



HNB

Euro adoption and EMU – perspective of a small EU Member State

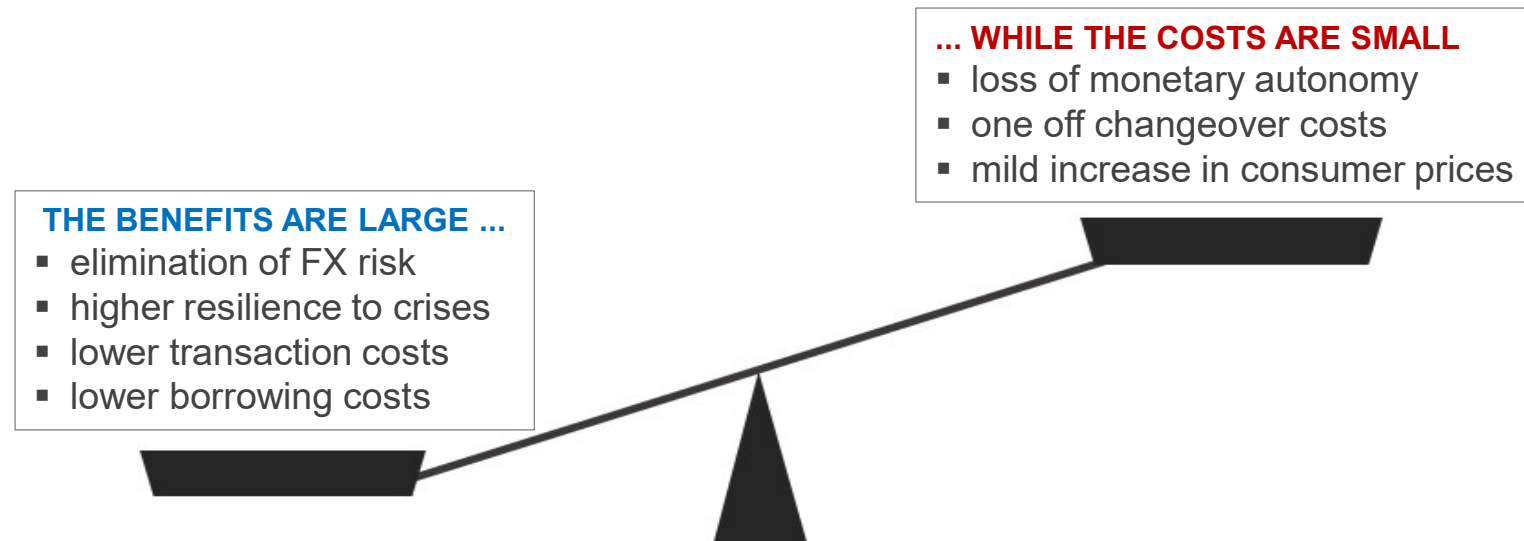
The European Central Bank Simulation Conference
9 December 2022

Boris Vujčić, Governor

HRVATSKA NARODNA BANKA • CROATIAN NATIONAL BANK

✓ Motivation for the adoption of the euro

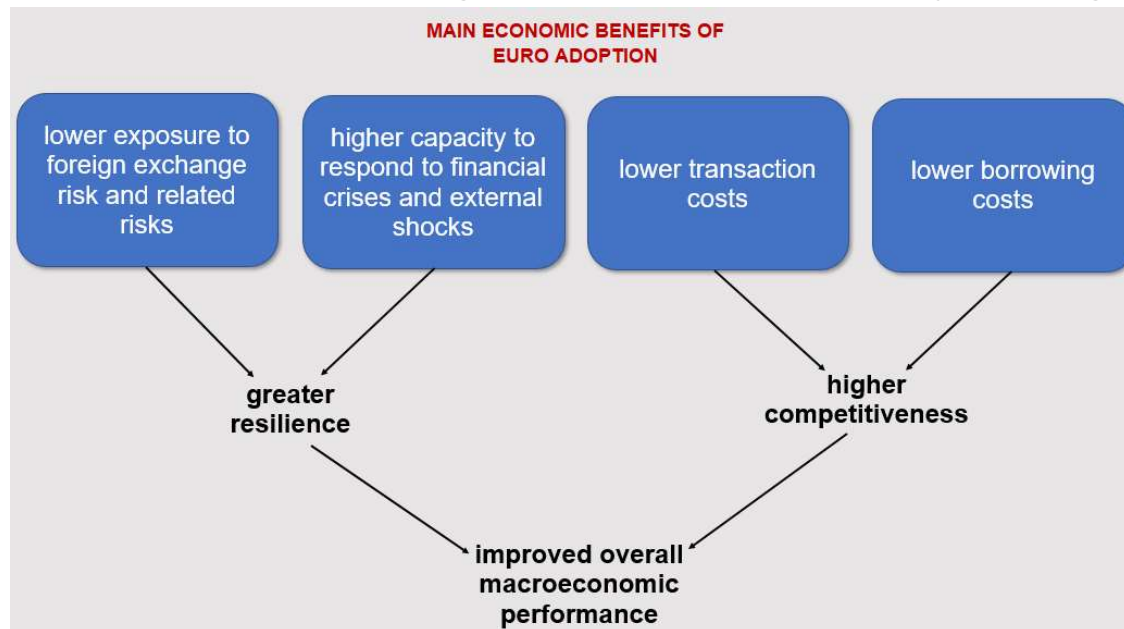
The economic benefits of adopting the euro significantly outweigh the economic costs ...

