



CROATIAN NATIONAL BANK

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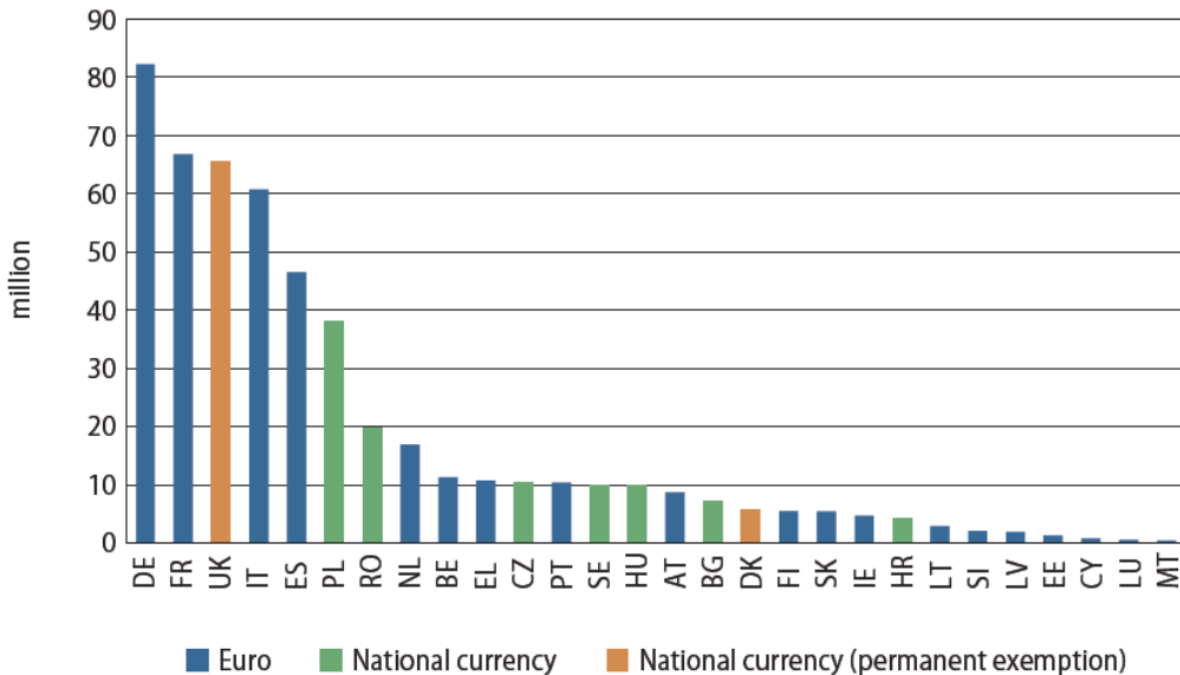
# CROATIA'S EUROSTRATEGY

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# Specific characteristics of Croatia's economy in favour of euro adoption

- Croatia is the smallest EU Member State that still uses its own currency



Source: Eurostat.

# Specific characteristics of Croatia's economy in favour of euro adoption

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- ❑ In terms of trade, Croatia is deeply 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
- ❑ Banking system is dominated by banks owned by institutions from the euro area – limited scope for monetary policy

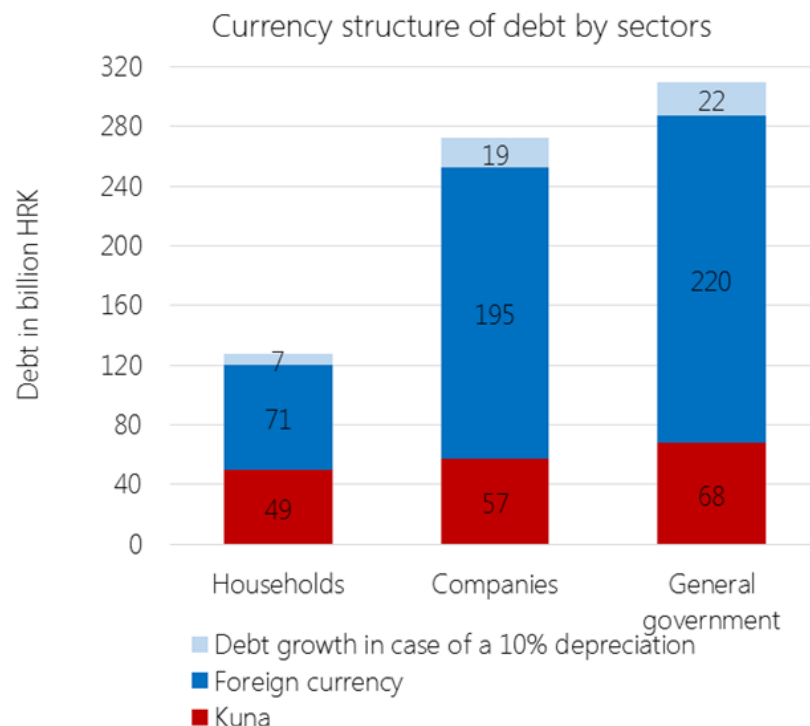
# Benefits of euro adoption in Croatia are considerable and long-term...

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

# Main 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 significant depreciation of the kuna against the euro would considerably increase 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**

# Main benefits (2)

## Reduction of interest rates

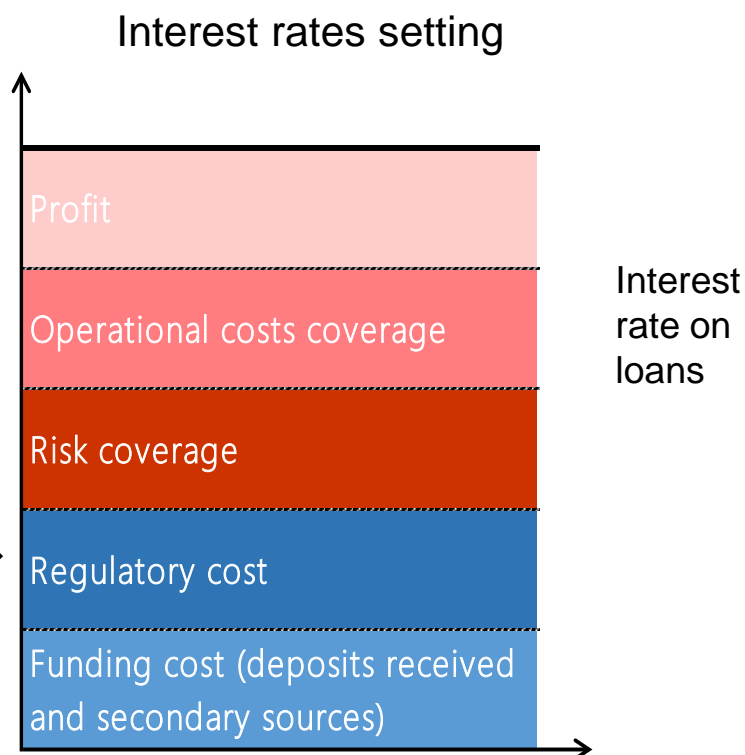
- Lower borrowing cost for all the sectors of the Croatian economy

