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**Article**

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## EXCHANGE RATE POLICY IN CROATIA

TIMO WOLLMERSHÄUSER\*

### Introduction

For many years, Croatia's growth was built on domestic demand financed by cheap foreign credit. Export performance was weak, so that Croatia ran large current account deficits from 2002 on and built up external debt rapidly. When the global financial crisis hit Croatia in 2008, credit conditions tightened and capital inflows slowed down, pushing the economy into a severe and protracted recession. The crisis exposed a major problem: Croatia's poor competitiveness. The country is simply too expensive for an export-led recovery.<sup>1</sup>

Improving price competitiveness involves difficult policy choices. One way of tackling this issue is to devalue internally, that is, by reducing wages. The other way of addressing the problem is to devalue externally, that is, by allowing the kuna to depreciate. Doing nothing or doing not enough about price competitiveness is not an option. Greece gives a very plastic example of where a country can steer itself into if it does not manage to reduce wages and prices enough to restore competitiveness while keeping the exchange rate stable. After a deep recession, Greek industrial production is devastated and there is still massive unemployment. Price competitiveness has improved only marginally, so that the current account balance is still negative – despite reductions in interest payments thanks to the European Central Bank's (ECB's) monetary policy and international rescue credits. Public debt and foreign liabilities increase relentlessly, and it is unclear how and when Greece will be able to service its debt obligations on its own, let alone to reduce debt levels.

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<sup>1</sup> See Bakker and Klingens (2012) for an overview of developments before and during the recent financial and economic crisis in Croatia.

This paper discusses the effects of external devaluation compared to internal devaluation. We propose a gradual, managed currency devaluation, which is an easier way to improve price competitiveness while smoothing out inevitable negative balance sheet effects. The policy proposal is designed such that incentives to borrow in foreign currency are eliminated. The proposed policy would thus not only help to promote exports, but also to reduce euroization, one of the key vulnerabilities of the Croatian economy.

### Macroeconomic situation

In contrast to most other countries in the region, the Croatian economy has not yet recovered from the recent financial and economic crisis. After six years of recession, GDP has shrunk by 13 percent since the second quarter of 2008 — the time just before the onset of the financial crisis marked by the collapse of Lehman Brothers. Industrial production, a motor of economic activity, has plunged by 17 percent, while in Central and Eastern Europe it is already 8 percent higher compared to the pre-crisis level. During the crisis, the unemployment rate has more than doubled in Croatia. Recently, it has risen even further and currently stands at 18.2 percent. Given the spare capacity in the economy, consumer price inflation is very low, at – 0.2 percent in April 2015. To some extent, this is due to reduced energy prices. However, core inflation that excludes energy, food, alcohol and tobacco prices only recovered from deflation in summer 2014, and is still fairly low, at 0.7 percent.

### Competitiveness problem

One major reason for Croatia's subdued economic performance is the fact that it has not been able to restore its price competitiveness enough to stimulate robust export growth. Measured by the real effective exchange rate based on the GDP deflator (the price index for all domestically produced goods) relative to its 37 most important trading partners, Croatia has only improved its competitiveness by 7 percent since the onset of the crisis, while it had appreciated in real

terms by 23 percent since 2000. The real effective exchange rate can fall either because the nominal exchange rate depreciates or because wages and prices inflate less compared to the trading partners, channels we refer to as external and internal devaluation, respectively. In Croatia, the improvement in price competitiveness is primarily due to external devaluation; the nominal effective exchange rate has depreciated by 5 percent since 2008. Internal devaluation has not been effective, although yearly growth of public wages has been negative between the end of 2009 and mid-2010, and since summer 2012.

An important indicator of a country's competitiveness is its current account balance. Having run current account deficits of 5 percent of GDP on average between 2000 and 2008, Croatia had a broadly balanced current account in 2012 and achieved small surpluses of 0.1 percent and 0.6 percent in 2013 and 2014. Yet it would be wrong to conclude that Croatia has solved its competitiveness problem. Firstly, a look into the components of the current account reveals that the improvements in Croatia are primarily a result of the recession, which strongly reduced imports. A boost in competitiveness would have led to strong exports, but they have increased only minimally.