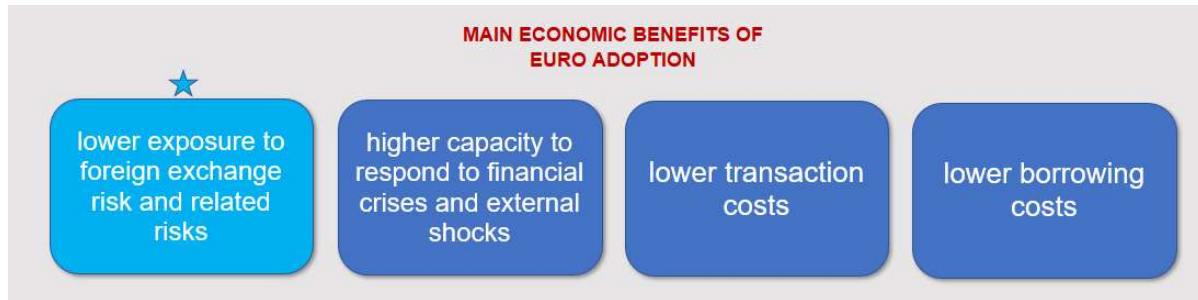


... while there are also some other important benefits

ECONOMIC BENEFITS

- Small countries can reap significant economic benefits by adopting the euro

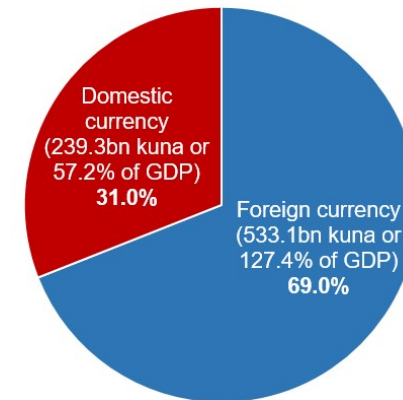




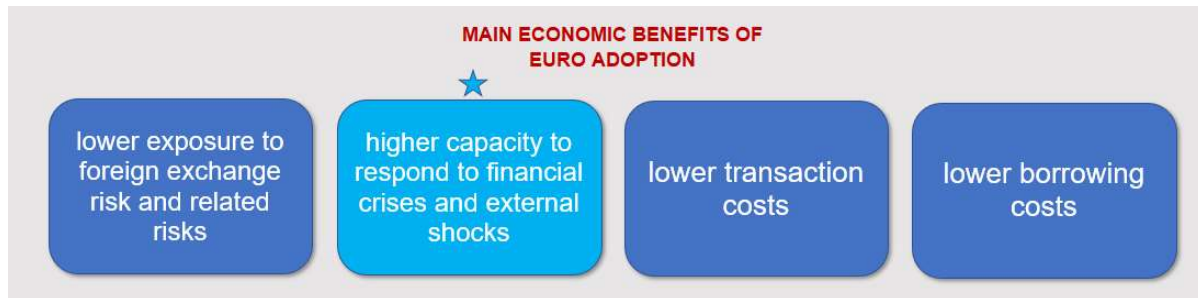
- By adopting the euro, a Member State removes most of FX risk from the financial system and the economy
 - as a result, the country becomes more resilient to adverse shocks

- This is particularly important for highly euroized countries, such as Croatia and Bulgaria
 - in contrast, it is less relevant for countries with low euroization levels (e.g. Poland and the Czech Republic)

