



Economic and political forecasting to support risk management and investment decisions

Croatia

Reflections on Euro adoption

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- ✓ We looked at the experience of eight countries and their Eurozone entry experience, from the inception of the Euro area to the latest addition, and discovered some broad trends on how the public and private sectors were affected by the currency switch.
- ✓ The impact of Euro adoption varies depending on the cyclical position of the economy, the degree of convergence achieved already, and the degree of active policy making before and after Euro entry. Overall, for Croatia, Euro adoption appears to be a relatively minor shock compared to most other countries.
- ✓ As Croatia is likely to adopt the Euro after the compulsory two years in the ERM2, we highlight briefly how the Eurozone is likely to change by then.
- ✓ We conclude with a few key themes that should be at the core of European policy makers' concerns in the coming years, and the likely implications if nothing is done about it.

What has happened in other countries?

- ✓ In order to evaluate the impact of the Eurozone accession, we have looked at the key variables that, in our view, are mostly affected by Euro adoption and that strongly influence potential growth in the following eight countries: France, Italy, Greece, Slovakia, Slovenia, Estonia, Latvia and Lithuania.
- ✓ We looked at the indebtedness of the private sector, the public debt to GDP ratio, and inflation and borrowing costs for the State, companies and households.
- ✓ We narrowed our attention to the “short run” before and after the Euro switch: three years before and three years after Euro adoption.
- ✓ We chose a broad set of countries to better capture all aspects that could be relevant for Croatia, as well as to highlight the impact in different stages of the business cycle.

	3 years before	Euro adoption	3 years after
Slovakia	2006-2008	01-Jan-09	2009-2011
Estonia	2008-2010	01-Jan-11	2011-2013
Slovenia	2004-2006	01-Jan-07	2007-2009
Latvia	2011-2013	01-Jan-14	2014-2016
Lithuania	2012-2014	01-Jan-15	2015-2017
Greece	1998-2000	01-Jan-01	2001-2003
Italy	1996-1998	01-Jan-99	1999-2001
France	1996-1999	01-Jan-99	1999-2002

What has happened in other countries?

- ✓ The most consistent impact of Euro entry is a drop in long-term bond yields. Baltic countries experienced a 150-300bps drop on average in the following three years; in the Eurozone, the drop ranged from a low of 50bps for France to a high of 200bps lower for Greece. Slovakia and Slovenia did not experience much of a change at the time.
- ✓ Borrowing costs for the private sector did drop for most (bar Slovenia, which entered just around the unfolding of the 2008 global crisis).
- ✓ Six out of eight countries saw rising private sector debt ratios for households and companies; the two exceptions were Latvia and Estonia – the former was still in the restructuring phase post the EU bailout and the latter did not need a bailout, but still had some debt excesses to work out.
- ✓ Public sector debt ratios were generally flat immediately after Euro adoption; however, by now, most countries have higher public debt ratios, despite spending less on servicing the debt.
- ✓ According to the inflation statistics, Slovakia, Lithuania, France and Italy experienced slower inflation in the year after Euro entry. Most countries saw a pick-up in inflation in the following three years anyway.
- ✓ There is an important divergence between perceived inflation and actual inflation. Many countries lately experience a wide gap between perceived past inflation and expected inflation. This gap tends to follow euro entry.

! Importantly, these averages do not illustrate the full story as the biggest Euro adoption implications show over a longer period of time and depend on the position in the business cycle.

Inflation surveys: past and expected

France



Italy



Slovenia



Croatia



What about Croatia?

- ✓ A drop in sovereign bond yields appears highly likely, best guess: up to 100bps drop at the 10 yr tenor.
- ✓ Sovereign credit rating should see upward pressure.
- ✓ As the eurozone is likely to re-accelerate once this soft patch fades, growth prospects for Croatia appear favourable.
- ✓ Price levels in Croatia appear already close to eurozone levels on the traded goods front and there is not loose credit growth taking place or likely in the near term. So we think inflationary pressures due to euro entry will be modest.
- ✓ It is quite plausible that by 2022-23 the eurozone business cycle will hit a trough, so the price pressures will be down, not up.
- ✓ In our best guess calculations private sector debt will not rise much. Though we could see a pick up in house prices, beyond what wage dynamics would suggest.
- ✓ Some rounding up of prices during euro change over appears plausible.
- ✓ The hardest challenge will be to navigate the long term outlook for eurozone policies and the wage convergence process.