### 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%)

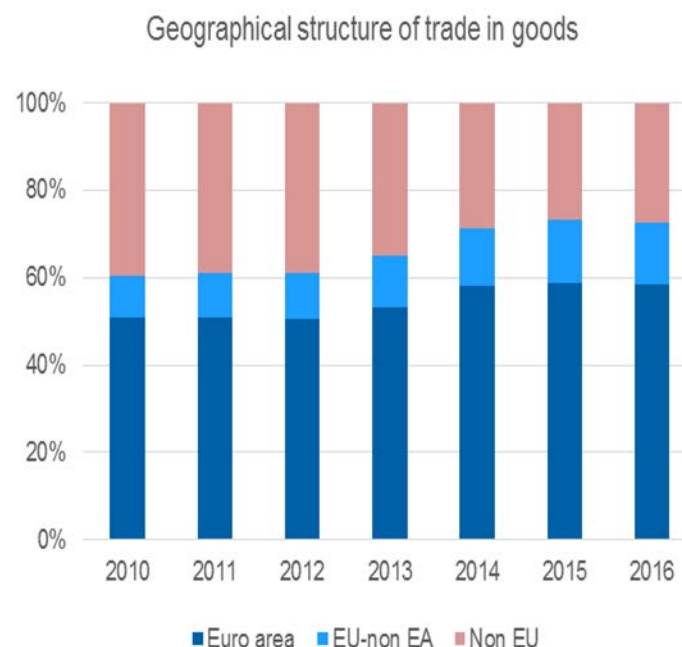


# Main benefits (3)

## Positive effects on exports and investments

- Introduction of the euro may contribute to international trade and investments 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 spent by non-residents originate from the euro area

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



Source: Eurostat and CNB calculation.

# Other benefits

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- ❑ 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.
- ❑ HNB 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).



# ...while costs are mostly one-off and small

|   | <b>Importance</b> | <b>Time impact</b> |
|---|-------------------|--------------------|
| <b>Loss of independent monetary policy</b>                                    | Small             | Permanent          |
| <b>Risk of conversion-related increase in price levels</b>                    | Small             | One-off            |
| <b>Risk of excessive capital inflows and accumulation of imbalances</b>       | Small             | Permanent          |
| <b>Conversion costs</b>   | Small             | One-off            |
| <b>Transfer of funds to the European Central Bank</b>                         | Small             | One-off            |
| <b>Participation in providing financial assistance to other Member States</b> | Medium            | One-off            |

# Main costs as perceived by the public (1)

## Loss of independent monetary policy

Loss of independent monetary policy may be reflected in:

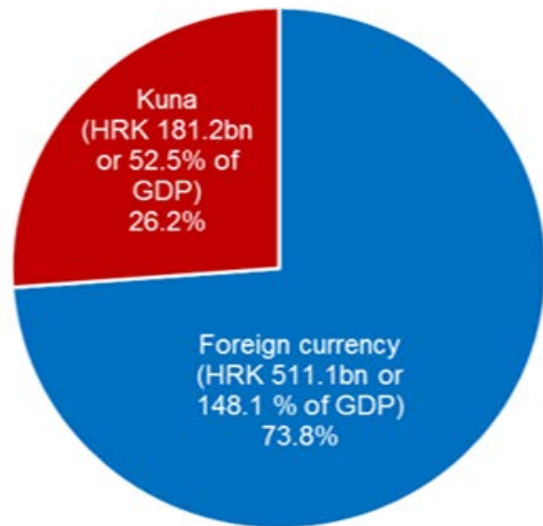
### 1) Real exchange rate channel

- room for maneuver of the monetary policy is limited due to high currency risk exposure

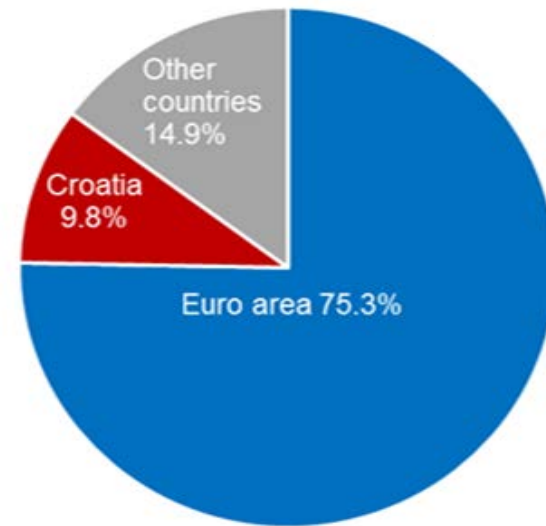
### 2) Real interest rate channel

- high share of foreign ownership in Croatian banking system limits the pursuit of a fully independent monetary policy

Currency structure of total debt of domestic sectors



Banking system structure, by country of owner head office



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

# Main costs as perceived by the public (2)

## Effect on price growth

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- Although historic price growth following the introduction of the euro is generally very small, public perception is negative.
- 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

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), 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

