

Preserving economic and financial stability in an emerging market country during the pandemic crisis: Croatia's experience

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Article**

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Abstract

The Croatian authorities' response to the pandemic crisis was considerably greater in size and scope than their reaction to the 2008-09 global financial crisis. This paper aims to identify the main factors that allowed the authorities to respond so ambitiously this time. In particular, the paper explains how solid macroeconomic fundamentals backed by a steady inflow of EU funds enabled the Croatian government and the Croatian National Bank to take bold steps to restore stability in key financial markets and provide liquidity support to the economy without compromising currency stability and fiscal sustainability. In addition, as an EU member state, Croatia was in a position to benefit from a currency swap line with the ECB, as well as from the EU's common recovery facility, which reduced concerns about the pandemic-induced rise in government debt. Finally, the paper identifies some positive external factors that were beneficial for all emerging market economies.

Keywords: monetary policy, fiscal policy, COVID-19, international reserves, financial crisis

1 INTRODUCTION

The outbreak of the COVID-19 pandemic in March 2020 was a massive shock for the entire global economy. It triggered a recession that was sharp and brief like no other before. Unlike most other recessions, this one was not caused by excessive borrowing and spending. Since it was triggered by a genuinely external shock, this time the blame could not be placed upon irresponsible governments or financial institutions.

The virus did not cause such a deep economic decline by itself. It was the virus containment measures that triggered the recession. The worldwide introduction of severe mobility restrictions, which were needed to contain the spread of the virus and to buy time to develop medical solutions to it, led to a virtual standstill of activity in contact-intensive sectors. Apart from producing a sharp drop in domestic demand, lockdown restrictions caused significant disruptions in cross-border trade and travel, which resulted in a compression of foreign demand. The extent of economic decline in a particular country was proportional to the severity of the health emergency as measured by infection rates, the share of contact-intensive sectors in gross value added and the country's reliance on tourism as a source of revenue (IMF, 2021).

Although Croatia was not among the worst performing EU member states according to the infection rates and death toll in the first wave of the pandemic, it reported one of the largest declines in real GDP in 2020, as its tourism-dependent economy suffered heavily due to strict bans on international travel. However, despite the unprecedented contraction of domestic and external demand and the consequent strong deterioration in public finances, Croatia managed to maintain financial and economic stability throughout the crisis, as evidenced by a stable exchange rate, low government bond yields, and a low unemployment rate.

The objective of this paper is to identify the main factors that helped Croatia contain the economic fallout of the pandemic. In particular, it explains how sound initial macroeconomic fundamentals enabled the Croatian authorities to deploy a wide range of measures – including some that had never been used before – to restore stability in key financial markets and support households and corporations negatively affected by the pandemic crisis. The sound fundamentals and the fact that Croatia was on a firm path towards ERM II made it possible for the Croatian National Bank to negotiate a precautionary currency swap line with the ECB in April 2020 worth 2 billion euro. Obtaining the swap line, which contributed significantly to efforts to preserve the stability of the kuna, would not have been possible if Croatia had shown poor economic performance or if it had not made progress towards euro adoption. Furthermore, as a member state of the EU, Croatia enjoyed a sizeable net inflow of EU funds both before and during the pandemic crisis, allowing it to maintain a strong balance of payments position in 2020 despite the sharp drop in tourism revenues that year. Finally, the Croatian authorities' ability to provide economic stimulus was further boosted by the establishment of an EU recovery facility – the Next Generation EU instrument. By improving the medium-term growth prospects of EU member states, the creation of the recovery facility helped ease investor concerns about the sustainability of their elevated debt levels.

Some of the factors that enabled Croatia to cope well with the COVID-19 turmoil were relevant for other emerging market economies as well. For example, the swift policy response by central banks and governments of advanced countries helped stem the panic and re-establish favourable liquidity conditions in international financial markets, which made it easier for emerging market countries to implement their own crisis response packages. In that regard, the experience with unconventional monetary policy measures gained during the global financial crisis of 2008-09 proved valuable, as advanced countries' central banks were able to reintroduce asset purchase programs shortly after the outbreak of the pandemic to provide relief. Interestingly, asset purchase programs were successfully implemented for the first time in a number of emerging market economies, including Croatia. Furthermore, the peculiar nature of this crisis – which was caused by a temporary health shock rather than by irresponsible behaviour of individual countries – seems to have made rating agencies and financial investors more tolerant of the large pandemic-related fiscal deficits and rising debt levels. In particular, the number of sovereign rating downgrades, especially in Europe, was significantly lower during the pandemic crisis than is usually the case in severe crises.

The paper is structured as follows. The next chapter provides a brief overview of the pandemic crisis and the global economic policy response to it, with particular emphasis on measures taken by central banks and governments of major advanced countries. Chapter 3 documents the comprehensive fiscal, monetary and prudential policy measures adopted by the Croatian government and the Croatian National Bank to curb the economic costs of the pandemic, while chapter 4

identifies factors, both country-specific and external, that enabled the Croatian authorities to respond to the pandemic crisis in such an ambitious way. Chapter 5 concludes the paper.

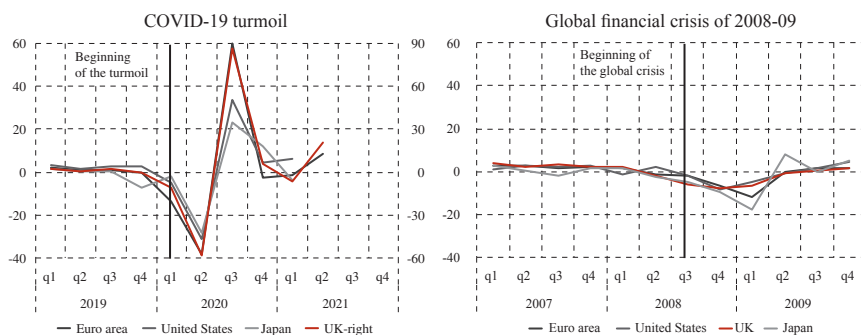
2 COVID-19 TURMOIL AND THE ECONOMIC POLICY RESPONSE WORLDWIDE

2.1 COVID-19 TURMOIL IN A HISTORICAL CONTEXT

The recession triggered by the COVID-19 pandemic was unprecedented in many ways. It was a brief, severe and highly synchronized contraction of economic activity at the global level. At the peak of the crisis, in the second quarter of 2020, most countries registered record-high quarterly drops in economic activity. This was in contrast with the usual pattern of recessions. Global recessions are never so severe at the beginning or so synchronized across countries. They typically evolve more gradually and affect different countries to different degrees. Figure 1 compares the annualized quarterly GDP growth rates of the main advanced economies during the two recent crises – the COVID-19 turmoil and the global financial crisis of 2008-09. While the global financial crisis was a severe recession – at the time, the strongest since the Great Depression – it was much milder than the COVID-19 turmoil in terms of the maximum quarterly decline in GDP. The reason behind such a harsh start to the COVID-19 crisis was the instant collapse of personal consumption and international trade caused by the introduction of the lockdown. As soon as the lockdown restrictions were eased, economic activity bounced back, also at unprecedented rates (figure 1).

FIGURE 1

Annualized quarterly real GDP growth rates in major advanced countries (in percent)



Sources: IMF, Federal Reserve Bank of St. Louis, Eurostat.

Another distinctive feature of this global recession is that it was intentional – governments all over the world deliberately closed parts of their economies to slow down the spread of the virus and save lives. In other words, the recession was a side effect of a shock that was triggered outside of the economic system. By contrast, a typical recession is endogenous, in the sense that it emerges from vulnerabilities that have built up within the economic and financial system. Three well-known episodes of global recession illustrate this point. Specifically, the beginning of the

Great Depression of 1929-1933 was associated with excessive speculation in the US in the run-up to the stock market crash in October 1929 (Friedman and Schwartz, 1963; Romer, 1993). On the other hand, at the root of the 1981-82 global recession was high inflation in advanced countries coupled with elevated external vulnerabilities in emerging market economies. As the Federal Reserve and other advanced countries' central banks tightened monetary policy to curb inflation, global interest rates rose significantly, causing a sharp economic slowdown and making it more difficult for emerging market countries to service their U.S. dollar-denominated debts (Kose, Sugawara and Terrones, 2020). Finally, the global financial crisis of 2008-09 was the result of an interaction between excessive private sector borrowing and a rapid accumulation of risks in the financial system in the context of a widespread use of complex credit derivatives.

2.2 ECONOMIC POLICY RESPONSE TO THE COVID-19 CRISIS

While its origins were different, the COVID-19 crisis threatened to produce economic damage of a magnitude similar to that produced by other severe global recessions. In particular, the collapse in aggregate demand caused by the outbreak of the pandemic led to a strong decline in corporate profits, some firms in contact-intensive sectors such as hotels and restaurants seeing their revenues drop to zero. If the authorities had not intervened, such a liquidity shock would inevitably have caused a massive surge in corporate insolvencies and job losses with long-term negative implications for growth. This, in turn, would have negatively affected banks' balance sheets, as an increasing share of loans to households and corporations would have become nonperforming. The natural reaction of banks to rising defaults would have made things even worse – by cutting down on new lending with an aim to reduce exposure to credit risk and recover their capital ratios, they would have precipitated a further decline in economic activity. In short, the outbreak of the pandemic threatened to set off a severe and self-sustaining recessionary spiral with tremendous economic and social costs.

In order to avoid such an adverse scenario, policymakers in advanced countries intervened promptly and decisively. While these measures could not prevent a recession from occurring in the first place, they were effective in limiting its long-term damage and in providing conditions for a swift recovery once the health crisis subsided. The main objective was to enable firms coping with a sudden drop in revenues to survive the liquidity shock and retain their employees. This was crucial to preserve the productive capacities of the economy. To accomplish this primary objective, authorities resorted to a wide range of fiscal, monetary, and prudential measures.

