CROATIAN NATIONAL BANK

Capital flows, macroprudential policy and growth

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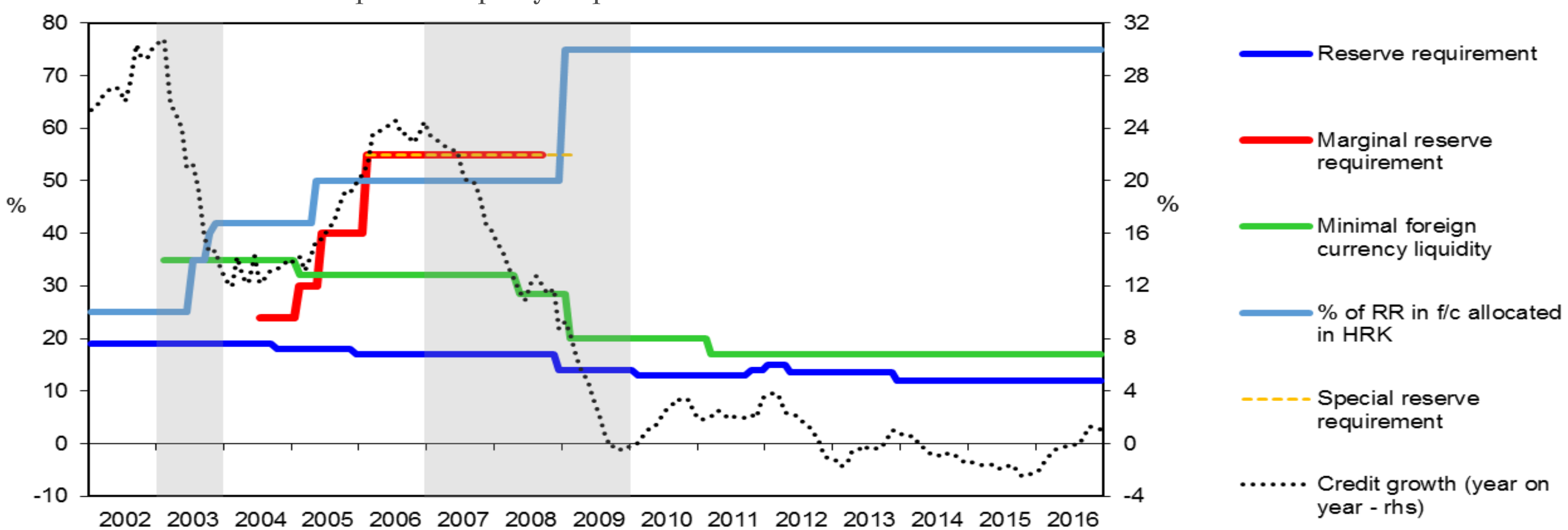
Content

- Overview of the Croatian economy and experience in macroprudential policy
  - Pre-crisis period
  - Reaction to the crisis
  - Challenges for the future

Anticyclical macroprudential policy in the pre-crisis period

- Most important pre-crisis measures:
  - high level of general reserve requirement (GRR)
  - FX interventions - mainly alleviating appreciation pressures
  - administrative restriction of loan growth - 16% - 2003, 12% 2007-2009
  - minimum required foreign currency claims (MRFCC)
  - marginal reserve requirements (MRR), special reserve requirement (SRR)
  - increased capital requirements for currency induced credit risk
  - increased capital adequacy requirement to 12%



Note: Shaded area represents periods when banks' credit growth was regulated with compulsory CNB bills.

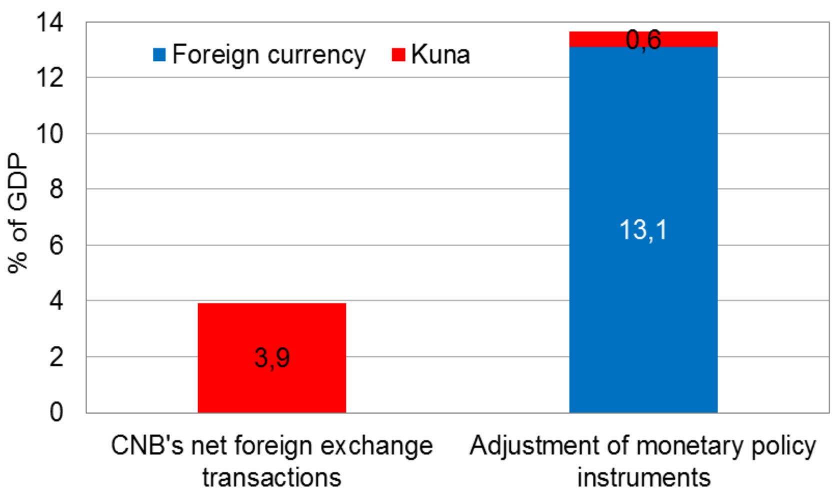
Source: CNB

Anticyclical macroprudential policy after the onset of the crisis

- Gradual **release of the system reserves** (CNB released **about 14% of GDP**)
  - MRR and SRR removed, GRR and MRFCC reduced, credit growth restrictions removed

