Primož Dolenc: Keynote speech – ACI FMA Croatia 30th Financial Markets Conference

Keynote speech by Mr Primož Dolenc, Vice Governor of Bank of the Slovenia, at the ACI FMA Croatia 30th Financial Markets Conference, Split, 24 October 2022.

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Ladies and gentlemen, good morning!

First of all I would like to thank the organisers for the invitation to this event. It's good to be here, especially at this specific event – at the 30th Financial Markets Conference which coincides with the upcoming Croatian adoption of the euro. It's also nice to be in Split at this quieter time of year.

I am supposed to talk about the Slovenian experience with adopting the euro. However, sharing our experience might have been more useful a couple of years ago, when Croatia was preparing for the euro.

Now the preparations are more or less over, and Croatia will enter the eurozone and adopt the currency as of January 1st, 2023, and so we warmly welcome you into the euro family.

Even though it has been already 15 years since Slovenia introduced the euro, there are still some valuable lessons from this period.

In this speech I will try to share some thoughts on the Slovenian experience of introducing the euro, and then touch upon some contemporary issues regarding common policies in this context.

Slovenia introduced the euro on January 1st, 2007, and its experience has long been a case study for other countries aiming to adopt our common currency.

It is in fact an interesting example. Slovenia was the first case when euro notes and coins were introduced by a single country in isolation, not joined by others at the same time. And Slovenia was in fact the first country in which the euro was introduced as both book money and cash on the same date, without a transition period. This is the so-called "big-bang" approach, which was considered the most effective method.

As such, Slovenia has been an interesting case study for other countries in the last 15 years, including Croatia, and I am sure our experience has been of much help to our Croatian colleagues while they have been preparing for the introduction of the euro. I am also convinced that the process will be as smooth in Croatia as it was in Slovenia back in 2007.

There are some points that need to be emphasised when a country decides to adopt a common currency. What we learned is that preparation is of crucial importance for the success of the project. It was the key success factor in Slovenia.

We had at that time a so-called changeover board that conveyed clear messages throughout the process, and this showed a clear commitment to the project at the highest levels of the government and the central bank. Further, according to our experience, one of the key challenges in introducing the euro was explaining the breadth and depth of the impacts of the project to businesses, the public and others.

I think the success of our introduction of the euro was also in part based on the fact that the public was very familiar with the currency. And here I think there are many parallels between Slovenia and Croatia, although that familiarity is perhaps now even greater in the latter than it was in the former. When we introduced the euro, the common currency had only been used as physical notes and coins for six years, whereas now it much more widely known, especially due to the fact that Croatia has such strong ties with eurozone countries, and not only due to tourism. Maybe it is strange to mention this, but in Slovenia we had a national campaign that targeted citizens who were most likely to be unfamiliar with the euro. However, I am sure that these groups are smaller and less numerous in Croatia today compared to Slovenia back in 2005 and 2006.

At that time it was an interesting supporting factor that many Slovenians already held their savings in euros, often in physical form. This came from the time when we were saving in Deutschmarks, back in the days of Yugoslavia, and having cash under the mattress was nothing unusual. Since we share that sad part of our history, this is probably also true for many in Croatia, even though those years are now more than three decades behind us.

The high level of legal certainty during the process was also very important in our case, and I have noticed that Croatia has fully followed our good practice in this regard, and the authorities have defined and communicated to the public the details of the planned changeover well in advance.

One of the most interesting issues during the introduction of the euro, and also in the following years, was that of inflation caused by adopting the currency. Because I spend so much time in Croatia in a personal capacity, I have a feeling that the same thing is also happening here.

I remember back in the early 2000s, when the euro was first introduced by some EU countries, there was a joke in Germany that the new currency was in fact the "teuro" – since "teuer" means expensive in German.

The issue of perceived inflation, in contrast to the reality, was also apparent in Slovenia, just as it had been in the first wave countries. Here Slovenia did not fully succeed where others had failed, and thus did not avoid the perceived inflation rate from being higher than the actual rate during the changeover. The perception that some retailers saw the introduction of the euro as an opportunity to put up prices remained. And while this certainly happened in some instances, the statistical evidence shows that this was more the case for services than for goods, although consumers did not make that distinction.

