



HRVATSKA NARODNA BANKA

EUROSUSTAV

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

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Ljubljana, 20 April 2023



# Overview

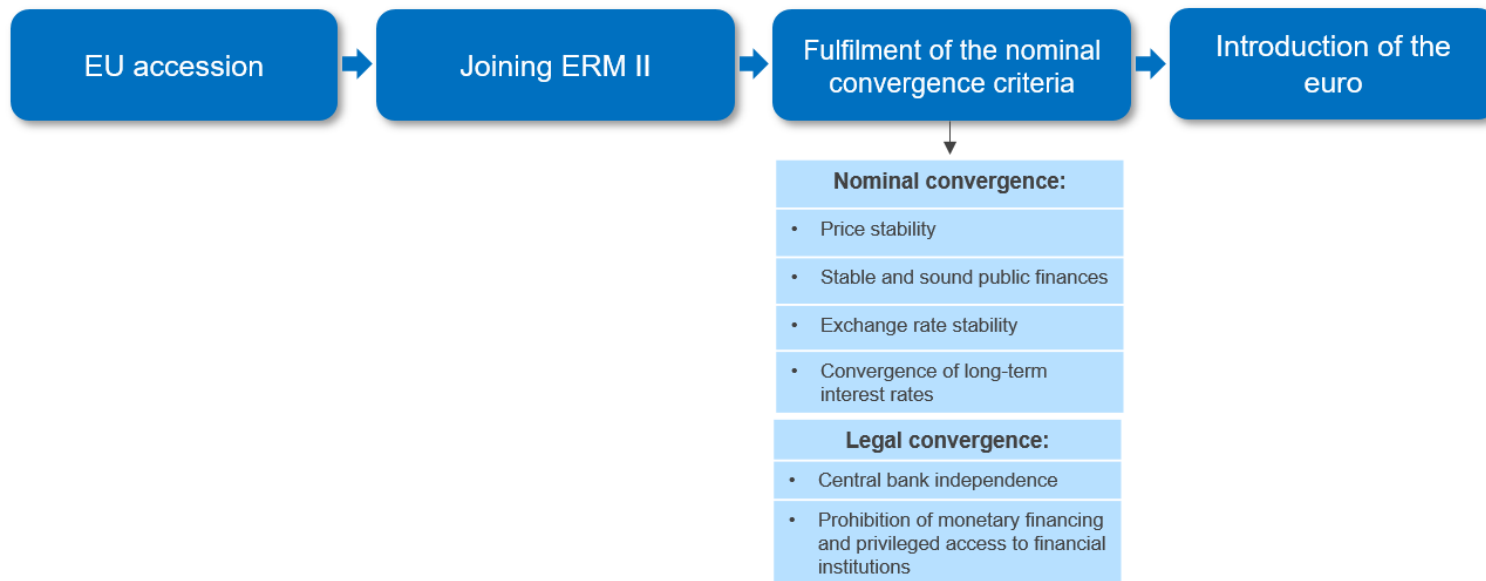
- The euro adoption process – then and now
- Challenges in the context of high inflation
- Motivation for the adoption of the euro

