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FINANCE

EFFECT OF CURRENCY DEVALUATION ON PERFORMANCE OF BANKING SECTOR IN CROATIA

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ABSTRACT

Purpose of the study: The study sought to examine the effect of currency devaluation on performance of banking sector in Croatia.

Research Methodology: The study relied upon the findings of the previous studies to make inferences. The study was conducted out thoroughly by examining the previous studies rather than physical investigations.

Findings: Currency devaluation reduces the performance of the local business while increasing the performance of the external businesses. Currency devaluation increases the prices of imports while reducing the market prices of exports. The study noted that currency devaluation weakens the confidence of the investors, thus reducing bank opportunities to obtain resources from those investors. The exports are relatively cheaper to foreign customers and on the other hand, imports are more expensive. When exports are high and the imports are low it makes the aggregate demand increase by the assumption that demand is relatively elastic, in normal situations higher aggregate demand is probably to cause higher real GDP and inflation. The increase of the aggregate demand can increase demand-pull inflation.

Conclusions: The study concluded there is a statistically significant and negative relationship between currency devaluation and performance. The currency devaluation makes the imports very expensive and exports cheap and this lowers the assurance of the investors. Investors are not willing to invest in countries that are having lower returns on exports. Devaluation decreases the hope of people in terms of deposits in the domestic currency.

Recommendations: The study recommended that currency devaluation needs to be avoided by the countries. Counties need to look for alternative strategies that could increase the level of exports rather than currency devaluation. The currency devaluation was found to have a negative effect on the entire economy. Investors are not willing to go to countries with low returns of the exports and this will drive away investors. It is also recommended that if the government wants to devalue the currency to achieve the monetary policy, it should also raise short-term interest rate under their control. The motive to raise the short-term interest is to make the domestic assets more attractive and higher interest rates should strengthen the currency.

Keywords: *Currency devaluation, performance, banking sector, Croatia*

1.0 BACKGROUND OF THE STUDY

The banking sector is fundamental in ensuring financial stability in an economy (Inaoka, Ninomiya, Taniguchi, Shimizu, & Takayasu, 2018). Banks act as the intermediaries between the borrowers and depositors and also government uses banks to reinforce the monetary policy. Banks act like middlemen between financial savings and financial investment (Gurley, & Shaw, 2020). Financial intermediaries and the saving-investment process institutions are categorized into the following categories; retail banks, industrial or company banks and investment banks. In most countries, central banks are the ones that manage the procedures of the banks (Norman, Shaw & Speight, 2019). The history of interbank settlement arrangements: exploring central banks' role in the payment system. One of the most important roles of banks is to moderate the transfer of money from creditors to borrowers, from buyers to sellers (Klapper, 2021). The financial industry plays an important duty thus revealing remarkable progression through the economic climate, introduction and implementation of monetary policy (Lucas & Stokey, 2012). The financial sector is the main facility for maintaining credit relationships for this reason this industry performs an essential role in the development of a nationwide economy. (Lavrushin, Valentseva & Fetisov, 2017). Thus, the performance of these institutions is deemed important for the economic growth of a nation. The currency devaluation is deemed to have a significant effect on the performance of the banks (Yiheyis, 2019; Lizondo & Montiel, 2018; Umoru & Oseme, 2019).

The performance is the difference between the costs and revenue. In most cases, the performance of the companies can be determined through financial and non-financial indicators (Dietrich & Wanzenried, 2019). The financial indicators include net profit margin ratio, return on assets and return on equity while non-financial indicators include growth, customer base and employee retention among others. The most performing companies can absorb the most qualified people in the market to strengthen efficiency (Alper & Anbar, 2021). Performance is the only reason that will make companies be sustainable. The act of performance needs to be taken with much consideration and institutions to develop the most effective strategies to increase the performance (Ahmedov (2017). The performance of the companies is expected to be determined by various factors and thus the study sought to examine the effect of currency devaluation on performance.

Currency devaluation is a deliberate downward adjustment of the value of a country's currency against another currency (Tanzi, 2020). A devaluation is a tool used by monetary authorities to improve the country's trade balance by boosting exports at moments when the trade deficit may become a problem for the economy. Unless the trading account is balanced, the idea is that devaluation changes the disbursement of income of the country leading to income change from employees to capital loss and from the private sector to the government (Eisner, 2019). By shifting the income to the high savers, devaluation can hence bring about by over savings over planned investment, therefore, leading to a decrease in real output and imports (Krugman & Taylor, 2021). In cases where there is an initial trade deficit, the contractionary effects start from the fact that, due to devaluation, the price change of traded commodities reduces the country's real income immediately while it increases it abroad.

