EURO

STRATEGIJA UVOĐENJA EURA U HRVATSKOJ

STRATEGY FOR THE ADOPTION OF THE EURO IN CROATIA

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Eurostrategy

- Eurostrategy is the starting point for the beginning of the process of euro adoption in Croatia

- The Eurostrategy document contains:
  - an analysis of economic costs and benefits of the introduction of the euro
  - a description of the process of the introduction of the euro
  - strategic determinants of the economic policy required for the introduction of the euro

- Eurostrategy does not set the target date for euro adoption since that is not only up to us

- The document serves as a basis for public discussion

- Costs and benefits of euro adoption

The specific characteristics of the Croatian economy speak in favour of euro adoption in Croatia

- Croatia is the smallest EU member state that still uses its own currency
- In terms of trade, Croatia is closely integrated in the euro area, which is reflected in high business cycle synchronisation
- Croatia's economy is highly euroised – a considerable portion of domestic savings (75%) and of total debt liabilities (67%) is linked to the euro
- The Croatian banking system is dominated by banks owned by institutions from the euro area - limited scope for the monetary policy

The benefits of euro adoption in Croatia are considerable and of permanent nature ...

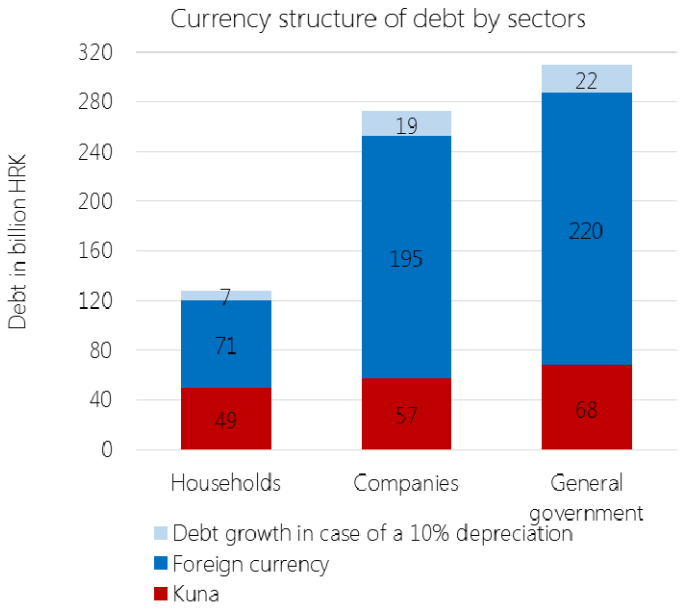
	Importance	Time impact
Currency risk elimination	Great	Permanent
Interest rates reduction	Medium	Permanent
Elimination of the risk of currency crisis and reduction of the risk of banking and balance of payments crisis	Medium	Permanent
Lower transaction costs	Small	Permanent
Boost to international trade and investments	Medium	Permanent
Participation in the distribution of Eurosystem's monetary income	Small	Permanent
Acess to euro area financial assistance mechanisms	Small	Permanent

…while the costs are mostly one-off and small

	Importance	Time impact
Loss of independent monetary policy	Small	Permanent
Risk of conversion-related increase in price levels	Small	One-off
Risk of excessive capital inflows and growing imbalances	Small	Permanent
Conversion costs	Small	One-off
Transfer of funds to the European Central Bank	Small	One-off
Participation in the provision of financial assistance to other member states	Medium	One-off

Benefits (1): Elimination of currency risk

- Croatian economy is highly exposed to currency risk
  - total debt in foreign currency exceeds HRK 500bn (approximately 150% of GDP)
  - any greater depreciation of the kuna would increase considerably the burden of debt repayments for households, companies and the government



Source: CNB.

The introduction of the euro will eliminate currency risk
- one of the main sources of vulnerability of the Croatian economy