- 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

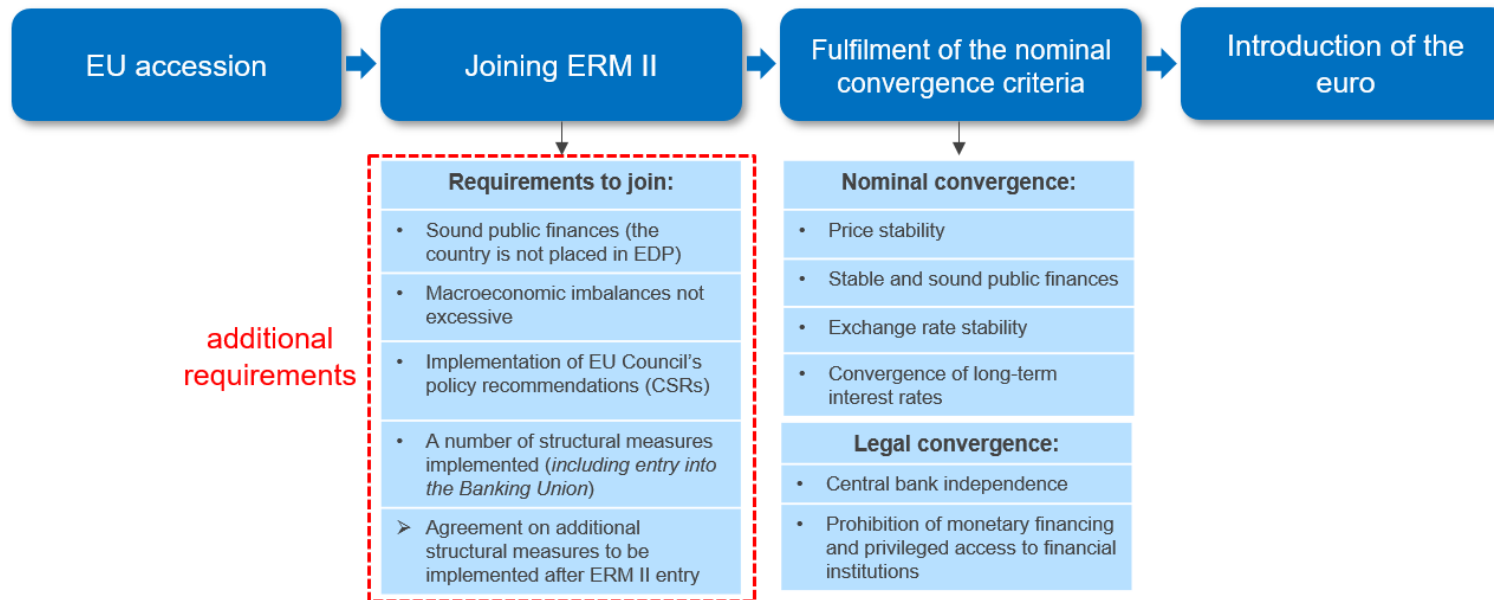
## The euro adoption process - then



## 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



# One of the key challenges were the policy measures that Croatia had to implement before and after joining ERM II

Before joining ERM II we had to implement 19 policy measures in **6 reform areas**:

- 1) further strengthen banking supervision by establishing close cooperation with the ECB
- 2) strengthen the macroprudential policy framework by setting out a legal basis for borrower-based measures
- 3) strengthen the anti-money laundering framework
- 4) upgrade the system of statistical data collection, processing and publication
- 5) improve public-sector management
- 6) reduce the administrative and financial burden on the economy.

under the responsibility of the HNB

After joining ERM II we had to implement additional 8 policy measures in **4 areas**:

- 1) strengthen the anti-money laundering framework
- 2) reduce the administrative and financial burden on the economy through further simplification of administrative procedures and decreases in parafiscal and non-tax charges
- 3) improve governance of state-owned enterprises
- 4) strengthen the national insolvency framework



## 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)**

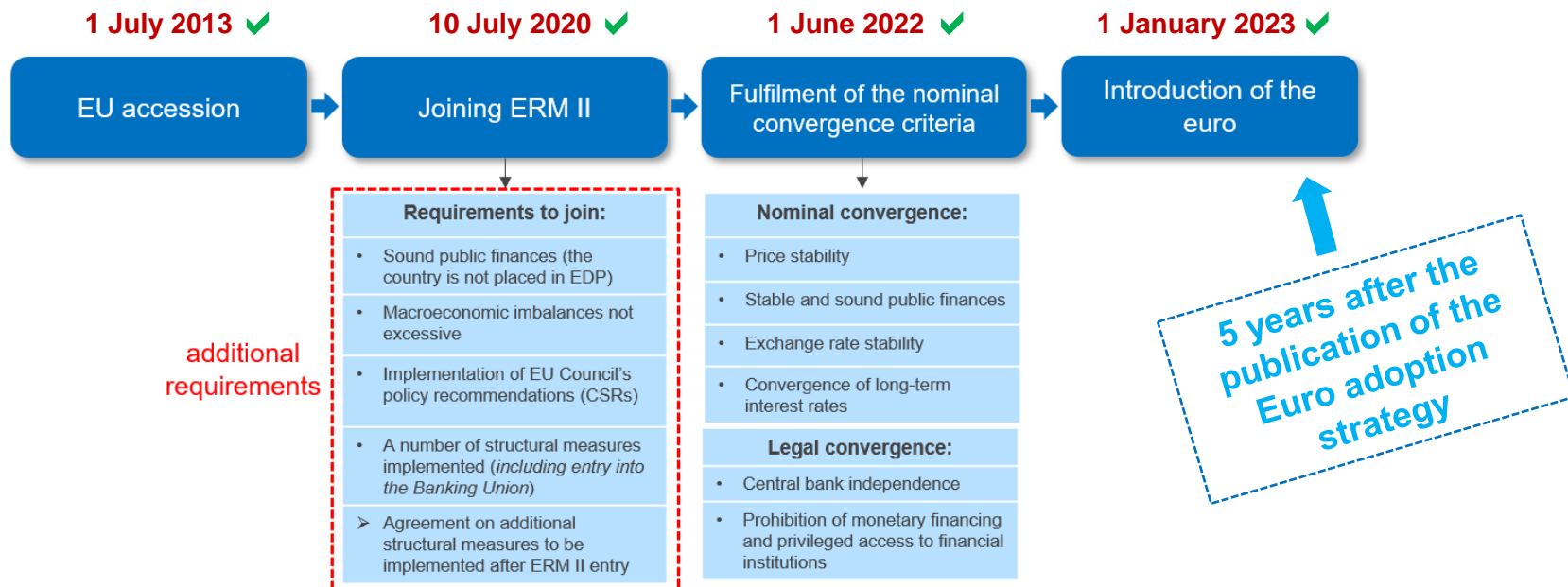
➤ **surge in global inflation (2021/2022)**

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 complete the euro adoption process in the shortest possible time

