export market shares, and other indicators within MIP procedure indicates severe macroeconomic imbalances in Croatia, as a result of procyclical monetary policy).

4. Independence versus accountability of the central bank

The third important structural change we have to address in this paper is the role of the central bank in the market economy and economic policy decision –making process. It is generally accepted that the actions of the central bank in conducting monetary policy should be independent of the fiscal policy or political pressures. This need comes from the fact that in most large market economies monetary policy is conducted through purchase and sale of government debt (open market operations). In order to prevent government to become tempted to print money and cause high inflation or hyperinflation, central bank is given institutional and operational independence in terms of how much and when it will purchase government debt (monetization of fiscal deficit is restricted, although ECB introduced and continued with OMT programme).

In Croatia the central bank independence is clearly defined, as a matter of fact in 2010 the independence of the central bank was put into the Constitution thereby making the central bank independence part of the basic law of the country and thus was included into constitutional system of “checks and balances”. However for some reason, central bank independence has not been accompanied with appropriate level of accountability and transparency. Central bank has “democratic deficit”. With more central bank independence, CNB is becoming less and less

accountable for its actions or lack of counter-cyclical monetary policy actions, without macroeconomic policies coordination, thus preventing economic policy decision - makers to implement optimal policy mix. In Croatia the central bank is an institution with very little or no action apart from maintaining the price stability and stability of the exchange rate, where pegged exchange rate regime serves as nominal anchor for disinflation and CNB monetary strategy has become “quasi - currency board”, with automatic adjustment mechanism.

As we have cited in this paper, there are numerous other examples where central bank representatives have clearly stated there is nothing the central bank can do in terms of recession and unemployment. Even recently CNB governor has numbered what are the problems of Croatian economy. Most of them are the usual problems like FDIs, deregulation, labor market flexibility, health and education reforms, etc. But what is staggering is the fact the CNB representatives has concluded the problems should be solved where they are, in real economy clearly implying the central bank and monetary policy are not part of the national economy in any way. Representative of the central bank has also once again stated that Croatia needs structural reforms, but not on the monetary side⁴. Although this CNB policy stance might be surprising from the data presented in this paper it is clear central bank has already executed several important structural changes which have all taken negative economic consequences and country is now under MIP and EDP procedures within European Semester of the EC⁵.

5. Concluding remarks

The main object of this paper is to address why the central bank in Croatia often demands structural reforms from other participants in the economy and in particular from fiscal policy (Government of Croatia), but never states there should be any reforms on the monetary side. This paper has shown that the central bank has a commitment to a low inflation target, was focused to monitoring only “core inflation”, while it was not concerned at all with other economic variables (credit - fuelled consumption inflation during 2000 – 2008), thus causing

⁴ Speech of CNB Governor , as presented at the 17th Scientific and Professional Conference of Croatian Money Market, Opatija, May 8th, 2014. Full presentation is available at www.hnb.hr.

⁵ MIP and EDP are the main obstacles for Croatia's entry into ERM-2 mechanism and subsequent early adoption of euro. Basically, monetary strategy of early euro adoption has failed. Croatia will be eligible for accession to EMU in the next ten years, after removing all macroeconomic imbalances. On AMR 2014 and MIP 2014 procedures for Croatia see: http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf and see statistical annex with all indicators on macroeconomic imbalances for Croatia in: http://ec.europa.eu/economy_finance/economic_governance/documents/alert_mechanism_report_2014_statistical_annex_en.pdf

macroeconomic instability. It is evident the central bank policy was and still is limited with outdated monetary theories⁶ and central banking strategies⁷. Central bank was focused only on core inflation targeting, neglecting assets - price inflation and systemic risks of bubble economy.

Supervisory role of the central bank was under strong influence of the banking industry and other special interest groups (regulatory capture), which made a substantial contribution to creating a bubble economy in Croatia. CNB macroprudential strategy was procyclical and ineffective, and it was an important impediment of the preventive role of the central bank. Consequently, we think that Croatia has to become the full member of EU banking union, in particular of Single Supervisory Mechanism (SSM), when European central bank has decisive role in monitoring systemic risk in financial sector. Macroeconomic imbalances in Croatia have to be addressed with comprehensive reforms, in coordination of central bank and government.

We can conclude that comprehensive package of economic reforms in Croatia, should start with financial sector reforms with aim to stabilize unstable economy, and they should include central bank reforms, enhancing accountability and transparency of the CNB, as well as shift from inflation targeting to nominal GDP targeting monetary strategy with credible commitment to financial stability, growth and employment.

⁶ On new monetary policy recommendations see paper by the IMF experts: Tamin Bayoumi, et al. (2014): „Monetary Policy in the New Normal“; IMF Staff Discussion Note,; SDN/3/14/; International monetary fund, Washington DC, April 2014: <http://www.imf.org/external/pubs/ft/sdn/2014/sdn1403.pdf> and Michael McLeay, et al. (2014): „Money Creation in the Modern Economy“, Quarterly Bulletin 2014Q1; Bank of England, London <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf>

⁷ Modern approach to central banking can be found in: Barry Eichengreen, et al. (2011): „Rethinking Central Banking“; Brookings Institution; Washington DC, September 2011: <http://www.brookings.edu/~media/Research/Files/Reports/2011/9/ciepr%20central%20banking/Rethinking%20Central%20Banking.PDF>