Benefits (2): Reduction of interest rates

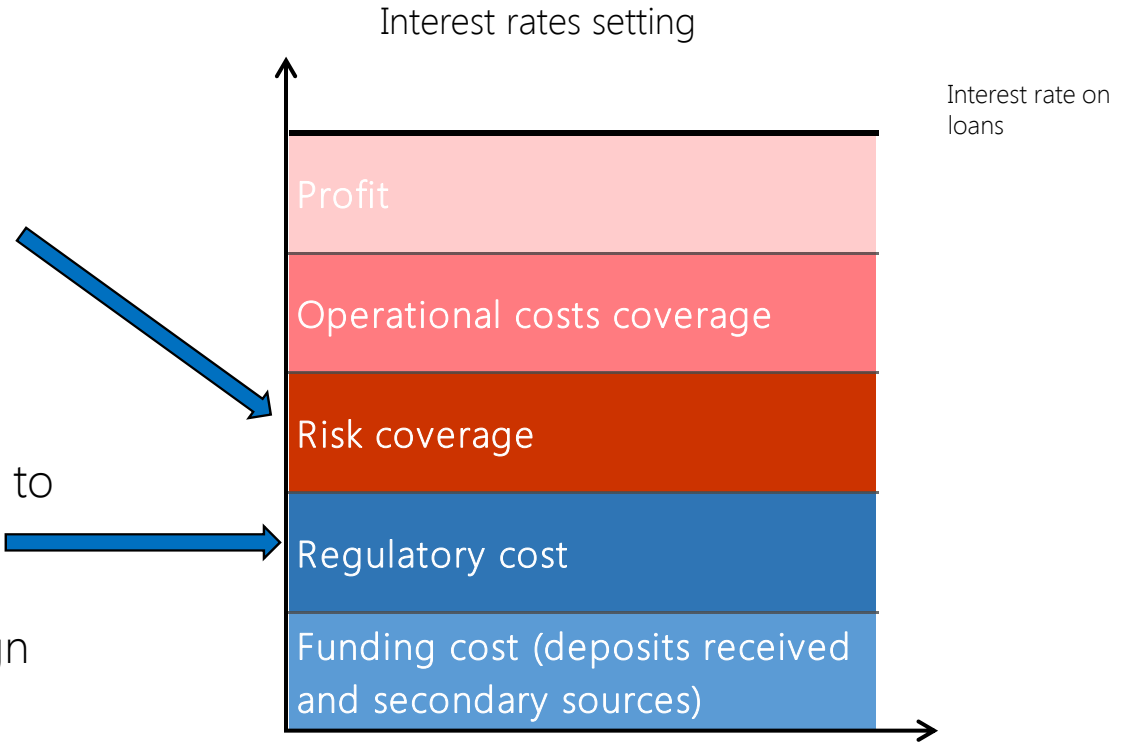
- Lower borrowing cost for all the sectors of the Croatian economy

Reduction of risk premium

- elimination of currency risk improves the perception of country risk
- particularly high reputational benefit of the introduction of the euro in highly-euroised countries

Reduction of regulatory cost:

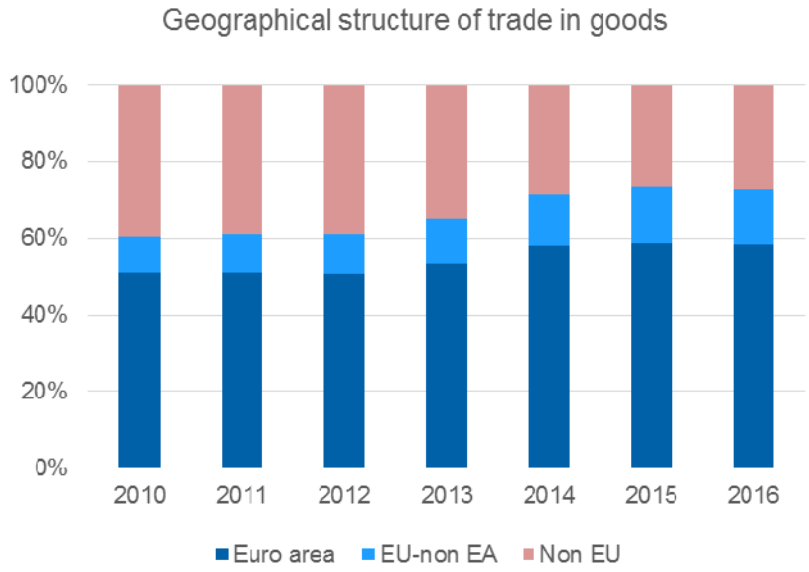
- reduction of the reserve requirement from 12% to 1%
- revocation of the requirement for minimum coverage of foreign currency liabilities by foreign currency claims (17%)



Benefits (3): Positive effects on exports and investments

- Introduction of the euro may contribute to international trade and investments strengthening through:
  - reduced transaction and currency conversion costs
  - improved transparency and easier price comparability
  - removal of uncertainties regarding exchange rate developments
  - strengthened competitiveness and reduced vulnerabilities of the Croatian economy
- Particularly positive impact on tourism
  - 70% of total revenues from tourism and 60% of total nights originate from the euro area

In terms of trade, Croatia is closely integrated in the euro area



Source: Eurostat and CNB calculation.

