

# CENTRAL BANK MONITORING – DECEMBER

Monetary Department  
Monetary Policy and Fiscal Analyses Division

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## IN THIS ISSUE

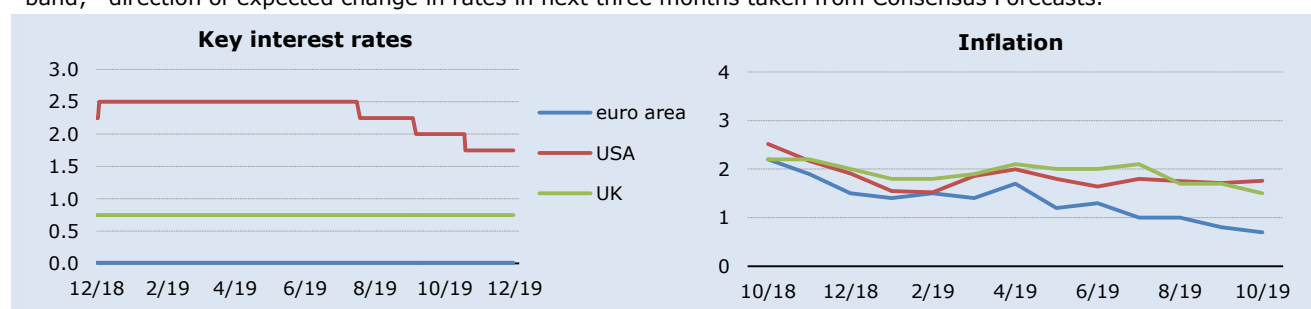
*GDP growth is slowing across the economies under review and most central banks are forecasting a further slowdown, mainly on account of weaker external demand. Inflation is close to the inflation targets in most of the economies we monitor, the exceptions being the euro area and Switzerland. The Fed has lowered its benchmark interest rate twice in the past quarter and three times over the last year and has renewed its purchases of Treasury bills. The ECB left its rates unchanged; according to the December forecast, inflation will stay below 2% through 2022. By contrast, the Norges Bank was the only central bank to raise its key interest rates in September, the third hike this year. Spotlight focuses on Croatia, which has applied to join ERM II and hence subsequently adopt the euro. In our Selected speech, Christian Hawkesby, member of the Monetary Policy Committee of the RBNZ, describes the benefits of, and limits to, the central bank's transparent communication.*

## 1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

### Key central banks of the Euro-Atlantic area

	<u>Euro area (ECB)</u>	<u>USA (Fed)</u>	<u>United Kingdom (BoE)</u>
<b>Inflation target</b>	<2% <sup>1</sup>	2% <sup>2</sup>	2 %
<b>MP meetings (rate changes)</b>	24 Oct (0.0); (0.0) <sup>3</sup> 12 Dec (0.0); (0.0) <sup>3</sup>	17–28 Sep <sup>5</sup> (-0.25) 29–30 Oct (-0.25) 10–11 Dec <sup>5</sup> (0.00)	19 Sep (0.00) 7 Nov (0.00)
<b>Current basic rate</b>	0.00%; -0.50% <sup>3</sup>	1.50–1.75%	0.75%
<b>Latest inflation</b>	1.0% (Nov 2019) <sup>4</sup>	1.8% (Oct 2019)	1.5% (Oct 2019)
<b>Expected MP meetings</b>	23 Jan 12 Mar	28–29 Jan	19 Dec 30 Jan
<b>Other expected events</b>	12 Mar: publication of forecast	Feb 2020: publication of Monetary Policy Report	30 Jan: publication of Monetary Policy Report
<b>Expected rate movements<sup>7</sup></b>	→	→	→

<sup>1</sup> ECB definition of price stability “below but close to 2%”; <sup>2</sup> January 2012 definition of inflation target; <sup>3</sup> deposit rate; <sup>4</sup> flash estimate; <sup>5</sup> meeting associated with summary of FOMC economic forecasts; <sup>6</sup> chart shows upper boundary of band; <sup>7</sup> direction of expected change in rates in next three months taken from Consensus Forecasts.



The **ECB** left its key interest rates unchanged at the meetings in October and December, the deposit rate at -0.5% and the rates on the main refinancing operations and the lending facility at 0% and 0.25% respectively. The Governing Council expects them to remain at their present or lower levels until the inflation outlook has robustly converged to a level sufficiently close to, but below, 2% and such convergence has been consistently reflected in underlying core inflation. On 1 November, the asset purchase programme (APP) was restarted at a monthly pace of EUR 20 billion. The ECB continues to reinvest, in full, the principal payments from maturing securities purchased under the APP and will do so past the date when it starts raising rates. In its new macroeconomic projections, it expects inflation of 1.2% for 2019, 1.1% for 2020 (up slightly from 1.0% in September), 1.4% for 2021 (down from 1.5%) and 1.6% for 2022. It has revised its GDP growth outlook up slightly to 1.2% for 2019 (from 1.1%) and down slightly to 1.1% in 2020 (from 1.2%). It expects GDP growth of 1.4% in 2021 and 2022.

