



CROATIAN NATIONAL BANK

EUROSYSTEM

Introducing the Euro in Times of High Inflation: the Case of Croatia

Boris Vujčić, Governor
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Overview

- The euro adoption process - then and now
- Challenges in the context of high inflation
- Benefits of adopting the euro for a small EU Member State

- **The euro adoption process – then and now**

Until 2008, the path towards the euro was fairly simple

- EU Member States interested in joining the euro area only had to fulfil the nominal convergence criteria (the Maastricht criteria) ...
 - price stability
 - stable and sound public finances
 - exchange rate stability (during the two-year participation in ERM II)
 - convergence of long-term interest rates
- ... and achieve the required degree of legal convergence
 - central bank independence
 - prohibition of monetary financing and privileged access of the public sector to financial institutions
- There were no preconditions for joining ERM II
 - new EU Member States that were willing to launch the euro adoption process were allowed to start participating in ERM II soon after they joined the EU in May 2004

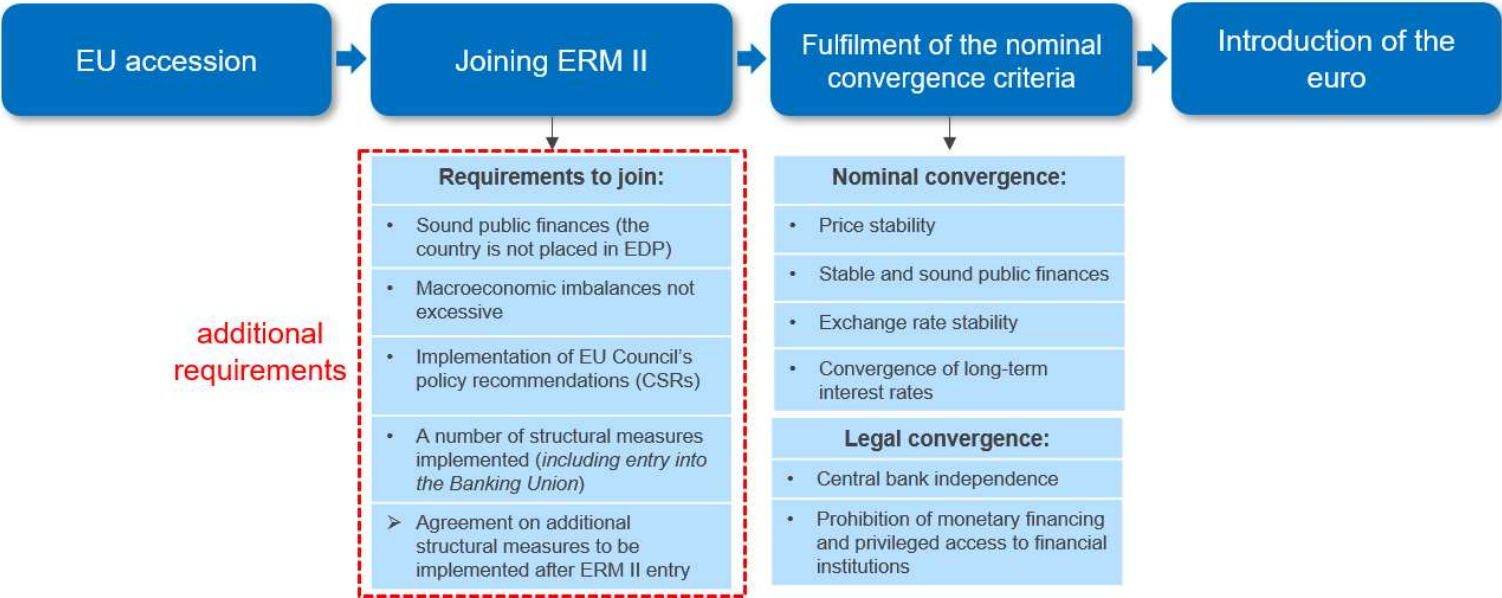
The euro adoption process - then



However, the process has become much more demanding after the 2008-09 global financial crisis

- 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** (EU Council country-specific recommendations - CSRs)
- Countries wishing to join the euro area are expected to be aligned with the EU's new institutional features even before they join ERM II
 - Croatia's path towards the ERM II participation is a case in point

The euro adoption process - now



In addition to being subject to a stricter formal procedure, Croatia was also hit by severe shocks on its road to the euro

- After Croatia had made its first steps towards the euro, the country was hit by a number of severe shocks that brought additional challenges to the authorities

- **COVID-19 outbreak (early 2020)**
 - **Zagreb earthquake (March 2020)**
 - **Petrinja earthquake (December 2020)**
 - **surge in global inflation (2021/2022)**
- before ERM II entry
(July 2020)
- adoption of the Euro Changeover
Plan (December 2020)
- before the assessment of the
convergence criteria (May 2022)

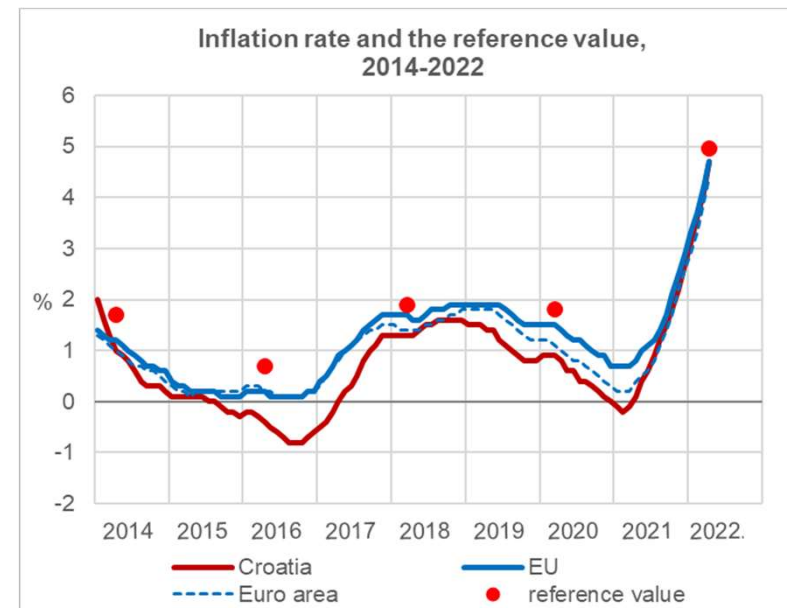
Despite all this, Croatia managed to adopt the euro in the shortest possible time