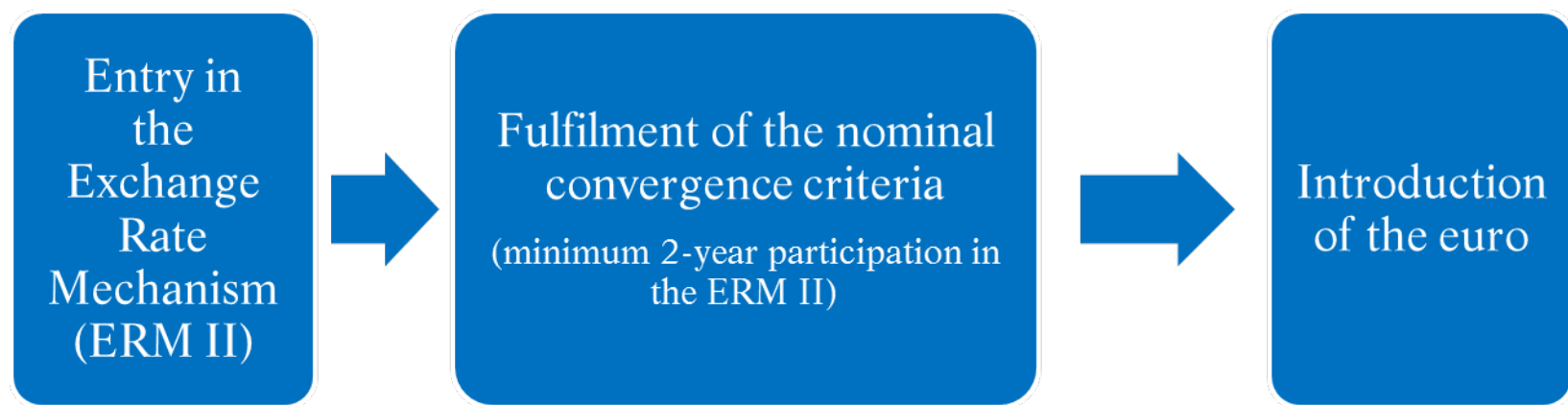
Transfer of funds to the European Central bank (ECB)

- 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 – approx. 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

# Maastricht criteria – how does Croatia stand?



**Price stability**  
(<1.5 percentage points+ average inflation rate of three member states with best price stability results)

**Croatia (2017)**  
1.3% (2.1%)



**Exchange rate stability**  
(exchange rate within the agreed thresholds during participation in the ERM II)

**Croatia (2016-17)**  
-1.5%/+2,3%  
(±15%)



**Public finances sustainability**

**Budget deficit**  
< 3% of GDP

**Croatia (2017e)**  
-0.2% of GDP

**Public debt**  
< 60% of GDP or falling at a sufficient speed

**Croatia (2017):**  
80.1% of GDP  
(2016: 82.9%)



**Public debt**  
< 60% of GDP or falling at a sufficient speed

**Croatia (2017):**  
80.1% of GDP  
(2016: 82.9%)



**Long-term interest rates**  
(<2 percentage points+ average interest rate of three member states with best price stability results)

**Croatia (2017)**  
2.5% (2.9%)



# ERM II entry is a key step in the process of the euro adoption (1)

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- To obtain support from European partners, it is essential to demonstrate that Croatia is a good candidate for euro introduction
  - sound macroeconomic fundamentals (no excessive imbalances)
  - prudent pursuit of economic policy
  - sufficient degree of real convergence
  - quality of institutions

# ERM II entry is a key step in the process of the euro adoption (2)

Current macroeconomic trends are favourable, but further improvements are needed:

## □ Public finance

- In 2017 Croatia exited the EDP, the government budget is close to balance
- Public debt on a downward path, but still high comparing to peers (close to 80% of GDP)

## □ Macroeconomic imbalances

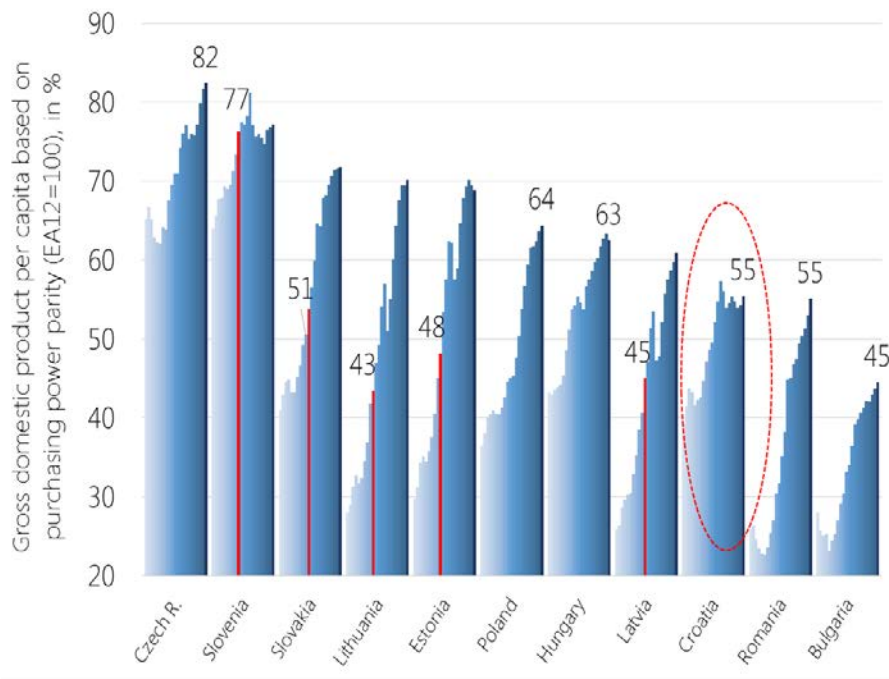
- Imbalances are declining rapidly
  - 3 out of 14 scoreboard indicators in breach in 2017 (7 out of 14 were in breach in 2013)
  - Commission assesses Croatia to continue having excessive imbalances with limited progress in implementation of CSRs (2018 MIP)

## □ Real convergence

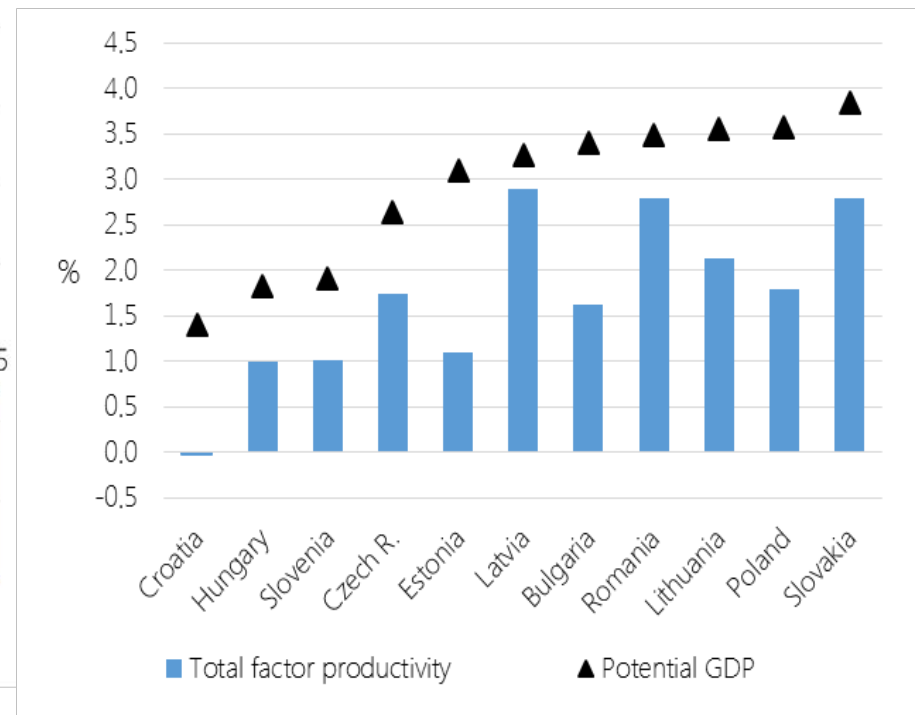
- Existing level of real convergence should be sufficient for joining ERM II,
  - however, dynamics of real convergence may be an issue – low potential growth is associated with slow productivity growth