**Currency composition of total debt in Croatia,
September 2021**

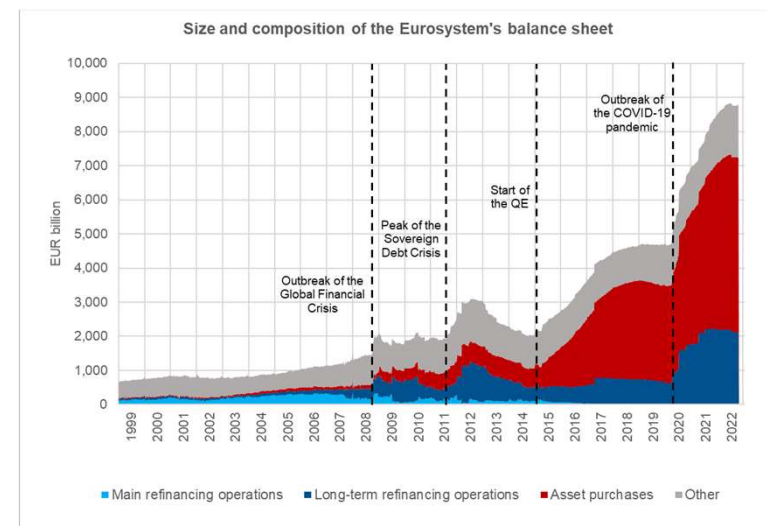


Source: HNB

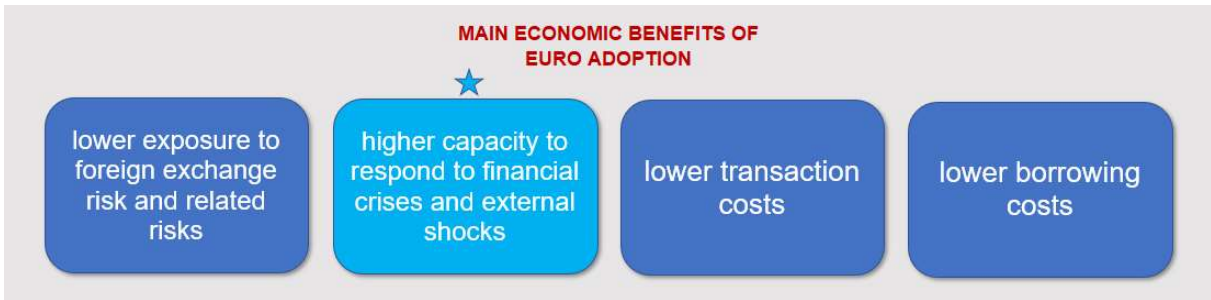


- As part of the euro area a small country is more capable of coping with adverse shocks:
 - a currency crisis no longer possible
 - domestic banks can access Eurosystem refinancing operations
 - it can benefit from the Eurosystem's unconventional monetary policy measures
 - it enjoys higher credibility in financial markets
 - it can access ESM financing in case of debt refinancing difficulties

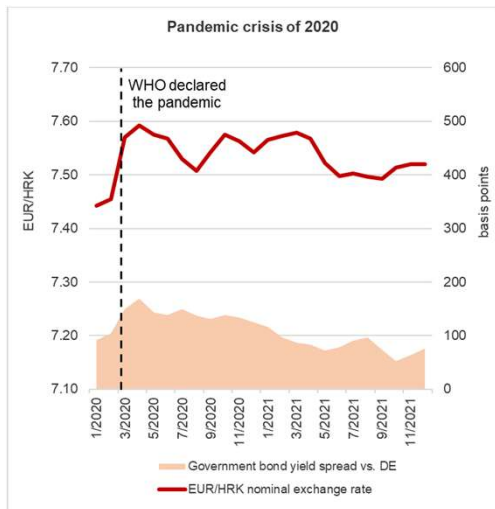
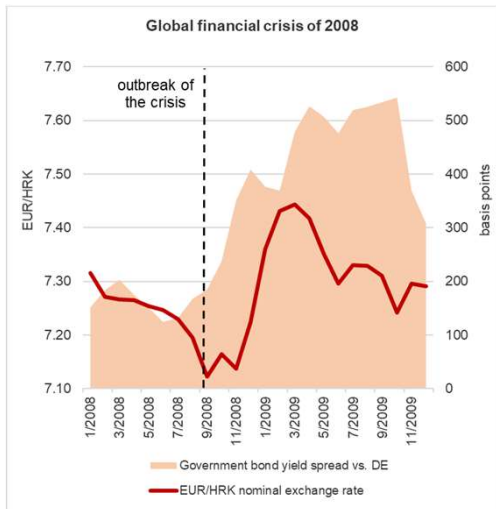
Eurosystem has virtually unlimited capacity to support financial stability in times of crisis