- **Challenges in the context of high inflation**

In the high-inflation environment, the price stability criterion was the greatest challenge among the nominal convergence criteria

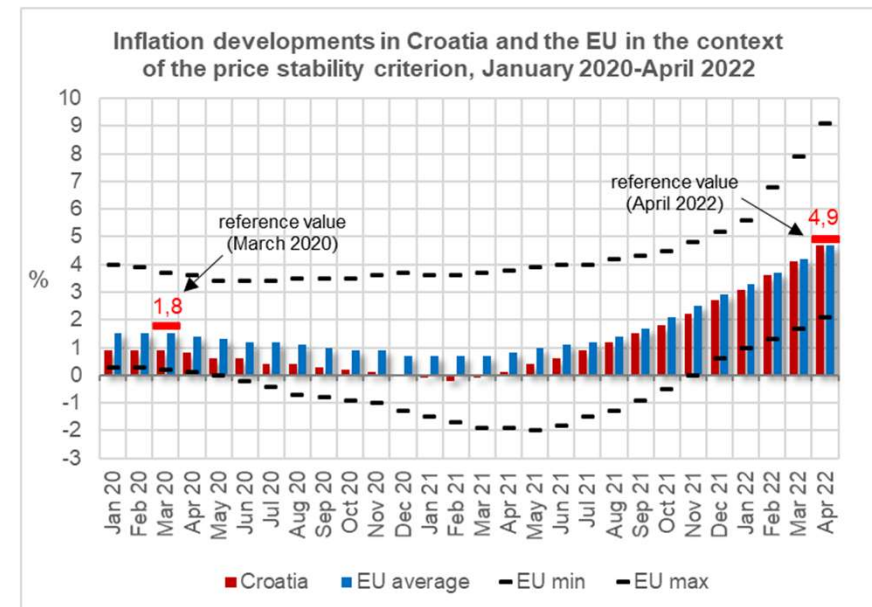
- Since its EU accession, Croatia has continuously been compliant with the price stability criterion
 - in fact, since 2016 Croatia was *de facto* compliant with all convergence criteria
- However, global inflationary pressures that emerged in 2021 and further intensified in 2022 called into question Croatia's ability to meet the criterion



Source: Eurostat

Croatia nevertheless fulfilled the price stability criterion

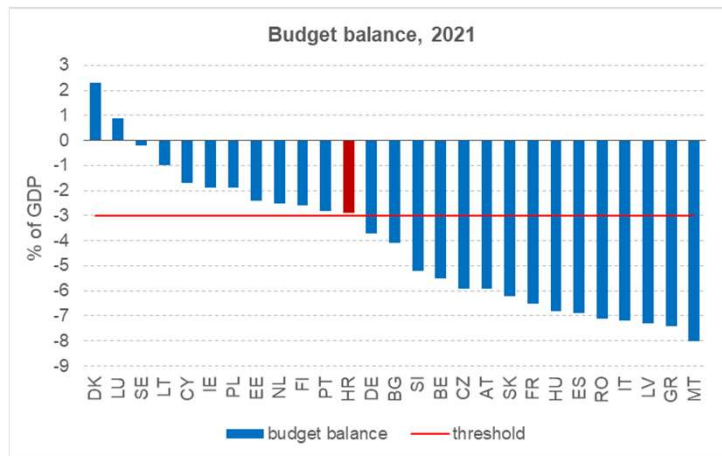
- Dispersion in inflation rates among EU Member States was historically high in spring 2022
- Given that inflation had picked up in most other Member States as well, the reference value increased significantly, enabling Croatia to meet the criterion
 - in April 2022, the 12m average inflation rate in Croatia (4.7%) was slightly lower than the reference value (4.9%)
- Therefore, in the Convergence Report of 1 June 2022 the Commission, as well as the ECB, assessed that Croatia had fulfilled the price stability criterion



Source: Eurostat

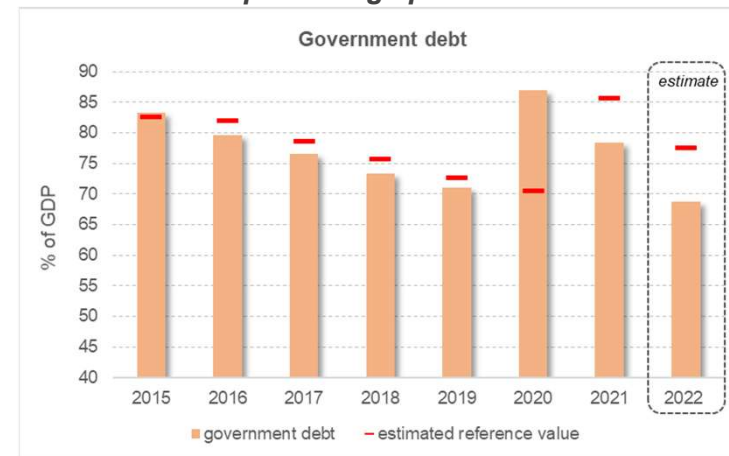
Croatia fulfilled other nominal convergence criteria as well: Stable and sound public finances

In 2021, Croatia had a budget deficit of below 3% of GDP ...