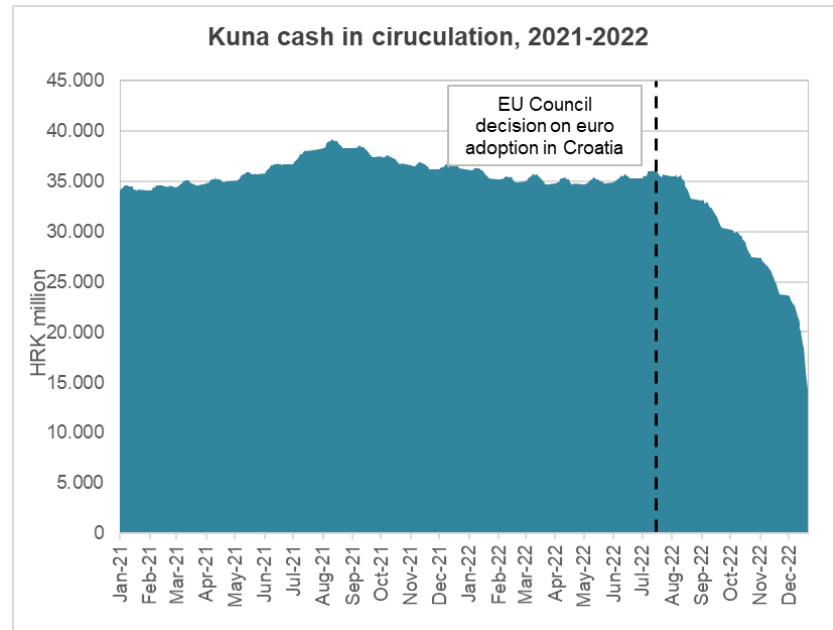


## Euro changeover – practical preparations

- The Euro Changeover Plan, adopted in **December 2020**, set out practical steps for the introduction of the euro:
  - how the procurement and distribution of euro cash will be organized
  - where and when will citizens be able to exchange kuna banknotes and coins for euros
  - what are the rules for recalculating prices
  - how kuna deposits and loans, as well as other financial instruments will be converted
  - how will interest rates be adjusted
  - what measures will be taken to protect consumers against unjustified price increases
- The Act on the Introduction of the Euro was adopted in **May 2022**

## The changeover was smooth and successful

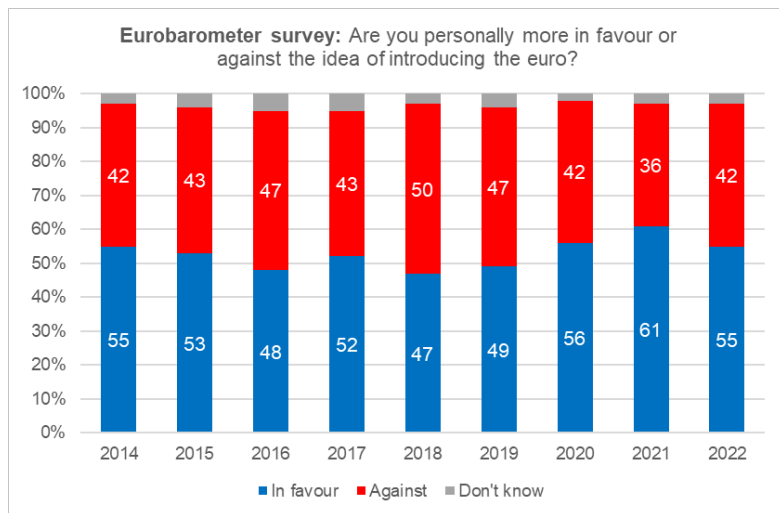
- Kuna cash in circulation declined by 60% by end 2022
- 2/3 of ATMs started to dispense euro banknotes already on 1 January
- No major problems during the dual circulation period
  - close to 900 thousand **euro coin starter kits** was sold to citizens by end 2022, which facilitated cash transactions in the first weeks
- The conversion of kuna deposits and loans was carried out properly; no incidents were reported
- Cash changeover available at all bank branches and offices of the Croatian Post and the Financial Agency free of charge by the end of 2023



Source: HNB

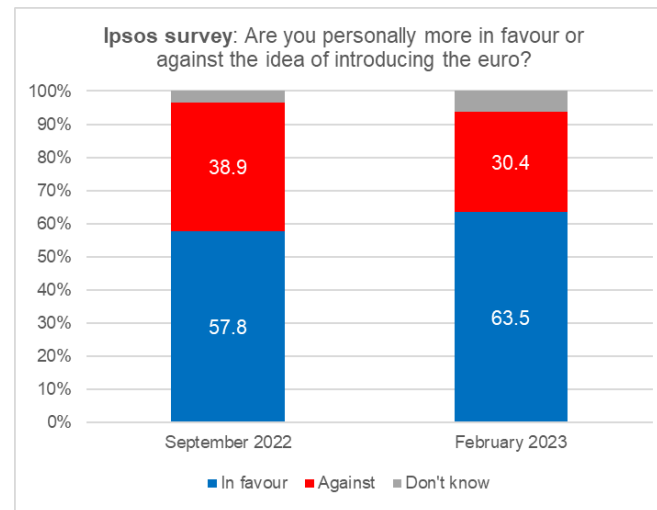
# Public support for euro adoption in Croatia