# Real convergence

*Relative GDP per capita in the year of ERM II entry*



*Average growth rate of potential GDP and contribution of overall factor productivity in 2002-2016*



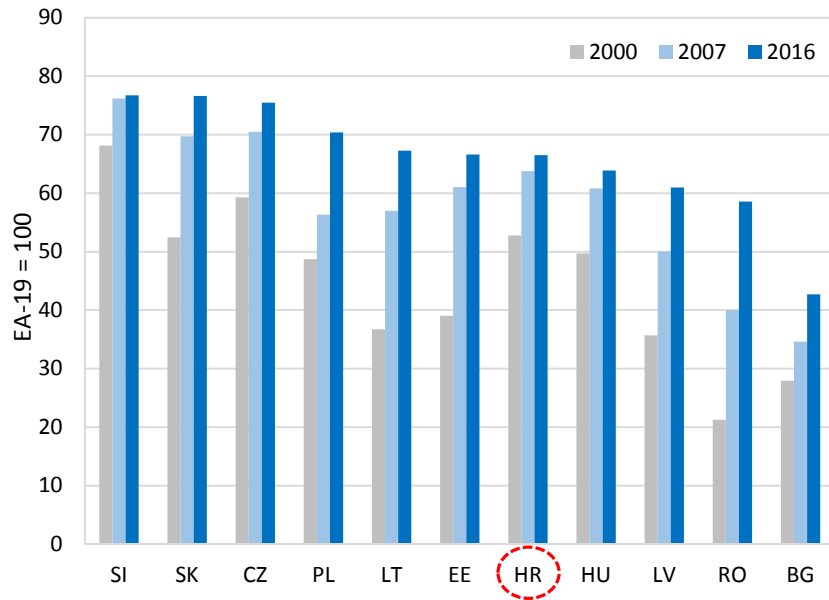
Note: Data for Croatia for the 1995 - 2000 period are CNB estimates. Red colour denotes the year of accession to the Exchange Rate Mechanism.  
Sources: Eurostat, CNB calculation.

Source: Ameco.



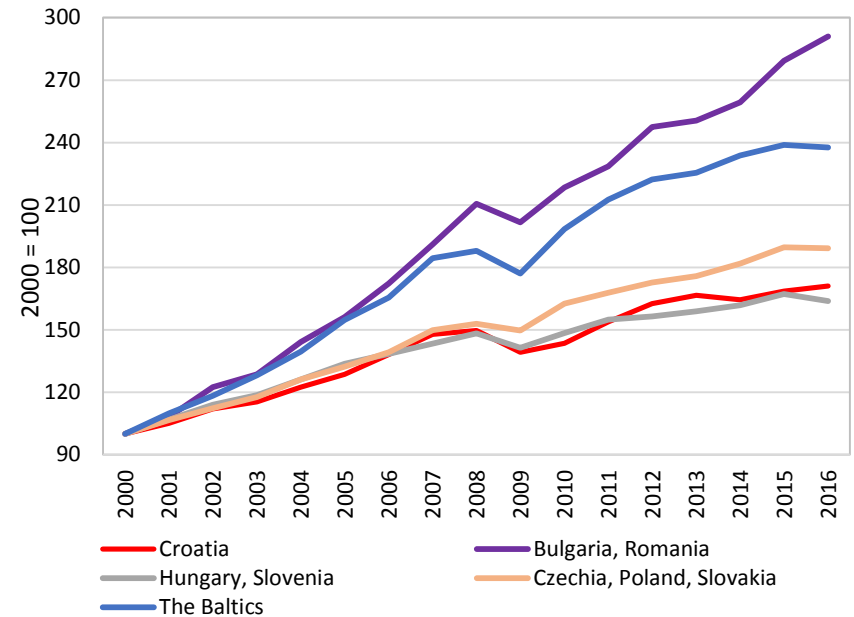
# Croatia lags behind its CEE peers in terms of labour productivity...

*Convergence of the productivity level*



Note: Labour productivity is calculated as the real purchasing power GDP per employed person.  
Source: Eurostat

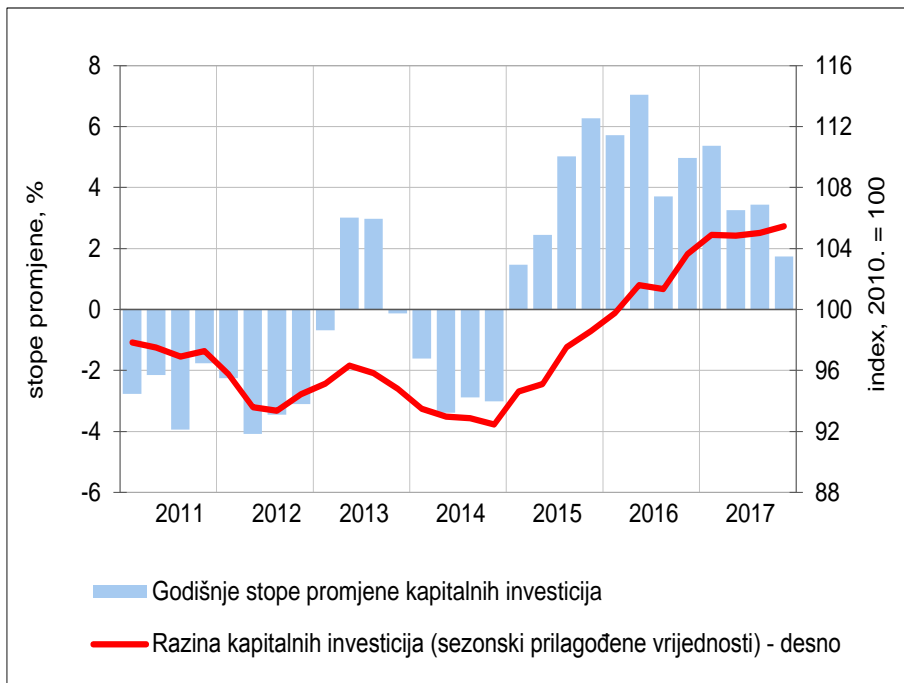
*Real labour productivity in CEE countries*