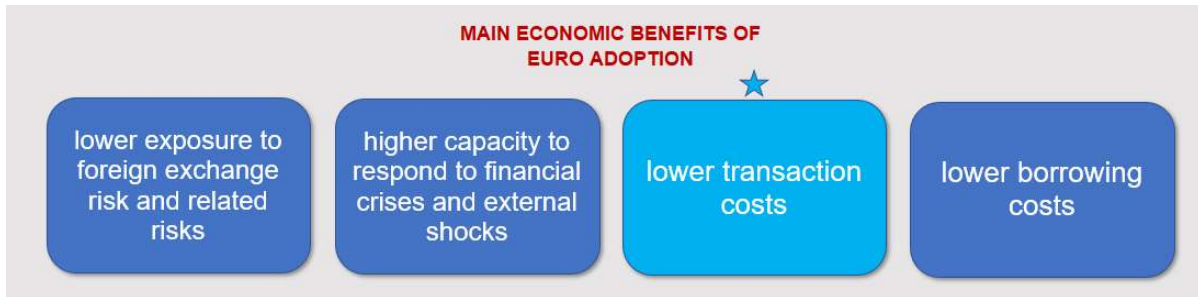
Source: ECB



- For a small country, the adoption of the euro provides much greater scope for counter-cyclical policy

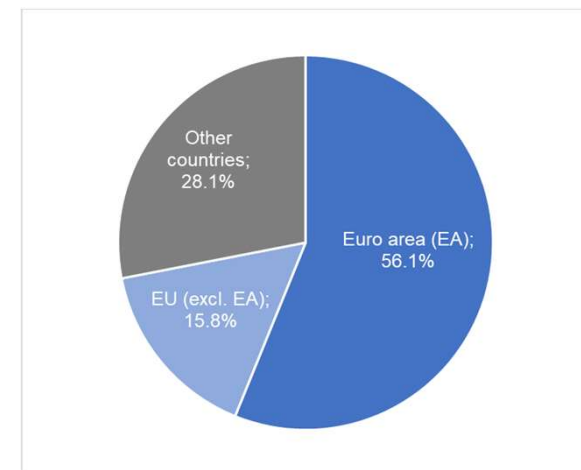


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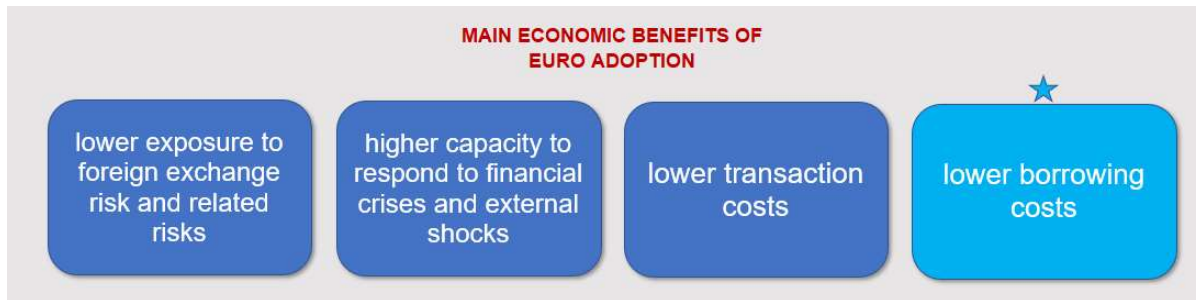


- Euro adoption eliminates the costs associated with exchange transactions involving the national currency and the euro
 - the resulting cost savings are particularly large in countries with strong trade links with the euro area, such as Croatia
- The positive effects on the economy are multiple:
 - the cost efficiency of firms engaged in foreign trade increases ...
 - ... thus facilitating further trade as well as financial integration ...
 - ... while a positive impact is expected also in certain sectors of tradable services (especially tourism)

Geographical composition of Croatia's international trade, 2021



Source: Eurostat



- Euro adoption can lead to a reduction in borrowing costs through **2 channels**:

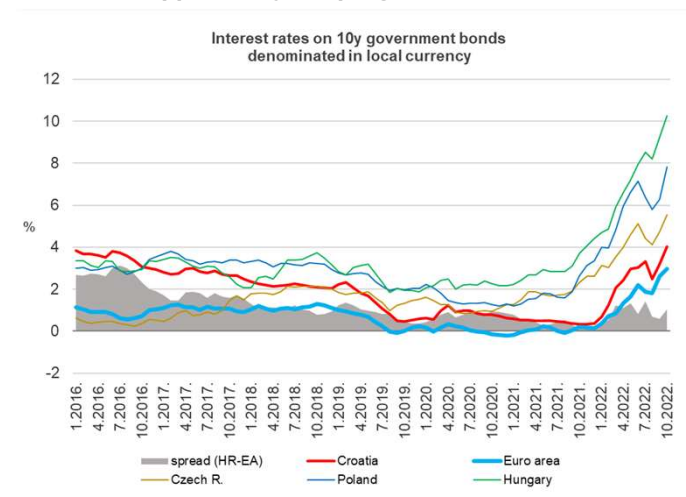
1) lower country risk premium

- greater resilience to shocks implies higher credibility in financial markets and therefore lower sovereign yields