When exports are high and the imports are low it makes the aggregate demand increase by the assumption that demand is relatively elastic, in normal situations higher aggregate demand is probably to cause higher real GDP and inflation. High inflation emerges according to fiscal inequalities, which paves a method for dollarization and also ultimately to currency replacement in the financial industry. Inflation is likely to occur following a devaluation because imports are more expensive and this can cause cost-push inflation. Moreover, the increase of the aggregate

demand can increase demand-pull inflation. With exports becoming cheaper, manufacturers may have less incentive to cut costs and become more efficient. Consequently, there will be higher exports and lower imports, which will reduce the current account deficit. The study noted that if demand is price inelastic, then a fall in the price of exports will lead to only a small rise in quantity. Therefore, the value of exports may fall.

In 2008, the world economic situation began in the mortgage market in the United States (Kotz, 2017). The explosion in the US economic market impacted the marketplaces of the European Union (EU), Japan and China and many other economies (Lipton, Sachs, Fischer & Kornai, (2020). When the worldwide situation began-by completion of 2008, the foreign exchange reserves were minimized from 6.1 to 5.2 billion US dollars by the end of 2016 (Brooks & Wohlforth, 2018). Horton et al. (2016) reviewed decline effects on the financial round in Central Asia and also Caucasian countries, the results also revealed that decrease can detrimentally impact bank equilibriums as well as a heavily dollarized economy. The empirical outcomes showed that any boost in debt burden in local currency better makes complex the financial debt solutions for borrowers in international money. This can increase economic risks and the rates of interest of non-performing loans likewise decline rewards for providing the hence unfavorable impact of these boosts on the financial institution profitability. Ibrahimov (2019) checked the result of decline on the financial sector of Croatia by panel data regression evaluation for the period of 2012-2015 and noted that devaluation impacts the banking sector detrimentally

The currency devaluation occurs in a free-floating currency exchange rate regime (Aleto, 2018). Devaluation is connected to two reasons; termination or decrease of foreign trade balance and eliminating incongruities between internal and external costs. During devaluation, the export rates in foreign currency are significantly lowered. The external demand for goods in the nation can be growing due to reduced export prices. (Prebisch, 2019). Among the goals of decline is to eliminate the balance of payment deficit. If a steady level of domestic prices can be kept, the decline can give affirmative results (Abdullayeva, 2017). Devaluation decreases the genuine supply level of money which makes it possible for a too much need for cash (Frankel, 2018). Thus, conducting the study is potent to examine the influence of the currency devaluation on the performance of the banking sector in Croatia.

1.0 LITERATURE REVIEW

Gylfason and Risager (2019) conducted a study to examine the effect of currency devaluation on performance among the commercial banks in Croatia. The study utilized a descriptive research design. The research instruments included questionnaires and an interview guide. The target population entailed 27 commercial banks based in Zagreb. The research findings indicated that currency devaluation affects the performance of the bank negatively. The study noted that currency devaluation weakens the confidence of the investors, thus reducing bank opportunities to obtain resources from those investors. The study concluded that currency devaluation is negatively related to performance. The exports are relatively cheaper to foreign customers and on the other hand imports are more expensive. Research conducted by Alper and Anbar (2011) reported that return on asset is negatively influenced by currency devaluation.

Dietrich and Wanzenried (2019) tested the effect of currency devaluation on the performance of banks in Switzerland. The study was conducted between 2005 and 2017. The results of the study showed that currency devaluation hurts the performance of the banks. A comparable research study carried out by Habtamu (2012) showed that currency devaluation negatively affects performance. The study noted that devaluation is likely to cause inflation since imports will be more expensive; the aggregate will increase hence causing demand-pull inflation and because exporters or firms have less incentive to cut cost since they can only rely on the devaluation to improve competitiveness thereby in long term devaluation may lead to lower productivity because of the decline in incentives (Alemu & Jin-sang, 2020).