Note: Labour productivity is calculated as the real purchasing power GDP per employed person. The Baltics are Estonia, Latvia and Lithuania.  
Source: Eurostat

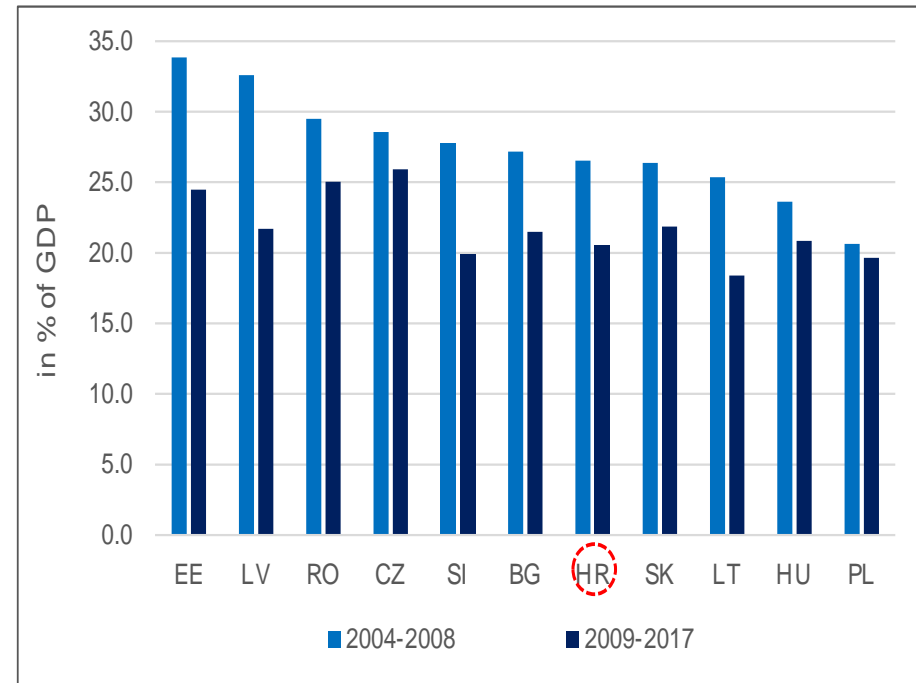
# Investments are starting to recover, but are still lower than before the crisis

Gross investments in fixed capital formation in Croatia



Source: DZS (seasonally adjusted by CNB)