2.2.1 FISCAL POLICY RESPONSE

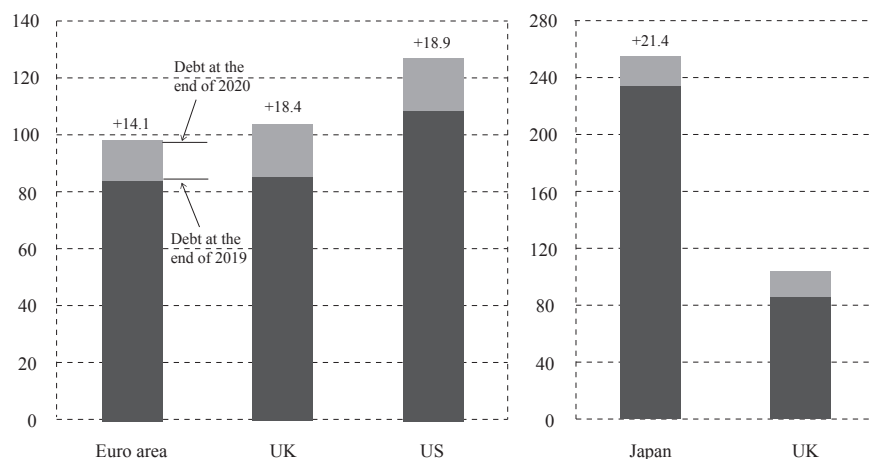
On the fiscal front, governments implemented significant economic relief programs. Due to the unprecedented severity of the economic contraction and the specific type of shock that caused it, the relief programs were understandably much larger than in previous crisis episodes. In a number of developing and emerging market countries, the costs of the pandemic exceeded the fiscal capacity of the government. By the end

of 2020, around 80 countries had requested financial assistance from the IMF to cover the costs of economic relief measures and increased health-related expenditure (IMF, 2020c). In the EU, discretionary fiscal support packages implemented by national governments during the first year of the pandemic were several times larger than those implemented in 2009, when the European economy was struggling with the fallout of the global financial crisis (Haroutunian, Osterloh and Sławińska, 2021). Moreover, confronted with the threat of a prolonged economic downturn, EU leaders agreed to implement for the first time in history a common fiscal response package – the Next Generation EU program worth more than 800 billion euro financed by a multi-year EU bond issuance program – to facilitate economic recovery after the pandemic (European Commission, 2020a).

Fiscal support, as a rule, consisted of a series of instruments aimed at providing comprehensive relief to the most affected parts of the economy (OECD, 2020). Most commonly used were part-time work schemes and wage subsidies, tax deferrals, loans granted by state development banks, and government guarantees, which enabled liquidity-constrained companies to obtain market funding on favourable terms. Some countries also resorted to tax relief and equity injections to support companies from vulnerable sectors more directly. Although each of these measures helps ease the liquidity constraints of companies, there is an important difference in their longer-term impact on solvency. In particular, while tax deferrals, public loans and government guarantees merely defer the burden of the crisis to a later period, wage subsidies, tax relief and equity injections constitute a permanent relief, as these funds are not expected to be repaid.

FIGURE 2

Increase in the government debt-to-GDP ratios, 2020 (percentage of GDP)



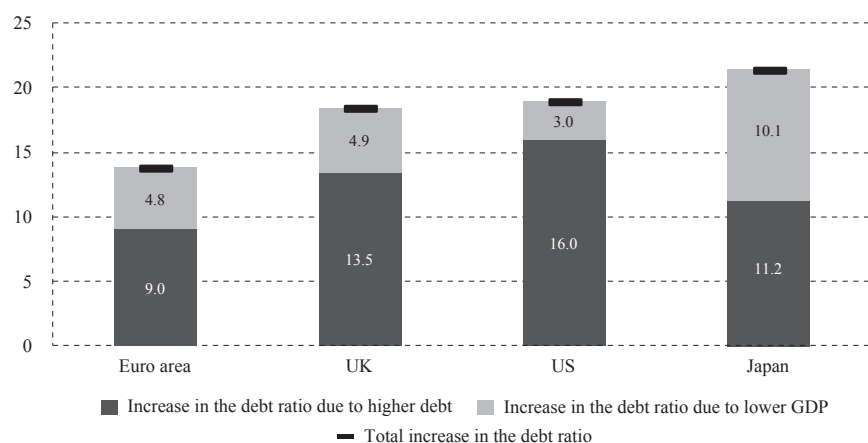
Sources: IMF, Eurostat.

The relative weights attributed to particular fiscal instruments varied from country to country. In the United States, for example, particular emphasis was placed on improving companies' access to credit and providing direct income support to vulnerable households. In the EU, on the other hand, part-time work schemes and wage subsidies accounted for a large share of overall fiscal stimulus, especially during the first wave of the pandemic when the most severe lockdown restrictions were in place (OECD, 2020). Reliance on wage subsidies was strongest in countries where sectors heavily affected by the lockdown represent a large part of the economy, such as in tourism-dependent Mediterranean countries (ESRB, 2021).

Discretionary fiscal support measures, combined with the operation of automatic stabilizers, resulted in a substantial widening of fiscal deficits and a sharp increase in the government debt-to-GDP ratios. Figure 2 illustrates the impact of the COVID-19 pandemic on government debt in four major advanced economies. In 2020, each of these economies reported a double-digit increase in the debt ratio, ranging between 14 and 21 percentage points of GDP. It is important to note that the sharp rise in the debt ratio was not only the result of the increase in debt caused by the need to finance pandemic-induced deficits. It was also a reflection of the unprecedented contraction of nominal GDP, which serves as the denominator in calculating the debt ratio. As shown in figure 3, the decline in the denominator was responsible for a quarter of the total increase in the debt-to-GDP ratio in the UK, for more than a third in the euro area and for almost a half of the total increase in Japan. The United States was an outlier with a relatively small contribution of nominal GDP decline to the overall increase in the debt ratio, given that it managed to avoid a severe economic contraction during the whole of 2020.

FIGURE 3

Contributions to the total increase in the debt-to-GDP ratio in 2020 (percentage points of GDP)



Source: IMF, Eurostat.

The fact that the outbreak of the COVID-19 pandemic was a truly exogenous shock, rather than a product of macroeconomic and financial imbalances, did not protect some highly indebted advanced countries from experiencing tensions in their sovereign debt markets. In particular, in early March 2020, Italy and Spain experienced a sharp rise in government bond yields following the introduction of lockdown restrictions (Corradin, Grimm and Schwaab, 2021). These two countries were particularly vulnerable, and were therefore most penalized by the financial markets, because of their high infection rates and elevated initial levels of government debt. Market participants correctly assumed that the severe contraction of economic activity triggered by the pandemic and the fiscal response to it would cause a further significant increase in their already high government debt levels.¹

Interestingly, during the acute phase of the market turmoil, liquidity strains were evident even in the U.S. Treasury market, which is universally regarded as the most deep and liquid market in the world and which serves as the main safe haven during financial crises. In the case of the US, the increase in yields was not caused by investor concerns regarding the sustainability of federal debt, but it was rather a reflection of liquidity disruptions that occurred in other segments of the financial market. Specifically, as money market funds faced large redemption requests that exceeded their available cash buffers, they began selling Treasuries and other high quality assets on a large scale to obtain the cash needed to meet the requests, which in turn transmitted liquidity strains to the U.S. Treasury market (Hespeler and Suntheim, 2020).

2.2.2 MONETARY POLICY RESPONSE

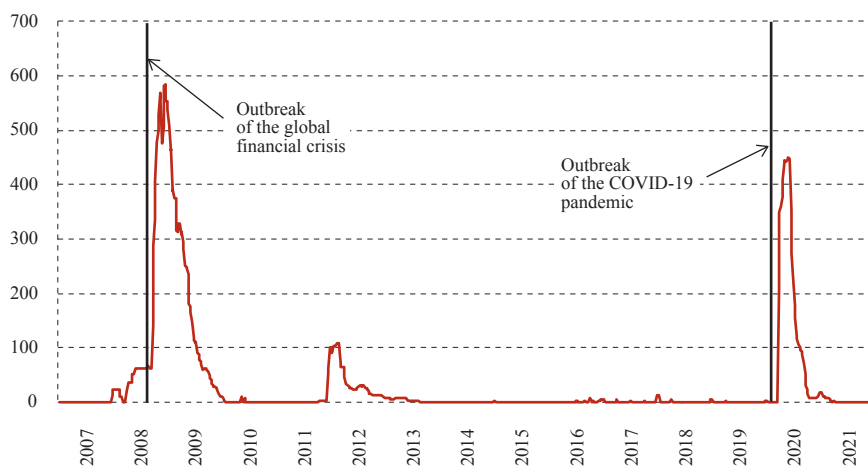
Central banks of advanced economies responded forcefully in March 2020 to address disruptions in sovereign debt markets and other key funding markets and in this way limit the overall economic damage of the pandemic. The approach was very similar across major central banks: all of them resorted to a wide range of tools, including policy rate cuts, enhanced liquidity provision to banks and, in some jurisdictions, to non-banks, asset purchases and forward guidance. The main idea behind these actions was to provide ample liquidity to financial markets, restore confidence, and thus enable both the public and private sector to enjoy favourable access to markets at the time when their financing needs were highest. In their response to the COVID-19 turmoil, central banks took advantage of the rich experience they had gained during the global financial crisis of 2008-09. In particular, given that asset purchase programs and enhanced liquidity provision operations had been successfully tested in the previous crisis, central banks were in operational terms prepared to launch similar programs soon after the outbreak of the pandemic. This crisis has confirmed that instruments considered unconventional in the past have become a standard part of central banks' toolkits (English, Forbes and Ubide, 2021).

¹ Indeed, by the end of 2020, Spain and Italy had seen their government debt-to-GDP ratios increase by more than 20 percentage points, reaching the very high levels of 120 and 156 percent of GDP, respectively.