I must admit I do not know what the expectations are for inflationary pressures in Croatia with the adoption of the euro, so I can only hope that the authorities have managed to combat idea that the introduction of the euro is inflationary. It is a statistical fact that the effect of adopting the euro on inflation was just 0.3% points in Slovenia, even though public perceptions might have been very different. For a comparison, the introduction of VAT in 1999 had significantly stronger effect on inflation, up 2.5% points in the first year.

Turning to a more topical consequence of adopting the euro, this development will further increase Croatia's integration with the EU, even though the country had already de facto lost its sovereign monetary policy well before this. This implies that despite a remaining idiosyncratic component, the overall monetary policy will be the same for Croatia as it is for other economies in the monetary union. There is a question, of course, of how such economic policies will react to the specific situation in Croatia.

What we found in these last 15 years in Slovenia is that the euro is in fact a good anchor in terms of inflationary pressures. Nevertheless, a common monetary policy does constrain the economic policy spectrum, and many, including in the general public, might argue that with the adoption of a single currency an important part of national sovereignty is lost. This is in a way true, but, to be honest, a small open economy cannot act as if it were an isolated island, even if it has its own monetary policy. In reality, however, there are still some economic policies at the disposal of national authorities, some also at the disposal of national central banks, which can be used to help smooth local economic cycles.

Let me focus next on two sets of policies, macroprudential and fiscal.

The experience of the first 20 years of Economic and Monetary Union (EMU) has shown that the amplitude of the business cycle can be intensified by the financial cycle. Indeed, the severity of the downturn following the global financial crisis across eurozone member states can be traced to excessive leverage. As long as central banks maintain tools to smooth the financial cycle, an important element of absorbing severe shocks or their amplification remains tailored to local economies.

The procyclical behaviour of the financial system, and especially of banks, can therefore amplify swings in economic activity. The strength with which the amplification mechanism operates depends on, among other things, financial imbalances accumulated in the pre-crisis period.

For example, weakly capitalised banks, when under intense stress from a solvency or liquidity perspective, are more likely to deleverage or sell assets in fire sales, thereby potentially creating further problems in other areas of the interconnected financial system. Such procyclical behaviour among financial intermediaries could significantly amplify the downturn, particularly if these intermediaries become capital-constrained or risk-averse.

In response to the global financial crisis, regulators introduced several macroprudential instruments. An important element of the new Basel III regulatory framework is the capital buffers, which are designed to increase banks' resilience to macro-financial shocks and reduce procyclicality and excessive amplification of the financial cycle.

The two key buffers included in the framework are the capital conservation buffer (CCoB) and the countercyclical capital buffer (CCyB), which ensure that banks have an additional layer of usable capital that can be drawn down when losses are incurred. Buffers for global and other systemically important institutions (G-SIIs and O-SIIs) and the systemic risk buffer (SyRB) are meant to provide additional loss-absorbing capacity for a specific set of institutions.

Further, an additional element in the arsenal of macroprudential instruments are borrower-based measures that directly impose limits on the terms and conditions of lending related to the riskiness of loans. The two most typical examples of borrower based instruments are limits on the loan-to-value (LTV) and debt-to-income ratio (DTI) ratio.

Macroprudential policy remains in hands of national authorities. However, under the SSM Regulation, the ECB is responsible for assessing the macroprudential measures adopted by national authorities in the countries subject to ECB banking supervision. The ECB has a "top-up" right for capital-based measures, meaning that it can impose stronger requirements beyond those any national supervisors propose.

A recent episode shows that the ECB and national authorities can work in a coordinated manner. With the outbreak of COVID-19, banks supervised by the ECB were allowed to operate below the level of the Pillar 2 Guidance (P2G) capital and capital conservation buffer (CCoB) requirements. These measures were further enhanced by the relaxation of the countercyclical capital buffer (CCyB) by national macroprudential authorities, and also by a relaxation of P2G for banks not under SSM supervision. Such an unprecedented relaxation of capital requirements was taken to support lending and mitigate any second-round effects of the lockdown measures via the banking sector.

The second set of economic policies are of course fiscal policies. In an environment of constrained policy space, it is crucial that such policies play a pronounced role in smoothing local cycles. EU fiscal rules should therefore also strive for countercyclicality at the member state level.