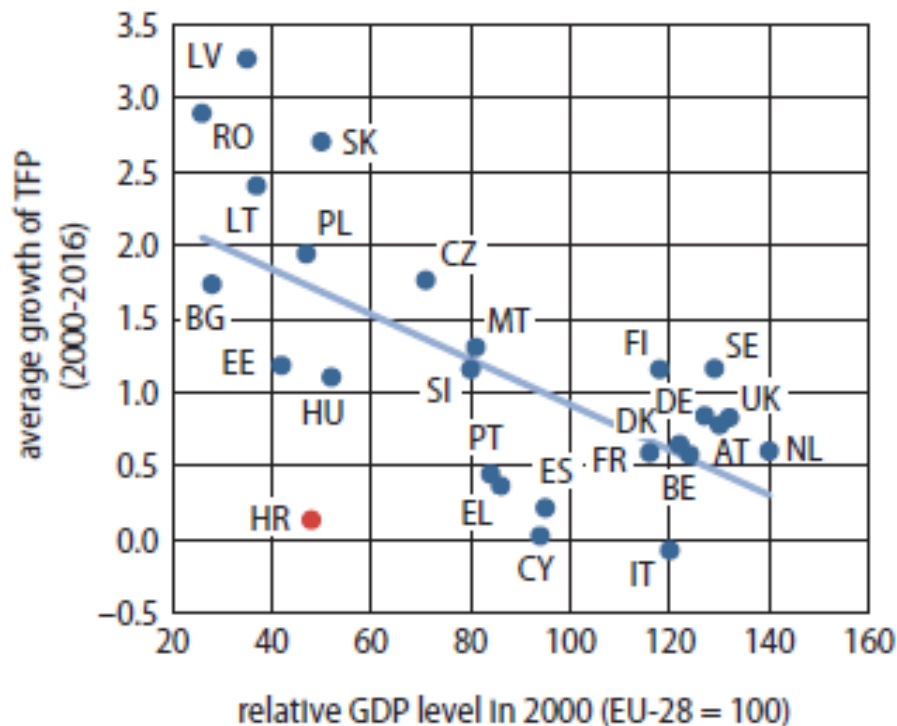
Croatia and peer countries



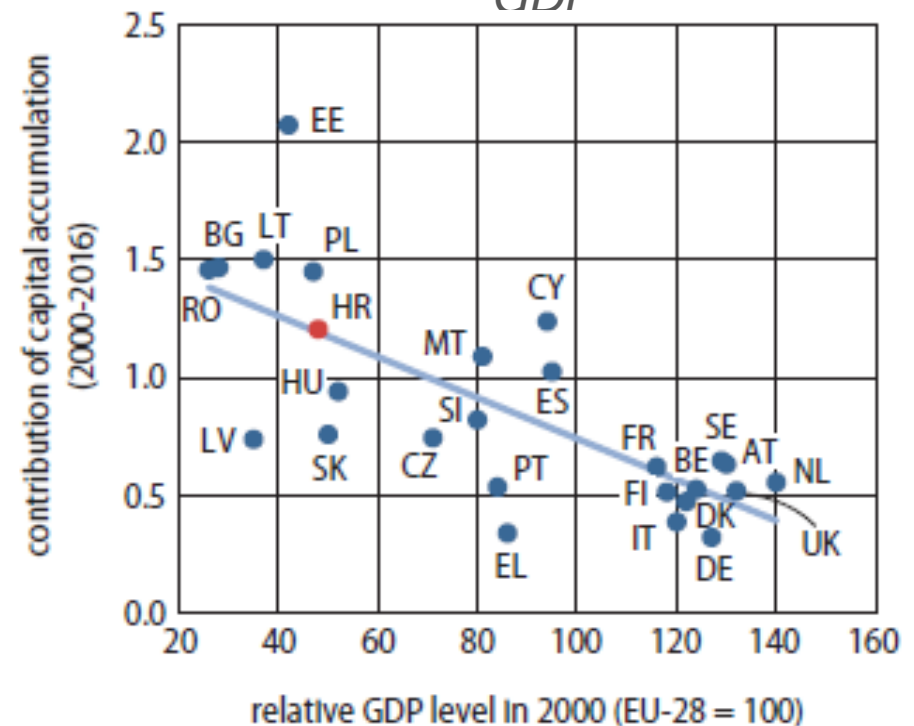
Source: Eurostat; DZS

# The level of investments is not so much of a problem, productivity much more so

*Average TFP growth*



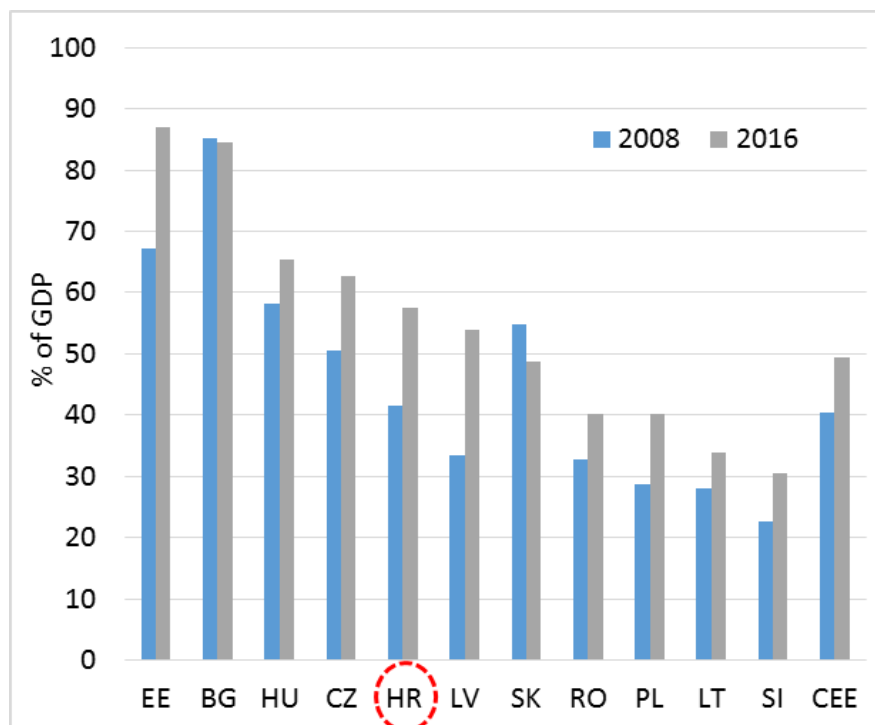
*Contribution of capital accumulation to potential GDP*



Source: Eurostat; Croatian National Bank calculations

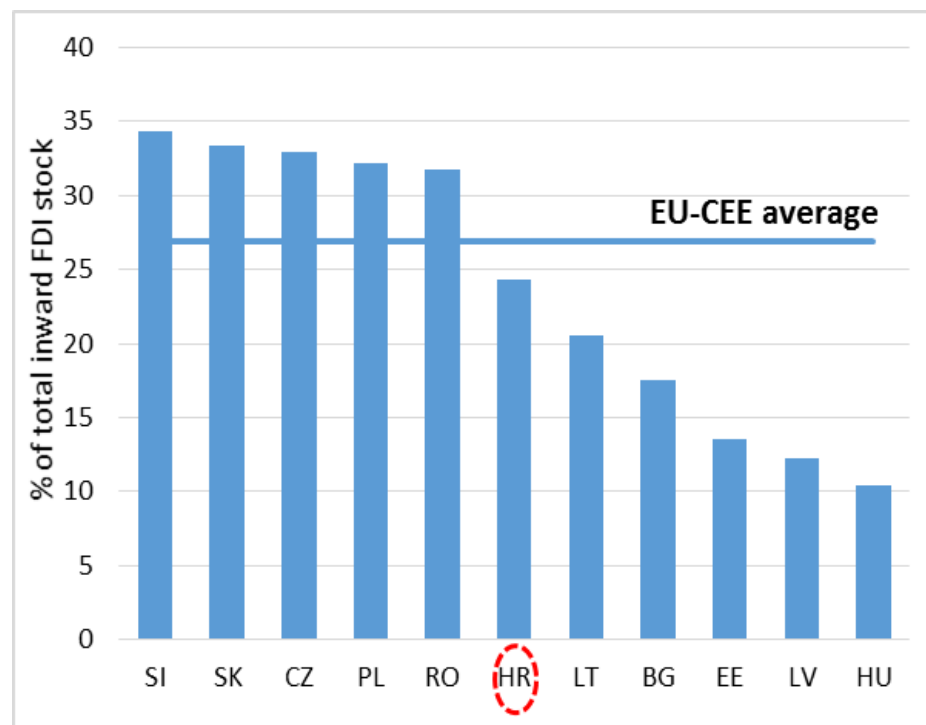
# Relatively high cumulative FDI inflow in Croatia compared to peer countries

*Inward FDI stock*



Note: Inward FDI stock by directional principle.  
Source: WiiW, 2017

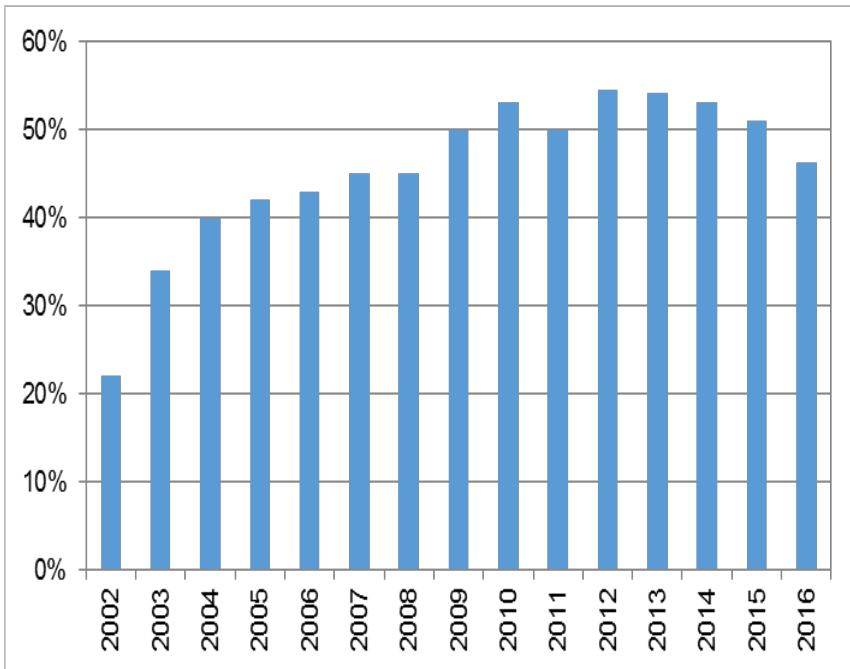
*Manufacturing industry, 2015*



Note: Data for Slovakia refer to the end of 2014. Inward FDI stock by directional principle.  
Source: WiiW, 2017