Other benefits (4):

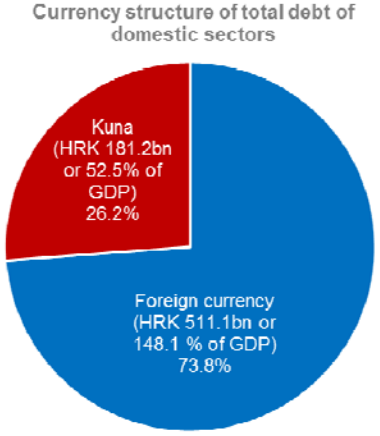
- Elimination of currency risk will eliminate the risk of an outbreak of a currency crisis
- Croatian banks will get access to monetary operations of the ECB, which reduces the risk of a banking and balance of payments crisis
- The costs of conversion of the kuna into the euro and vice versa will disappear
- Transaction costs (fees) for cross-border euro payments will be reduced
- The CNB will be entitled to a share in the annual distribution of Eurosystem's monetary income
- Croatia will get access to the European Stability Mechanism (ESM)

Costs and risks (1): Loss of independent monetary policy

- Loss of independent monetary policy may be reflected in:

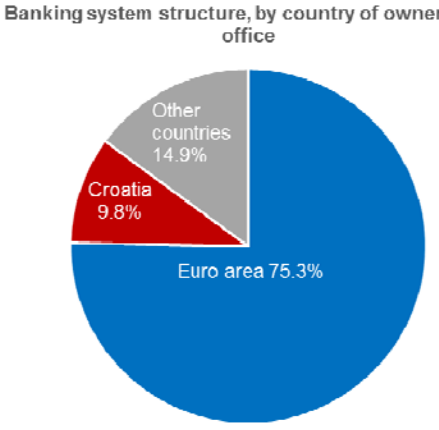
1) the real exchange rate channel

- The maneuvering space of the monetary policy is limited as it is owing to a high currency risk exposure
  → the exchange rate is kept stable and may not be used as a tool for improving competitiveness



2) the real interest rate channel

- Croatia is closely financially integrated in the euro area, with a high share of foreign ownership in its banking system, which limits the pursuit of a fully independent monetary policy



In case of Croatia, neither of the channels should have a significant negative impact

Costs and risks (2): Very small and one-off effect on price growth

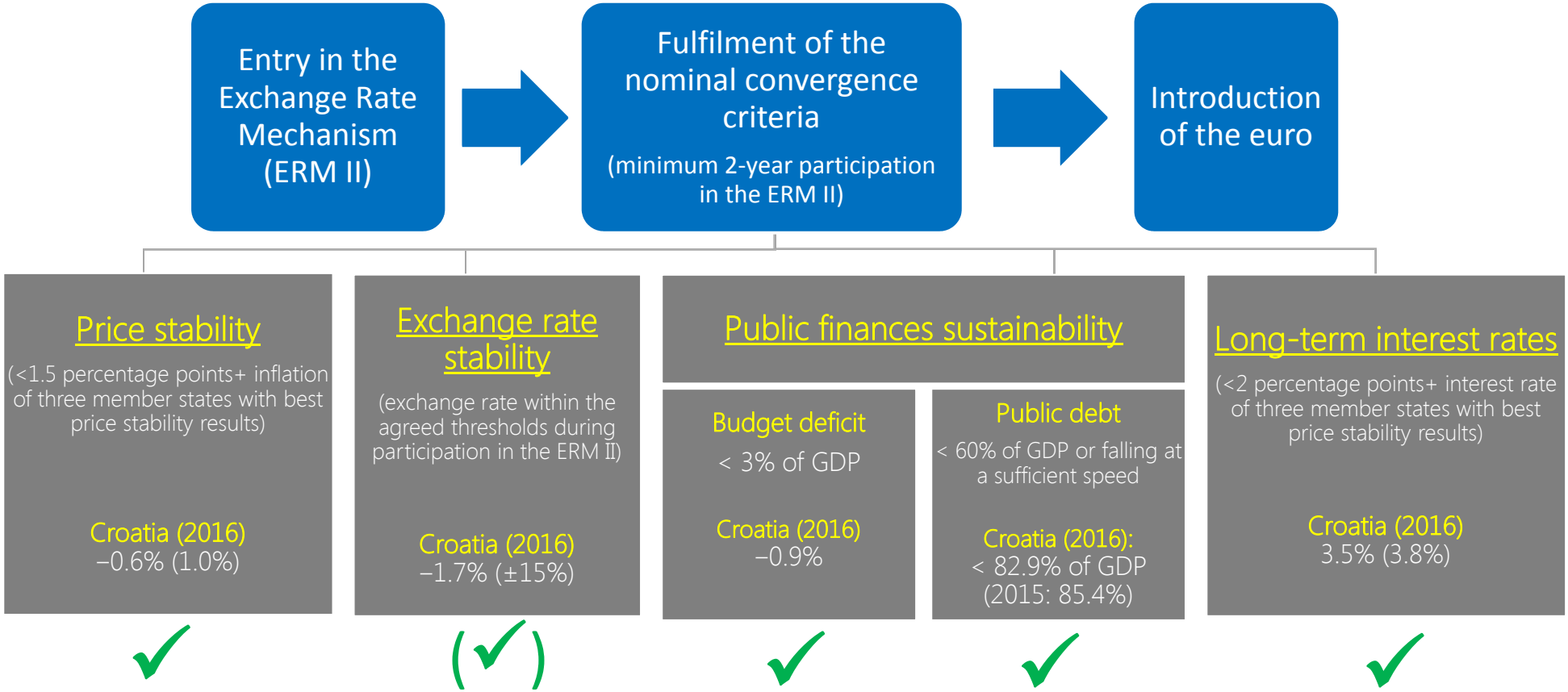
- Price growth following the introduction of the euro is generally very small, although public perception differs
- The effect of conversion on prices (HICP) in new member states of the euro area stands on average at 0.23 percentage points
- The assessment of the impact for Croatia: 0.2 percentage points on the consumer price index (CPI)
- A more pronounced effect in services and a smaller number of frequently bought products
- A smaller effect on consumer baskets of lower income citizens