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



Source: Eurobarometer

... and has increased further following the successful changeover

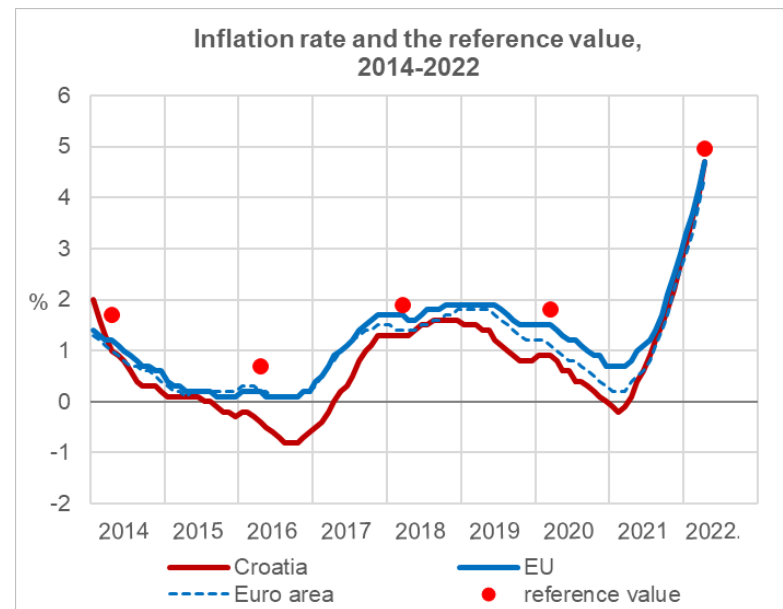


Source: Ipsos

- 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

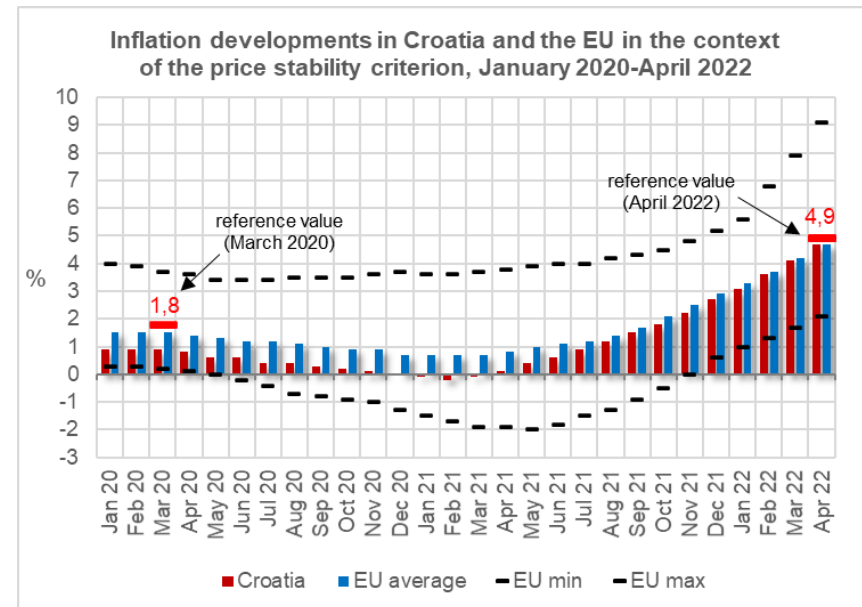
- Since its EU accession, Croatia has continuously been compliant with the price stability criterion
  - in fact, since 2016 Croatia was *de facto* compliant with all convergence criteria
- However, global inflationary pressures that emerged in 2021 and further intensified in 2022 called into question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

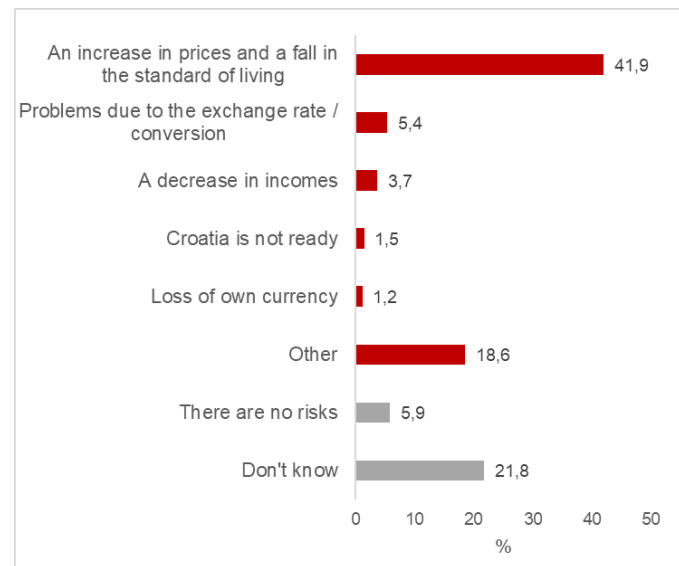




## High inflation has reinforced the (incorrect) public perception of the negative impact of the euro on living standards