In the U.S., the Federal Reserve intervened in a similar way as in 2008. The target range for the federal funds rate was lowered by 150 basis points to zero, discount window borrowing was made more affordable, and a large-scale asset purchase program was launched with the aim of addressing disruptions in the U.S. Treasury and mortgage-backed securities markets (Clarida, Duygan-Bump and Scotti, 2021). Several other facilities that had been used extensively during the global financial crisis were reintroduced in March 2020. One of these facilities – the Primary Dealer Credit Facility – was aimed at improving the liquidity positions of primary dealers, which are key non-bank financial institutions in the U.S., while other facilities helped to ease tensions in the commercial paper market and the asset-backed securities market.

FIGURE 4

Federal Reserve's liquidity swaps with other central banks (USD bn)



Source: Federal Reserve Bank of St. Louis (FRED database).

Apart from making efforts to address disruptions in domestic financial markets, the Federal Reserve once again acted as the global lender of last resort. In particular, to address the shortage of U.S. dollar liquidity in international financial markets, the Federal Reserve provided ample liquidity to other major central banks through bilateral currency swap lines (figure 4). Liquidity was provided through the Federal Reserve's permanent swap lines with the ECB, the Bank of England, the Bank of Canada, the Swiss National Bank and the Bank of Japan, but also through temporary swap lines that were set up with nine other central banks, from both advanced and emerging market countries. These central banks channelled the dollar liquidity they obtained from the Federal Reserve to their domestic financial institutions that had refinancing needs in US dollars.²

² Addressing the worldwide shortage of U.S. dollar liquidity was not only important to other countries but it was also in the interest of the United States itself. When foreign financial institutions lose the ability to borrow in U.S. dollars in wholesale markets, their only remaining option to obtain dollar liquidity is to sell their dollar-denominated assets, such as U.S. Treasuries, which can create downward pressure on their prices. Therefore, by acting as the global lender of last resort in times of financial turmoil, the Federal Reserve indirectly supports the stability of the U.S. financial system.

While the general approach was very similar, there are two important differences in the Federal Reserve's response to the global financial crisis of 2008-09 and the recent COVID-19 turmoil. First, during the recent turmoil there was no need for the Federal Reserve to engage in recapitalizations of failing institutions, as none of the systemically important institutions experienced financial difficulties.³ Their greater resilience during the COVID-19 turmoil was the outcome of comprehensive regulatory reforms that had been implemented in the aftermath of the global financial crisis, due to which major financial institutions entered this crisis better capitalized and more liquid, and much less dependent on wholesale funding sources (Financial Stability Board, 2021b). Second, as the lockdown restrictions affected the real sector more severely than the financial sector, this time the Federal Reserve also established facilities that channelled funds directly to the economy (Clarida, Duygan-Bump and Scotti, 2021). Specifically, three programs were set up through which the Federal Reserve invested directly in corporate bonds and loans, in both the primary and the secondary market.

In the euro area, the monetary policy response was equally comprehensive. While the ECB had no room for policy rate cuts, it successfully deployed all the other tools available to stem the panic. Most importantly, in March 2020, the ECB launched a massive asset purchase program – the Pandemic Emergency Purchase Program (PEPP) – which played a key role in stabilizing the euro area sovereign debt markets in the early stage of the turmoil. Under the PEPP, the ECB committed to purchase up to 750 billion euro⁴ of euro area government bonds in a highly flexible manner, as there was no upper limit on the share of an individual member state's outstanding debt that could be bought within the program.⁵ The announcement of the program provided an instant relief to sovereign debt markets, especially in Italy and Spain, which were particularly vulnerable at that time (Corradin, Grimm and Schwaab, 2021). Had the ECB not intervened in such a way, financial markets in the euro area would have experienced fragmentation along national lines – as happened during the European sovereign debt crisis a decade earlier – with bond yields of fiscally vulnerable member states rising to prohibitive levels. This would not only have raised serious doubts about the ability of these member states to continue servicing their large debt stocks, but it would also have made it more difficult for the ECB to run monetary policy.

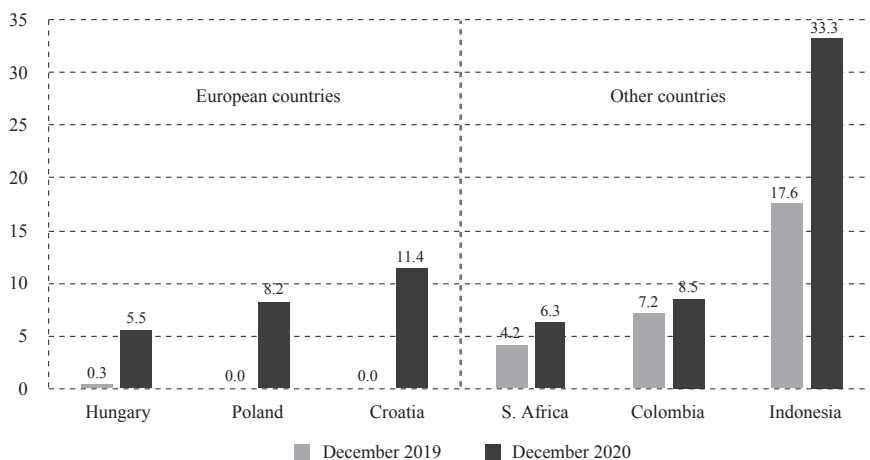
³ By contrast, in 2008, the Federal Reserve committed substantial resources to facilitate the takeover of the failing investment bank Bear Stearns by JP Morgan and to support the recapitalization of the large insurance company AIG, which was on the brink of bankruptcy due to heavy losses on its credit default swap contracts (Mishkin, 2011).

⁴ The program was later gradually scaled up to 1,850 billion euro.

⁵ In contrast, under the earlier program – the Public Sector Purchase Program, which ran from 2015 to 2018 – the Eurosystem could buy only up to 33% of a member state's total outstanding debt.

FIGURE 5

Claims on central government as percent of total central bank assets, selected emerging market economies (percentage of total assets)



Source: IMF Monetary and Financial Statistics.

An interesting fact about the monetary policy response to the COVID-19 crisis was that even some emerging market economies launched asset purchase programs to support the stability of their sovereign debt markets. Previously, it was believed that unconventional monetary policy tools were available only to advanced countries' central banks, as central banks of emerging market countries lack the necessary credibility for their use. In particular, it was believed that monetary expansion associated with asset purchases would trigger inflationary expectations and currency depreciation, which in turn would offset the positive effects of asset purchases. Heavily dollarized countries were considered the least suitable to use such tools, given that they are especially vulnerable to currency depreciation. Nevertheless, during the COVID-19 turmoil, central banks of several emerging market economies successfully implemented government bond purchase programs while preserving price and exchange rate stability (Sever et al., 2020; Arena et al., 2021). As a reflection of bond purchases, claims on central government as a share of total central bank assets increased markedly in several countries (figure 5). Emerging market economies that successfully implemented asset purchase programs had one thing in common: they all had had sound initial macroeconomic fundamentals and a proven track record in maintaining low inflation. Their experience provides an important lesson for the future, as it shows that unconventional monetary policy tools can be effectively used by emerging market economies as well, provided they have the ability to maintain macroeconomic stability.

2.2.3 PRUDENTIAL POLICY RESPONSE

The crisis caused by COVID-19 required also a swift counter-cyclical response by prudential authorities. As some parts of the economy experienced a sharp drop in income due to the lockdown, the quality of banks' lending portfolios was expected

to deteriorate significantly. However, despite the expected sharp increase in non-performing loans, it was crucial for banks to keep on lending, in order to mitigate liquidity pressures in the economy. If banks had instead decided to deleverage, the resulting credit crunch would have made the recession much more severe. Encouraging banks to lend in the environment of a sharp recession and unprecedented uncertainty was challenging because it was against the basic principles of prudent risk management. Hence, prudential authorities had to take several important steps to stimulate bank lending.

First, they had to make sure that the temporary increase in non-performing loans did not produce excessive costs for the banking system. The pandemic was an external shock, so households and corporations that were affected by it were in no way responsible for the deterioration in their debt servicing capacity. In such a context, accepting a sharp temporary rise in non-performing loans without engaging in forced collection was in the best interest of both banks and their customers. In order to incentivize banks to follow a “wait and see” approach and offer moratoriums on loan repayment to crisis-affected borrowers, prudential authorities around the world temporarily relaxed the rules on loan classification (Coelho and Zamil, 2020). In particular, they issued guidelines according to which loans that became non-performing after the onset of the pandemic could still be classified as performing. Such a favourable regulatory treatment of overdue loans made it possible for banks to grant moratoriums to crisis-affected borrowers without experiencing a consequent increase in loan loss provisions. In most countries loan repayment moratoriums played a major role in providing relief to households and corporations facing cash-flow problems (Financial Stability Board, 2021a).

Second, capital and liquidity requirements were eased so that they would not represent an obstacle to continued credit provision (Financial Stability Board, 2020). In countries where the counter-cyclical capital buffer rate was above 0% before the outbreak of the pandemic, prudential authorities released the buffer altogether, thus freeing up capital for new lending. In some cases, prudential authorities went as far as reducing the structural buffers, such as the systemic risk buffer, which were originally not intended to be released in times of crisis. However, it turned out that most banks were not willing to consume the released buffers, probably due to the fear that a decline in their capital ratios would be penalized by financial markets.

Third, prudential authorities advised banks to retain earnings instead of paying out dividends to their shareholders. Given the high uncertainty associated with the future course of the pandemic and the pace of economic recovery, keeping banks well capitalized was important to ensure that they had sufficient capacity to absorb losses and provide credit to the economy. Advising banks to retain earnings was also justified because banks were large beneficiaries of fiscal and other policy support programs: fiscal measures such as wage subsidies, tax deferrals and loan guarantees helped keep the economy afloat and in this way mitigated the deterioration in banks’ loan portfolios. Furthermore, the decision of prudential authorities to relax the loan

classification rules prevented a large increase in the cost of provisions for loans that had already become non-performing. In such an environment, where banks' profits were directly and indirectly supported by various policy measures, it would have been unreasonable to allow them to be distributed to shareholders. Restrictions on dividend payments were eventually lifted in the second part of 2021, as the economic recovery gained momentum and uncertainty subsided.