Other costs and risks (3):

Risk of excessive capital inflow and accumulation of imbalances	• The risk is mitigated by new mechanisms set up for the coordination of economic policies (Macroeconomic Imbalance Procedure, (MIP), the European Systemic Risk Board (ESRB), common banking regulation)
One-off conversion costs	• Production and replacement of banknotes and coins • Alignment of IT, accounting and other systems • Costs of informing and educating the public • One-off conversion costs in old euro area member states were estimated at approximately 0.5% of GDP
Transfer of funds to the European Central bank (ECB)	• Remaining payment to ECB capital – EUR 62.8m • Payments to the revaluation account and provisions of the ECB – approximately EUR 300m • Transfer of a part of reserves to ECB reserves – approximately EUR 350m
Participation in financial assistance to other member states through the ESM	• Payment to the ESM capital - EUR 425m in the first five years • Following a transitional period of 12 years, the total payment obligation stands at approximately EUR 690m • In extreme situations, the obligations of member states may rise

- Procedure for euro adoption

Conditions for euro adoption



Entry in the ERM II is a key step in the process of euro adoption

- The introduction of the common currency is the obligation of all new member states
  - but it is up to the member states to decide when they wish to start the process of the introduction of the euro
- There are no clearly defined critera for entry in the ERM II
- It is important to obtain political support by EU member states and institutions
- Step one – informal consultations with euro area member states and EU institutions
- Step two – submitting the formal application for participation in the ERM II
- Negotiations on a country's entry in the ERM II do not have a limited time frame
- The last EU member state entered the mechanism in November 2005

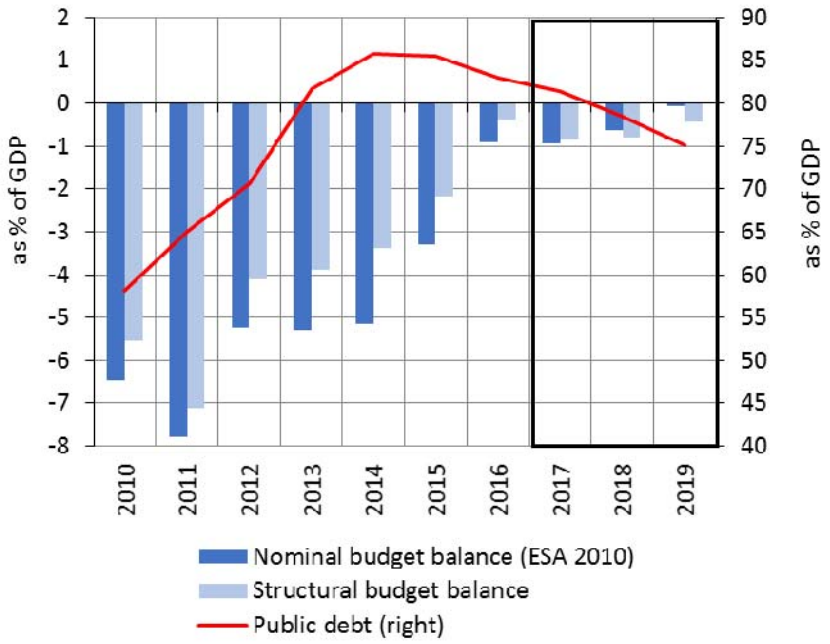
Entry in the ERM II is a key step in the process of euro adoption