- 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?*

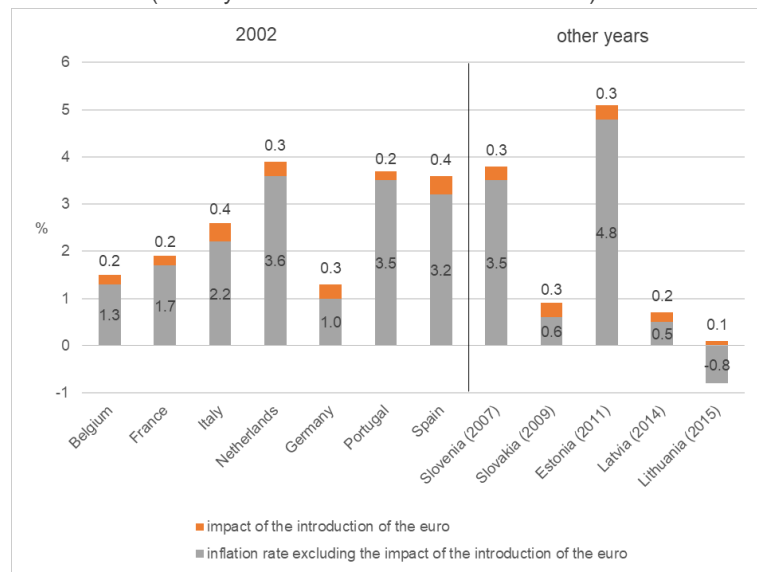


Source: Ipsos, March 2021

## 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)

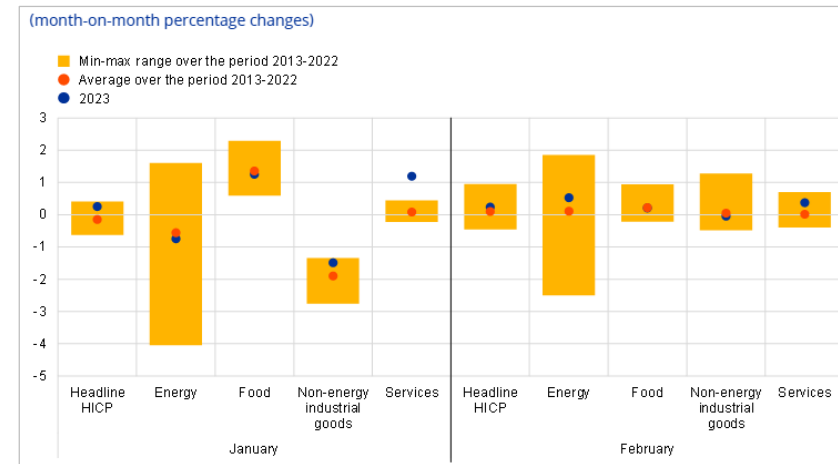


Sources: Eurostat; Pufnik, A. (2018.), MMF

## ... although in services sectors a more noticeable increase in consumer prices was observed

- 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**

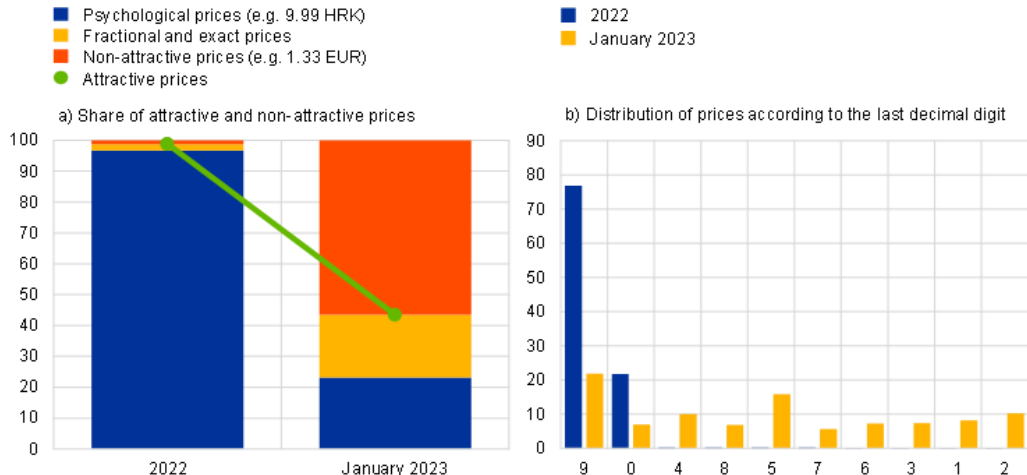
Headline HICP inflation and its main components in Croatia