Source: Eurostat

... while the debt-to-GDP ratio fell by as much as 7.5 percentage points

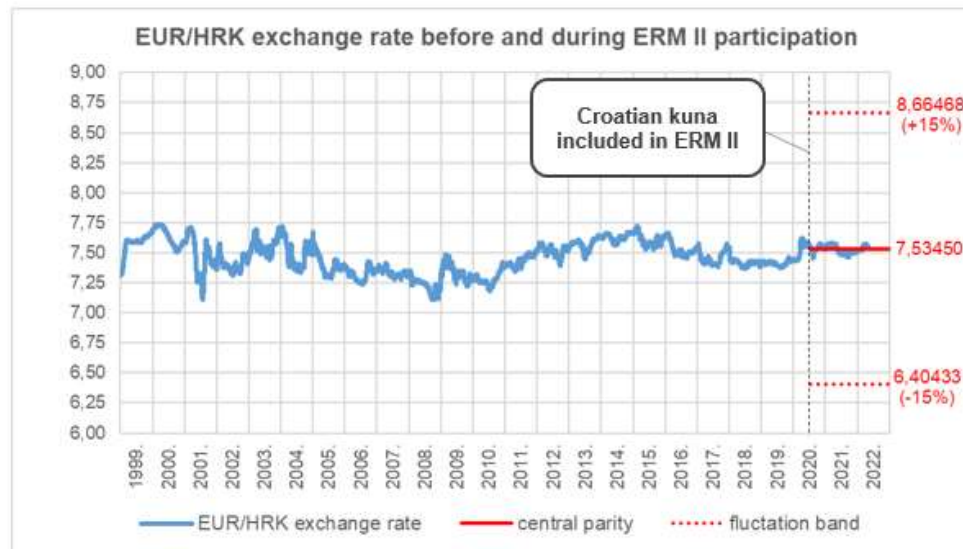


Source: HNB

⇒ Even if the reference values for the budget balance and government debt for 2021 had been breached, Croatia would have fulfilled this criterion because the EU's fiscal rules have been suspended since March 2020 in response to the outbreak of the COVID-19 pandemic (the so-called „general escape clause” was activated).

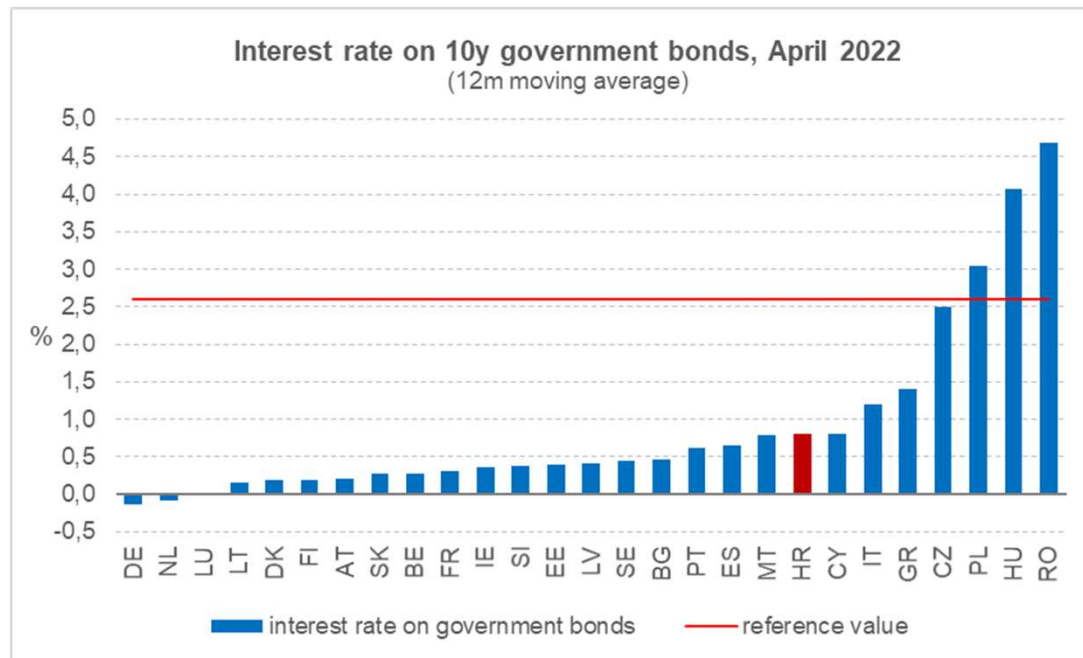
Croatia fulfilled other nominal convergence criteria as well: Exchange rate stability

During the participation in ERM II, the EUR/HRK exchange rate fluctuated very close to the central parity



Source: CNB

Croatia fulfilled other nominal convergence criteria as well: Convergence of long-term interest rates

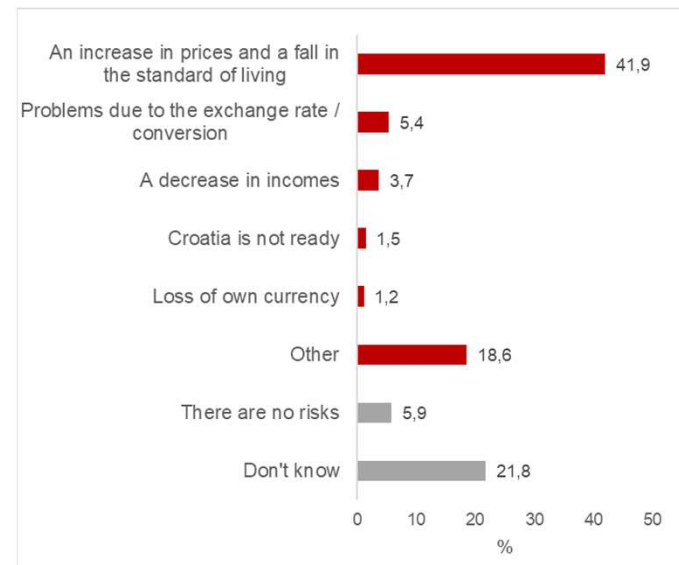


Source: Eurostat

High inflation has reinforced the (incorrect) public perception of the negative impact of the euro on living standards