Secondly, although a balanced current account is often used as a metric for external sustainability, this concept does not take into account the accumulated stock of net external liabilities, that is, foreign capital inflows that have financed former trade deficits as well as any additional borrowing that was needed to meet corresponding interest obligations. In fact, a balanced current account merely means that a country realizes a trade surplus large enough to cover interest payments to foreign investors (and employment compensation to non-residents). Only with substantial current account surpluses is a country able to reduce external liabilities. In fact, Croatia is still heavily indebted abroad; its external liabilities fell only slightly, from 95 percent of GDP in 2010 to 89 percent in 2013, which is still far above the European Commission's threshold of 35 percent. This threshold for external sustainability is somewhat arbitrary; other values range from 25 percent to 60 percent (Pill *et al.* 2012; European Commission 2015). However, if a country's net external liabilities are much higher, investors could doubt its capacity to meet its current and future debt service obligations. In this case, they could demand a risk premium on investments, which would increase interest rates and, in turn, raise the debt burden, so that a vicious circle and a severe debt crisis could ensue.

### Devaluation requirements

To achieve larger and sustained current account surpluses based on robust export growth, Croatia needs to devalue further in real terms. But how large are the devaluation requirements? Actually, there are various measures to assess the real exchange rate and they all lead to different conclusions. The IMF's estimates for Croatia vary between 10 percent overvaluation and 7 percent undervaluation (IMF 2014). Accordingly, Croatia could appreciate in real terms by almost 7 percent and its net external liabilities would remain stable at its current level. To reduce it to 40 percent, the real effective exchange rate is broadly balanced. However, these estimates are based on a range of assumptions about real growth, inflation, interest rates, and the time frame. Under these assumptions, Croatia would reach sustainable external debt levels over a long time period and by further reducing imports rather than by increasing exports. The IMF's preferred method analyses competitiveness by comparing unit labor costs relative to competitors. In a cross-country regression of average wages on labor productivity, Croatia turns out to be overvalued by 10 percent.

We use an alternative, though related, method that assesses competitiveness more directly by comparing prices of key export goods and services relative to competitors rather than unit labor costs. To evaluate whether a currency is over- or undervalued, comparative price levels contrast the nominal exchange rate with purchasing power parity, which is the level of an exchange rate at which prices of certain baskets of goods and services are equal between two countries. Key Croatian export sectors are tourism, transport equipment and electrical equipment. Comparing prices for restaurants and hotels in Greece, Italy and Turkey relative to Croatia, it becomes obvious that the Croatian tourism industry is quite competitive; in 2013, prices in Croatia were 4 percent lower than in Turkey, 17 percent lower than in Greece and no less than 49 percent lower than in Italy. However, for manufactured goods, the picture is somewhat different, especially in comparison to a country like Poland, where prices for transport equipment, including shipbuilding, were 7 percent lower and for electrical equipment, including electrical transformers, 5 percent lower than in Croatia. From these data, we conclude that Croatia has to devalue in real terms by up to 7 percent, which is broadly in line with the IMF estimate of 10 percent.

### External devaluation as preferred policy option

There are three reasons why external devaluation is to be preferred to internal devaluation. Firstly, devaluing the currency is much easier than restricting or, worse, lowering wages. In Croatia, reducing unit labor costs seems to be difficult because of the large shadow economy and a relatively inflexible labor market characterized by rigid wage setting and a high degree of employment protection (Bakker and Klingen 2012; Kunovac 2014). If Croatia relies on internal devaluation, but does not succeed in lowering prices sufficiently, this strategy will further reduce demand without increasing exports.

Secondly, an important argument in favor of external devaluation is that allowing for more exchange rate flexibility would reduce the extent of euroization of the Croatian economy. In fact, a relatively stable exchange rate aggravates the exchange rate illusion for which many debtors seem to fall. Seeing that foreign interest rates are lower than local interest rates, they presume that foreign-currency loans are cheaper. But they do not take into account potential negative effects due to depreciation of the local currency. A more flexible exchange rate regime could reduce incentives to borrow in foreign currency by making people aware of exchange rate risks.

Thirdly, it is true that external devaluation would lead to negative balance sheet effects, especially for the Croatian government and non-financial firms. The household sector as a whole would be better off, but gains and losses would be unevenly distributed between richer and poorer households. But when devaluation is gradual, these balance sheet effects are smoothed and can therefore be better digested by debtors and banks. Furthermore, it should be kept in mind that internal devaluation *also* leads to adverse balance sheet effects. The difference is that with external devaluation, balance sheet effects affect all those holding foreign-currency debt, while with internal devaluation, adverse effects are shared among all debtors because debt now has to be serviced with lower nominal income.