Source: ECB

# Retail chains have complied with the rules on conversion and rounding of prices

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

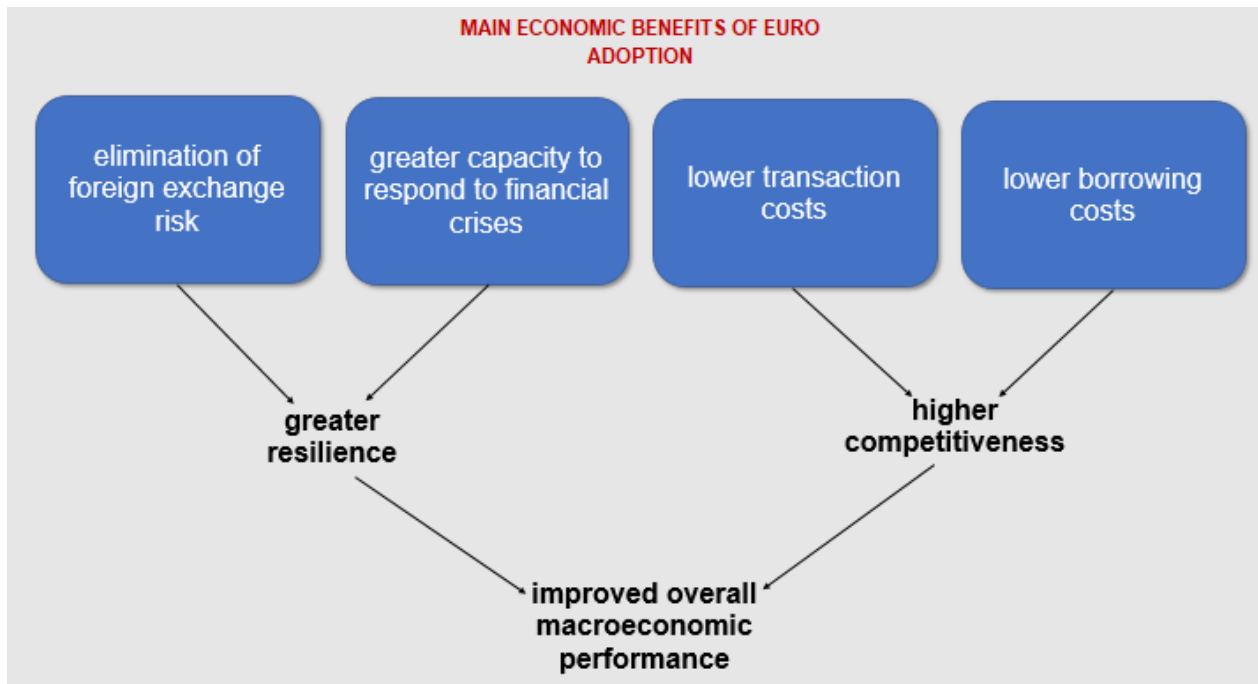


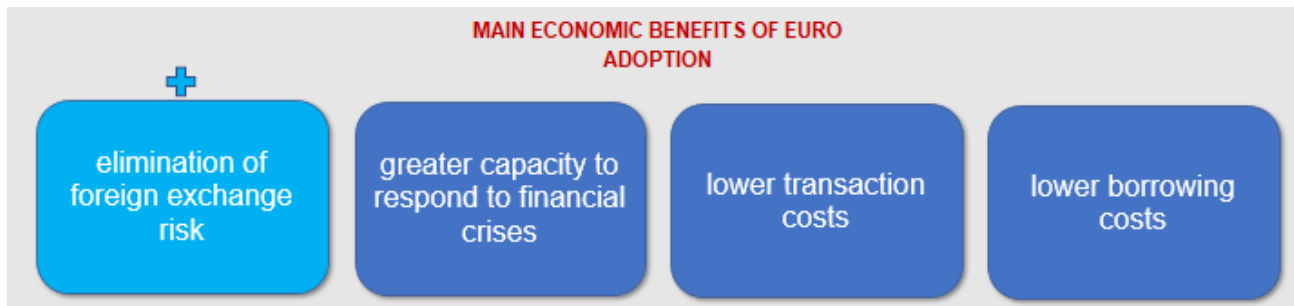
Source: ECB

- 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

- Motivation for the adoption of the euro

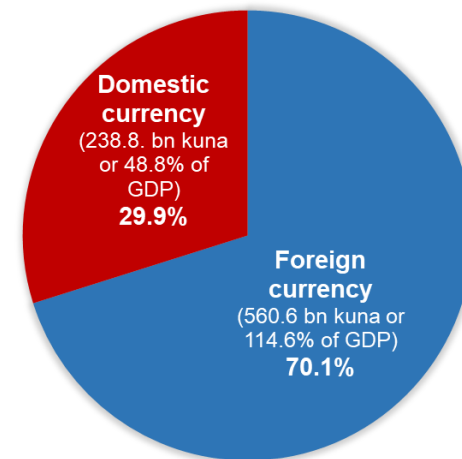
## Euro adoption brings significant and permanent economic benefits to small and highly euroized EU Member States



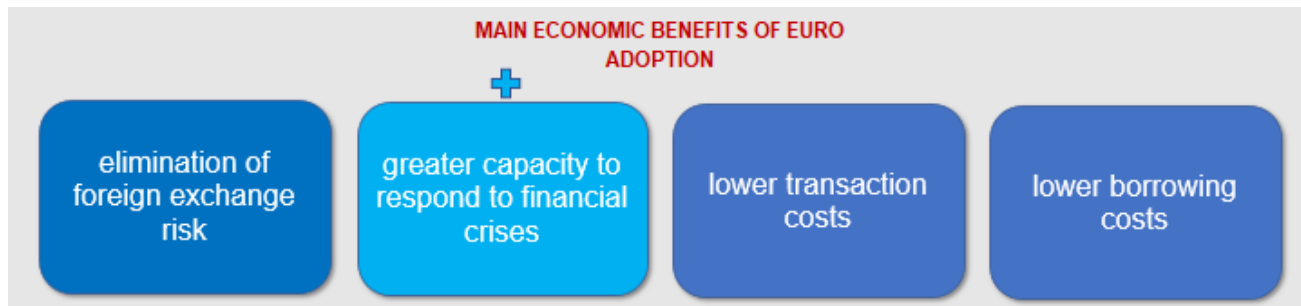


- By adopting the euro, a Member State removes most of FX risk from the financial system and the economy
  - as a result, the country becomes more resilient to adverse shocks
- This is particularly important for highly euroized countries such as Croatia
  - in contrast, it is less relevant for countries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