Public finances: worsening, in most cases

General government debt as % of GDP

	3 years before	3 years after	2018
France	61	59	98
Italy	114	107	132
Greece	100	105	181
Slovakia	30	40	49
Slovenia	26	26	70
Estonia	6	9	8
Lithuania	40	41	34
Latvia	41	39	36
Croatia	-	-	75

Companies debt, % of GDP

	3 years before	3 years after	2017
France	72%	78%	111.8%
Italy	58%	64%	85.4%
Greece	43%	51%	68.5%
Slovakia	76.8%	74.2%	88.4%
Slovenia	77.2%	100.2%	68.7%
Estonia	106%	92%	86.0%
Lithuania	52.3%	53.4%	55.9%
Latvia	103.9%	98.7%	95.9%
Croatia	-	-	78.3%

Households debt in % of GDP

	3 years before	3 years after	2017
France	44%	46%	70.7%
Italy	22%	27%	45.8%
Greece	17%	28%	62.0%
Slovakia	21.7%	26.4%	43.4%
Slovenia	23.3%	30.8%	31.2%
Estonia	59%	44%	40.9%
Lithuania	27.6%	28.3%	26.3%
Latvia	37.1%	26.9%	24.8%
Croatia	-	-	35.3%

Borrowing costs

10-year government bond yields

	Long-term government bond yields		
	3 years before	3 years after	2018
France	5.51	4.98	0.78
Italy	7.05	5.17	2.61
Greece	6.96	4.90	4.19
Slovakia	4.54	4.34	0.89
Slovenia	4.11	4.51	0.93
Estonia	7.304	-	-
Lithuania	3.82	0.86	0.31
Latvia	4.61	1.33	0.90
Croatia	-	-	2.17

Lending rates: other Eurozone countries

		Lending rates to NFCs and HH		
		3 years before	3 years after	2019*
Lithuania	NFCs	4.25	2.42	2.92
	HH	5.88	3.89	3.87
Latvia	NFCs	5.27	6.06	6.84
	HH	23.41	18.84	12.70
Estonia	NFCs	5.97	4.20	3.21
	HH	11.38	20.9	14.58
Slovakia	NFCs	4.82	3.25	1.82
	HH	6.72	13.68	8.08
Slovenia	NFCs	6.18	6.51	3.54
	HH	8.29	7.61	6.04
Croatia	NFCs	-	-	3.68
	HH	-	-	5.58