2) lower regulatory costs for the banking system

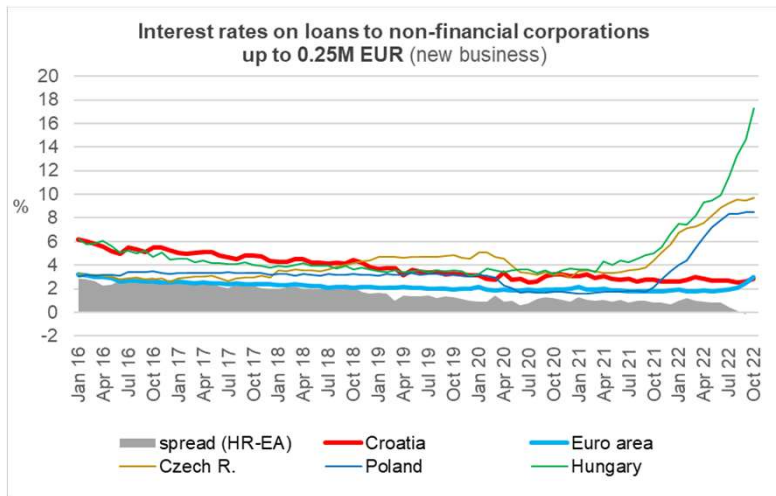
- the minimum reserve requirement rate in the EA is only 1%
- most countries maintain tighter regulatory requirements before they adopt the euro – these requirements have to be relaxed

Croatia's sovereign yield spread has declined since 2016 supported by our progress towards the euro