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

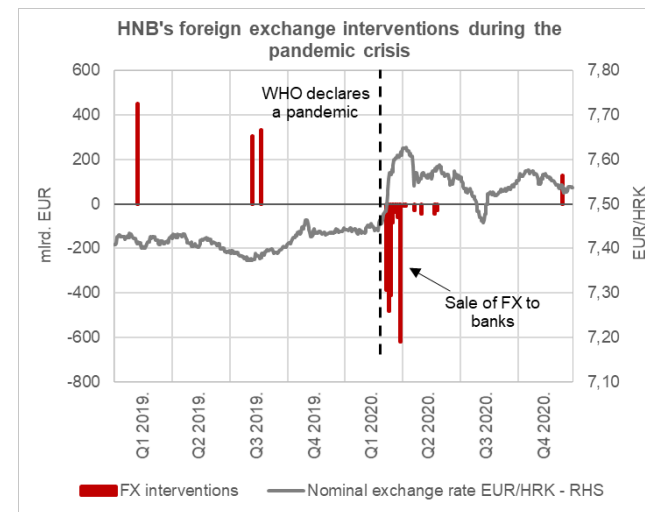


Source: HNB



- 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



## MAIN ECONOMIC BENEFITS OF EURO ADOPTION

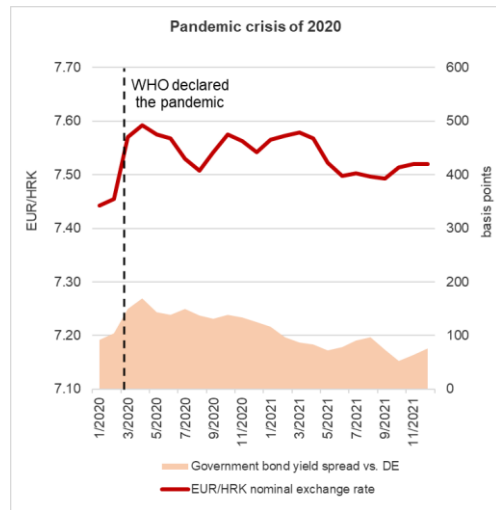
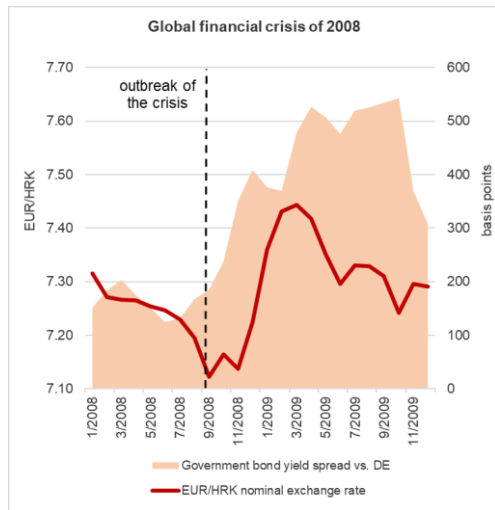
elimination of foreign exchange risk