- To obtain support, it is essential to demonstrate that Croatia is a good candidate for the introduction of the euro:
  - sound macroeconomic fundamentals (elimination of excessive macroeconomic imbalances)
  - prudent pursuit of economic policy
  - sufficient degree of real convergence
  - quality of institutions
- The presence of excessive macroeconomic imbalances in a country wishing to introduce the euro may slow down its progress towards monetary union

Are we ready for ERM II? (1): macroeconomic imbalances – public finances

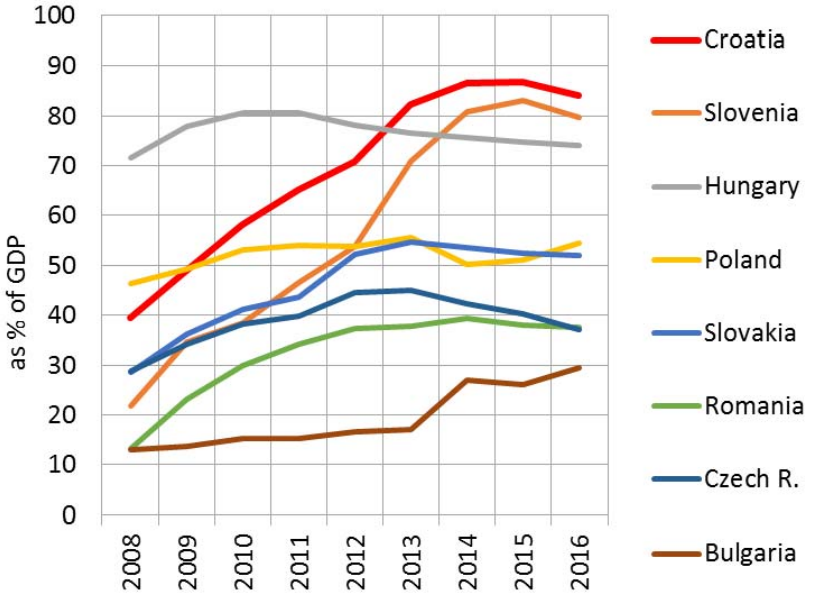
- In 2017, Croatia exited the excessive deficit procedure (EDP)

Cyclical and structural deficit reduction



Sources: MF, Eurostat, CNB.

Public debt is on a downward path, although it ranks the highest among peer countries



Sources: Eurostat, CBS.

Are we ready for ERM II? (2): macroeconomic imbalances

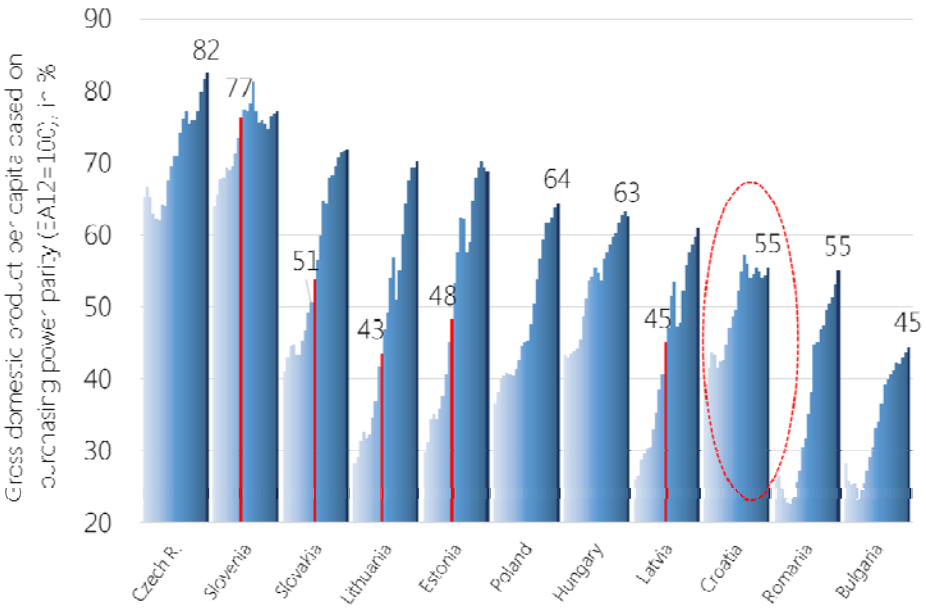
- Macroeconomic imbalances are shrinking but are still there