To sum up, the crisis brought about by the COVID-19 pandemic prompted an ambitious and comprehensive response by fiscal, monetary and prudential authorities across the globe. The measures taken achieved their goals: the stability of financial markets was quickly restored, while corporate insolvencies and employment losses were contained, which set the stage for a strong economic rebound after the worst phase of the pandemic had passed. However, the capacity to provide economic relief varied among countries depending on the health of their macro-financial fundamentals. The better the fundamentals were, the more able the authorities were to support the economy and the financial system. The next two chapters deal particularly with the policy response in Croatia. In particular, they illustrate how sound initial macro-financial fundamentals, EU membership and a clear perspective to introduce the euro in the near future enabled the Croatian authorities to implement – by international standards – a very generous economic relief program.

3 ECONOMIC POLICY RESPONSE IN CROATIA

The Croatian authorities were confronted with multiple challenges following the outbreak of the pandemic. As in virtually all other countries, the spread of the virus required the introduction of severe restrictions to save lives and alleviate the pressure on the healthcare system. The lockdown and the high uncertainty over its duration led to a significant deterioration in the outlook for economic growth and public finances. The negative impact on the economic outlook was more pronounced than in most other EU member states given Croatia's heavy reliance on tourism, which was a particularly vulnerable sector in the early stages of the pandemic. In its economic forecast published in May 2020, the European Commission indicated that it expected Croatia to record the fourth largest decline in real GDP in 2020, just behind its Mediterranean peers – Greece, Italy and Spain (European Commission, 2020b).

3.1 EFFORTS TO PRESERVE FINANCIAL STABILITY

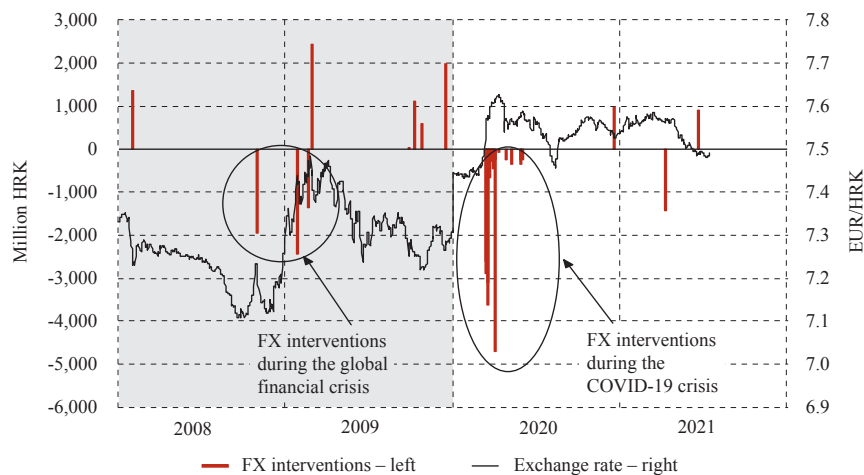
The deteriorating economic outlook weighed on the financial markets, particularly the foreign exchange market and the sovereign debt market. In the foreign exchange market, the Croatian kuna was exposed to strong depreciation pressures in March and April 2020 due to worries that the lockdown would severely affect the services-oriented Croatian economy (CNB, 2021a). In particular, some financial institutions had to close their short foreign exchange positions as expectations about the tourist season deteriorated. As it was clear that the tourism sector would underperform in 2020 because of travel restrictions, financial institutions correctly assumed that the kuna would not exhibit its typical seasonal appreciation in

the summer months. In addition, pressures on the currency were a side effect of increased outflows from investment funds. To avoid potential losses, many investors decided to sell their fund shares and put their money instead in much safer foreign currency deposits with banks, which contributed to depreciation pressures. Liquidity disturbances in the investment fund sector affected not only the foreign exchange market, but also the sovereign debt market. Specifically, in order to obtain the cash needed to meet redemption requests, investment funds started selling government bonds on a large scale, thus exerting downward pressure on their prices (CNB, 2021a).

In such a challenging environment, the authorities responded ambitiously by deploying a range of tools, some of which had never been used before. The Croatian National Bank played a key role in addressing the turmoil on the financial market. In doing so, the central bank found itself in a difficult position, because it had to simultaneously manage disruptions that occurred in different market segments. In order to counter depreciation pressures on the kuna, the central bank intervened strongly in the foreign exchange market by selling a total of 2.7 billion euro of its international reserves, which was equal to 5.5 percent of GDP. The interventions were larger than those carried out during the global financial crisis when similar tensions arose in the foreign exchange market⁶ (figure 6).

FIGURE 6

FX interventions during the global financial crisis and the COVID-19 pandemic



Source: Croatian National Bank.

⁶ The total amount of liquidity released through foreign exchange interventions in late 2008 and early 2009 was 0.9 billion euro. However, it should be borne in mind that at the height of the global financial crisis, the Croatian National Bank used other instruments in addition to foreign exchange interventions to provide the financial system with much-needed foreign currency liquidity (Galac, 2010). In particular, the central bank abolished the marginal reserve requirement, reduced the minimum required foreign currency claims, and reduced and adjusted the general reserve requirement, thus releasing additional 3.6 billion euro into the banking system.

The Croatian National Bank's strong focus on exchange rate stability in times of crisis is necessary given that a stable currency is a prerequisite for macroeconomic stability in the heavily euroized Croatian economy. Specifically, if the kuna had been allowed to depreciate in spring 2020, this would have made it more expensive for the government and other sectors to service their foreign currency-indexed liabilities, thus aggravating the decline in disposable incomes. Moreover, risks in the banking system would have materialized: some foreign currency loans would have become non-performing due to the inability of borrowers to meet higher monthly instalments, while the general drop in confidence would have prompted many depositors either to convert their kuna deposits into foreign currency deposits or to withdraw their deposits from the banking system. Finally, a depreciation of the kuna would have caused the country's risk premium to increase, which would have worsened the government's ability to borrow in the international financial markets. All this would have made the pandemic-induced crisis much more severe and costly.

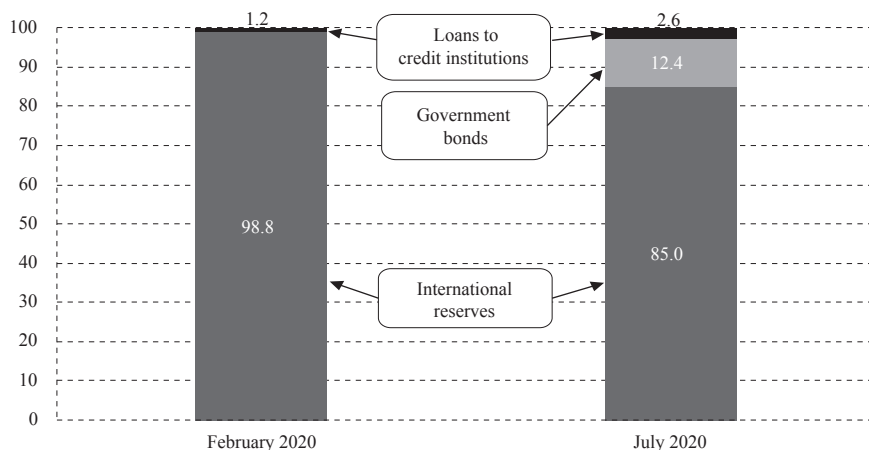
Apart from intervening in the foreign exchange market, the Croatian National Bank took decisive steps to restore stability in the sovereign debt market. In line with actions taken by the ECB and other major central banks at the time, the Croatian National Bank acted as a buyer of last resort to prevent interest rates on government bonds from soaring (CNB, 2021a; Arena et al., 2021). As mentioned above, liquidity strains in the sovereign debt market arose immediately after the outbreak of the pandemic when investment funds, confronted with substantial outflows, began liquidating their positions in government securities. Given that tensions in the sovereign debt market were caused by a temporary imbalance between demand and supply, rather than by concerns about fiscal sustainability, the central bank's decision to perform the role of buyer of last resort was justified and, as it turned out later, highly effective. However, launching a government bond purchase program in March 2020 was a delicate decision for the central bank, as such transactions had never been tested in Croatia before. In particular, there was a risk that purchases of domestic currency-denominated government bonds could feed depreciation expectations and thus undermine efforts to preserve the stability of the kuna.

To enable the program to have a meaningful impact, the central bank first had to expand the list of eligible counterparties to allow the non-bank financial institutions – investment funds, pension funds and insurance companies – that held a large share of outstanding government bonds to participate in the auctions. From March to June 2020, five auctions were held at which the Croatian National Bank purchased government bonds with a total market value of 20.3 billion kuna, or 5.5 percent of GDP. The implementation of the bond purchase program altered the composition of the central bank's balance sheet (figure 7). In February 2020, before bond purchases were launched, the central bank's assets were almost entirely composed of international reserves. By July, however, the share of international reserves had dropped to 85%, while government bond holdings had reached 12% of the total assets. This was the result of both the reduction of reserves due to foreign exchange interventions

and the creation of a large government bond portfolio under the bond purchase program. Loans to credit institutions as a share of total central bank's assets had increased as well, mostly due to a large structural repo operation carried out in March to support favourable liquidity conditions.

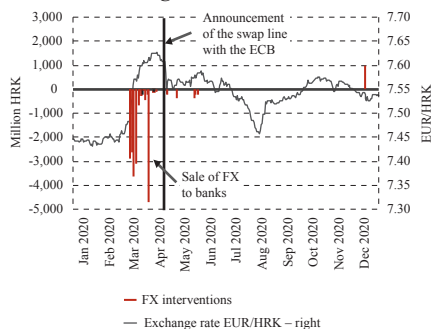
FIGURE 7

Composition of the Croatian National Bank's assets (percentage of total)

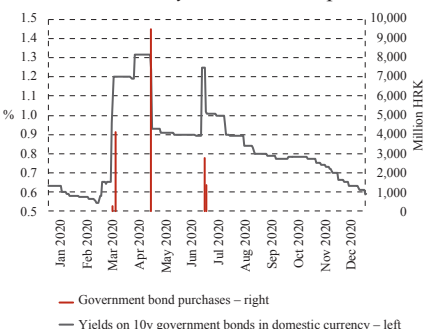


Source: Croatian National Bank.