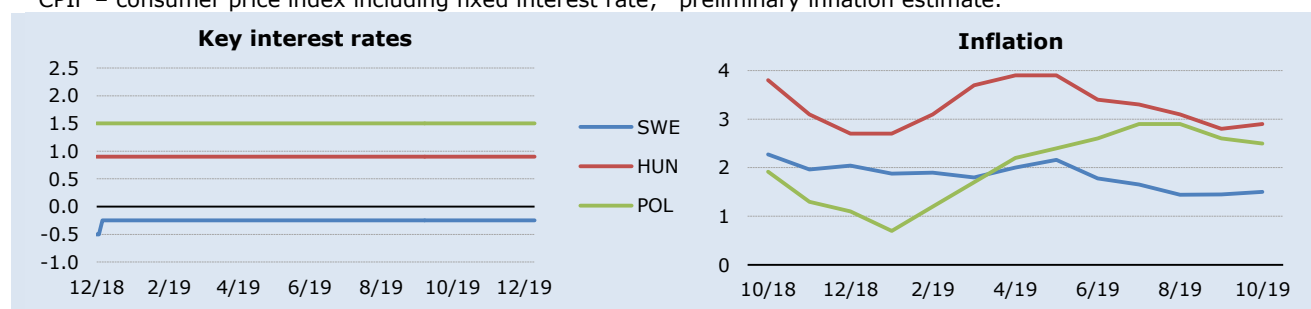
The **Fed** lowered the target range for its benchmark rate by 0.25 pp in both September and October, to 1.50%–1.75%. Its rate has thus reduced it three times this year. The FOMC based the rate cuts on concerns that the external economic environment was having a negative effect on domestic economic growth. At the December meeting, interest rates were left unchanged. The Fed has resumed purchases of Treasury bills but does not regard these purchases as QE, and has introduced liquidity-providing repo operations (see *News*). The FOMC members’ projections published in December 2019 expect a median rate of 1.6% for 2020 and 1.9% for 2021. The FOMC left the GDP outlook unchanged from the September forecast, expecting GDP growth of 2.2% this year, 2.0% in 2020 and 1.9% in 2021. The inflation forecast is 1.6% for this year (compared to 1.8% in September) and around 2% for the following two years. The unemployment rate outlook is fluctuating around 3.6%.

The **BoE** kept its key rate at 0.75% and maintained the stock of government and corporate bond purchases at GBP 435 billion and GBP 10 billion respectively. Two MPC members nonetheless voted to lower the interest rate. The UK economy has slowed this year due to Brexit-related uncertainties; the response of companies and households to Brexit developments will affect the economy going forward. The BoE expects GDP to grow by 0.2% quarter on quarter and inflation to drop to 1.4% in 2019 Q4. It considers this decline below the 2% inflation target to be temporary.

## Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
<b>Inflation target</b>	2% <sup>3</sup>	3%	2.5%
<b>MP meetings (rate changes)</b>	23 Oct (0.00)	24 Sep (0.00) 22 Oct (0.00) 19 Nov (0.00)	1–2 Oct (0.00) 5–6 Nov (0.00) 3–4 Dec (0.00)
<b>Current basic rate</b>	-0.25%; -1.00% <sup>2</sup>	0.9%; -0.05% <sup>2</sup>	1.50%
<b>Latest inflation</b>	1.5% (Oct 2019)	2.9% (Oct 2019)	2.6% (Nov 2019) <sup>4</sup>
<b>Expected MP meetings</b>	19 Dec 11 Feb	17 Dec 28 Jan 25 Feb	7–8 Jan 4–5 Feb 3–4 Mar
<b>Other expected events</b>	12 Feb: publication of Monetary Policy Report	17 Dec: publication of Inflation Report	mid-March: publication of Inflation Report
<b>Expected rate movements<sup>1</sup></b>	↑	→	→

<sup>1</sup> Direction of expected change in rates in next three months taken from Consensus Forecast survey; <sup>2</sup> deposit rate; <sup>3</sup> CPIF – consumer price index including fixed interest rate; <sup>4</sup> preliminary inflation estimate.



The **Riksbank** left its policy rate unchanged at -0.25%. Although the key rate will probably be raised to 0% at the December monetary policy meeting, the October forecast expects rates to be unchanged for a prolonged period thereafter (until the end of 2022 according to the rate path). The slower pace of increase than the Riksbank had forecasted is due to worse sentiment abroad and low foreign interest rates. With effect from July 2019 to December 2020, the Riksbank will purchase government bonds totalling SEK 45 billion. This corresponds to around half of the principal payments and coupons that the Riksbank will receive from the bond portfolio during this period. The purchases are intended to maintain the portfolio at an appropriate level and continue the Riksbank's presence on the market. The inflation outlook (CPIF) for 2019 and 2020 remains virtually unchanged from the previous forecast, i.e. 1.7% and 1.8%. The Riksbank lowered its GDP growth forecast by around 0.3 pp to 1.3%, 1.2% and 1.6% in 2019, 2020 and 2021 respectively.

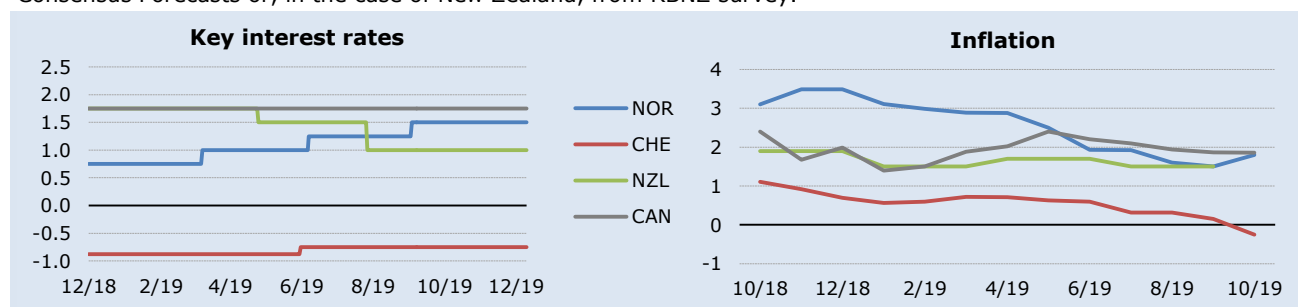
The **MNB** maintained its base rate at 0.9% and its deposit rate at -0.05%. The Hungarian economy grew by 5% in Q3, mainly driven by services and industry. GDP will grow by 4.5% in 2019 and slow to 3.3% in the next two years according to the MNB forecast. The MNB assumes that this will be due both to weakening economic activity in Europe and slowing growth in household consumption. Since September 2019, the MNB has been buying corporate bonds to diversify funding to the domestic corporate sector. The target amount of the Bond Funding for Growth Scheme is HUF 300 billion and, as a consequence, increased issues of corporate bonds are expected for Q4. Under the complementary Funding for Growth Scheme Fix, participating credit institutions had concluded loan contracts with domestic SMEs totalling HUF 310 billion as of the end of October.