	Threshold	2012	2013	2014	2015	2016
Number of indicators exceeded (of total 14)		**7**	**7**	**6**	**3**	**3**
Net international investment position (as % of GDP)	> -35%	**-90.8**	**-88.9**	**-86.8**	**-77.3**	**-70.8**
Change in export market share (% of global exports) in 5 years	> -6%	**-23.7**	**-23.0**	**-18.5**	-3.4	10.3
General government debt (as % of GDP)	< 60%	**70.6**	**81.7**	**85.8**	**85.4**	**82.9**
Unemployment rate (a three-year average)	< 10%	**13.8**	**15.6**	**16.8**	**16.9**	**15.5**
Population activity rate 15-64 (% change in 3 years)	> -0.2%	**-1.7**	**-1.4**	2.0	3.0	1.9
Long-term unemployment rate 15-74 (% change in 3 years)	< 0.5%	**5.1**	**4.4**	**1.7**	0.0	-4.4
Youth (15-24) unemployment rate (% change in 3 years)	< 2%	**16.8**	**17.6**	**8.3**	0.1	-18.4

Note: Data for the general government debt for 2015 and 2016 updated with MF data.
Source: Eurostat.

Are we ready for ERM II? (3): real convergence

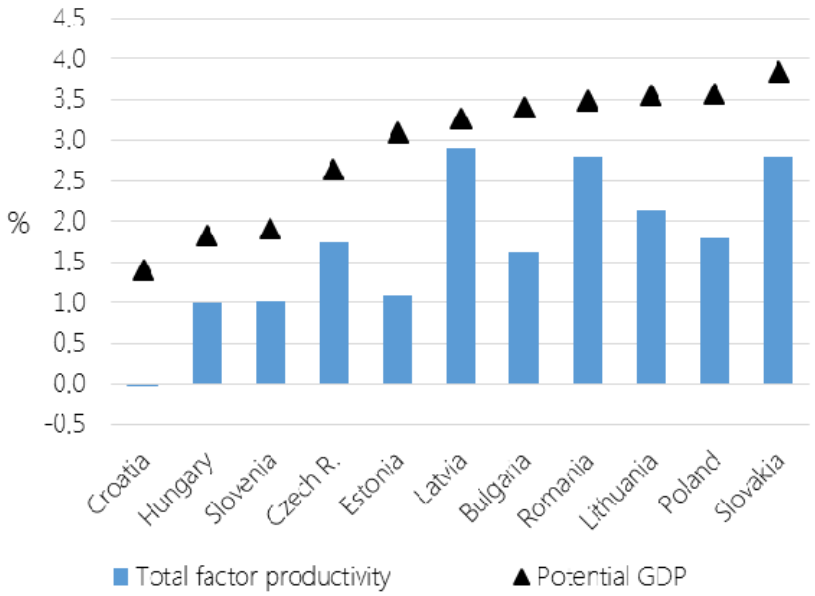
The achieved level of real convergence sufficient for accession to the exchange rate mechanism, but ...



Note: Data for Croatia for the 1995 - 2000 period are CNB estimates. Red colour denotes the year of accession to the Exchange Rate Mechanism.
Sources: Eurostat, CNB calculation.

... low potential growth associated with slow productivity growth

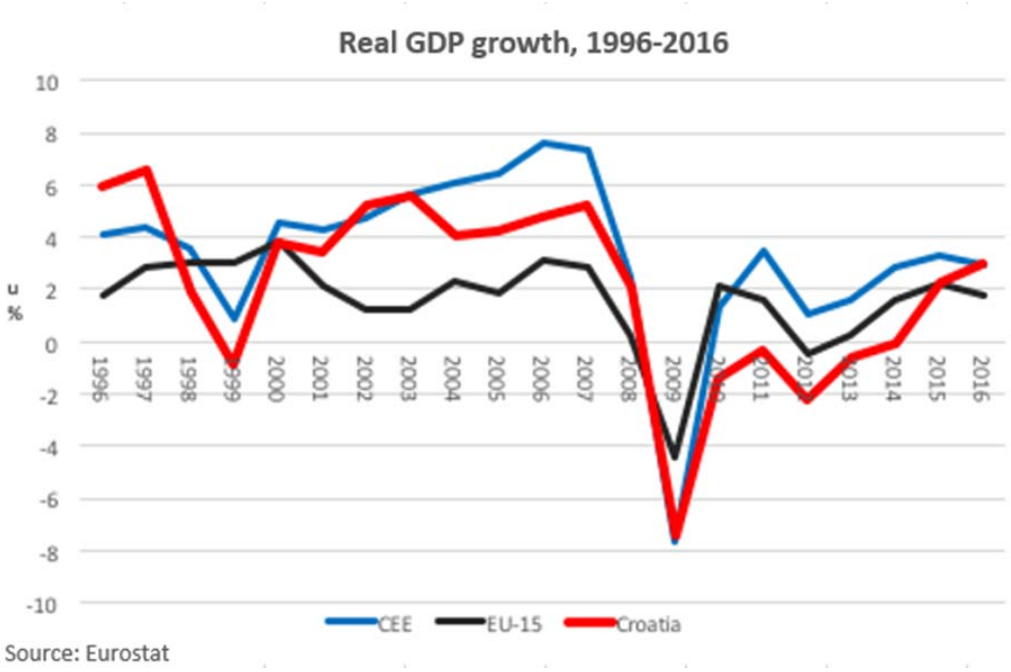
The average growth rate of potential GDP and contribution of overall factor productivity in 2002 - 2016