greater capacity to respond to financial crises

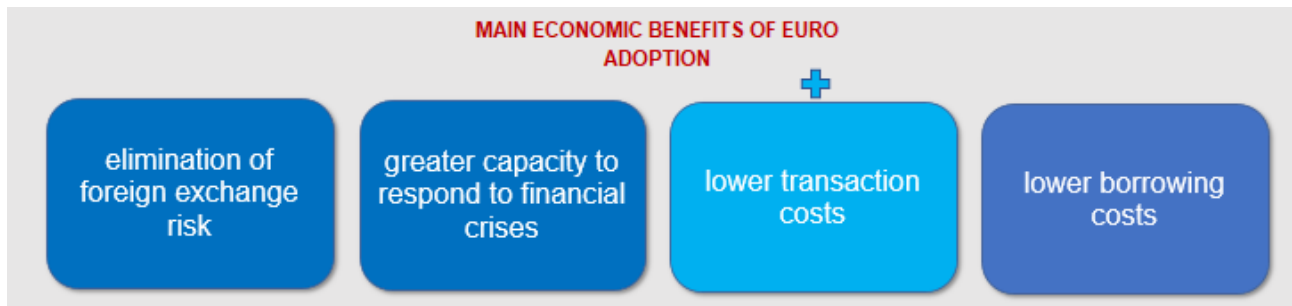
lower transaction costs

lower borrowing costs

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

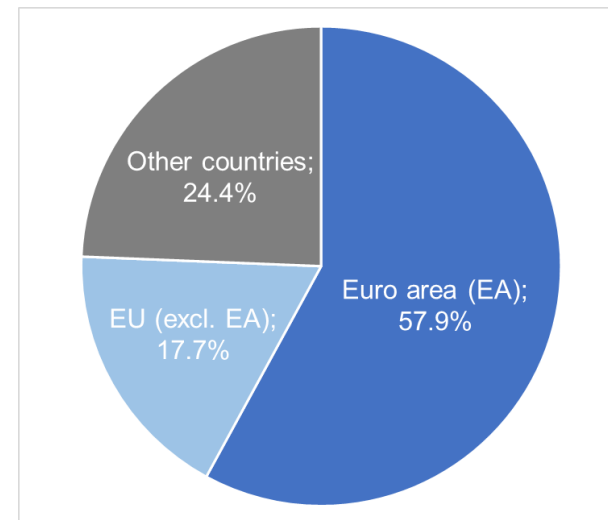


Source: HNB



- 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

## MAIN ECONOMIC BENEFITS OF EURO ADOPTION

elimination of  
foreign exchange  
risk

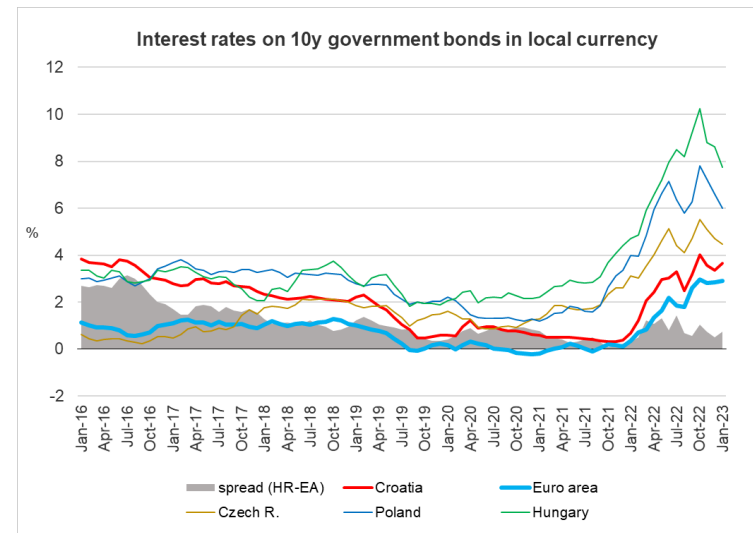
greater capacity to  
respond to financial  
crises

lower transaction  
costs

lower borrowing  
costs

- 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%

*Croatia's sovereign yield spread has declined significantly since we started our journey towards the euro*



Source: Eurostat

## MAIN ECONOMIC BENEFITS OF EURO ADOPTION

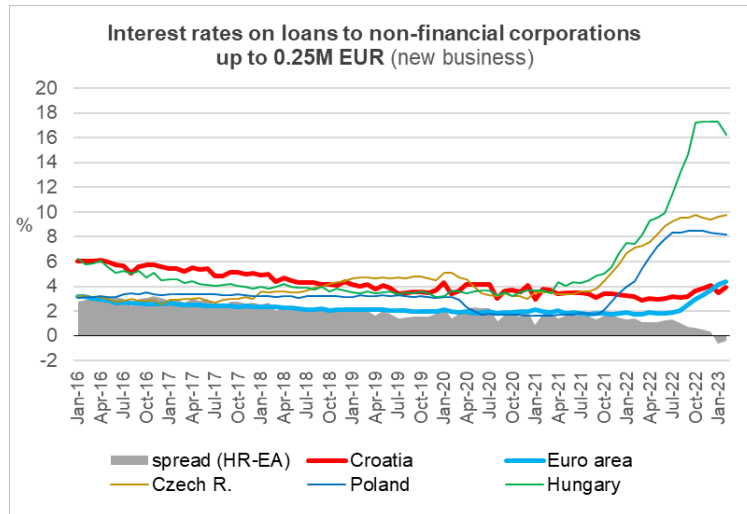
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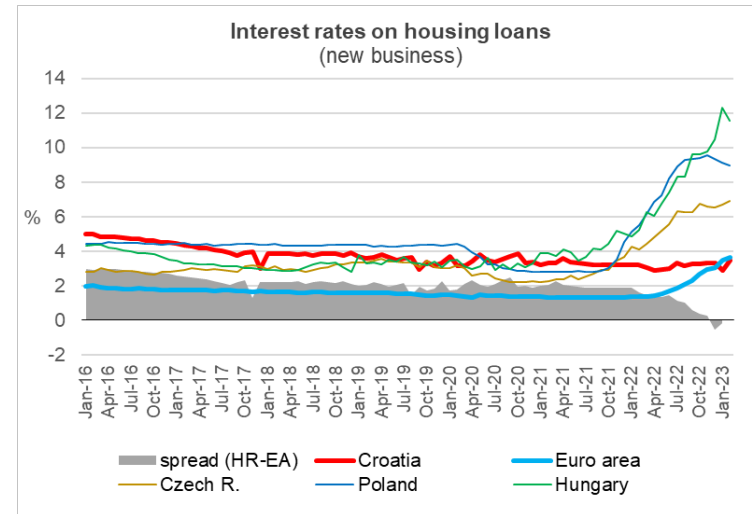
lower transaction  
costs

lower borrowing  
costs

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



Source: ECB



Source: ECB

## 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
  - Croatia had to go through a stricter formal euro adoption process than Slovenia and other 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
  - some of these benefits were felt even before Croatia adopted the euro

Thank you  
for your attention!

