Monetary policy framework

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The CNB's monetary policy framework is based on maintaining the stability of the nominal exchange rate of the kuna against the euro. A stable exchange rate of the kuna against the euro constitutes the so-called nominal anchor of monetary policy by which the CNB stabilises inflationary expectations and, ultimately, inflation itself.

In most countries, the primary objective of the monetary policy is to maintain price stability; however, ways in which central banks pursue this objective vary. Monetary policy framework is the manner in which the central bank uses monetary policy instruments to achieve its objective. For their monetary policy framework, central banks usually identify a particular variable the level and/or the dynamics of which they are able to influence, and through which they intend to indirectly achieve their primary objective - maintaining price stability. The chosen variable may, for instance, be an interest rate, a nominal exchange rate or a monetary aggregate. Accordingly, the monetary policy framework may be based on an exchange rate anchor, monetary anchor or inflation targeting or it may be a combined framework.

The Croatian National Bank chose the stability of the exchange rate of the kuna against the euro as the nominal anchor of the monetary policy. By maintaining the stability of the exchange rate of the kuna against the euro, the CNB indirectly pursues its primary objective, price stability. Against the backdrop of the high euroisation of the Croatian banking system, exchange rate stability is a tool by which the CNB maintains financial stability as well, which, in turn, ensures the macroeconomic stability of the country and the preservation of the real value of funds in all economic sectors.

Why is the stability of the kuna against the euro important?

The choice of monetary framework and monetary policy anchor depends on important characteristics and specificities of an economy. In case of Croatia, the following factors are relevant: (a) very high level of euroisation; (b) the fact that Croatia is a small and open economy; (c) high dependency on imports; and (d) high level of foreign-currency debt of all domestic sectors. Among the above mentioned factors, the high level of euroisation is the most important.

1. Euroisation is a term which describes the frequent use of a foreign currency, in particular the euro, as a means of savings and as a measure of value in an economy. In Croatia, high euroisation is a result of past experiences with high inflation which led to a deeply rooted distrust in the domestic currency, which persists in spite of the stability of the kuna since its introduction. As a result, Croatia experiences high level of currency substitution (replacement of the domestic currency with a foreign currency), reflected in the fact that the majority of bank deposits is in foreign currency (more than 80%), predominantly in euro.
   High deposit euroisation causes high credit euroisation. Banks strive and are obliged by legal regulations to hedge against the risk of exchange rate changes (foreign currency risk) in order to maintain their financial stability and preserve the trust of their clients. This is why banks with a large share of foreign currency deposits also grant a large share of foreign currency loans or loans indexed to the exchange rate with a foreign currency clause. Consequently, around two thirds of Croatian banks' placements are indexed to a foreign currency.
2. The Croatian economy is small and open, meaning that the international trade of goods and services has a significant effect on the overall economic activity in Croatia. The combined share of

imports and exports of goods and services in the gross domestic product stood at 90% in 2014, with more than half of the merchandise exports going to and around 60% of the merchandise imports coming from the euro area member states. In addition, prices of exports of services, which are primarily tourism services, are strongly related to the exchange rate of the kuna against the euro, since more than 60% of foreign tourist arrivals and overnight stays in Croatia are attributable to tourists from the euro area. Sharp fluctuations of the exchange rate of the kuna against the euro would lead to increased volatility of import and export prices, thus complicating their predictability and increasing uncertainty in doing business with foreign partners.

3. Due to the high dependency of the Croatian economy on imports, domestic prices are sensitive to exchange rate changes. Since a large share of goods on the Croatian market comes from imports from the euro area (around 60% in 2014), a substantial increase of the exchange rate of the kuna against the euro could cause the prices of such goods denominated in kuna to rise and thus indirectly result in an increase of the general price level, i.e. inflation. Exchange rate changes also affect household inflationary expectations due to adverse past experiences with high inflation in Croatia.
4. In addition to the highly euroised debt owed to domestic banks, the Croatian economy is also exposed to exchange rate risks due to the high level of external debt which is also predominantly denominated in euro. This results from the fact that most countries cannot borrow abroad in their own currency (only a very small number of countries is able to do so, and currencies of such countries are referred to as "global reserve currencies"). Given the large share of domestic sectors' debt indexed to the euro/kuna exchange rate, Croatian households, corporations and the government are extremely vulnerable to significant changes in the exchange rate because a weakening of the kuna relative to the euro would greatly increase the burden of their debt repayment.

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