# FDIs and exports

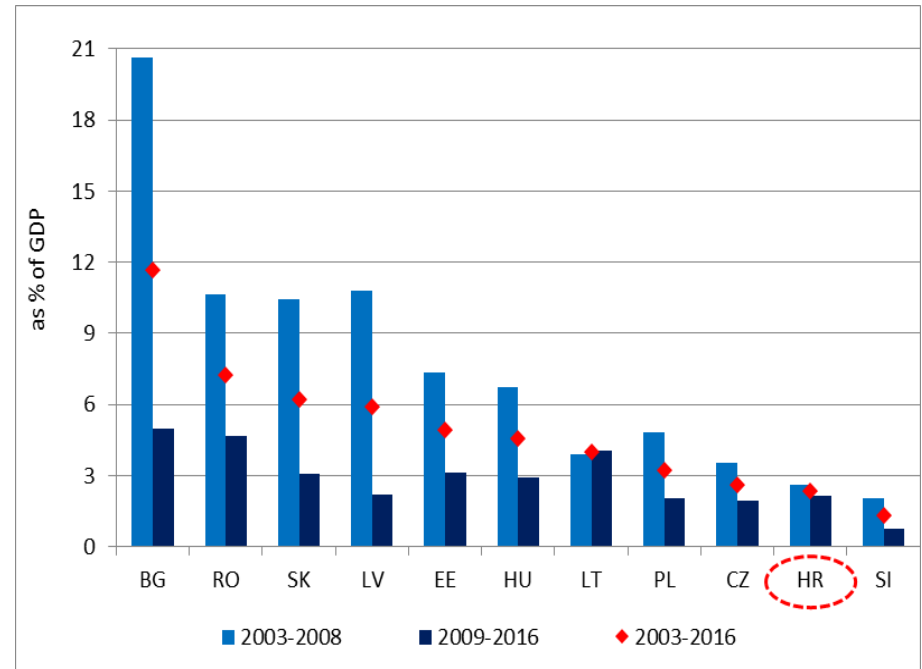
*Share of FDI firms in Croatian exports*



Note: FDI refer to companies were share of foreign ownership exceeds 10%. Recent decrease in share of FDI firms in Croatian exports can be partly explained by higher quasi-transit.

Sources: FINA for data until 2010, later CBS and CNB

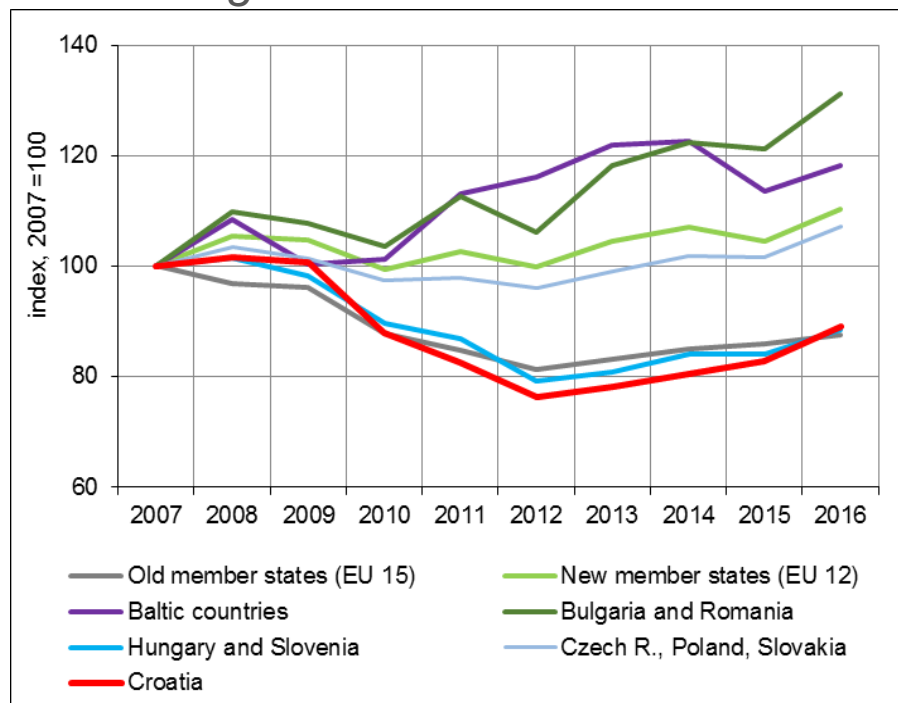
*Greenfield investment projects, annual average*



Sources: UNCTAD, World Investment Report 2017; Eurostat

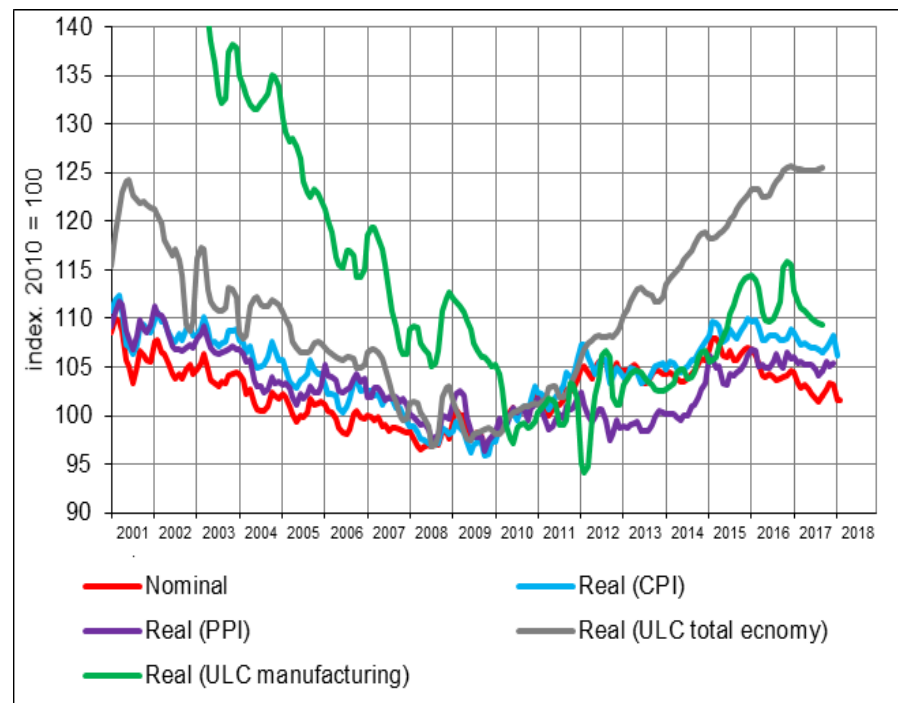
# Croatia's export market share on the rise following EU accession, while price competitiveness has been improving since the onset of the crisis