The **NBP** left its interest rate at 1.5%. Nevertheless, according to the [minutes](#), a motion to cut interest rates by 0.25 pp was submitted at the November meeting. GDP growth slowed but remained robust in 2019 Q3 (almost 4%). The growth consists mainly of household consumption, supported by rapid wage growth and positive consumer sentiment. Poland is currently the fastest growing economy in Europe. The flash inflation estimate in November was 2.6%. According to the November NBP forecast, GDP will grow by 4.3% this year and slow to 3.6% in 2020 and 3.3% in 2021. The outlook for consumer inflation is 2.3% for 2019, rising to 2.8% in 2020 and falling back to 2.6% in 2021.

## Other selected inflation-targeting countries

	<u>Norway (NB)</u>	<u>Switzerland (SNB)</u>	<u>New Zealand (RBNZ)</u>	<u>Canada (BoC)</u>
<b>Inflation target</b>	2%	0–2%	2%	2%
<b>MP meetings (rate changes)</b>	19 Sep (+0.25) 24 Oct (0.00)	19 Sep (0.00) 12 Dec (0.00)	25 Sep (0.00) 13 Nov (0.00)	30 Oct (0.00) 4 Dec (0.00)
<b>Current basic rate</b>	1.5%	-0.75% <sup>1</sup>	1.0%	1.75%
<b>Latest inflation</b>	1.8% (Oct 2019)	-0.3% (Oct 2019)	1.5% (2019 Q3)	1.9% (Oct 2019)
<b>Expected MP meetings</b>	19 Dec 23 Jan	19 Mar	12 Feb	22 Jan 4 Mar
<b>Other expected events</b>	19 Dec: publication of Monetary Policy Report	18 Dec: publication of Quarterly Bulletin	12 Feb: publication of Monetary Policy Statement	22 Jan: publication of Monetary Policy Report
<b>Expected rate movements<sup>2</sup></b>	↑	→	→	→

<sup>1</sup> new SNB key monetary policy rate; <sup>2</sup> direction of expected change in rates in next three months taken from Consensus Forecasts or, in the case of New Zealand, from RBNZ survey.



The **NB** left its key interest rate unchanged at 1.5% in October following a 0.25 pp hike in September. According to the NB, the rate will most likely remain unchanged in the coming period. Inflation is close to the target and growth in the Norwegian economy remains quite strong. At the same time, uncertainties regarding global trade tensions are weighing on the economy. Based on the September forecast, the NB expects inflation to decline temporarily below the 2% target and return to the target in late 2020/early 2021, with CPI-ATE (inflation adjusted for tax changes and excluding energy products) temporarily hitting the target from above and staying slightly above it again for the rest of the forecast period. The countercyclical capital buffer is at the highest possible level, i.e. 2.5%.

The **SNB** kept its new SNB policy rate (introduced in June) at -0.75%. It changed the method used to calculate banks' account balances with the SNB, to which a negative rate is applied. The previously fixed rate will now be updated on a monthly basis depending on banks' balance sheets. The SNB continues to reserve the right to intervene in the foreign exchange market as necessary. The December inflation forecast was lowered slightly at the shorter end of the outlook. The SNB thus expects inflation of 0.4% this year, 0.1% in 2020 and 0.5% in 2021. According to the initial estimate, the Swiss economy grew by 1.6% in Q3, driven primarily by manufacturing (manufacture of pharmaceutical products in particular). The SNB expects GDP to grow by 1% this year and 1.5%–2% in 2020.

The **RBNZ** left its official rate at 1.0%. Employment remains near its maximum sustainable level and inflation is slightly below the inflation target. The RBNZ expects domestic pressures stemming from the labour market and production capacity shortages to ease in the period ahead. Inflation is currently below the target (at 1.5% in Q3) and is likely to stay below it in 2020. GDP growth slowed to 2.1% in Q2 (from 3.2%) and will probably remain around 2% until the year-end. Economic growth will exceed 2% in 2020.

The **BoC** maintained its key rate at 1.75%. Inflation reached 1.9% in October. It will increase temporarily in the coming months due to faster growth in fuel prices and later return close to the 2% target. Measures of core inflation also remain close to 2%. The annual growth of the Canadian economy slowed to 1.3% in Q3, as expected by the BoC. This was due mainly to solid growth in household consumption, transport project-related investment spending, and housing investment, driven by population growth and low mortgage rates.