The Croatian National Bank's actions proved to be sufficient to restore stability in the foreign exchange market and the sovereign debt market (figures 8 and 9). The liquidity support provided by the central bank to stabilize these two markets was abundant – foreign exchange interventions and bond purchases combined amounted to 11 percent of GDP. Half of the total effort was financed by international reserves. As already mentioned, the total amount of foreign exchange sold to banks to curb depreciation pressures was 2.7 billion euro, which was equal to 15 percent of net international reserves. Despite this sharp decline, reserves remained sufficient according to all reserve adequacy indicators (Lukinić Čardić, 2020). On the other hand, bond purchases were financed by money creation, as the central bank bought exclusively government bonds denominated in domestic currency. However, the fact that bond purchases were financed by printing money does not mean that the capacity of the Croatian National Bank to support the sovereign debt market was unlimited. Had the volume of bond purchases become too large, this could have triggered speculation against the currency, with negative implications for the financial system and the economy. Advanced countries' central banks, such as the Federal Reserve and the ECB, do not face such limitations when they intervene in their sovereign debt markets (Brkić, 2021).

FIGURE 8
Nominal exchange rate and FX interventions

Source: Croatian National Bank.

FIGURE 9
Government bond yields and bond purchases

Source: Croatian National Bank, Eurostat.

The credibility of the central bank's response to the COVID-19 crisis was enhanced by the signing of a precautionary swap line with the ECB in mid-April 2020. The swap line enabled the Croatian National Bank to obtain, if needed, up to 2 billion euro from the ECB in exchange for an equivalent amount of the Croatian kuna. Gaining access to the ECB's liquidity was very valuable at the time given the loss of reserves that had been sustained in the first weeks of the pandemic. Although the possibility of obtaining euro liquidity at the ECB was never used, the agreement on the swap line had a major positive impact on financial stability (CNB, 2021a). It sent a signal to the markets that the central bank had additional firepower at its disposal – on top of international reserves – to support the domestic currency and financial stability in general. The announcement of the swap line therefore contributed to the stabilization of the foreign exchange market in the second half of April (figure 8).

3.2 SUPPORT PROVIDED TO THE REAL ECONOMY

While monetary policy tools were applied to restore stability in key financial markets, the main objective of fiscal policy and prudential policy was to improve liquidity positions of businesses and households. In particular, the government adopted a sizeable fiscal stimulus package, while the central bank relaxed the loan classification rules, encouraging banks to offer moratoriums on loan repayments to distressed borrowers. The fiscal response to the COVID-19 crisis cannot be viewed in complete isolation from monetary policy actions. Specifically, had the central bank failed to curb tensions in the foreign exchange and sovereign debt markets, the government probably would not have been able to implement a strong fiscal stimulus without resorting to international financial assistance. In other words, a successful monetary policy response was a necessary precondition for an effective fiscal policy response. As shown in the previous chapter, the case in the euro area was the same: without a massive intervention by the ECB, some member states would have experienced a sharp increase in borrowing costs, which would have made it more difficult for them to cope with the large fiscal burden of the pandemic.

The fiscal stimulus package was large by international standards. Its size was justified given Croatia's strong reliance on services, particularly on the tourism

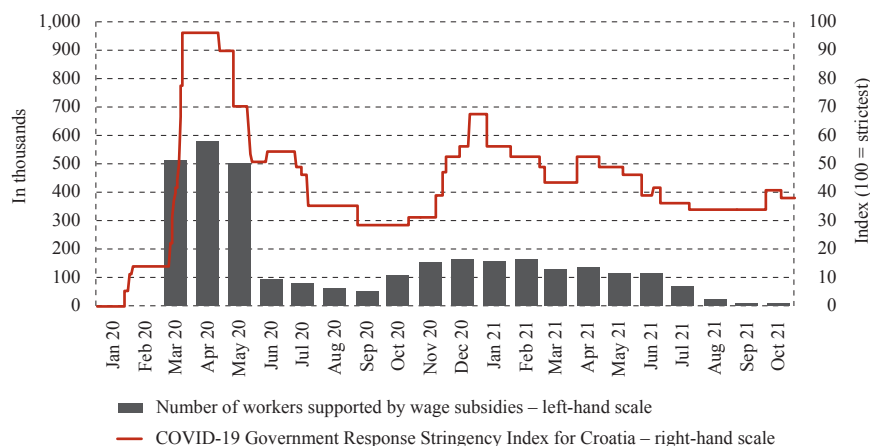
sector, which experienced a virtual standstill following the introduction of the lockdown. In addition, the large fiscal effort was motivated by the authorities' desire to prevent the pandemic crisis from turning into another protracted recession with massive job losses, such as the one that had occurred in 2009-2014. The fiscal stimulus, as in other EU member states, consisted of a large number of measures that were designed to help businesses – and, indirectly, households – overcome the liquidity squeeze caused by the lockdown. For example, businesses that had suffered a sharp drop in revenues were eligible for wage subsidies so that they could retain their employees, and were allowed to postpone the payment of taxes and social security contributions falling due during the lockdown (Government of the Republic of Croatia, 2021). Significant relief for businesses also resulted from the adjustment in the value added tax system, as companies were no longer obliged to pay VAT immediately after the invoice was issued, but after the customer paid the invoice. The government also made steps to improve companies' access to finance by issuing state guarantees and boosting the lending capacity of the Croatian Bank for Reconstruction and Development (HBOR) and the Croatian Agency for SMEs, Innovation and Investments (HAMAG-BICRO).

It is important to note that the composition of the fiscal stimulus package was not constant throughout the crisis. As time went on, the government fine-tuned some of the measures introduced previously to better respond to the needs of the beneficiaries. In particular, the first package of support measures announced in March 2020 included a tax deferral scheme, which was meant to be a key measure to alleviate liquidity difficulties in the corporate sector. In this way, companies affected by the lockdown were allowed to postpone the payment of direct taxes and social security contributions for the period when they were closed or operating at reduced capacity. However, as early as the following month, the government adopted a second fiscal support package, under which the tax deferral scheme was effectively replaced by tax relief. Specifically, lockdown-affected companies were exempted – partially or completely, depending on the size of the company and the severity of the fall in revenue it had suffered – from the obligation to pay taxes and contributions for the period when they were operating at reduced capacity. This was a very generous measure, as it constituted a permanent (solvency) support, in contrast to the tax deferral scheme, which would merely delay tax payments to a later date and thus provide only temporary (liquidity) support. Only a few EU member states decided to grant tax relief to businesses as part of their fiscal support programs, and Croatia stood out among them in terms of the total amount of tax relief granted (ESRB, 2021).

Of the many fiscal measures implemented, wage subsidies and tax relief had the strongest impact. In the period March-May 2020, when the first lockdown was in place, around 100,000 companies employing more than half a million workers, or 30 percent of total employment, were beneficiaries of wage subsidies (figure 10). The take-up of subsidies later decreased as the first wave waned and the restrictions were eased. The outbreak of the second wave of the pandemic in autumn 2020

brought another round of restrictions, and thus a renewed interest in wage subsidies. However, as the restrictions imposed in the second and subsequent waves were less severe than those introduced in the first wave, the number of workers covered by wage subsidies never again reached the levels recorded in spring 2020. Although wage subsidies generated substantial fiscal costs⁷ – close to 3 percent of GDP – their introduction was highly appropriate and justified as they shielded a large percentage of the workforce from losing their jobs. There is no doubt that wage subsidies were the main reason why the pandemic crisis, despite triggering a sharp recession, had a relatively mild impact on the labour market. The second key measure, tax relief, was granted to as many as 130,000 companies. The total amount of tax relief granted was lower than the total amount of wage subsidies, but still substantial – by April 2021, taxes and contributions written-off had reached 1.1 percent of GDP (Government of the Republic of Croatia, 2021).

FIGURE 10
Use of wage subsidies in Croatia during the pandemic



Sources: Croatian Employment Service (HZZ), Hale et al. (2020).

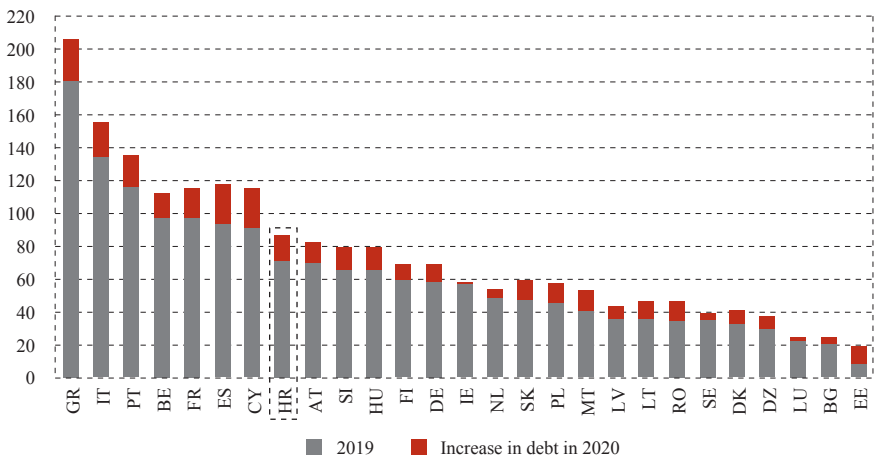
In the area of prudential policy, the Croatian National Bank took the necessary steps to facilitate the use of moratoriums on loan repayments. As explained in the previous chapter, given the specific nature of the pandemic crisis, it was reasonable for banks to be patient with clients whose debt servicing capacity was temporarily reduced due to cash-flow problems caused by the lockdown. To encourage banks to offer moratoriums to such clients, the central bank relaxed the loan classification rules, allowing banks to treat loans that had turned non-performing due to the pandemic as performing loans regardless of the temporary deterioration in their quality. Specifically, clients who had been classified as “A clients” at the end

⁷ According to the Croatian Employment Service, the total fiscal cost of job preservation measures implemented from the outbreak of the pandemic until October 2021 amounted to 11.8 billion kuna, or 2.9 percent of 2019 GDP.

of 2019 could still be classified as “A clients” even if they failed to meet their instalments for three consecutive months starting from April 2020. This adjustment was critical, as it enabled banks to grant loan repayment moratoriums to distressed borrowers without being required to set aside provisions for such loans. Given such a favourable regulatory treatment of moratoriums, banks were willing to grant moratoriums to virtually all borrowers who applied for them. As a result, a large number of borrowers experiencing cash-flow problems made use of this possibility during the pandemic crisis. By September 2020, the total value of loans under moratoriums had reached 14.9 percent of GDP⁸ (CNB, 2021a). The take-up was higher among companies than in the household sector. While more than a quarter of total corporate loans were covered by moratoriums, the same was the case with less than 10 percent of total loans to households. When looking at individual business sectors, it is not surprising that companies from the accommodation and food services sector relied the most on moratoriums – repayment of about 40 percent of their total debt to banks was either suspended or postponed (CNB, 2021b).