*Exports of goods and services – global market share*



Note: Baltic countries include Estonia, Latvia and Lithuania  
Source: Eurostat

*Nominal and real effective exchange rate of the kuna*

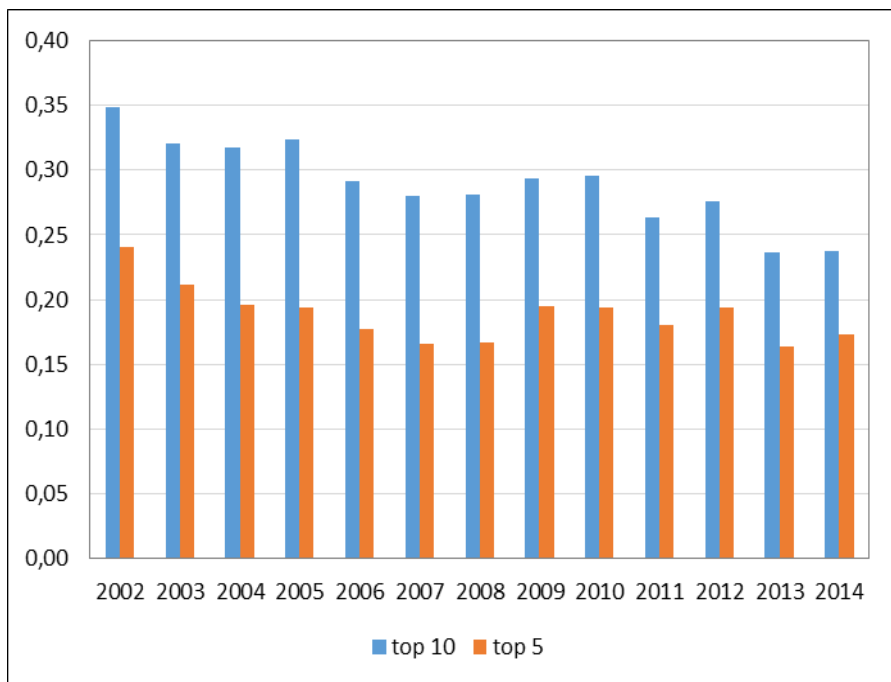


Note: The real effective exchange rate of the kuna deflated by producer prices includes the Croatian index of industrial producer prices on the total market. The unit labour cost is calculated as the ratio between compensation per employee and labour productivity (defined as GDP per person employed), while the real effective exchange rate of the kuna deflated by unit labour costs is the result of the interpolation of quarterly values. A fall in the index indicates an effective appreciation of the kuna.

Source: CNB

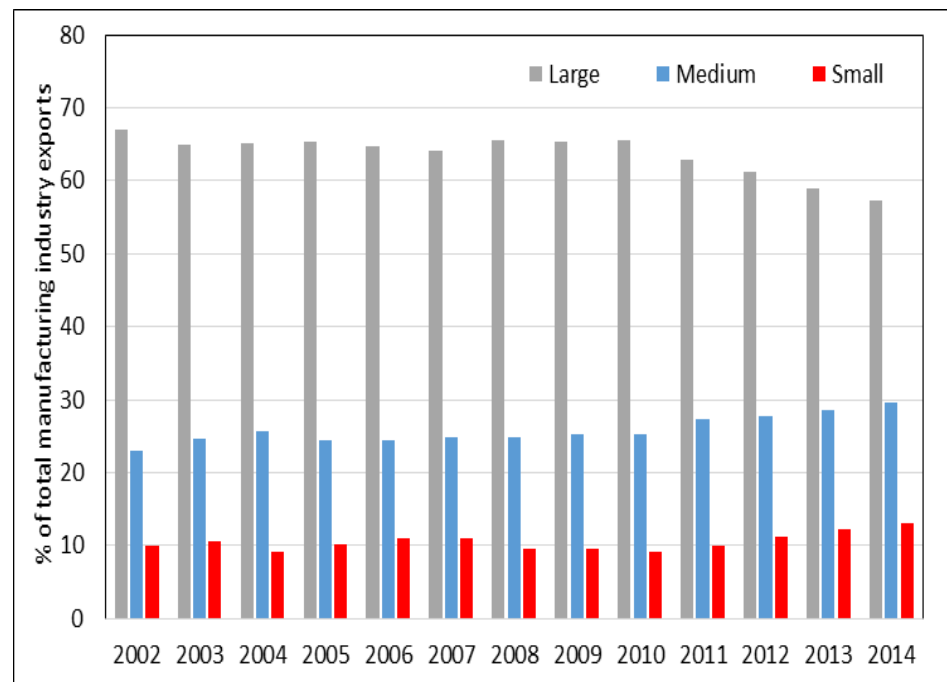
# The share of top exporters in manufacturing sector exports is declining, while the share of small and medium firms is increasing

*Share of top exporters, manufacturing sector*



Source: Valdec i Zrnc (unpublished)

*Share of small, medium and large firms, manufacturing sector*



Note: Small companies have less than 50 employees, medium size companies from 50 to 250 employees, and large more than 250 employees.

Source: Valdec i Zrnc (unpublished)

# Priorities of the economic policy during the process of euro adoption

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- Further pursuit of prudent fiscal policy
  - further fiscal consolidation is necessary
  - public debt is still high and is a key source of vulnerability
  - irrespective of the goal to introduce the euro, persistent reduction of the public debt will increase economy's resilience to shocks
  
- Croatia has to continue with efforts in key reform areas aimed at increasing potential growth:
  - judiciary reform
  - effective reduction of the economy's tax burden
  - increasing public sector efficacy
  - wage dynamics in line with productivity growth
  - education system reform
  - ensuring health and pension system sustainability
  - improving state property management
  - and other measures aimed at improving business environment