### Achieving external devaluation through a managed float

In a managed floating regime, the central bank has two independent instruments at its disposal, the ex-

change rate and short-term interest rates. A centerpiece of international macroeconomics is the ‘impossible trinity’, which says that a country with open capital markets must choose between monetary independence and a stable exchange rate (Fleming 1962; Mundell 1963). However, with intermediate policies such as the proposed managed floating, a country receives greater monetary independence (Bofinger and Wollmershäuser 2001 and 2003; Radošević 2014). The central bank is then able to fully sterilize its foreign exchange interventions, thereby keeping local interest rates at the desired level.

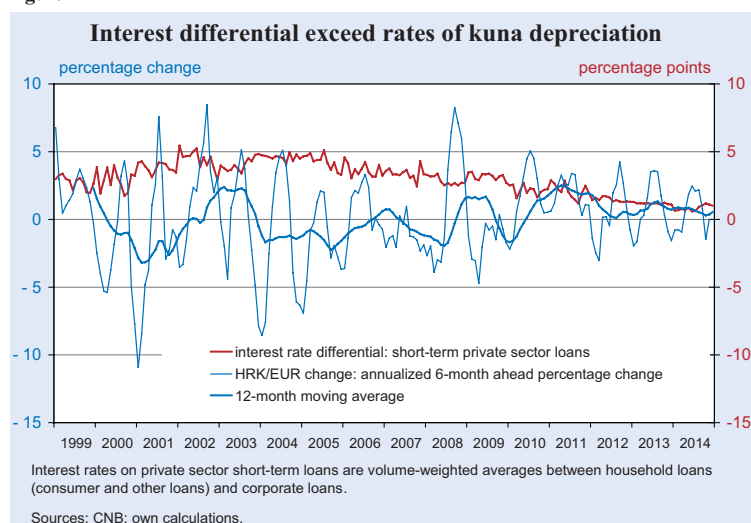
In practice, the central bank first determines the appropriate degree of restriction given its inflation target and the state of the economy, that is, the degree to which it stimulates or dampens domestic production and inflation. Subsequently, it chooses an optimal policy mix between short-term interest rates and the exchange rate such that investors and borrowers are indifferent between local and foreign investments and loans, respectively. To reach an optimal policy mix, exchange rate changes should offset differentials between local and foreign interest rates on average. In the case of Croatia, where local interest rates lie above foreign interest rates, the local currency should depreciate. Thus, the advantage of cheaper foreign credit is fully compensated by the fact that the value of the loan increases due to depreciation.

Although the kuna depreciated somewhat on average during the years 2009 to 2014 it was not sufficient to counteract the interest rate differential between local and foreign interest rates (see Figure 1).<sup>2</sup> *Ex post*, it was actually cheaper to take out loans in foreign currency than in kunas. Since the beginning of 2014, the policy mix was almost optimal, with an average interest rate differential only slightly larger than the average annualized depreciation.

Managing a devaluation path implies that if the exchange rate is not depreciating sufficiently, the Croatian National Bank (CNB) should buy foreign exchange against kunas. In this case, the CNB would keep on increasing foreign-currency reserves. Currently, the corresponding increase in kuna liquidity should be welcome, so it should not be sterilized. Should sterilization become necessary to avoid an overheating of the economy, the CNB should issue interest-bearing CNB bills, raise the interest rate on overnight deposits

<sup>2</sup> For an in-depth analysis of Croatian monetary and exchange rate policy, see Buchen and Wollmershäuser (2016).

Figure 1



or offer an interest-bearing deposit facility on excess reserves. Rising CNB rates would increase domestic banks' loan rates and thereby exert a contractionary effect on the economy.

If, however, depreciation has to be decelerated, the policy of managed floating has its limitations. The CNB would have to sell foreign exchange against kunas, running down its foreign exchange reserves. To avoid large losses, the CNB should seek an agreement with the ECB to provide short-term credit lines to the CNB in such a scenario. Joining the Exchange Rate Mechanism, a system designed to stabilize the exchange rate prior to euro adoption, could be a possible framework for such central bank cooperation. However, the ECB made clear that apart from fiscal consolidation it is necessary for Croatia to address euroization and enhance the attractiveness of financial intermediation in local currency before the ECB would be willing to accept Croatia's membership in ERM II (ECB 2004). Thus, an easy exit strategy does not seem to exist, but our proposed policy is one way of reducing euroization for which Croatia can hope to get the ECB's support.

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