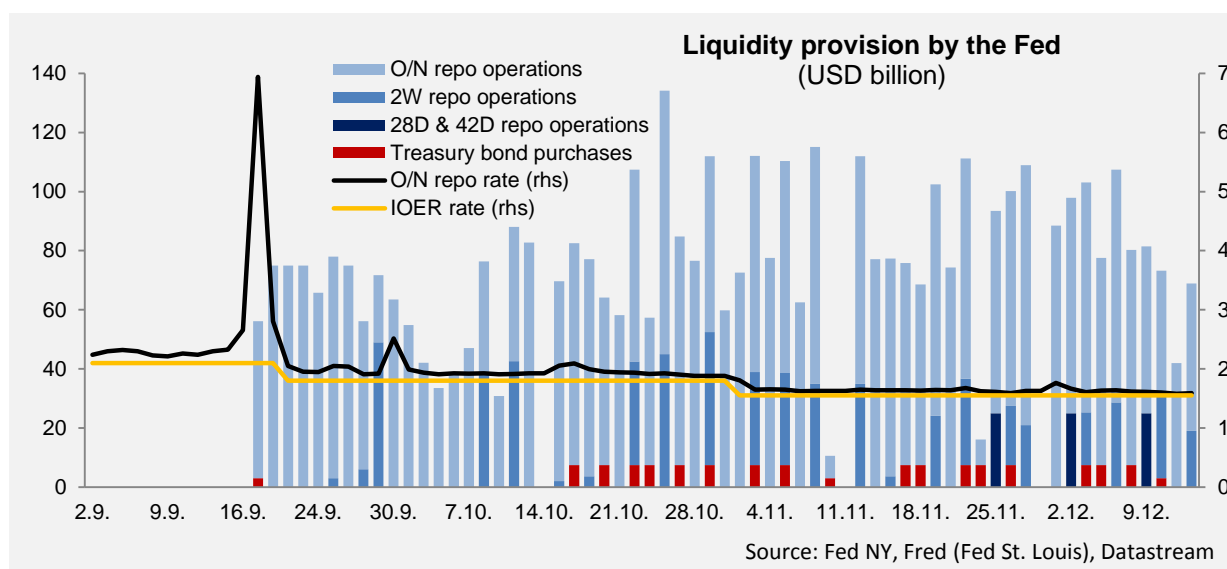
## 2. NEWS OVER THE LAST THREE MONTHS

### US Fed addresses lack of liquidity among banks and starts buying Treasury bonds again

The New York Fed [announced](#) on 11 October – in accordance with an FOMC [directive](#) – that from mid-October it would restart purchases of Treasury bills at a pace of approximately USD 60 billion per month at least into the second quarter of next year, i.e. until the end of 2020 Q2. Fed officials have repeatedly stressed that these purchases do not represent a reopening of the quantitative easing programme (aimed at supporting the economy), but that the aim of the operations is to increase the reserve balances in the banking sector and ensure sufficient liquidity in the interbank market.

The Treasury bill purchases started several weeks after the Fed had to respond to a 17 September spike in the repo rate on the interbank market. A lack of liquidity pushed the rate temporarily up to almost 10%, several times higher than the federal funds rate (FFR), which was 2.25% at the time. In response to this rise in the short-term rate, the Fed immediately started to provide banks with liquidity in the form of term and overnight (O/N) repo operations in daily volumes of up to USD 75 billion (O/N repos) and USD 60 billion (term repos).<sup>1</sup> The last time the Fed provided similar liquidity injections to the interbank market was in 2008.

At its September meeting, the Fed also cut the IOER rate from 2.1% to 1.8% to support interbank lending (and lowered the FFR corridor to 1.75%–2.00%; at the end of October there was yet another rate cut).



The reason for the sharp rise in interest rates on the interbank market in September is not entirely clear and the Financial Stability Oversight Council has initiated an analysis to identify them. Fed Vice Chair Randall Quarles said a complex set of factors contributed to the spike, one of which could be the over-strict setting of liquidity stress tests for banks.

<sup>1</sup> The Fed sets a “minimum bid rate” for repo operations; the minimum bid rate for term repo operations is based on prevailing market rates that reflect market expectations for the path of the FFR over a similar maturity to that of the repo operation. In its 11 October statement, the Fed also [announced](#) it would continue to offer repo operations until at least January 2020 in an amount of at least USD 35 billion for term (two-week) repos and at least USD 75 billion for O/N repos. To span the end of October, the amounts offered were [raised](#) to at least USD 45 billion and USD 120 billion respectively. In November, the two-week repo was reduced back to at least USD 35 billion. The Fed also [announced](#) that up to mid-December it would offer three additional USD 25 billion repo operations with longer maturities (42 days and 28 days) to help banks bridge the end of the year. In mid-December, it [announced](#) that it would offer another USD 32 billion repo operation with a maturity of 32 days. There is strong interest among banks in these operations with longer maturities; demand for them in auctions has been several times higher than supply. The O/N repo operations are mostly in the range of USD 70–75 billion a day. To calm the situation at the end of the year, in mid-December the Fed also [announced](#) that it would offer USD 150 billion O/N repo operations on December 31 and January 2, and on December 30 a USD 75 billion repo maturing on January 2, 2020.

Markets are worried that despite the Fed's steps, a similar situation as in September might recur in December, as banks usually limit their market presence before the end of the year for accounting reasons and the repo rate is therefore rising due to lower liquidity supply.

### **ECB prepares review of monetary policy strategy**

At her [hearing](#) in the European Parliament and at a [press conference](#) following the December monetary policy meeting, the new ECB President Christine Lagarde reported in more detail about the upcoming revision of the ECB's monetary policy. The review should follow the same principle as the one currently going on in the US Fed and the one carried out every five years in the Bank of Canada. The last such in-depth strategy review at the ECB took place in 2003. The forthcoming review will cover the ECB's monetary policy strategy and its instruments and key objectives – in particular how to best define the medium-term objective of monetary policy, so as to ensure that expectations are firmly anchored. Lagarde also confirmed that the ECB's position on climate change should be an important part of the revision. Some members of the Governing Council have also proposed changes in the decisions and transparency of the Governing Council, some are asking for votes on each monetary policy decision (the voting currently takes place only on the initiative of the ECB President), and the publication of voting results is also sometimes mentioned. However, the precise scope, direction and timeline of the review have not yet been discussed by the ECB Governing Council.

### **Changes in ECB Executive Board**

At the end of October, Mario Draghi's mandate as ECB President ended and he was replaced by Christine Lagarde (see [September CBM](#)). At the end of September, Sabine Lautenschläger resigned from the ECB's Executive Board, officially without giving a reason, but unofficially mainly due to disagreements with the September easing of the ECB's monetary policy. Her mandate ended at the end of October, and for the vacancy Germany proposed Isabel Schnabel, a professor at the University of Bonn. At the end of this year, the mandate of another member of the Executive Board, Benoît Cœuré, ends; for the vacancy Italy has proposed Senior Deputy Governor of the Bank of Italy Fabio Panetta. Both nominations have been supported by the Eurogroup and recommended by Ecofin to the European Council. The European Council, after consulting the ECB and the European Parliament, is responsible for appointing the candidates; both appointments are expected by the end of this year. These nominations thus maintained the unwritten tradition that the three largest euro area economies (Germany, France and Italy) each have the right to appoint one of the six members of the ECB's Executive Board.

### **Swedish MPs propose dual mandate for Riksbank**

The Riksbank Committee of the Riksdag (the Swedish Parliament), set up by the Swedish Government in 2016 to revise the Riksbank monetary policy framework and the Riksbank Act, [submitted](#) its final report to the Swedish Government at the end of November (a [summary](#) of the report is available in English). Among other things, MPs propose extending the current Riksbank mandate to a dual one, including employment in addition to price stability. The Riksbank and other stakeholders [can comment](#) on this report by the end of March.

