CNB's Response to the IMF Staff Report for the Article IV Consultation with Croatia

The Croatian National Bank has already responded to the Article IV Concluding Statement released following the IMF mission's visit undertaken as part of regular consultation under Article IV of the IMF's Articles of Agreement. In that response the CNB states that, while a substantial amount of agreement was reached on most issues in the course of the discussions, diverging views were expressed on two issues: the assessment of the adequacy of the international reserve level and the proposed changes in the foreign exchange intervention technique.

In the meantime, the IMF mission staff has compiled a Republic of Croatia Staff Report for the 2011 Article IV Consultation, which has been discussed by the IMF Executive Board. This CNB response offers comments on some paragraphs of the Report and refers again to the two above-mentioned contentious issues concerning monetary policy.

The CNB agrees with most of the recommendations made by the IMF staff, especially those regarding the need for a sustained and pressing implementation of structural reforms aimed at enhancing the international competitiveness of the economy, including a fiscal deficit reduction and restrictive wage policy. This is the only sound way to establish the preconditions for producing higher rates of sustained economic growth and reduce the economy's external vulnerabilities in the years to come. The CNB also agrees with the need to further build up the currently record-high international reserves, as demonstrated by its regular operations. The reserve strengthening is aimed at mitigating the consequences of potential new external shocks, while continuing with strong regulatory and supervisory measures is in the function of preserving the resilience of the financial system. Of vital importance in this respect is maintaining a stable exchange rate, as the basis for financial stability and economic stability in general.

However, the CNB disagrees with the IMF staff's claim that international reserves are relatively low and wishes to reiterate that they are adequate. The previous CNB response provides an explanation of what a comprehensive, country-specific analysis of the adequacy of the international reserve level should contain. Such an analysis is lacking in the Report, which renders the IMF staff's claim unconvincing. What is more, the IMF Executive Board discussion on the Report also reveals that some executive directors are not convinced that the IMF staff's assessment of the adequacy of Croatia's international reserves has a strong analytical basis.

Furthermore, the CNB also disagrees with the IMF staff in that such relatively low international reserves and reduced prudential foreign currency buffers will limit room for the CNB to respond to foreign exchange market movements in the forthcoming period, as well with the IMF staff's proposal to change the foreign exchange intervention technique. It needs to be reiterated that the CNB will continue to use the entire set of available foreign exchange, kuna and prudential instruments, including, as appropriate, foreign exchange interventions, irrespective of the direction of exchange rate pressures, and to manage kuna liquidity, thereby further ensuring a sustainable growth in the country's foreign exchange reserves and exchange rate stability. The CNB will therefore continue to conduct foreign exchange interventions in the forthcoming period using the same technique.

The CNB has on several occasions indicated to the IMF staff that in Croatia foreign exchange interventions play a very important signalling role in enabling the CNB to manage exchange rate expectations. If the foreign exchange intervention technique were changed, as proposed by the IMF staff, this would almost inevitably produce an adverse effect on exchange rate expectations and market confidence, leading to a drop in international reserves and/or interest rate hike, with the resultant lower credit growth and negative impact on the fragile economic recovery in progress. The country's credit rating could also be downgraded as a result. The latest Moody's report indicates that Croatia's credit rating could be downgraded in case of a sustained weakening of the kuna.

The CNB also disagrees with the IMF staff's statement that the stable exchange rate policy has contributed to the accumulation of vulnerabilities arising from overleveraging in foreign currencies (euroisation). Overleveraging in foreign currency has occurred in many other countries in the region, irrespective of their exchange rate regimes, but in Croatia euroisation is clearly due to something completely different – a long history of unstable exchange rates related to hyperinflation periods dating back to pre-transition and early transition times. It should be noted that in Croatia euroisation is primarily reflected in a high share of foreign currency (and foreign currency indexed) deposits in total deposits, because of which banks extend foreign currency indexed loans in order to offset their balance sheet foreign exchange exposures. Euroisation in Croatia therefore differs from euroisation in many other CEE countries, where a substantial share of total loans granted is denominated in (or indexed to) foreign currency, although the bulk of household savings is in the national currency. In these countries this is due to banks borrowing abroad (in foreign currency) and lending these funds "at home" (with a currency clause). A distinction should be made between these two forms of euroisation. While in the latter case a flexible exchange rate may contribute towards reducing the level of euroisation, in the case of Croatia and the countries where euroisation is induced through household foreign currency savings it is exactly the opposite. This country's experience clearly shows that a stable exchange rate, in combination with other monetary and prudential measures, contributed to a gradual and significant reduction in the level of euroisation in the pre-crisis period. However, the onset of the crisis in 2008 brought about a reversal in the long-standing trend, with the level of euroisation rebounding and again reaching approximately 80% in late 2010. The fact that it has proven difficult to reverse the euroisation trend, and that small advances made in reducing the euroisation level over the years have been almost completely nullified by the global financial crisis, confirms the deep-rootedness of psychological factors related to monetary instability in the past, and calls for caution in conducting exchange rate policy.

With respect to exchange rate policy, the CNB also wishes to point out that Croatia's stable exchange rate policy does not make the implementation of structural and fiscal reforms "all the more necessary", as stated by the IMF staff in paragraph 16 of the Report. Such a statement could imply that the implementation of reforms would not be that necessary if the exchange rate regime was different, which is not true. The CNB holds the view that there is no sound alternative to structural and fiscal reforms (aimed at enhancing productivity and external competitiveness). Changing the exchange rate regime can neither be a substitute for these reforms nor can it buy more time for their implementation. The main task is therefore to step up the implementation of structural reforms and fiscal consolidation in order to reduce external vulnerabilities.