- Before the adoption of the euro, a possible substantial increase in the price level was considered by many Croatian citizens as the main disadvantage of the euro
- Addressing such a negative public perception has been difficult given that the euro was introduced in the environment of already high inflation

PUBLIC OPINION SURVEY (2021): *What is the greatest risk of euro introduction?*

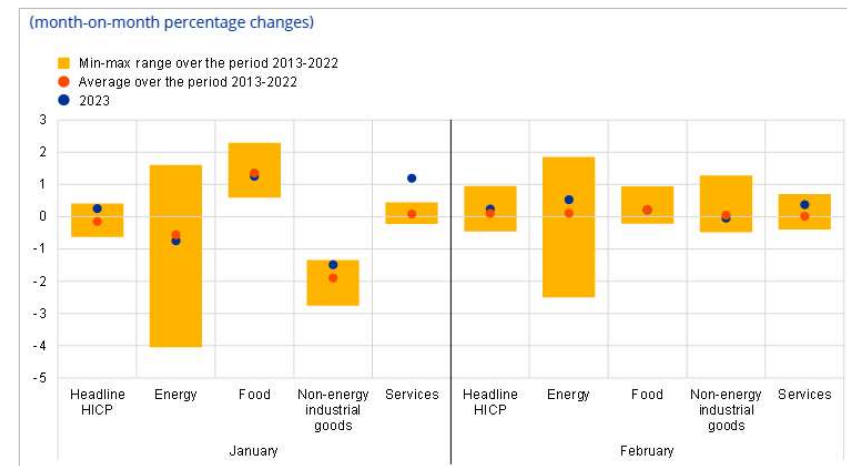


Source: Ipsos, March 2021

Increase in consumer prices due to rounding observed primarily in services sectors, ...

- Price developments in early 2023 did not deviate much from the typical seasonal pattern observed over the previous 10 years
- However, there was an unusually high m-o-m increase in prices of services in January 2023
 - bars, restaurants, hairdressers, dental and medical facilities have increased their prices the most
- According to an ECB-HNB simulation, if the prices of services had followed the same pattern as in the previous 10 years, the overall inflation rate in January 2023 would have been lower by **0.4 percentage points**

Headline HICP inflation and its main components in Croatia



Source: ECB

... while retail chains have complied with the rules on the conversion and rounding of prices

Pricing strategy in big retail chains in Croatia before and after the euro changeover



Source: ECB

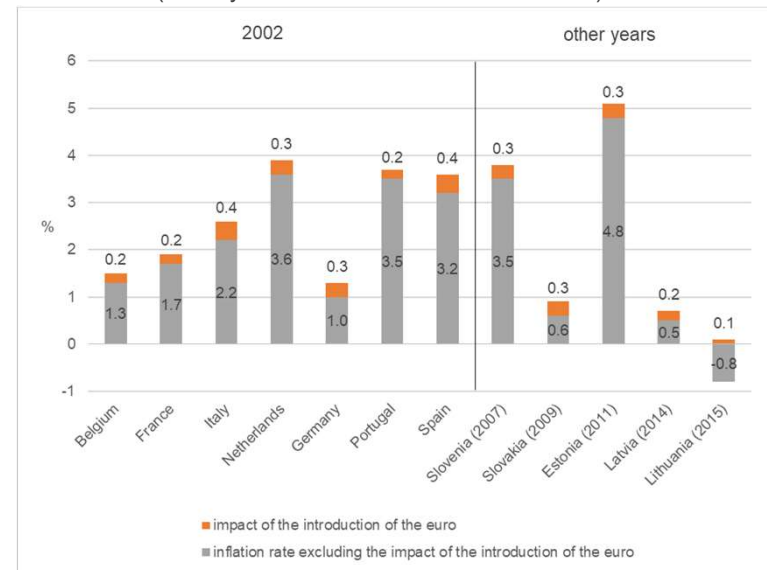
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- Prices of around 65% of products did not change after the euro changeover
 - a strong decrease in the share of so-called "attractive" prices
- It is likely that retailers will gradually set their prices at new attractive levels
 - these changes might occur as part of regular price adjustments
 - due to market competition and the obligation to display prices in both currencies by end-2023, the new attractive levels may not necessarily be higher

The impact on the aggregate price level was in line with the past experiences of other Member States

- Croatia is the only Member State that introduced the euro in a period of very high inflation
- Despite this, the estimated overall impact on prices was equally mild – **0.4 percentage points** – as in Member States that had adopted the euro in a low-inflation environment
 - in their case as well, services sectors were the main driver of the overall euro-induced increase in prices