### **Riksbank mulls publishing new reference rate as alternative to STIBOR**

The Riksbank [announced](#) that it is considering the administration and publication of one or more overnight rates from 2020. One of these bank-calculated rates could be used as an alternative or complement to the existing Stockholm Interbank Offered Rate (STIBOR), which is the direction most central banks are moving in (see the [September CBM](#)). The Riksbank has invited interested institutions and other authorities to comment on its proposal by mid-November; it will then publish a summary of their responses on its website. According to the Riksbank, the aim of the new rates is to better be able to evaluate the implementation of monetary policy.

### **[Changes in Riksbank Executive Board](#)**

Anna Breman, Chief Economist of Swedbank, has been appointed a new member of the Riksbank Executive Board from December. She replaces Kerstin af Jochnick, who was [appointed](#) as the ECB representative to the Supervisory Board of ECB Banking Supervision for a five-year term and therefore left the Riksbank in October. In November, Cecilia Skingsley, hitherto a member of the Executive Board, was appointed First Deputy Governor, the position previously held by af Jochnick.

### **BoE: Inflation Report becomes Monetary Policy Report**

At the end of October, the Bank of England [changed](#) the name and structure of its main monetary policy publication. Instead of the previous Inflation Report, it started to issue a Monetary Policy Report. According to the BoE, this change represents a further step in the ongoing development of central bank communication and is intended to ensure that the public has all the information necessary to understand the BoE's monetary policy decisions and to hold it to account. In addition to the change in the title, the structure of the report has changed. The forecast of future developments has been placed first and the description of current developments has been abridged, with thematic discussions on issues affecting the current monetary policy decision being given more space. The first new Monetary Policy Report was published in [early November](#).

### **Benoît Cœuré to lead BIS Innovation Hub**

This June, the BIS [decided](#) to establish a [BIS Innovation Hub](#) for central banks. Effective mid-January 2020, Benoît Cœuré, whose mandate on the ECB's Executive Board expires at the end of the year (see above), was [appointed](#) head of the new Hub. The BIS Innovation Hub should foster international collaboration between central banks on innovative financial technology. Possible areas of interest according to the BIS include central bank digital currencies (CBDCs), the impact of big tech on financial intermediation, technological innovations in the regulatory and supervisory fields (regtech and suptech), fast-paced electronic markets and digitalisation of trade finance. The Hub will have multidisciplinary teams located in Singapore, Hong Kong and Switzerland.



### 3. SPOTLIGHT: CROATIA

*In July this year, Croatia applied to join the ERM II exchange rate mechanism and subsequently the euro area. Adopting the euro is a natural way for it to eliminate the risks arising from the high degree of spontaneous euroisation of its banking sector and the economy as a whole, which stems from Croatian savers' long distrust of the domestic currency. Simultaneously with ERM II entry, which it expects to occur by mid-2020, Croatia will also join the Banking Union. This article summarises the history of Croatia and its economy from the establishment of the independent state in 1992 to the present.*

#### Historical context

The establishment of the independent Croatia dates back to the early 1990s and is marked by the war in the former Yugoslavia. However, the roots of this bloody conflict are much older. Considerable instability – caused by national and religious differences – arose in the region soon after the creation of the first common South Slavic state<sup>1</sup> on this territory in 1918 and culminated in the break-up of the state during World War II. The post-war reunification under Josip Broz Tito led to the establishment of a totalitarian communist state that suppressed the national and religious differences.<sup>2</sup> The democratic reforms that gradually evolved in Yugoslavia in 1989–1990 after the collapse of the Eastern European totalitarian regimes, were, however, accompanied by a rise in nationalism and separatist tendencies in the individual republics of the region. In June 1991, Croatia and Slovenia declared independence, which, however, the Yugoslavian Federation did not recognise. This unleashed a series of conflicts that lasted intermittently until the late 1990s.<sup>3</sup>



The European Community recognised the independent Croatia in January 1992 and the country was accepted into the UN the same year. However, it remained somewhat isolated internationally in the 1990s due to its involvement in the war in Bosnia and Herzegovina (which lasted until 1995). Croatia's post-war path towards consolidation of national sovereignty was not accompanied by sufficient progress with democratisation of society and respect for human rights. This hindered the development of its relations with the EU. The situation turned around after a change of political representation in 2000. Croatia applied to join the EU in 2003 but became a member only in July 2013 after lengthy accession talks.<sup>4</sup> Currently the newest EU member state, it is not part of the Schengen area, but according to a recent European Commission statement it is now compliant with all the entry requirements. However, its entry may be vetoed by Slovenia (due to the still unresolved border dispute). Croatia will hold the Presidency of the EU Council from January to June 2020.

#### Economy

Croatia had a head start over the other former Eastern Bloc countries in some areas of transformation towards a market economy, as it had embarked on this path while still part of Yugoslavia, but the subsequent war pushed economic issues to the background and resulted in a sharp downturn. In the early 1990s, it grappled with hyperinflation (annual consumer price inflation exceeded 1,000% in 1993) and a sharp decline in GDP. The Croatian dinar was pegged to the German mark under a stabilisation programme supported by the IMF. This led inflation to drop (below 100% in 1994 and to just 2% in 1995) without GDP falling any further. In 1994, the devalued dinar was replaced with a new currency – the Croatian kuna (HRK). The high proportion of foreign currencies (especially German marks and later

<sup>1</sup> The Kingdom of Serbs, Croats and Slovenes, later the Kingdom of Yugoslavia.