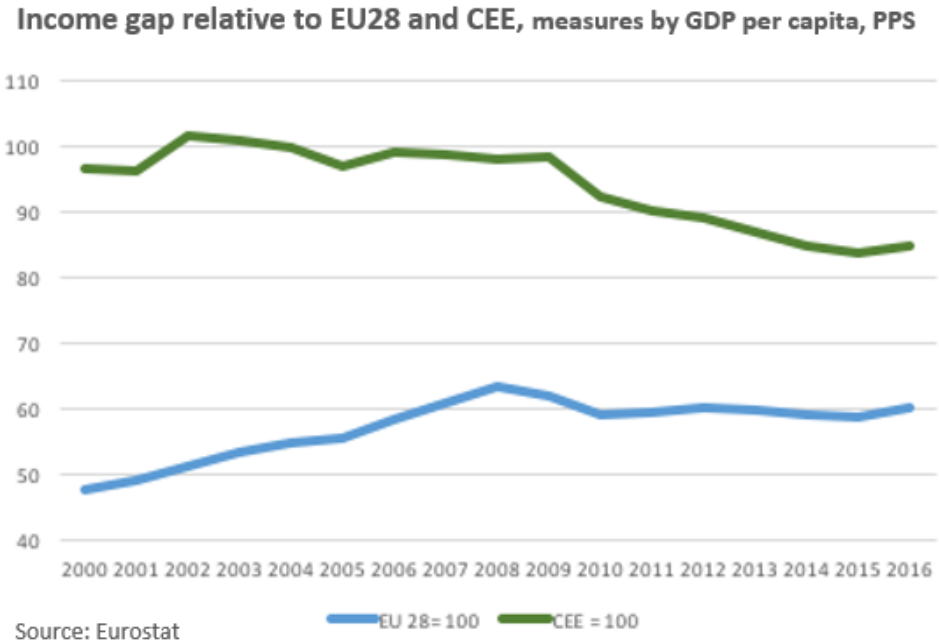
Source: Ameco.

- Economic policies in the context of euro adoption

Growth path and income gap



Source: Eurostat



Source: Eurostat

Productivity of the economy – reason for lagging behind and motivation for reforms?



Sources: World Penn Tables 9.0; authors' calculations



Sources: World Penn Tables 9.0; authors' calculations



Sources: World Penn Tables 9.0; authors' calculations

Labour productivity = Real GDP based on PPP (in million 2011 USD)/number of employed persons
Capital per worker = Capital stock based on PPP (in million 2011 USD)/number of employed persons

Priorities of the economic policy during the process of euro adoption

- Further prudent pursuit of fiscal policy with the aim of:
  - balancing the budget
  - reducing public debt
  - creating fiscal space for crisis periods (countercyclical action)

- Structural reforms for increasing potential growth:
  - reduction of macroeconomic imbalances
  - achievement of sustainable economic growth
  - creation of new jobs

Structural reforms for increasing potential growth

- Effective reduction of the economy's tax burden
  - boosting competitiveness of the economy through streamlined and cheaper tax administration
- Reduction of the economy's administrative burden
  - uniting inspection services in the economy and further reducing administrative costs and non-tax costs, ensuring simpler regulation
- Reform of the judiciary
  - streamlining the work organisation and management of the judiciary, reducing the length of court proceedings and the backlog of unresolved cases

Structural reforms for increasing potential growth

- Increasing public sector efficacy
  - ensuring efficient human resources management and revision of the system of wage determination that will foster expertise and secure remuneration based on employee work performance; wage policy which will make sure that wage increases in the public sector are in line with productivity growth in the economy
  - simplifying the rules and accelerating the work of administration and courts by means of information technology, with the aim of achieving greater public service efficiency and quality; improving the provision of electronic services