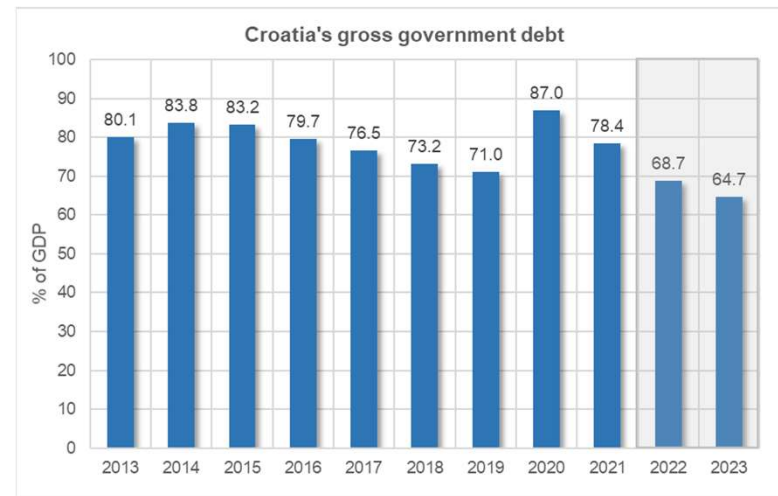


Source: Eurostat

MAIN ECONOMIC BENEFITS OF EURO ADOPTION



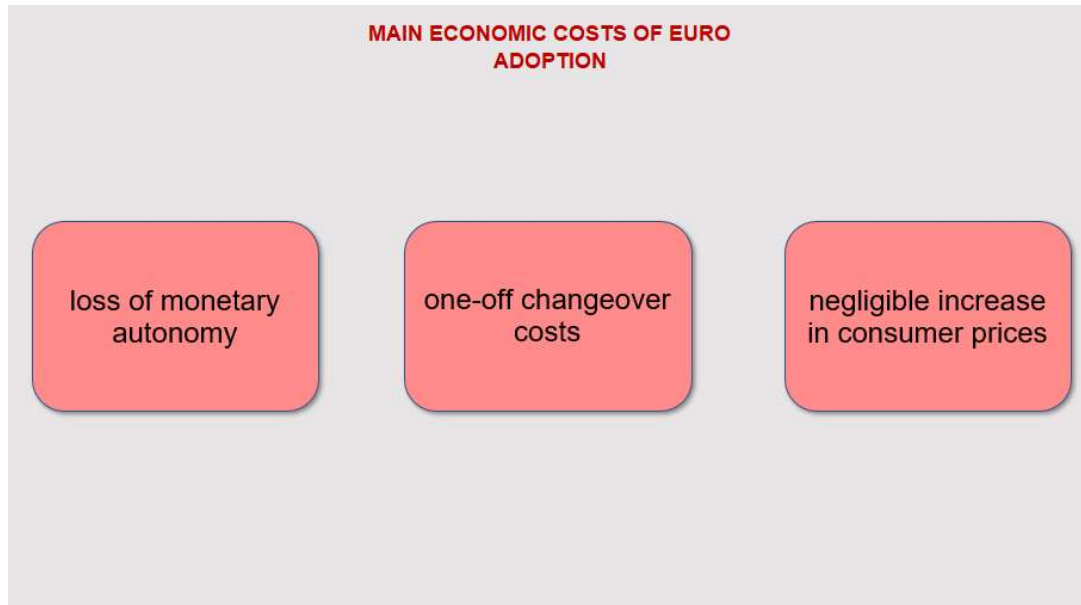
Source: ECB



Note: The shaded area represents HNB forecast
Source: HNB

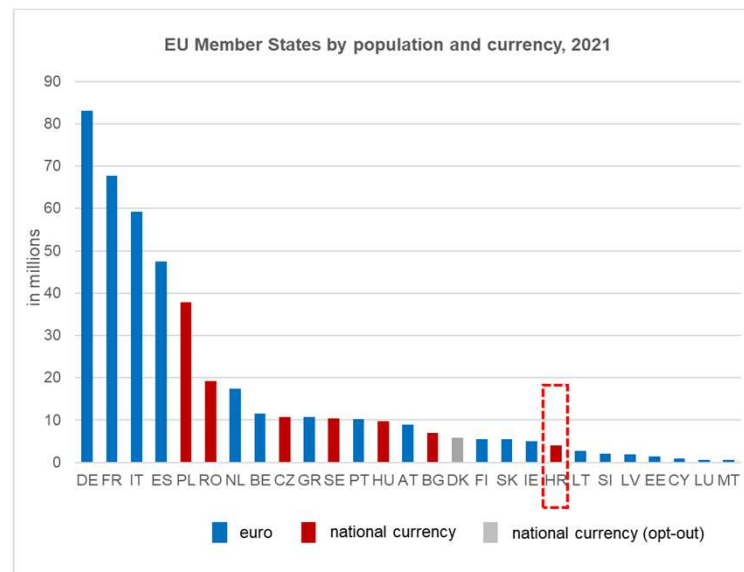
ECONOMIC COSTS

- Euro adoption also implies certain costs, which are mostly small and one-off





- Small EU Member States have limited room for an autonomous monetary policy

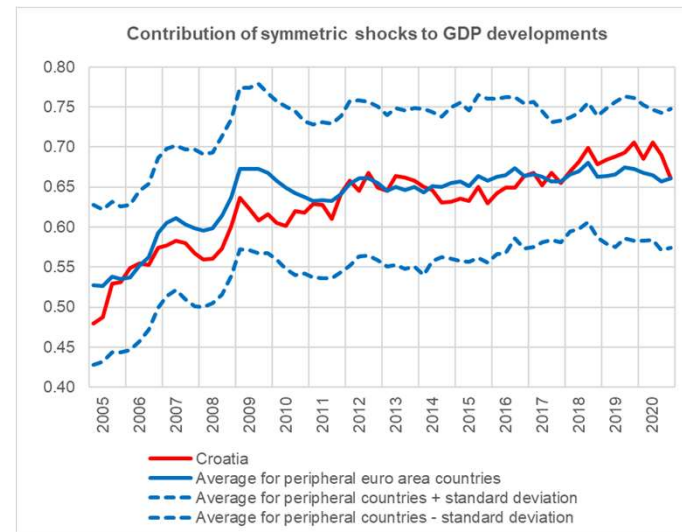
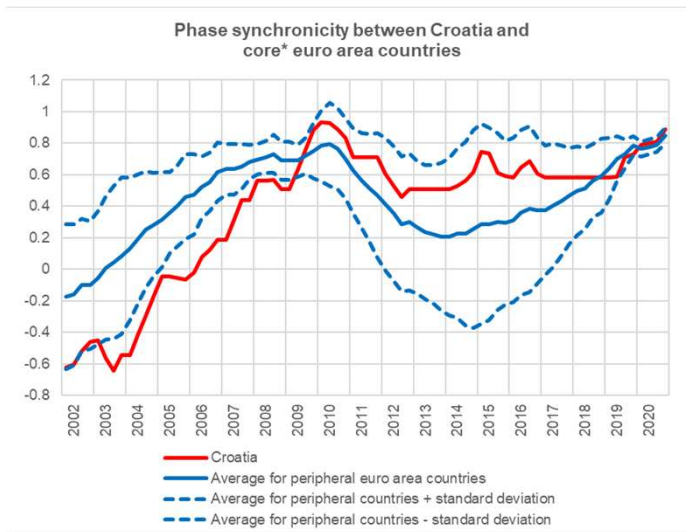


Source: Eurostat

- By adopting the euro, a country loses the ability to run monetary policy on its own
- The significance of this loss depends on how effective the autonomous monetary policy really is, as well as how synchronised business cycles are
- In small Member States, the effectiveness of monetary policy is typically constrained by several factors:
 - import dependence (high pass-through of ER changes)
 - strong presence of foreign banks with direct access to cross-border financing
 - liability euroization (vulnerability to ER depreciation)



- Monetary policy of the ECB will be appropriate for the Croatian economy



Note: The seven largest economies that together account for around 90% of euro area GDP (DE, FR, IT, ES, NL, BE and AT) are considered core countries. The remaining 12 smaller countries are considered peripheral countries.