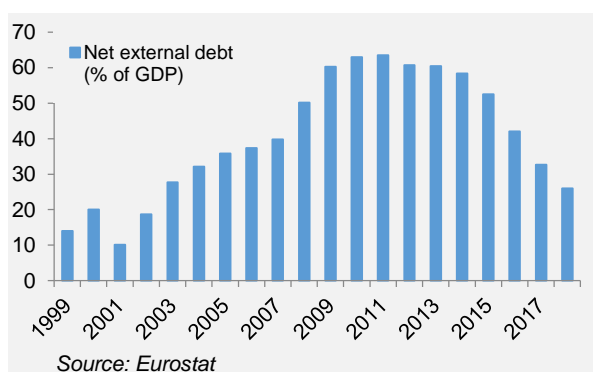
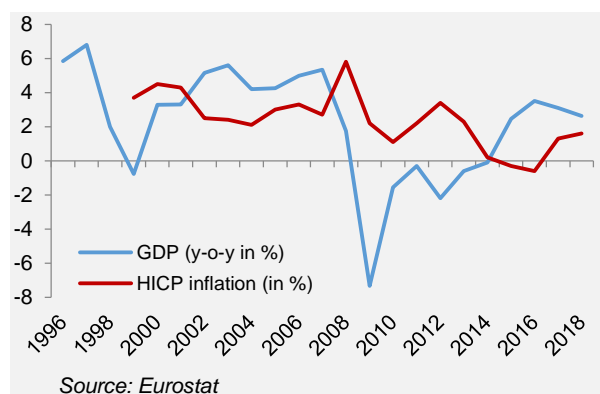
<sup>2</sup> The Federal People's Republic of Yugoslavia, and from 1963 the Socialist Federal Republic of Yugoslavia, shared a number of features with the other countries of the former Eastern Bloc (such as a one-party policy), but differed in many areas (in allowing private ownership, having a more open economy and distancing itself from the Soviet Union).

<sup>3</sup> The secession of Slovenia was accompanied by a war lasting only a few days. The war between the Croats and the Serbs continued on and off until 1995 (a truce was agreed in January 1992, after the independent Croatia was internationally recognised, but it was repeatedly broken). A parallel war between the Croats, the Serbs and the Bosnians over parts of the territory of the multicultural Bosnia and Herzegovina also went on until 1995. A war in Kosovo and a civil war in Macedonia were later fought.

<sup>4</sup> In its accession talks, Croatia was aided by its cooperation with the International Criminal Tribunal for the former Yugoslavia. Until 2009, though, the accession talks were blocked by Slovenia due to a dispute over the Slovene-Croat border (Slovenia's access to international waters in the Adriatic Sea). The dispute was resolved by an agreement between the two countries to leave the matter to UN arbitration. Croatia became only the second country of the former Yugoslavia after Slovenia to be accepted into the EU. Croatia is one of the smaller EU countries, ranking 19th in the EU by area (about 22,000 square miles) and 21st by population size (about 4 million).

euros) in the assets of Croatian savers caused the Croatian National Bank (Hrvatska narodna banka, HNB) to worry about the potential impacts of strong exchange rate volatility. The HNB thus continued to make frequent interventions in the foreign exchange market. To this day, it keeps a close eye on the movements of its currency under a tightly managed float.

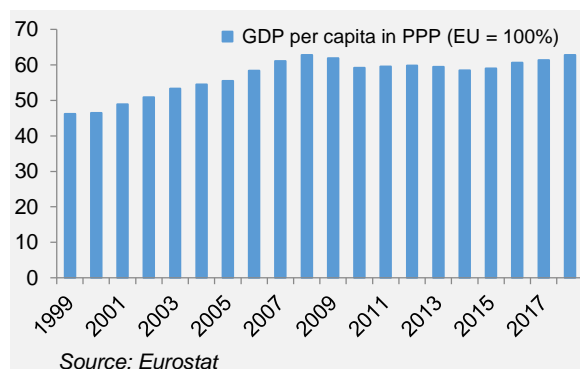
During the post-war reconstruction (i.e. after 1995),<sup>5</sup> the country gradually introduced structural reforms and the economy quite quickly began to grow. After inflation had been tamed, however, the poor condition of the balance sheets of its banks, impaired by a legacy of bad assets, the war and the break-up of Yugoslavia, came to light. In 1995–1996, Croatia went through a banking crisis. A second banking crisis, attributed to bad bank management and insufficient supervision, occurred in 1998–1999, when an economic slowdown was reflected in worse loan repayment. In response, Croatia improved banking supervision and decided to speed up the sale of state-owned banks to foreign investors, who in previous years had been deterred from entering the Croatian market by the ongoing war. Most Croatian banks thus came under the control of foreign investors in the following five years.



After a lengthy period of expansion, Croatia's economy stopped growing again with the onset of the global financial crisis. A slump in external demand, coupled with low competitiveness and a narrow export base, led to an economic downturn. Labour market rigidity and bureaucracy (discouraging inflows of foreign investment) fostered a protracted recession lasting from 2009 to 2014. This was reflected in a deterioration in government debt, which almost doubled to more than 80% of GDP. External debt, which had already been high before the crisis due to a long-running current account deficit, rose further during the crisis, with net external debt exceeding

60% of GDP. Monetary policy was only moderately easy, as the authorities kept the kuna relatively stable against the euro rate due to the high euroisation of the Croatian economy, so the exchange rate did not absorb external shocks. The corporate sector was hit hard by the crisis and had to be deleveraged, but the banking system remained stable.

The economic recovery in 2015 was driven by tourism, private consumption and foreign trade, boosted by Croatia's 2013 EU entry.<sup>6</sup> However, GDP did not return to the pre-crisis level until this year. The length of the crisis was also reflected in a sharp slowdown in real economic convergence to the EU. With an economic level (as measured by GDP per capita in purchasing power parity) at 63% of the EU average in 2018, Croatia ranked next-to-last in the EU (ahead of Bulgaria).



The current favourable trend of the Croatian economy is fostering a gradual decline in private and public sector debt. However, the level of debt remains high. According to the IMF, cutting debt further is one of the main challenges for the Croatian economy. The European Commission (EC) has a similar view. It has conducted an in-depth review (IDR) under the Macroeconomic Imbalance Procedure in Croatia every year since the country joined the EU. According to

<sup>5</sup> The post-war reconstruction of Croatia was supported by various international organisations (the IMF, the World Bank, the European Bank for Reconstruction and Development, the EU and humanitarian organisations).

<sup>6</sup> Low take-up of EU funds and administrative barriers limited the contribution of investment.

the IDR, Croatia has been facing imbalances this year. The vulnerability of the Croatian economy is associated with high levels of public, private and external debt, much of which, moreover, is denominated in foreign currency. However, the situation has improved compared with previous years, when excessive imbalances were identified. The net external position remains strongly negative but is decreasing thanks to a current account surplus. The Croatian banking sector is profitable and the amount of non-performing loans is falling. According to the EC, however, corporations' and households' exposure to foreign currencies (especially the euro) remains a source of vulnerability.