FIGURE 11

Government debt in EU member states (percentage of GDP)



Source: Eurostat.

It is safe to say that the above-mentioned fiscal and prudential measures delivered on their objectives. By preventing massive job losses and corporate bankruptcies and by mitigating the fall in disposable incomes, policy support measures helped preserve the foundations for a strong economic rebound that started as soon as the restrictions were eased. However, the generous policy response was anything but a free lunch. As in other EU member states, it came at the cost of a significant increase in government indebtedness (figure 11). By the end of 2020, the government debt-to-GDP ratio had reached 87 percent, which was 16 p.p. higher than a year earlier.

⁸ The positive impact of moratoriums on liquidity was, of course, much less than 14.9 percent of GDP because that figure reflects the total value of loans under moratoriums rather than the value of monthly loan instalments that were delayed due to moratoriums.

This effectively offset the entire progress in fiscal adjustment that had been made since 2015. Yet, despite a significant deterioration in fiscal indicators, Croatia maintained its investment-grade credit rating and enjoyed favourable financing costs throughout the pandemic. This suggests that there must have been some factors at play that helped Croatia remain resilient and credible in the face of the pandemic. These factors are identified and discussed in the next chapter.

4 HOW CROATIA MANAGED TO IMPLEMENT SUCH A STRONG POLICY RESPONSE

The economic relief program implemented in Croatia after the outbreak of the COVID-19 pandemic was considerably larger than that employed during the 2008-09 global financial crisis. At the height of the global financial crisis, Croatia did not have the capacity for a discretionary fiscal stimulus. In fact, confronted with a sudden deterioration in financing conditions, the government was forced to engage in pro-cyclical fiscal tightening in order to reduce the budget deficit and restore investor confidence. The tight fiscal policy, predictably, was an additional drag on domestic demand, contributing to a deep recession. In such an environment, monetary policy was “the only game in town” at that time. In late 2008 and early 2009, the Croatian National Bank released substantial buffers of foreign currency liquidity into the banking system to alleviate pressures on the currency, preserve financial stability and allow the government to refinance its maturing debts (Galac, 2010).

The overall policy mix was much more supportive during the COVID-19 crisis. Instead of becoming tighter as in the previous crisis, fiscal policy took a highly expansionary stance which, as explained above, was key to mitigating the economic fallout of the pandemic. Monetary policy responded even more forcefully than during the global financial crisis. The central bank not only provided the banking system with ample domestic and foreign currency liquidity, but it also successfully implemented a government bond purchase program for the first time ever.

In the remainder of this chapter, three groups of factors that enabled the Croatian authorities to provide such a strong economic stimulus are identified. First, sound initial macroeconomic fundamentals – with healthy public finances and a comfortable balance of payments position – allowed the authorities to temporarily step up public spending and release part of foreign exchange reserves without jeopardizing fiscal sustainability and the credibility of the currency peg to the euro. Second, the authorities’ capacity to provide economic stimulus was further boosted by Croatia’s EU membership. In particular, a steady inflow of EU funds ensured that the balance of payments position remained stable despite the sharp drop in exports, while the announcement of a future common EU recovery fund reduced concerns regarding the sustainability of the larger government debt. Furthermore, as Croatia was at the time close to joining ERM II, the Croatian National Bank managed to negotiate in April 2020 a currency swap line with the ECB, which had a major calming effect on the foreign exchange market in Croatia. Third, the fact that governments and central banks of the largest economies, such as the U.S. and

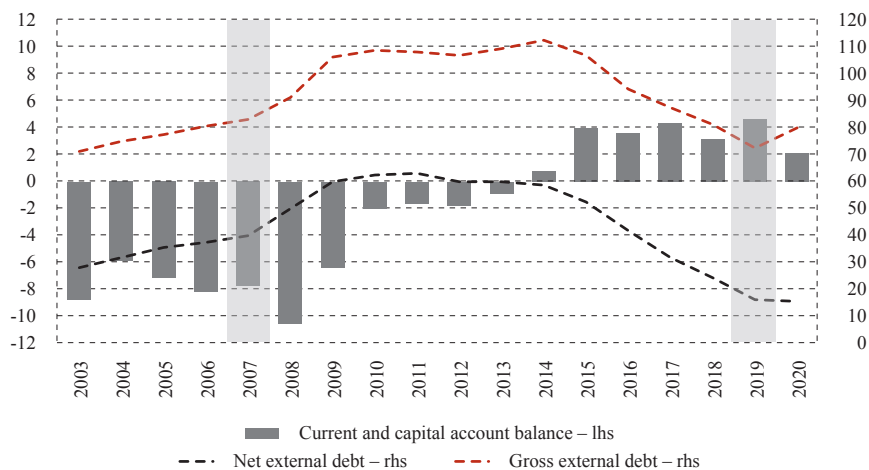
the euro area, managed to restore confidence in global financial markets very soon after the outbreak of the pandemic made it easier for emerging market countries such as Croatia to carry out their own stimulus programs.

4.1 SOUND INITIAL MACROECONOMIC FUNDAMENTALS

Croatia showed solid macroeconomic performance in the years leading up to the pandemic. The economy had been expanding continuously since 2015 on account of robust domestic demand and exports, particularly exports of services. In 2019, foreign exchange revenues of the tourism sector alone reached a record-high level of 10.5 billion euro, which was equal to 19 percent of GDP. Due to strong exports and a steady net inflow of transfers from the EU budget, Croatia recorded sizeable current and capital account surpluses (figure 12). These favourable “flow” indicators were mirrored by a substantial reduction in “stock” imbalances: between 2015 and 2019, gross and net external debt declined by 34 and 36 percentage points of GDP, respectively. The persistent surpluses in the current and capital account supported a rapid accumulation of foreign exchange reserves. By the end of 2019, gross reserves had reached a comfortable level of 18.6 billion euro, or 33 percent of GDP. As a result, on the eve of the pandemic, Croatia was able to satisfy all relevant benchmarks of reserve adequacy by a large margin (IMF, 2020b).

FIGURE 12

External vulnerability indicators in the period 2003-2020 (percentage of GDP)



Note: The shaded areas represent the year before the onset of the global financial crisis and the year before the outbreak of the COVID-19 pandemic.

Source: Eurostat.

In contrast, as shown in figure 12, Croatia’s external fundamentals were very weak in 2007, the year preceding the global financial crisis. In the pre-crisis period, Croatia was going through unsustainable economic expansion fuelled by external borrowing, which was reflected in a rapidly increasing debt and persistent current account deficits (Brkić and Šabić, 2014). Pronounced external imbalances

and excessive reliance on capital inflows had made the Croatian economy vulnerable to external shocks. This is the main reason why, after being hit by the global financial crisis, Croatia ended up in a long and deep recession.

The financial disruptions that occurred in 2020 illustrated how important it is for a small, euroized country like Croatia to build ample foreign exchange reserves in good times. Owing to large reserves, the Croatian National Bank was well equipped to counter the strong depreciation pressures that emerged with the onset of the pandemic in early March 2020. By the end of May, the central bank had sold a total of 2.7 billion euro to commercial banks to satisfy the increased demand for foreign currency. Although the size of the interventions carried out between March and May was unprecedented, the remaining stock of reserves was still more than sufficient to guarantee financial stability (Lukinić Čardić, 2020).

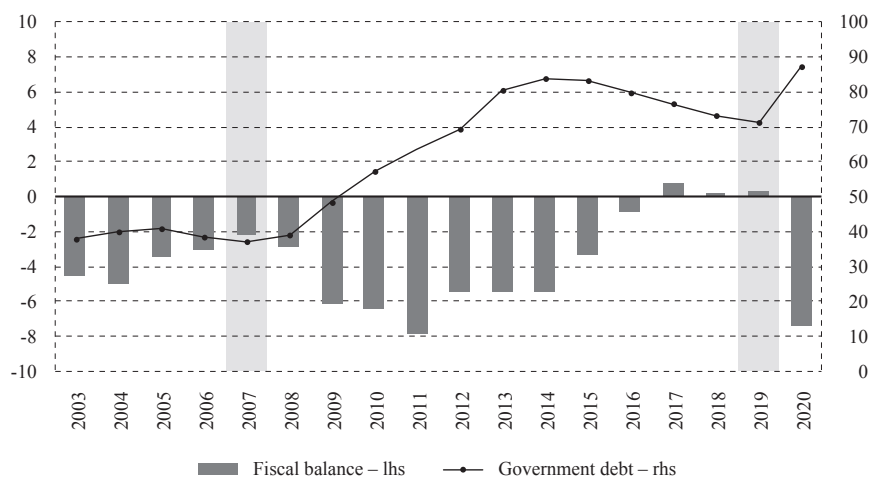
As mentioned earlier, the central bank not only intervened in the foreign exchange market to support the currency but it also made significant efforts to mitigate tensions in the market for kuna-denominated government bonds (CNB, 2021a; Arena et al., 2021). Although these two objectives were in part mutually conflicting – in the sense that foreign exchange interventions drained kuna liquidity from the financial system, while bond purchases injected it – the central bank managed to attain both of these objectives. Therefore, the pandemic crisis once again demonstrated that the Croatian National Bank possesses sufficient financial and institutional capacity to act as an effective crisis manager.⁹ The financial capacity for managing crises is guaranteed by the Croatian National Bank's sizeable foreign exchange reserves, while the institutional capacity is a reflection of its proven track record in maintaining financial stability, which serves as an anchor for expectations in crisis times. The decision by one of the major credit rating agencies to keep Croatia's rating unchanged following the outbreak of the pandemic was to a large extent based on the abundance of foreign exchange reserves and the credibility of the Croatian National Bank in safeguarding exchange rate stability (Fitch Ratings, 2020b).