Source: HNB

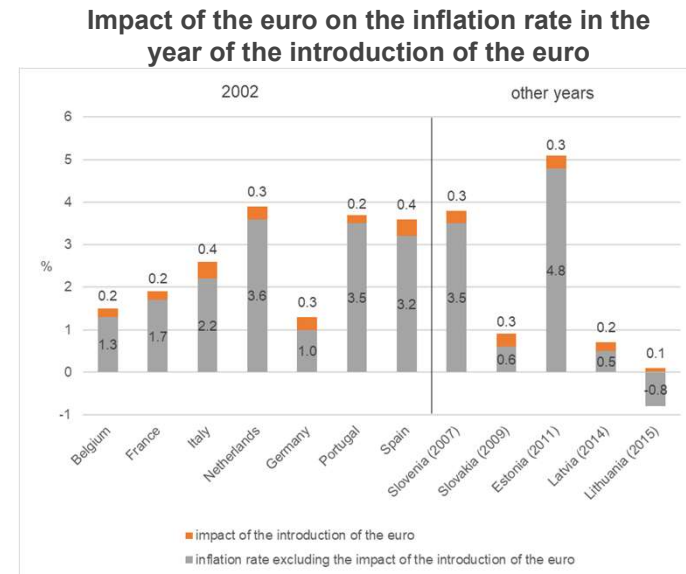


- Adoption of the euro requires some operational adjustments, some of which are being carried out by the state, and some by the private sector:

- procurement/production of euro banknotes and coins
 - withdrawing legacy banknotes and coins and putting euro banknotes and coins into circulation
 - adjustment of ATMs and other adjustments in the financial sector
 - IT and administrative adjustments in the government sector and the private sector
 - information activities directed at citizens and entrepreneurs
 - transfer of funds to EU institutions' capital
- } 0.5-1.0%
of GDP
- } 1.5-2.0%
of GDP



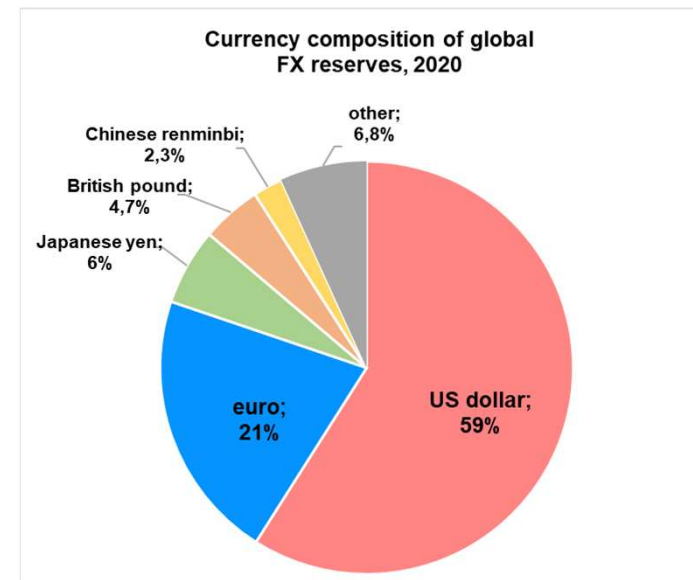
- Changeover to the euro may be accompanied by an increase in consumer prices
 - firms may see the changeover as an opportunity to raise their prices and profit margins
 - prices could be rounded up to reach a new "attractive" level (e.g. 7,95 EUR)
- However, research has shown that the impact of euro adoption on the price level is typically mild and temporary
 - between 0,1 and 0,6 percentage points in EA12
 - 0.23 percentage points on average in NM
- Dual display of prices has proven to be an effective tool to prevent unjustified price increases



Sources: Eurostat; Pufnik, A. (2018.), MMF

OTHER BENEFITS (1): Reputational gains

- Euro area is an elite currency bloc
 - the 2nd richest among large economies (behind the US)
 - the world's 2nd largest exporter (behind China)
 - three G7 countries (DE, FR and IT) are members of the bloc
 - the euro is the 2nd most important reserve currency
- Therefore, by adopting the euro a small country can achieve substantial reputational gains
 - these gains are reflected in an easier access to financing and lower borrowing costs



Source: ECB

OTHER BENEFITS (2): Participation in euro area decision-making

Composition of the ECB's decision-making bodies



Source: CNB Annual Report 2021

- By adopting the euro, the country gains the right to **influence** the monetary policy of the ECB
- Small Member States are **overrepresented** in the ECB's Governing Council
 - every NCB governor has one vote, regardless of the economic weight of his country
 - the rotation system in place since 2015 has slightly shifted the balance of voting power towards larger Member States, but small Member States are still well represented

✓ The EMU today

To adopt the euro has become more demanding reflecting significant changes of the EMU's institutional setup, ...