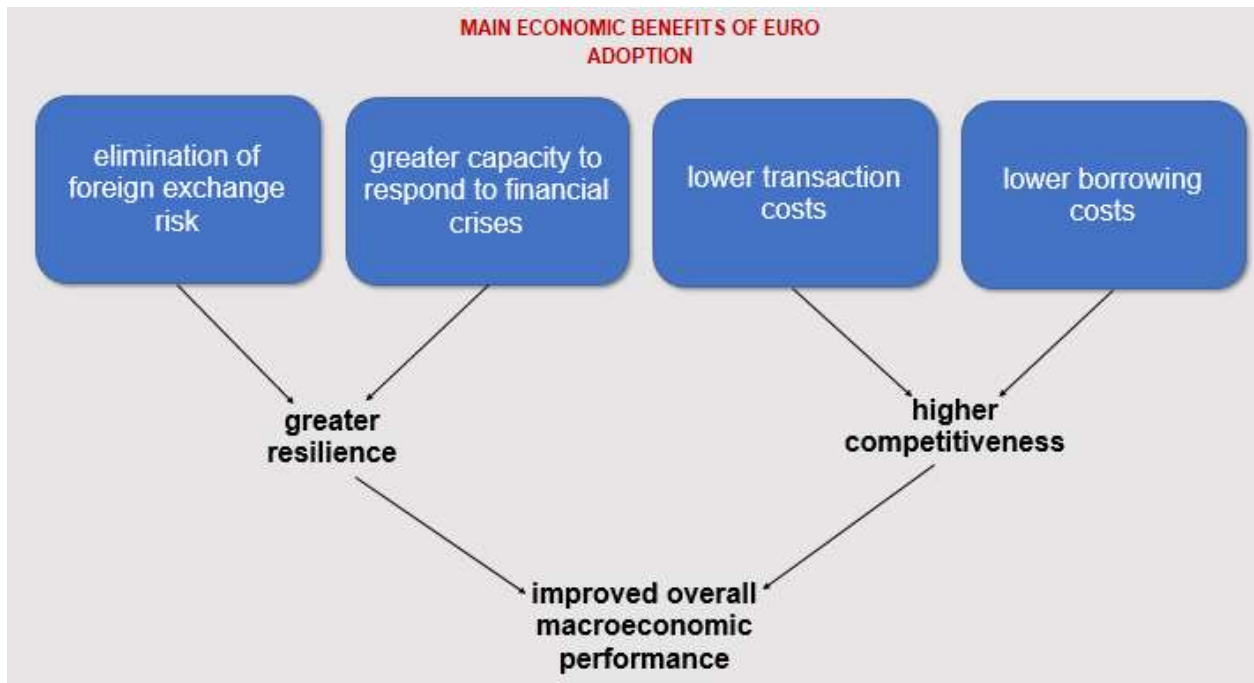
Impact of the euro on the inflation rate
(in the year of the introduction of the euro)

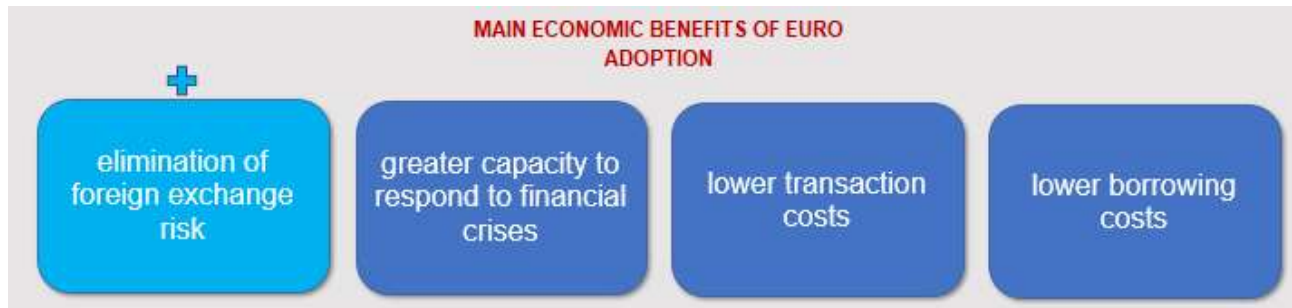


Sources: Eurostat; Pufnik, A. (2018.), MMF

- **Benefits of adopting the euro for a small EU Member State**

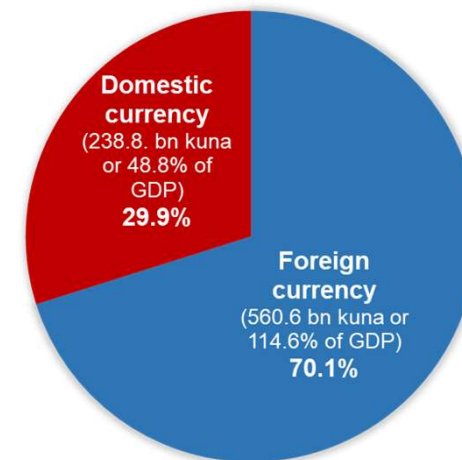
Euro adoption brings significant economic benefits to small and highly euroized EU Member States



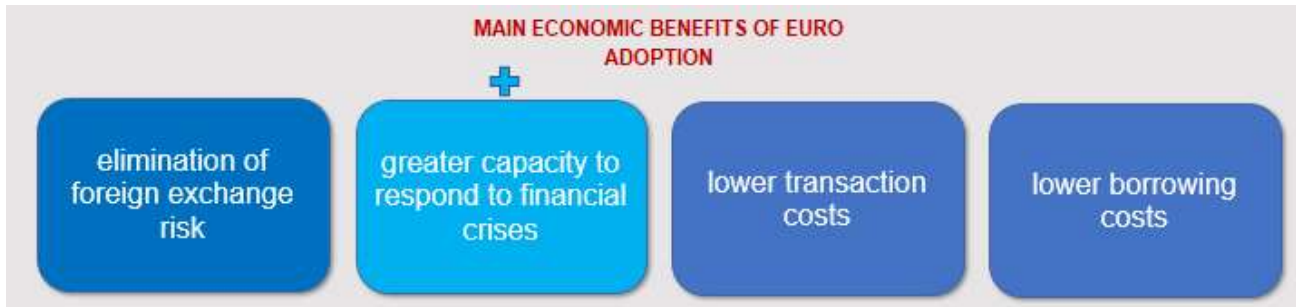


- By adopting the euro, a Member State removes most of FX risk from the financial system and the economy
 - as a result, the country becomes more resilient to adverse shocks
- This is particularly important for highly euroized countries such as Croatia
 - in contrast, it is less relevant for countries with low euroization levels (e.g. Poland and the Czech Republic)