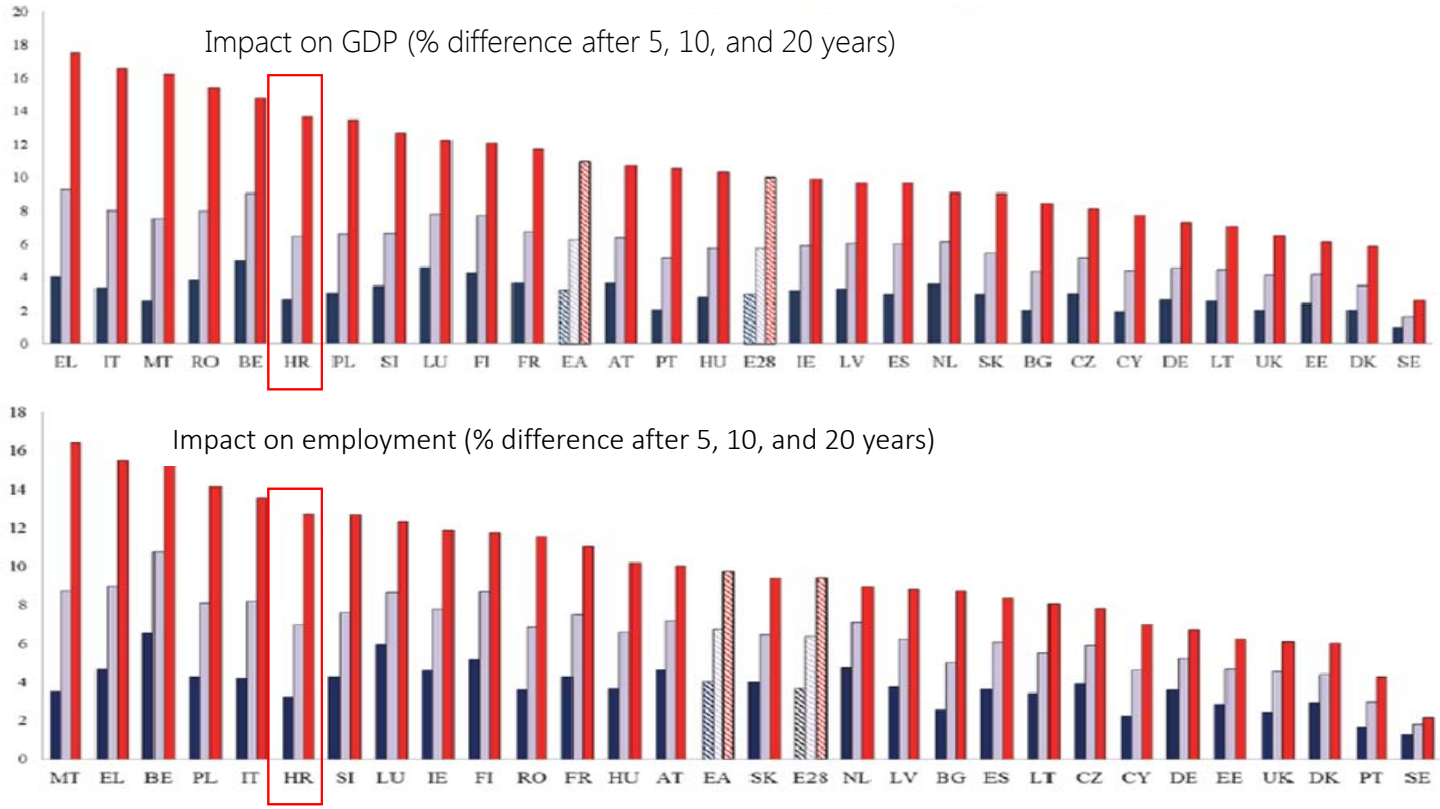
- Educational system reform
  - a comprehensive educational system reform; improving the quality of adult education system

Structural reforms for increasing potential growth

- Improving state property management
  - promoting corporate management in state-owned companies; reducing the state portfolio
- Increasing health and pension system sustainability
  - ensuring the conditions for long-term health and pension system sustainability
- Further increasing the use of EU funds
  - further increasing withdrawal of EU funds and the use of funds under the Structural Reform Support Programme

Structural reforms are not important only because of accession to the Exchange Rate Mechanism

Estimated macroeconomic impact of structural reforms



Source: European Commission (2014). The potential growth impact of structural reforms in the EU

Key messages

- With the introduction of the euro, Croatia will gain significant and permanent benefits, which greatly outweigh the costs
- It is in Croatia's interest to start the process of the introduction of the euro
- The dynamics of the process of the introduction of the euro largely depends on us; however, not everything is in our hands
  - The improvement of macroeconomic and fiscal indicators, and a sufficient level of real convergence speak in favour of our readiness to start talks with EU institutions about initiating the process of the introduction of the euro ...
  - ... however, the main challenge will be to win the support of EU member states and institutions for accession to the Exchange Rate Mechanism, which largely depends on their readiness to expand the euro area
- The economic and structural policies required for the introduction of the euro in Croatia are necessary, irrespective of the objective of the introduction of the euro

Thank you for your attention!