### **Euroisation<sup>7</sup>**

A characteristic feature of the Croatian economy is its high spontaneous euroisation, i.e. unofficial substitution of the Croatian kuna with the euro. The substitution of a domestic currency with a more credible one is often a result of a negative experience with high inflation. This phenomenon accompanied the transformation towards a market economy in many post-socialist countries.<sup>8</sup> In Croatia, however, its roots go back to the 1960s and 1970s, when domestic savers converted their assets into German marks – an activity that was allowed at the time – in response to a sharp devaluation of the domestic currency accompanied by high inflation. Another factor was the inflow of foreign currencies related to the development of tourism. The hyperinflation that accompanied the establishment of the independent Croatia fuelled the trend further. Although the subsequent stabilisation programme was successful, achieving low inflation and a stable exchange rate, the share of foreign currency in total bank deposits has been fluctuating between 80% and 90% for most of the time since the introduction of the kuna in 1994. The euroisation of bank deposits peaked after Croatia overcame the banking crisis in the late 1990s/early 2000s and depositors started to put their savings, until then held in cash or on foreign accounts, in local bank accounts. The phenomenon intensified when some European currencies were converted into the new euro.

The high euroisation of bank deposits also gradually led to euroisation of loans as banks tried to hedge against exchange rate risk. Credit euroisation accelerated after the banking sector was privatised in the late 1990s and was boosted in the early 2000s by strong lending activity supported by foreign capital inflows. The euroisation of bank deposits and bank loans in Croatia is thus the highest in Central and Eastern Europe and among the highest in the world.<sup>9</sup> A marked decline in the euroisation of both deposits and loans was observed in Croatia in 2006–2008.<sup>10</sup> However, it was halted by the onset of the global financial crisis and euroisation returned to the previous level very quickly.<sup>11</sup>

Given the high level of euroisation, the Croatian central bank applies a tightly managed float in the pursuit of its primary objective of price stability; the exchange rate thus serves as a nominal anchor. Exchange rate stability is also crucial for maintaining financial stability given the high foreign currency debt in all domestic sectors of the economy. Although the HNB has set no target exchange rate, the Croatian kuna has been fluctuating around its average level of HRK 7.4/EUR within a relatively narrow band of  $\pm 5\%$  over the past 15 years.<sup>12</sup> Annual inflation has averaged around 2% and has never reached double figures in this period. However, the low inflation, the stable kuna-euro rate, the positive interest rate differential in favour of kuna deposits and the stability of the banking system have not been enough to change consumers' behaviour and preferences regarding saving in foreign currency. Experience from other countries confirms that euroisation is a persistent phenomenon that is very difficult to reverse. The deep-rooted distrust of the domestic currency in Croatia is thus a strong argument for adopting the euro.

<sup>7</sup> This part of the text draws on Mirna Dumičić, Igor Ljubaj and Ana Martinis: *Persistence of Euroisation in Croatia* (Croatian National Bank Working Paper, 2018).

<sup>8</sup> During the economic transformation it mostly involved dollarisation.

<sup>9</sup> The level of spontaneous euroisation is similar in Serbia and rather lower in Bosnia and Herzegovina and Macedonia.

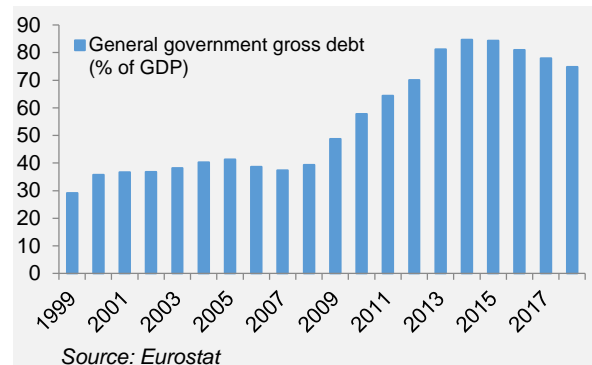
<sup>10</sup> The decline in euroisation was due to appreciation of the Croatian kuna and macroprudential measures introduced by the HNB starting in 2003 aimed at reducing systemic risks arising from excessive credit growth and the growing external imbalance. The related growth in the costs of foreign currency banking operations simultaneously indirectly limited euroisation.

<sup>11</sup> During the subsequent euro area debt crisis, some savers in Croatia temporarily switched to other global currencies, such as the US dollar, the Canadian dollar, the Swiss franc and the Norwegian krone.

<sup>12</sup> According to the HNB, the exchange rate of the kuna against the euro floats freely depending on supply and demand on the foreign exchange market. However, the HNB stabilises the exchange rate by making occasional market interventions. It enters the market especially if it considers the actual or expected exchange rate fluctuation excessive. However, it does not predetermine an upper or lower limit for the kuna-euro exchange rate which it would defend (an upper or lower intervention point).

## Accession to the euro area

Croatia has been evaluated three times in the ECB's and EC's convergence reports since joining the EU (in 2014, 2016 and 2018). It has always had difficulty fulfilling the criterion on public finances, but has met the other criteria (except for the exchange rate criterion tied to participation in ERM II). In January 2014, Croatia was found to be non-compliant with the deficit and debt criterion and became subject to the corrective arm of the Stability and Growth Pact – the Excessive Deficit Procedure (EDP). The EU Council issued a recommendation calling on the country to correct the deficit by 2016. The Croatian public finance deficit decreased below 1% that year and a surplus was recorded in the following years. The government debt-to-GDP ratio peaked (at around 84%) in 2014 and then gradually declined. The EDP against Croatia was ended in June 2017.



The EC's latest 2018 convergence report evaluates the public finance criterion as having been fulfilled, as the government debt-to-GDP ratio is converging towards the reference value despite still exceeding it. Croatia was comfortably compliant with the criteria on price stability and interest rates. Croatia's legislation is fully compatible with EU law.