- Unfavourable developments in the euro area following the outbreak of the GFC inspired a significant overhaul of the EU's institutional framework
 - Banking union (though not yet completed)
 - Macroeconomic Imbalances Procedure
 - European Semester

- Countries wishing to join the euro area are expected to be aligned with the EU's new institutional features
 - Croatia's path towards the ERM II participation is a case in point

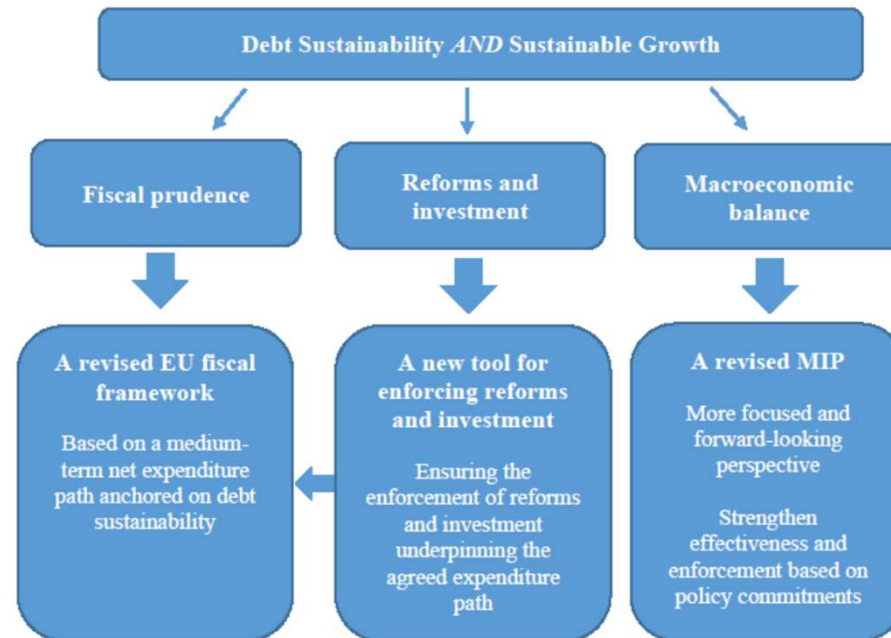
... requiring Member States to make significant efforts to earn the „green light” for the adoption of the euro

STEPS IN THE EURO ADOPTION PROCESS	CROATIA	MEMBER STATES WHICH JOINED ERM II BEFORE 2008
Exit from the EDP before the start of negotiations about ERM II entry	YES	NO
Elimination of excessive imbalances (monitored through MIP) before the start of negotiations on ERM II entry	YES	NO (imbalances were not monitored)
Implementation of specific structural reforms (incl. CSRs) before ERM II entry	YES	NO
Entry into the Banking Union at the latest at the moment of ERM II entry	YES	NO (the Banking Union did not exist)
Entry into ERM II	YES	YES
Implementation of additional structural reforms after ERM II entry	YES	NO
Fulfillment of the nominal convergence criteria	YES	YES
EU Council decision on euro adoption	YES	YES

EMU has undergone a major overhaul over the last 10 years, but there is still room for further enhancement

- There is no complete EMU without a full implementation of the EU's economic governance framework, ...
 - relatively low rate of implementation of CSRs
 - lack of national ownership of processes related to European semester implementation
 - credibility issues related to initiating the Excessive Imbalances Procedure (EIP)
- ... while some argue that a common fiscal capacity or even a fiscal union are necessary for a complete EMU
 - there are „success stories” (NGEU, SURE, RRF) showing that some form of a central fiscal capacity is possible within the existing framework
 - for more, stronger political support is required

The ongoing discussions on economic governance framework could pave the way towards a stronger EMU



Source: European Commission, November 2022

Concluding remarks

- The euro brings significant and permanent economic benefits to small EU Member States in the form of lower exposure to risks, greater resilience to crises, higher cost efficiency and more favourable access to financing
- On the other hand, the economic costs of adopting the euro are small and mostly one-off
- Euro adoption is now more demanding reflecting significant changes in the EMU's institutional setup
- Current reflections and proposals on reforming EU's economic governance framework have a potential for making a more solid EMU
 - “Europe will be forged in crisis, and will be the sum of the solutions adopted for those crises” (Jean Monnet)

Thank you for your attention!