**Currency composition of total debt in Croatia,
September 2022**

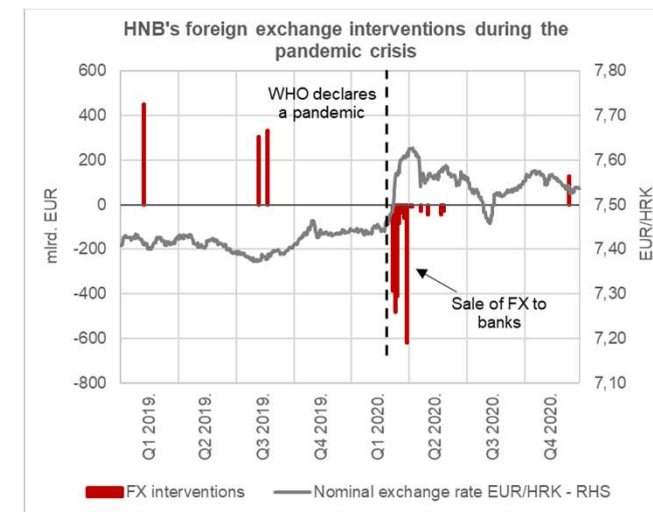


Source: HNB

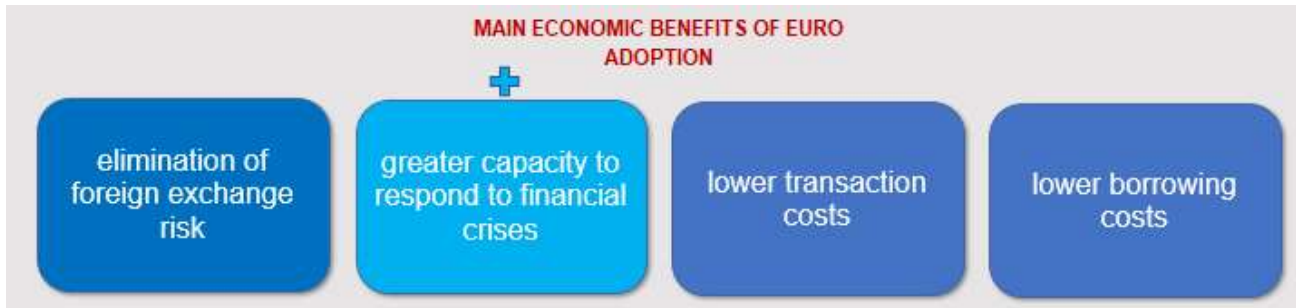


- As part of the euro area a small country is more capable of coping with adverse shocks:
 - a currency crisis is no longer possible
 - domestic banks can access Eurosystem refinancing operations
 - it can benefit from the Eurosystem's unconventional monetary policy measures
 - it enjoys higher credibility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

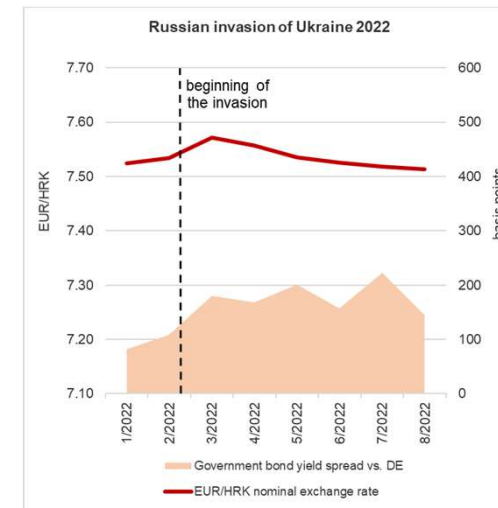
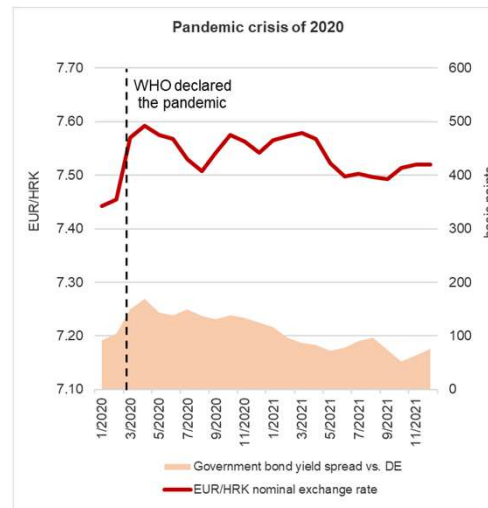
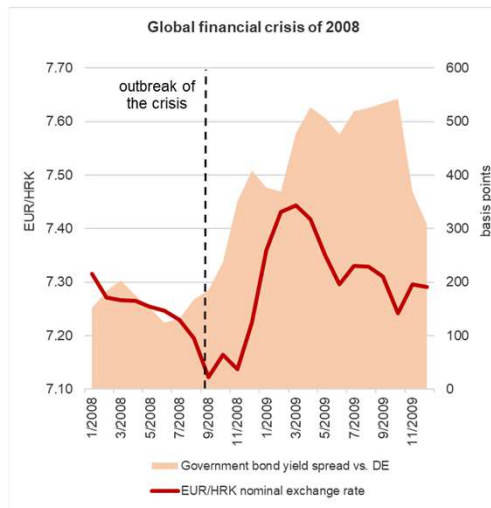
Pressures in the FX market no longer possible after the adoption of the euro



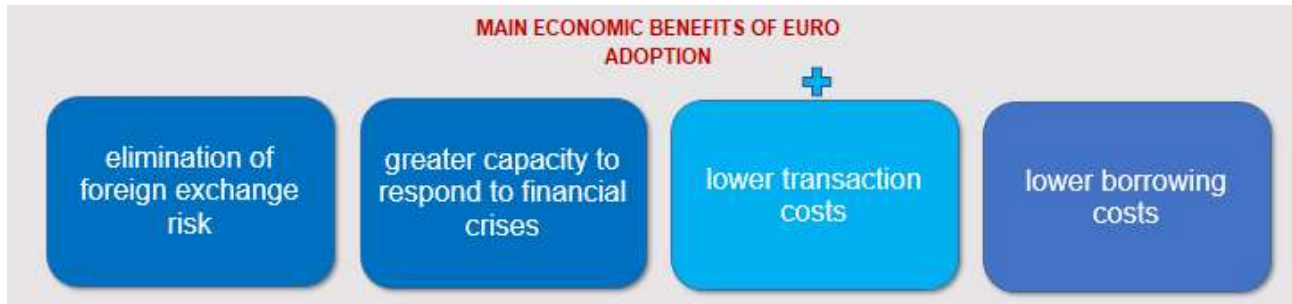
Source: HNB



- The euro adoption process itself made Croatia more resilient to shocks:

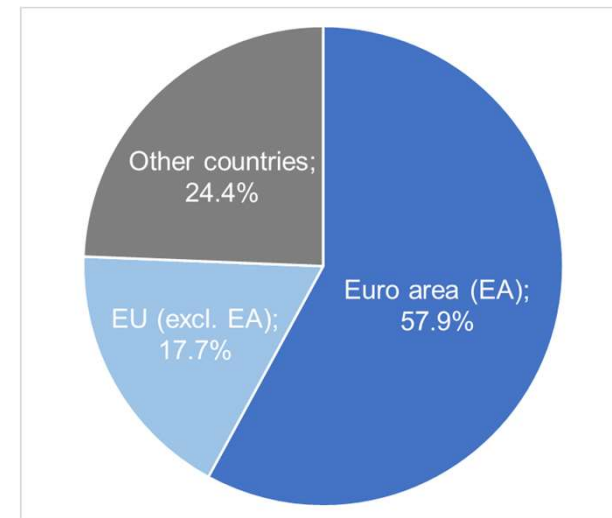


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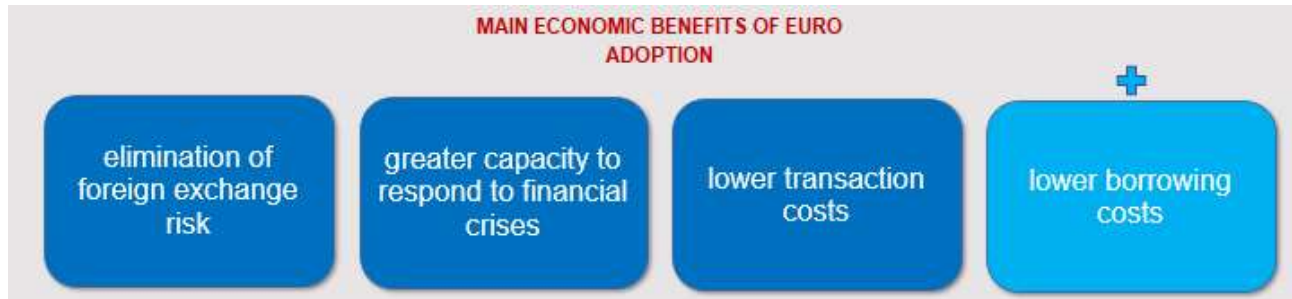


- Euro adoption eliminates currency conversion costs
 - the resulting cost savings are particularly large in countries with strong trade links with the euro area, such as Croatia
- The positive effects on the economy are multiple:
 - the cost efficiency of firms engaged in foreign trade increases ...
 - ... 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**:

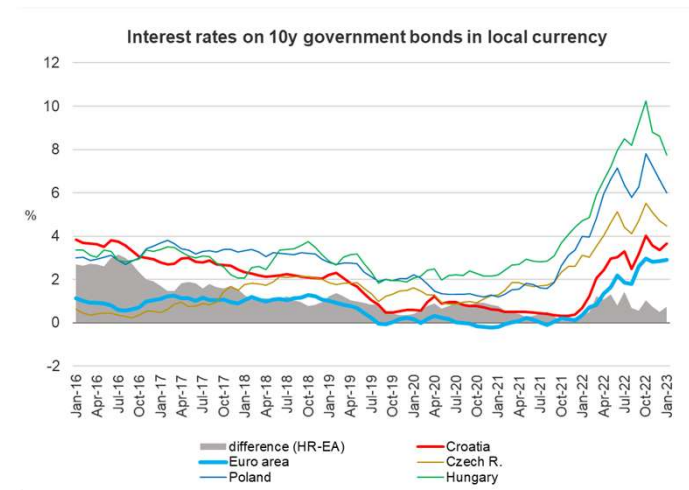
1) lower country risk premium

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

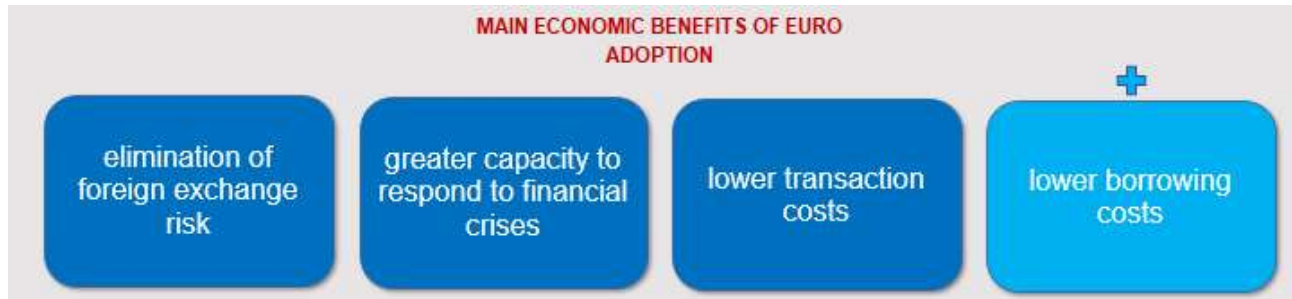
2) lower regulatory costs for the banking system