Large and rapid devaluation may scare off foreign investors; it makes investors less willing to hold government debt because the devaluation is effectively reducing the real value of their holdings (Mishkin, 2018). If consumers have debts e.g., mortgages in foreign currency, after devaluation they will see a sharp rise in the cost of their debt repayments. This occurred in Hungary when many had taken out a mortgage in foreign currency and after the devaluation, it became very expensive to pay off Euro-dominated mortgages. Also, it depends on the state of the business cycle whereby if it is within recession devaluation can help boost growth without causing inflation but during a boom, inflation is likely to occur (Lowe, 2020). Furthermore, it depends with the type of economy; In a developing economy which relies on import of raw materials may experience serious cost from devaluation which makes basic goods and food more expensive (Headey & Fan, 2018).

Alper and Anbar (2021) conducted a study on bank-specific and macroeconomic determinants of commercial bank profitability in Turkey. The study utilized a cross research design. The research instruments included questionnaires and an interview guide. The target population entailed 27 commercial banks based in Turkey. The research findings indicated that currency devaluation affects the performance of the bank negatively. The study noted that currency devaluation weakens the confidence of the investors, thus reducing bank opportunities to obtain resources from those investors. The study concluded that currency devaluation is negatively related to performance. The exports are relatively cheaper to foreign customers and on the other hand, imports are more expensive.

The currency devaluation affects the entire factors of production negatively (Mishkin, 2020). Unless the professional account is well balanced initially, the concept is that decline changes the distribution of income of the nation causing earnings to shift from workers to resources loss and also from the private sector to the federal government (Eisner, 2019). By moving the earnings to the high savers, the decline can for this reason bring about by excess financial savings over-organized investment for that reason resulting in a reduction in real output as well as imports (Krugman & Taylor, 2021). In cases where there is a preliminary trade deficit the contractionary impacts start from the truths that, due to decline, a rate change of traded assets lowers the nation's actual earnings quickly while it enhances it abroad. The various networks where contractionary results on accumulated demand may turn around the expansionary results of the expenses switching subsequent devaluation (Yiheyis, 2019).

According to Ahmedov (2017), the stressful decline shock in 2015 substantiated a distinct decrease in lending, a quick rise in the number of issue loans and consistent negative failures in the financial industry of Croatia. Decrease created the wear and tear of the bank's annual report and also increased foreign currency debts. Regular decrease of the currency and high volatility in currency exchange rate caused a boost of foreign money down payments, while the high rising cost of living

subsequently and dollarizes bank loans: comparable association amongst inflation decrease and dollarization (Goujon, 2020). He concluded that money decline in developing countries is common among the ultimate sequences of high and variable rates of the rising cost of living. When exports are high and the imports are low it makes the aggregate demand increase by the assumption that demand is relatively elastic, in normal situations higher aggregate demand is probably to cause higher real GDP and inflation. High inflation emerges according to fiscal inequalities, which paves a method for dollarization and also ultimately to currency replacement in the financial industry.

A study conducted by Headey and Fan (2018) indicated that currency devaluation negatively affects the performance of banks. The study noted that currency devaluation makes exports more competitive and appear cheaper to foreigners. As a result, the exported goods will be cheap in the foreign market and this increases the sales. However, in some cases, the imports become expensive and this hurts the economy. Devydenko (2021) estimated the Arrelano-Bover/Blundell-Bond linear dynamic panel data approach for gauging the performance of Ukrainian financial institutions from 2005 to 2019. The results showed that the currency exchange rate devaluation highlights favorable effects on income. This situation is associated with financial institution manager's predictions worrying about currency exchange rate variations. Consequently, this variable can cause a rise in benefit from procedures with foreign currency. The empirical results showed that the efficiency of Ukrainian banks is characterized by the low quality of finances for this reason Ukrainian banks benefited from the currency decrease, although a tiny profit from the important financial solutions.

A study investigated by Aghion, Bacchetta and Banerjee (2021) reported that devaluation means imports, such as petrol, food and raw materials will become more expensive. This will reduce the demand for imports. In cases where the imports of goods and services are expensive people will not be attracted to invest in those countries because the returns will be low. Instead, many will invest in countries that are having high returns. Horton et al. (2016) reviewed the impacts of currency devaluation on performance. The results of the study showed that devaluation hurts a country. Inflation is likely to occur following a devaluation because imports are more expensive and this can cause cost-push inflation. Moreover, the increase of the aggregate demand can increase demand-pull inflation. With exports becoming cheaper, manufacturers may have less incentive to cut costs and become more efficient. Therefore, over time, costs may increase. Ibrahimov (2019) checked the result of the decline in the financial sector of Croatia by panel data regression evaluation for the period of 2012-2015. He assessed the relationship between oil prices and devaluation in the banking market. According to the findings, bank success is affirmatively marked by oil rates as an external macroeconomic element. Subsequently, devaluation affects the banking sector detrimentally.