- Results:
  - significantly improved system liquidity
  - ensured smooth servicing of the government's liabilities to foreign creditors
  - **preserved** EUR/HRK stability and the **overall financial stability**

Creating and releasing liquidity during the crisis (Q4 2008 - 2015)



Source: CNB

Monetary policy indicator of the CNB

Note: Monetary policy indicator = Banks' assets required by regulation/Total banks' assets.
Source: CNB

Character of reforms from macroeconomic perspective

- Crisis revealed the necessity for macro-prudential approach to financial system assessment - **significant share of systemic risk arises from system itself, independently of risks and soundness of individual market actors and financial institutions**.

- Until now, regulators have used measures of macro-prudential character discretionary - new regulation **harmonizes and to some extent pre-determines policy** reactions (Basel III- CRD IV/CRR, ESRB recommendations, BRRD)

- Additionally, the regulation has introduced penalties (for institutions) that are based on macro-prudential assessment.

- Finnaly, coordination in fighting "leakages" (**on national and international level**) has after the crisis, compared to previous years, important role in conducting macroprudential policy

Recent macroprudential activites (1)

- **The Act on the Financial Stability Council** - FSC (Dec 2013) – related to ESRB recommendation on MP mandate
  - establishes the FSC, regulates the area of financial stability and macroprudential policy

- **Amanded Act on the CNB** - specific task of contributing to stability of the financial system

- Recent activites related to ESRB recommendation on FX lending – existing toolkit for dealing with risks arising from FX lending expanded in the area of consumer information (stress-test on repayment and availability of equivalent domestic currency loans)

Recent macroprudential activites (2)

Capital buffers:

- **Capital conservation buffer**: 2,5% (Jan 2014)
- **Structural systemic risk buffer**: 1,5% all banks + additional 1,5% for large banks (substitute for O-SII in pre-2016 period) (May 2014)
- **Countercyclical capital buffer rate** - due to deleveraging in a crisis environment – no evidence for setting the buffer rate above 0% (Jan 2015)
- **Capital buffers for other systemically important institutions** (Jan 2016)

Supervisory actions:

- 2013 - Tightened provisioning standards (If a bank does not adequately tackle the loan resolution process (regardless of collateral) it has to increase the provisioning level progressively with time)
- 2014 - **Risk weights for exposures secured by mortgages on residential property** (Maintaining stricter definition of residential property for preferential risk weighting (e.g. owner cannot have more than 2 residential properties, exclusion of holiday homes, need for occupation by owner or tenant)
- 2014 - **Risk weights for exposures secured by mortgages on commercial property** (CNB's recommendation issued to banks (not legally binding measure) on avoiding the use of risk weights of 50% to exposures secured by CRE during low market liquidity)
- 2016 - **Risk weights for exposures secured by mortgages on commercial property** (Decision on higher risk weights for exposures secured by mortgages on commercial immovable property. RW set at 100% (substituted CNB's recommendation from 2014, i.e. effectively increased from 50%))

Changing the structure of capital flows

- In the pre-crisis period financial flows were dominated by debt instruments increasing countries' financial system vulnerabilities

- In the post-crisis period countries are trying to attract more FDI inflows to redress imbalances
  - non-debt-creating and more productive foreign liability

- But attracting FDI is not sufficient
  - it is important to reduce resource misallocation as much as possible
  - capital should move towards the firms that are more productive

What policy options do we have?

- **In the short term:**
  - more productive allocation of scarce FDI (into tradable sector)
  - better absorption of the EU funds
  - macro policies focused on reducing vulnerabilities and rebuilding resiliance (key for restoring investors' confidence and cost of financing)
- **In the long run, structural reforms are the key:**
  - business environment – reducing the complexity and cost of compliance
  - product market reforms – removing barriers to entrepreneurship
  - labour market reforms – promoting higher labour force participation
  - human capital development – reconnecting education and business

Conclusion

- Rich experience in macroprudential policy – valuable lessons
  - Even tightly intertwined monetary and macroprudential policies may hardly be sufficient do deal with the boom-bust cycle along the convergence path
  - Early action slowed down systemic risk accumulation
  - Capital and liquidity buffers enabled counter-cyclical policy
  - Importance of coordination in fighting "leakages" - both on national and international level

- Main challenges for the future:
  - increase FDI in the tradable sector, better EU funds absorption and **structural reforms**