On the other hand, as the pandemic crisis has clearly shown, maintaining financial stability is a much more difficult task for central banks in countries with low foreign exchange reserves and a troubled recent financial past. In such countries, when a crisis hits, depreciation expectations tend to be so strong that they typically become self-fulfilling, leading to a depletion of reserves and an actual depreciation of the currency. A case in point here is Turkey, a country with modest reserves, weak fundamentals and a history of recurrent financial crises. Turkey's central bank took a highly expansionary stance in 2020 to cushion the impact of the pandemic crisis, which indeed allowed Turkey to avoid a recession, but at the expense of a sharp depreciation of the lira (Cakmakli et al., 2020).

⁹ The Croatian National Bank was praised in the past for successfully alleviating the impact of the 2008-09 global financial crisis on the Croatian economy (IMF, 2009).

FIGURE 13

Fiscal balance and government debt in the period 2003-2020 (percentage of GDP)



Note: The shaded areas represent the year before the onset of the global financial crisis and the year before the outbreak of the COVID-19 pandemic.

Sources: Croatia Bureau of Statistics, Croatian National Bank.

In addition to having a strong balance of payments position, Croatia entered the pandemic crisis with resilient public finances. Despite a larger initial level of government debt, it is safe to say that public finances were healthier on the eve of the COVID-19 pandemic than they were before the start of the 2008-09 global financial crisis. There are three main arguments in support of this claim. First, due to prudent fiscal policy and positive nominal GDP growth, Croatia's fiscal balance was in surplus in three consecutive years preceding the pandemic crisis, while the debt-to-GDP ratio was declining rapidly (figure 13). The solid fiscal performance coupled with the reduction of external imbalances enabled Croatia to regain its investment-grade credit rating and enjoy very favourable financing conditions (CNB, 2020a). In contrast, in the run-up to the global financial crisis, Croatia reported fiscal deficits although the economy was overheating. Second, the maturity structure of government debt was more favourable at the onset of the pandemic crisis. This was the result of the authorities' efforts to lock in favourable financing conditions by issuing bonds with longer maturities (Government of the Republic of Croatia, 2021)¹⁰. These actions have not only secured lower debt servicing costs for the years to come, but they have also made Croatia less exposed to refinancing risk. Finally, risks for public finances stemming from general macroeconomic developments were less severe on the eve of the pandemic than they were before the global financial crisis. Due to a healthy initial state of the economy, Croatia was able to recover quickly from the pandemic crisis, so the deterioration in public finances, although very sharp, was short-lived. By contrast, given

¹⁰ The share of debt with a maturity longer than 10 years in total government debt increased from 40% at the end of 2015 to 50% at the end of 2019.

the high vulnerability of the Croatian economy at the time, the global financial crisis of 2008-09 pushed Croatia into a deep and long recession that was mirrored by persistently high fiscal deficits and a rapidly increasing debt (figure 13).

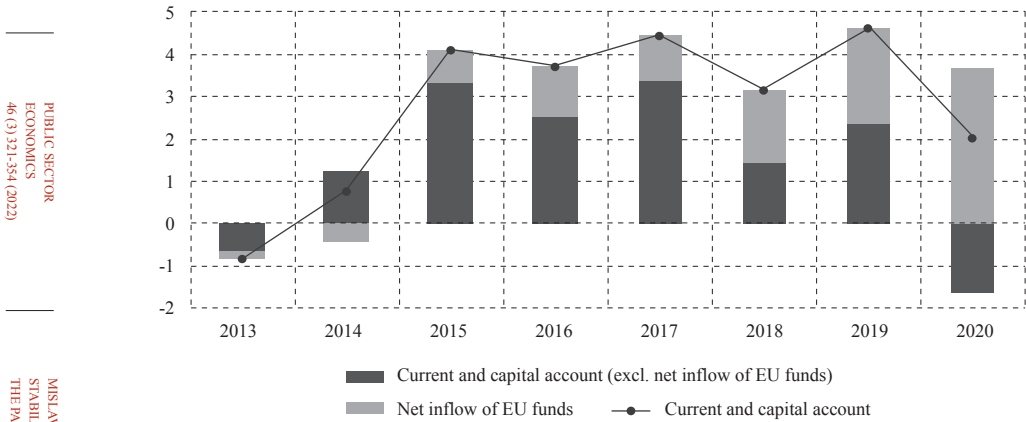
4.2 EU MEMBERSHIP

There is no doubt that the improvement in macroeconomic fundamentals in the years leading up to the pandemic was to a large extent the result of Croatia's EU membership. Since its accession to the EU in July 2013, Croatia has reaped substantial macroeconomic benefits in terms of free access to the common market and a sizeable net inflow of EU funds. These benefits have provided a strong impetus to economic growth and the balance of payments, thus enhancing Croatia's resilience to external shocks. In particular, EU accession introduced a simplified regime for cross-border trade with the EU, which has made it easier for Croatian exporters to place their products on the common market. As noted by Lukinić Čardić and Šlebaj (2021), in the first few years after joining the EU, Croatia recorded rates of growth of merchandise exports higher than its peers from Central and Eastern Europe. Indeed, robust export growth facilitated by EU accession was a key driver of economic recovery in the aftermath of the global financial crisis.

The impact of EU funds on the balance of payments position has been significant. In the first two years, net inflow of EU funds was actually negative because payments to the EU budget exceeded the absorption of EU funds. However, as the public administration's capacity to manage EU funds improved over time, annual net inflows gradually increased, resulting in comfortable current and capital account surpluses (figure 14). The inflows peaked in 2020 when the disbursement of EU funds intensified in the entire EU due to the relaxation of disbursement rules, which was part of the EU's common response to the pandemic crisis. Owing to the significant inflow of EU funds, Croatia managed to achieve a current and capital account surplus that year, despite a 54 percent drop in net income from tourism¹¹. Therefore, it is safe to say that the balance of payments position would have been much less favourable before and during the pandemic if Croatia had not been a member state of the EU.

¹¹ The drop in tourism revenues, although very sharp, was less pronounced than in some other Mediterranean EU member states, such as Greece, Spain, Malta and Cyprus, which recorded a drop in net income from tourism in excess of 75 percent. The relatively solid performance of the Croatian tourism sector in 2020 can be explained by some of its specific characteristics, which are in normal circumstances regarded as structural weaknesses (CNB, 2020b). One of these characteristics is Croatia's relatively low reliance on guests arriving by air. As the pandemic affected air transport much more than road transport, Croatia managed to perform better than countries where foreign guests arrive primarily by air. Another specific characteristic that proved beneficial in 2020 is the high seasonality of Croatian tourism: as almost three quarters of total nights spent are usually realized in the summer months, Croatia was – compared to countries where the tourist season lasts longer – relatively less affected by the restrictions on international travel that were in force in the spring and autumn of 2020.

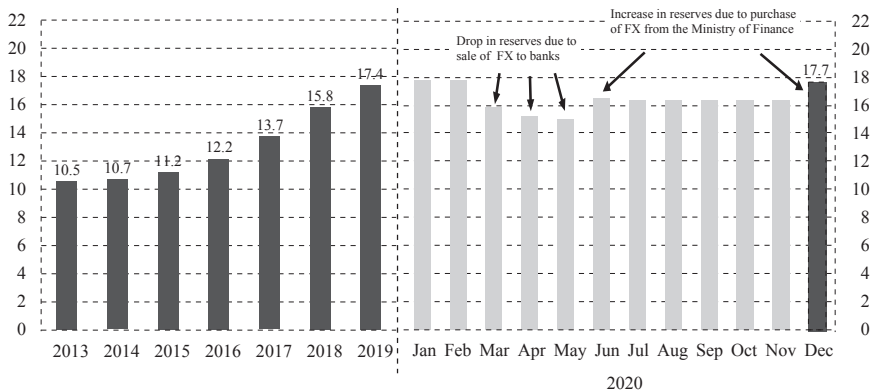
FIGURE 14
Impact of EU funds on the balance of payments (percentage of GDP)



Source: Croatian National Bank.

The same conclusion applies to foreign exchange reserves. By allowing Croatia to enjoy consistently high current and capital account surpluses, net inflow of EU funds supported the rapid accumulation of reserves in the years before the pandemic. Importantly, the sizeable net inflow of EU funds in 2020, coupled with the proceeds from the government’s international bond issue in June that year, allowed the central bank to quickly replenish its partly depleted reserves by purchasing foreign exchange from the Ministry of Finance (CNB, 2021a). Net foreign exchange reserves stood at 17.7 billion euro in December 2020, which was even higher than at the end of 2019 (figure 15). This was remarkable given that as much as 2.7 billion euro of reserves had been sold to banks in the first half of 2020 in an effort to preserve the stability of the currency. Such a rapid recovery of foreign exchange reserves would not have been possible without the large inflow of EU funds.

FIGURE 15
Net foreign exchange reserves, 2013-2020 (EUR bn)



Source: Croatian National Bank.