According to the EC, the Croatian economy is well integrated with the euro area through trade and investment linkages. With regard to the business environment, however, Croatia performs worse than most euro-area member states according to several indicators. Challenges also relate to the institutional framework, including regulatory quality. The in-depth review found that Croatia continues to experience macroeconomic imbalances linked to high levels of public, private and external debt.

According to the ECB's convergence report, achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. These should be aimed at increasing overall productivity and raising the potential growth of the economy. In particular, they should seek to improve the institutional and business environment and corporate governance standards, boost competition in the product markets, reduce mismatches in the labour market and enhance the quantity and quality of the labour supply, as well as the efficiency of the public administration and the judicial system. Croatia should also improve its use of EU funds. In order to bolster confidence in the financial system, it should continue to improve its supervisory practices.

### Convergence criteria fulfilment according to the 2018 Convergence Report

	2016	2017	2018	Reference value
<b>Price stability criterion</b>	-0.6	1.3	1.3	1.9
<b>Public finance criterion</b>				
General govt. deficit /surplus (% of GDP)	-0.9	0.8	0.7	-3.0
General govt. debt (% of GDP)	80.6	78.0	73.7	60.0
<b>Interest rate criterion</b>	3.5	2.8	2.6	3.2
<b>Exchange rate criterion</b>	-	-	-	-

Note: Red denotes that the reference value of the criterion has been exceeded. The data on inflation and interest rates for 2018 refer to the period between April 2017 and March 2018. The data on public finances for 2018 are taken from the EC's spring 2018 economic forecast.

In July 2019, Croatia applied to join the ERM II exchange rate mechanism and subsequently the euro area. In so doing, it took a number of commitments that are of high relevance for a smooth transition to, and participation in, ERM II. Specifically, it pledged to (1) further strengthen banking supervision through close cooperation with the EU, (2) develop the macroprudential framework, (3) enhance the anti-money laundering

framework, (4) improve the collection, production and dissemination of statistics, (5) improve public sector governance and (6) reduce the financial and administrative burden on entrepreneurs. Simultaneously with ERM II entry, Croatia expects to join the Banking Union by mid-2020.

The EU Council confirmed in a statement that Croatia's entry to ERM II would be linked with entry to the Banking Union. Croatia will also participate in the Single Resolution Mechanism. In line with the principle of equal treatment, the process applied to Croatia was the same as that followed for Bulgaria, which applied to join ERM II in 2018. According to the EU Council's statement, a similar approach will be followed for Member States wishing to join ERM II in the future.

#### 4. SELECTED SPEECH: SPEAKING, LISTENING AND UNDERSTANDING: THE ART OF MONETARY POLICY COMMUNICATIONS

*The Reserve Bank of New Zealand (RBNZ) is one of the most transparent central banks in the world. A member of its monetary policy committee (MPC), Christian Hawkesby, in his October [speech](#) in Sydney, described the benefits of, and limits to, the RBNZ's transparency. He also outlined the RBNZ's approach to communication, which he said should be two-way, meaning that it should include not only publishing information, but also listening to information from financial markets.*

Since the mid-1990s central bank communications have undergone a major revolution. While previously central banks were effectively mute, they are now more and more willing to convey their perspective on the state of the economy and the outlook for interest rates. In this context, Hawkesby noted that the RBNZ was an early adopter of a more transparent approach and has consistently ranked towards the top of transparency league tables; the most widely used measure, the Dincer-Eichengreen index, placing the RBNZ third, behind only the Riksbank and the CNB. A key way the RBNZ has been transparent since the late 1990s is by publishing projections for the future path of short-term interest rates. Today, only a handful of central banks do this.

Hawkesby sees three main benefits of publishing a full set of projections for the economy, including the policy interest rate. Firstly, by sharing its research and expertise on its expectations for the economy and monetary policy, the central bank can give individuals and businesses more information that helps them make more educated economic decisions. The second benefit lies in moving medium and long-term interest to a level that is consistent with the monetary policy objective. This is significant since the entire yield curve, rather than just the short-term Official Cash Rate, has an impact on economic activity. Thirdly, the central bank's projections convey the bank's view of the significant factors for monetary policy and how these can change as new information becomes available. The bank thus shows how it is learning from past experiences. This ultimately builds trust. According to Hawkesby, the RBNZ expects a combination of transparency and a consistent approach will help markets understand how the Reserve Bank reacts to new data and economic developments. Markets should then respond to information from new economic data as it occurs, rather than waiting for the central bank to make a policy announcement.

While transparency has many benefits, it is also important to understand the limitations, as well as some potential costs and unintended consequences, of providing the market with too much information. Firstly, publishing projections can portray a false sense of precision. In reality, the uncertainties inherent in forecasting mean that the economy will almost always evolve differently to expectations. The only certainty when making a forecast is that it is unlikely to be exactly right. It is therefore extremely important that market participants understand the central bank's interest rate projections are conditional on a number of assumptions. A second limitation of publishing projections is that it can create a disincentive for policy makers to change their view and adapt even as new economic data and developments emerge. A third limitation of transparency is the noise that it can create. An example of this is the diversity of views of individual members of a monetary policy committee, which can make it harder for financial markets to interpret the reaction function of the collective group. A paradox of these limitations is that greater transparency does not necessarily equate to increased clarity for market participants and the general public. Just because more information is available does not necessarily mean the audience will have a greater understanding of how and why central banks make decisions.

An important part of the RBNZ's role is to extract information from financial markets. However, there is a trade-off. The more the bank communicates and tries to influence market pricing, the more market pricing can merely reflect what the bank has said. Market pricing thus can fail to be a useful signal in itself. There is a danger that markets end up paying too much attention to the bank's communications, leaving no one left to analyse the incoming economic data. However, any market disagreement with the central bank's policy decisions or projections is an invaluable exercise to test the bank's assumptions and reasoning. In the context of the considerations described above, Hawkesby gave more detail on the RBNZ's approach to communication. A principle underlying this approach is that the RBNZ wants the market to use the information it publishes in a way that is consistent with the way the bank uses it itself. The RBNZ believes that publishing projections for short-term interest rates conveys valuable information to financial markets – but only if they are interpreted correctly.

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