As a reaction to the global financial crisis, all major central banks resorted to unconventional monetary policies. However, the Eurozone faced a specific challenge in the interaction between the single monetary policy and the varied economic and fiscal positions of member states. This challenge was insufficiently addressed during the first decade of EMU, and was revealed – and, in part, worsened – by the two crises. After the financial crisis, both monetary and fiscal policies were strongly accommodative at the aggregate level in the period 2009-10. However, during the 2012-13 recession, monetary policy offered a stimulus that was modest by historical comparison, while fiscal policy switched to discretionary consolidation to address debt overhang and debt sustainability concerns in the aftermath of the sovereign debt crisis.

The analysis of the Eurosystem staff during last year's monetary policy strategy review showed that the contribution of discretionary fiscal policies to eurozone core inflation, which had been around 0.3-0.4 percentage points during most of the period of EMU, fell to around zero in the period 2014-15.

The SGP aims at a countercyclical fiscal policy, but is not designed to sufficiently support monetary policy in a lower bound environment in which monetary and fiscal policies can become strategic complements rather than substitutes.

And finally there are structural policies. It is not only country specific shocks which present an issue, but also common shocks with diverging effects due to the structural heterogeneity within the eurozone. Going forward it will be crucial that the EU works towards structural convergence, which will limit the divergent amplification and transmission of common shocks across the eurozone.

Let me stress again, that in joining the monetary union a country does give up a certain degree of sovereignty, but that central banks still maintain important tools which can be deployed to smooth idiosyncratic shocks. In our opinion, and in our experience, the benefits of a single currency far outweigh the costs.

Finally, let me briefly touch upon our current monetary policy, which Croatia will soon be part of. Just after our adoption of the euro, the economic and financial crisis hit economies around the world, and soon after the sovereign debt crisis also hit Europe. In that situation I am convinced that Slovenia was better off being part of the broader monetary area that if it were trying to deal with these issues alone.

As you might remember, at that time a "new era" of monetary policy started. Central banks around the world did not hesitate to expand their balance sheets. The first wave of this was after the economic and financial crisis, and the second was more recently, during the pandemic.

As a result, the Eurosystem's balance sheet peaked at a previously unimaginable EUR 8.8 trillion at the end of June 2022, and has declined very gradually since. It currently represents a 66% share of GDP. Assets purchased for monetary policy purposes represent around 55% of total Eurosystem assets, while lending operations around 25% of total assets.

If we in the eurozone have been battling too low inflation over the last decade, the issue of high, or even too high inflation emerged at the end of last year, and of course things have only worsened in this regard due to geopolitical tensions in Ukraine. With inflation at multi-decade highs in many countries and with risks to the inflation outlook tilted to the upside, several central banks, including the ECB, have started with the tightening cycle of their monetary policy, in terms of both frequency and magnitude of rate hikes. Some central banks have also begun to reduce the size of their balance sheets, moving further toward normalisation of policy.

Monetary policy normalisation means a gradual withdrawal of unconventional or non-standard monetary policy measures, which have been used for quite some time. This process began with the ECB's announcement that we would end net asset purchases under the pandemic emergency purchase programme (PEPP) in the first quarter of 2022, and later on the APP programme at the beginning of July. The exit from negative interest rates allowed us to make a transition to a meeting-by-meeting approach to interest rate decisions. The future policy rate path will continue to be data dependent. In July, the GovC also announced a new instrument – the so-called Transmission Protection Instrument (TPI) – with the aim to support the effective transmission of monetary policy. The TPI can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the eurozone. In the next step, it is expected that we will start discussing the reduction of the balance sheet when the normalisation of interest rates has been completed.

There is another important issue I would like to point out. As in many other economic policies, both in Europe and more broadly, we try to include the issue of the transition to a greener economy in our actions. As you probably know, we at the ECB have adopted a new strategy of monetary policy last year that also includes an emphasis on climate issues, and have adopted the so-called "ECB pledge on climate change action".

Both moves indicate, in fact promise, ambitious steps to further incorporate climate change considerations into our monetary policy framework. Among them are the following: tilting CSPP holdings toward issuers with better climate performance through reinvestments over the coming years, limiting the share of assets issued by entities with a high carbon footprint in the counterparties' collateral pools, and implementing climate-related disclosure requirements for collateral.

Let me conclude on this final point. I strongly believe that further Croatian integration into the EU framework will enrich and strengthen not only Croatia, but also the whole eurozone. As such, we look forward to cooperating further with you, and wish you every success in these final preparations for the adoption of the euro.