- 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

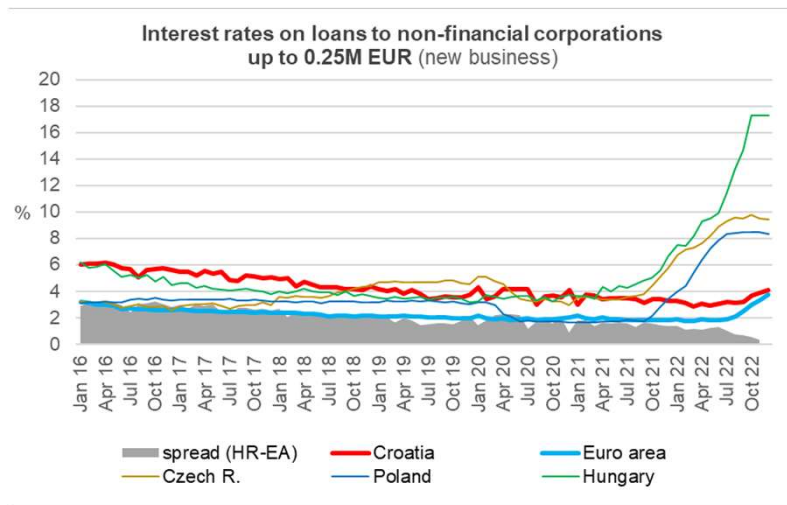
Croatia's sovereign yield spread has declined since 2016 supported by the progress towards the euro



Source: Eurostat

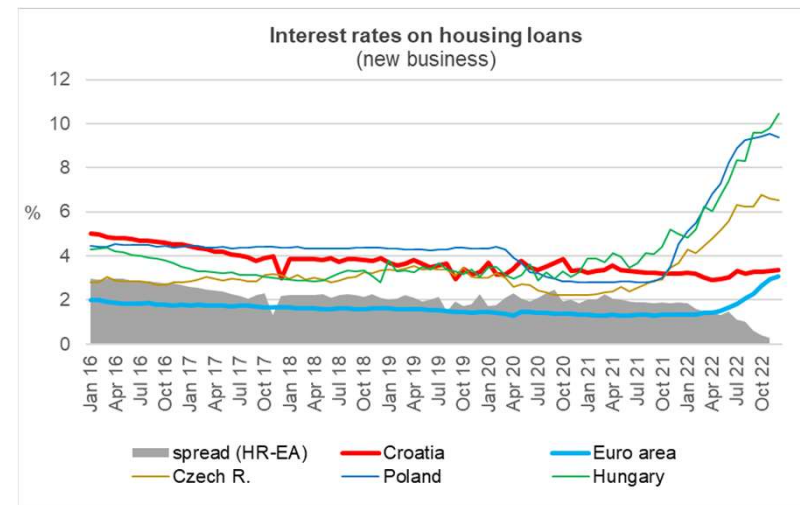


- The private sector has already felt the positive effects of the euro on financing conditions:



Source: ECB SDW

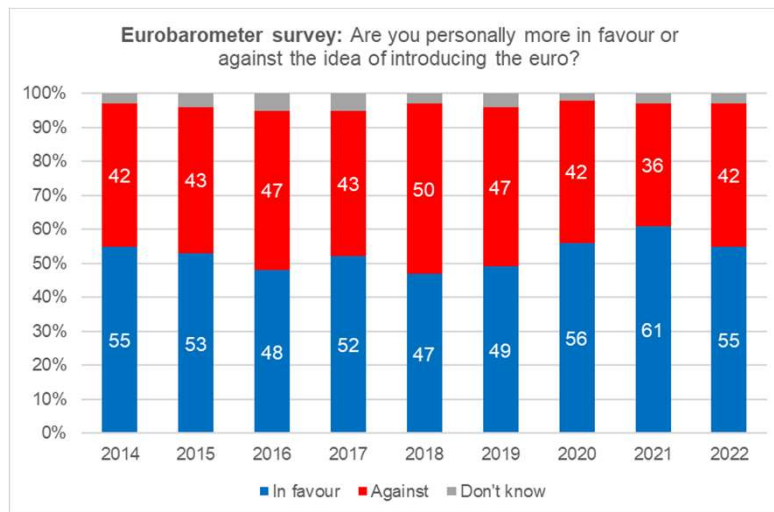
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Source: ECB SDW

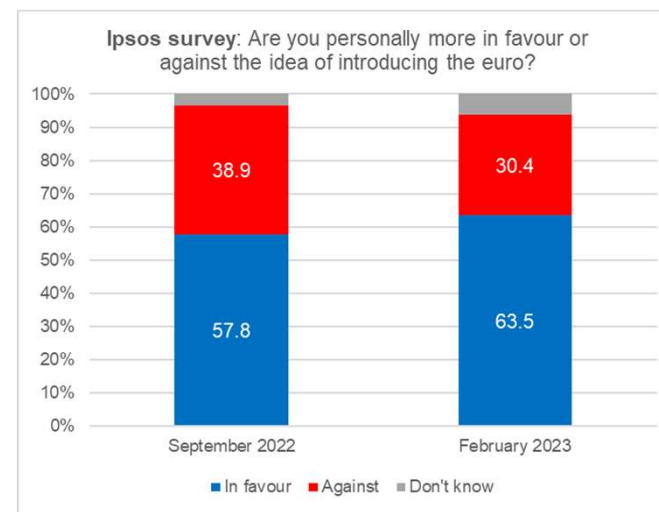
Public support for euro adoption in Croatia

The level of support was relatively high before the adoption of the euro ...



Source: Eurobarometer

... and has increased further following the successful changeover



Source: Ipsos

Concluding remarks

- The euro adoption process has become much more demanding reflecting significant changes in the EMU's institutional setup after the 2008-09 global financial crisis
 - as a result, Croatia had to go through a stricter formal euro adoption process than countries in the past
- Croatia's road to the euro was made even more challenging by severe shocks that hit the country in the period 2020-2022
 - the surge in global inflation in 2021-22 jeopardized Croatia's ability to fulfil the nominal convergence criteria, and it also added to the (incorrect) public perception that the adoption of the euro led to a sharp increase in the price level
- 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 favorable access to financing

Thank you for your attention!