The research study by Hasanov, Bayramli and Al-Musehel (2017) indicated that currency devaluation makes exports more competitive and imports more expensive. Consequently, there will be higher exports and lower imports, which will reduce the current account deficit. The study noted that if demand is price inelastic, then a fall in the price of exports will lead to only a small rise in quantity. Therefore, the value of exports may fall. An improvement in the current account on the balance of payments depends upon the Marshall Lerner condition and the elasticity of demand for exports and imports. Mirzeyev (2017) underscored that the twofold devaluation of Azerbaijan Manat in 2015 instantaneously prompted massive credit report losses, currency exposure for local financial institutions and crisis for banks whereby this dilemma has been observed with substantial withdrawals of their funds by worldwide investors in Azerbaijan.

A study was conducted by Davydenko (2021) to examine the factors that influence the profitability of banks in Ukraine. The study collected the data in a period of five years from 2015 to 2019. The outcome of the study indicated that currency devaluation negatively affects profitability. The currency devaluation makes the imports very expensive and exports cheap and this lowers the trust of the investors. Investors are not willing to invest in countries that are having lower returns on exports. As a result, most businesses are established in other countries and this impacts cuts across the entire economy. The currency devaluation can also lead to inflation and this will make the cost of living high. In countries with a high cost of living, fewer investors will be willing to come.

3.0 RESEARCH METHODOLOGY

The study relied upon the findings of the previous studies to make inferences. The study was conducted out thoroughly by examining the previous studies rather than physical investigations. This type of study's importance is that secondary data is easily accessible and saves time and cost. The desktop research supported the researcher's understanding of the research problem and conclusions were based on the preceding researchers' opinions.

4.0 CONCLUSION

The study concluded that currency devaluation is negatively associated with performance. Based on the reviewed literature, it was noted that the currency devaluation increases the prices of the imports while reducing the market prices of the exports. The study noted that currency devaluation weakens the confidence of the investors, thus reducing bank opportunities to obtain resources from those investors. The exports are relatively cheaper to foreign customers and on the other hand, imports are more expensive. When exports are high and the imports are low it makes the aggregate demand increase by the assumption that demand is relatively elastic, in normal situations higher aggregate demand is probably to cause higher real GDP and inflation. High inflation emerges according to fiscal inequalities, which paves a method for dollarization and also ultimately to currency replacement in the financial industry. Inflation is likely to occur following a devaluation because imports are more expensive and this can cause cost-push inflation. Moreover, the increase of the aggregate demand can increase demand-pull inflation. With exports becoming cheaper, manufacturers may have less incentive to cut costs and become more efficient. Consequently, there will be higher exports and lower imports, which will reduce the current account deficit. The study noted that if demand is price inelastic, then a fall in the price of exports will lead to only a small rise in quantity. Therefore, the value of exports may fall.

The currency devaluation makes the imports very expensive and exports cheap and this lowers the assurance of the investors. Investors are not willing to invest in countries that are having lower returns on exports. As a result, most businesses are established in other countries and this impacts cuts across the entire economy. A sharp decrease in domestic currency brings disastrous effects on the performance of banks by raising the value of foreign currency debts of financial institutions as well as demoting the top quality of the credit history profile denominated in international currency. Currency depreciation has a negative long-run effect on the growth of the economy. Devaluation decreases the hope of people in terms of deposits in the domestic currency. The study concluded that based on the research findings, there is a statistically significant and negative relationship between currency devaluation and performance.

5.0 RECOMMENDATIONS

The study recommended that currency devaluation needs to be avoided by the countries. Counties need to look for alternative strategies that could increase the level of exports rather than currency devaluation. The currency devaluation was found to have a negative effect on the entire economy. Investors are not willing to go to countries with low returns of the exports and this will drive away investors. Moreover, the currency devaluation has the potential of bringing inflation to countries that could lead to a high cost of living. As a result, the study recommended that to safeguard against inflation and currency devaluation, it is fundamental to hold real assets to non-inflating currencies. The study further recommended that if a country is likely to devalue its currency, then it is important for the businesses to move money abroad and buy foreign assets like foreign stocks, or trade for gold or dollars. It is also recommended that if the government wants to devalue the currency to achieve the monetary policy, its should also raise some short term interest rate under their control. The motive to raise the short-term interest is to make the domestic assets more attractive and higher interest rates should strengthen the currency.

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