Finally, EU membership provided Croatia with access to emergency financing, which helped ease pressures on the currency and reduce concerns about the pandemic-related increase in government debt. On the one hand, given that Croatia was at the onset of the pandemic an EU member state with a clear prospect of joining ERM II and adopting the euro, the Croatian National Bank was in a position to negotiate a currency swap line with the ECB worth 2 billion euro. As explained earlier, the setting-up of the swap line in mid-April 2020 sent a signal to the financial markets that the central bank had additional euro liquidity at its disposal to support the currency in case of need. Pressures on the currency subsided soon after the announcement of the arrangement with the ECB, so the swap line never had to be drawn upon (CNB, 2021a). On the other hand, as a member state of the EU, Croatia benefited from positive confidence effects generated by the decision to create a common EU recovery facility – Next Generation EU. As the announcement of the recovery facility sparked optimism about member states' ability to recover from the pandemic crisis, concerns about the sustainability of their heightened debt levels waned. The expected positive impact of the recovery facility was among the factors that supported Croatia's investment-grade credit rating during the pandemic (Fitch Ratings, 2020a).

4.3 OTHER FACTORS

Croatia's capacity to deal with the pandemic crisis was strengthened also by some external factors that were beneficial to other emerging market economies as well. One of these positive common factors was the quick normalization of global liquidity conditions following the swift policy response by leading central banks. Drawing on the experience with unconventional monetary policy tools gained during and after the 2008-09 global financial crisis, the Federal Reserve, the ECB and other leading central banks responded forcefully to the outbreak of the pandemic in March 2020 by expanding the size of their liquidity-providing operations and launching large-scale asset purchase programs. Announcements of these monetary interventions brought a quick rebound in investor confidence, with positive spill over effects on emerging markets (IMF, 2020a). In particular, as global risk appetite recovered due to expectations that major central banks would be successful in cushioning the impact of the pandemic, emerging market economies with sound fundamentals, including Croatia, enjoyed strong investor demand when placing their bonds in international financial markets.

Another positive common factor was the ability of emerging market central banks to carry out their own asset purchase programs without being penalized by financial markets. Before the pandemic, it was believed that asset purchase programs were not a suitable policy tool for emerging market central banks because – due to their insufficient institutional credibility – asset purchases could feed depreciation pressures and therefore become self-defeating. However, in early 2020, confronted with the massive COVID-19 shock, a number of emerging market central banks, including the Croatian National Bank, decided to take their chances and launch asset purchase programs for the first time ever. Surprisingly, in most of

these countries asset purchases were highly effective in stabilizing bond markets, with virtually no side effects in terms of currency depreciations or higher inflation (Sever et al., 2020; Arena et al., 2021).

The explanation of the success of asset purchase programs in emerging market economies consists of three parts. First, since advanced economies relied extensively on asset purchases during and after the 2008-09 global financial crisis, a view seems to have formed that it is legitimate for central banks to act as buyers of last resort in sovereign debt markets in times of stress. In other words, following the global financial crisis, asset purchases have gradually become part of the standard toolkit of central banks. This partly explains why financial markets did not react negatively to the announcements of asset purchases by emerging market central banks. Second, given the prolonged low interest rate environment – further supported by additional monetary stimulus from major central banks starting from March 2020 – there were few incentives for capital to leave emerging markets that had started conducting asset purchases (Arena et al., 2021). Emerging market economies would have found it much harder to avoid currency depreciation had interest rates in advanced economies been higher at the time. Finally, the fact that the crisis was caused by a global health emergency rather than by country-specific vulnerabilities increased the likelihood that market participants would take a positive view of these central bank interventions, particularly if a country's macroeconomic fundamentals had been sound before the start of the pandemic.

The credit rating agencies' flexible treatment of the pandemic-induced fiscal deficits was yet another external factor that made this crisis easier to deal with. During the pandemic crisis, credit ratings agencies seemed to have been more tolerant of deteriorating public finances than they had been previously. In particular, while during the 2010-12 European sovereign debt crisis a number of EU member states suffered a rating downgrade, there were virtually no sovereign rating downgrades in the EU during the pandemic crisis despite the significant increase in debt levels (Arnal et al., 2021). Again, such an approach by credit rating agencies was reasonable given the peculiar nature of the pandemic crisis, which was a genuinely external shock. Financing a large fiscal deficit would have been more difficult for Croatia or any other country if its credit rating had been downgraded, particularly if it had lost its investment grade status because of the downgrade.

To sum up, there were a number of factors, both country-specific and common, that enabled the Croatian authorities to respond aggressively to limit the economic fallout of the COVID-19 pandemic. Croatia entered the crisis equipped with sound macroeconomic fundamentals and easy access to EU financing, while also indirectly benefiting from significant policy efforts taken at the global level, more flexible credit rating agencies and the fact that central bank interventions in sovereign debt markets were considered legitimate by credit rating agencies and financial markets. These positive factors did not exist at the onset of the 2008-09 global financial crisis, so the Croatian authorities' overall policy response to that crisis was much more limited in size and scope.

5 CONCLUSION

The outbreak of the COVID-19 pandemic in March 2020 pushed the global economy into a short, but severe recession. In an attempt to slow down the spread of the virus and save lives, countries all over the world decided to impose strict nationwide lockdowns. While necessary at the time, strict lockdowns were highly disruptive, as they brought a sudden stop to economic activity in some sectors.

In order to contain the economic fallout of the pandemic, central banks and governments of advanced countries intervened promptly and decisively. Central banks resorted to a range of conventional and unconventional tools, including government bond purchase programs and enhanced liquidity provision. On the fiscal front, governments carried out large-scale economic relief programs, designed to provide financial support to companies and households negatively affected by the lockdown. Prudential policy was also used in a counter-cyclical manner: central banks and other regulators decided to relax certain prudential rules to encourage financial institutions to keep providing credit to their clients despite the sharp increase in default rates.

The economic policy response in Croatia was, in terms of its size and scope, comparable to policy responses in major advanced economies. Given Croatia's heavy reliance on tourism, the negative impact of the pandemic on economic activity was more pronounced than in most other EU member states. The deteriorating economic outlook weighed on the financial markets, particularly the foreign exchange market and the sovereign debt market. In order to counter depreciation pressures on the kuna, the Croatian National Bank intervened strongly in the foreign exchange market, while at the same time acting as buyer of last resort in the sovereign debt market. Although these two objectives were in part mutually conflicting – in the sense that foreign exchange interventions drained kuna liquidity from the financial system, while bond purchases injected it – the central bank managed to attain both of these objectives. The liquidity support provided by the central bank to stabilize these two markets was sizeable: the foreign exchange interventions and bond purchases combined amounted to 11 percent of GDP.

While monetary policy tools were applied to restore stability in key financial markets, the main objective of fiscal policy and prudential policy was to improve liquidity positions of companies and households. The fiscal stimulus consisted of a large number of measures, among which wage subsidies and tax relief were the most widely used and therefore had the strongest positive impact on the economy. In the area of prudential policy, the Croatian National Bank relaxed the loan classification rules, enabling banks to treat loans that had turned non-performing due to the pandemic as performing loans regardless of the temporary deterioration in their quality. This adjustment was critical, as it enabled banks to grant loan repayment moratoriums to distressed borrowers without being required to set aside provisions for such loans.

The policy response to the pandemic crisis was considerably larger than the policy response to the 2008-09 global financial crisis. There were essentially three groups

of factors which enabled the Croatian authorities to play such an active role this time. First, Croatia's sound initial macroeconomic fundamentals allowed the authorities to expand public spending and release part of the foreign exchange reserves without jeopardizing fiscal sustainability and exchange rate stability. In the years leading up to the pandemic, Croatia showed solid macroeconomic performance, as evidenced by robust growth, stable public finances and a strong balance of payments coupled with abundant foreign exchange reserves. Owing to sound fundamentals, the authorities had the necessary capacity and credibility to support financial markets and the economy once the pandemic began. In contrast, on the eve of the 2008-09 global financial crisis, Croatia's fundamentals were very weak, significantly constraining the authorities' capacity to provide relief.

Second, managing the pandemic crisis was made easier by Croatia's EU membership. Since 2015, sizeable net inflows of EU funds have been a major driver of Croatia's persistent current and capital account surpluses and have therefore supported the rapid accumulation of foreign exchange reserves. For example, the sizeable inflow of EU funds in the second half of 2020 allowed the Croatian National Bank to quickly replenish its reserves after 2.7 billion euro of reserves had been spent in the period March-May 2020 to support the kuna. Furthermore, given that Croatia was at the time an EU member state with a clear prospect of joining ERM II, the Croatian National Bank was able to negotiate a currency swap line with the ECB worth 2 billion euro. In addition, EU membership enabled Croatia to benefit in mid-2020 from the positive confidence effects generated by the decision to create a common EU recovery facility – the Next Generation EU instrument worth more than 800 billion euro.

Third, Croatia was positively affected by some external factors that were beneficial to other emerging market economies as well. One of these positive common factors was the quick normalization of global liquidity conditions following the swift policy response by leading central banks. Another positive common factor was the ability of central banks of emerging market economies to carry out asset purchase programs for the first time ever without being penalized by financial markets. The Croatian National Bank was one of them. Their experience provides an important lesson for the future, as it shows that unconventional monetary policy tools can be effectively used by emerging market economies as well, provided they have previously demonstrated the ability to maintain macroeconomic stability. Finally, during the pandemic crisis, credit ratings agencies seemed to have been more tolerant of deteriorating public finances than they had been in the past. There were virtually no sovereign rating downgrades in the EU during the pandemic crisis, despite the sharp increase in debt levels. Financing the large pandemic-induced deficits would certainly have been more difficult for member states had their credit ratings been downgraded.

Hence, the capacity of the Croatian authorities to maintain macroeconomic stability during the pandemic crisis was strengthened by a number of factors, both

common and country-specific. Among them, Croatia's sound initial macroeconomic fundamentals seemed to have been the most critical. Had the fundamentals been poor in early 2020, the overall scale of policy support during the pandemic would have been much lower, while the Croatian National Bank would certainly not have been able to negotiate a currency swap line with the ECB. The experience of the pandemic crisis is therefore another reminder of how important it is for a small, highly euroized country to build policy space in good times.

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