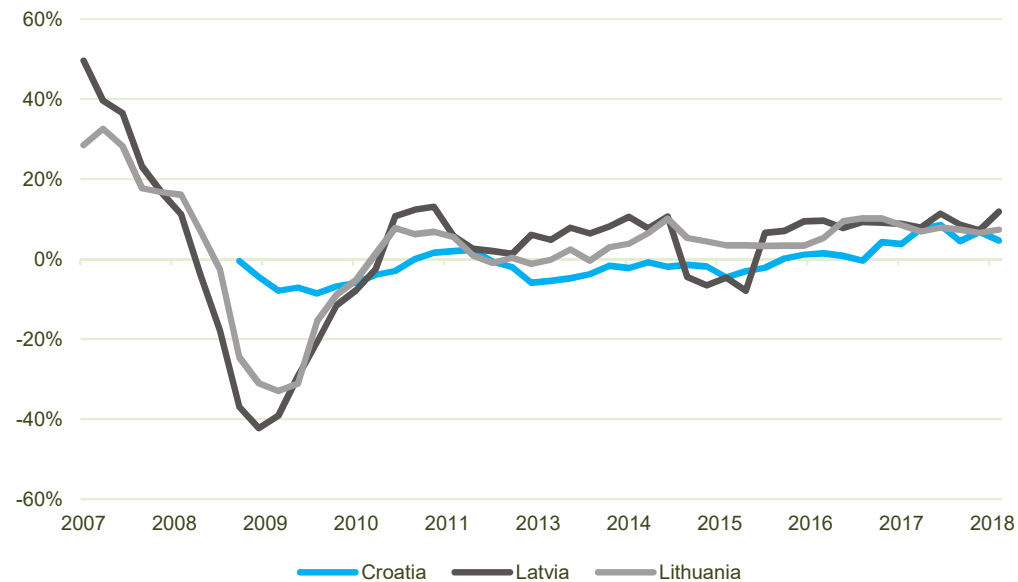
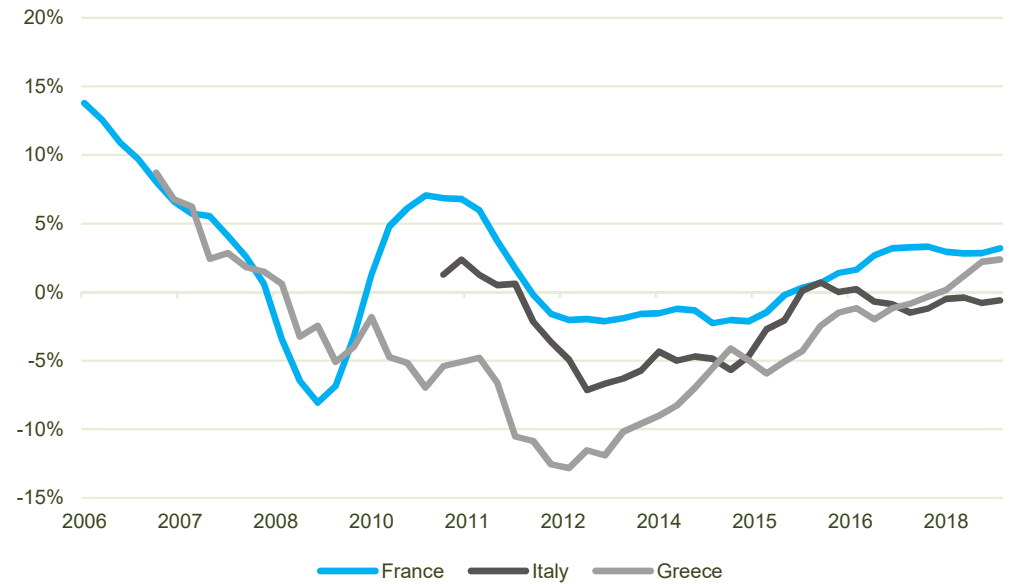
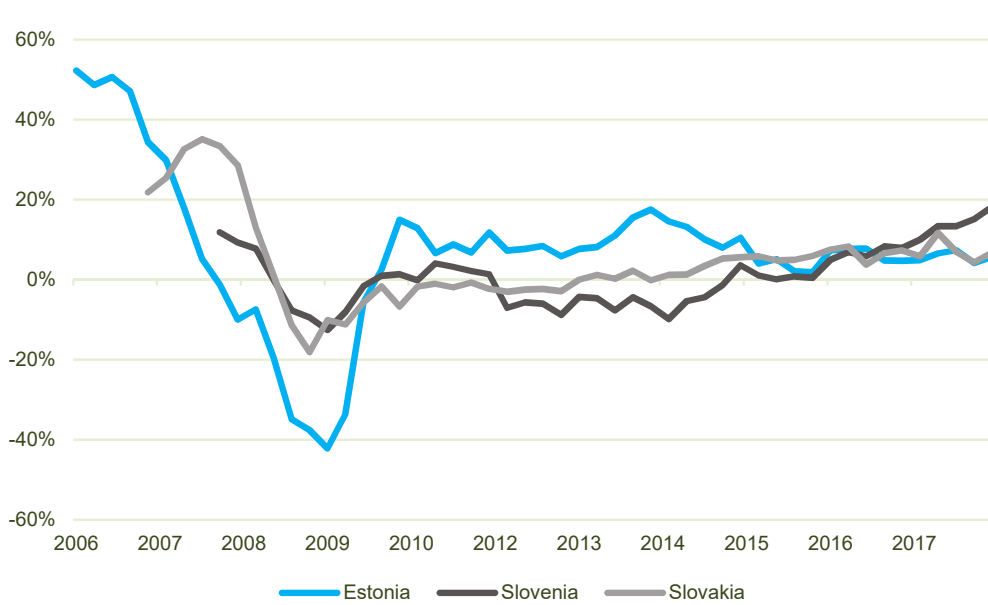
What will the Eurozone look like by 2023E?

- ✓ **MOMENTUM:** We are seeing an extension of the global business cycle as the large central banks have pre-empted any genuine recession risk and squashed borrowing costs again.
- ✓ This means easily another three+ years of growth, before the next recession becomes genuinely likely.
- ✓ **WATCH OUT FOR TOO MUCH DEBT:** The name of the game is thus indebtedness: the next three years will be about boosting private sector debt.
- ✓ **HOUSING BUBBLES:** This structurally supports housing market inflation.
- ✓ In our view, the higher the leverage, the lower the neutral rate.
- ✓ Lending leads to growth in the near term, but longer potential balance sheet adjustments later on.

Who will be the most indebted by 2023E?

	Households		Non-financial corporations	
	2018	2023E	2018	2023E
Croatia	35%	36%	78.3%	63.9%
Eurozone	70.9%	69.2%	162.3%	148.6%
Germany	52.4%	54.0%	96.6%	116.8%
France	69.3%	80.8%	183.9%	214.3%
Italy	53.1%	51.3%	111.4%	73.7%
Greece	58.1%	50.3%	65.6%	51.1%
Czech Republic	33.6%	43.8%	112.0%	132.7%
Hungary	21.0%	21.5%	111.0%	163.0%
Romania	17.2%	18.9%	107.7%	102.7%
Poland	34.9%	33.3%	84.8%	82.8%
Turkey	16.2%	11.5%	94.3%	74.4%
Russia	17.2%	25.9%	174.2%	131.5%

House price inflation

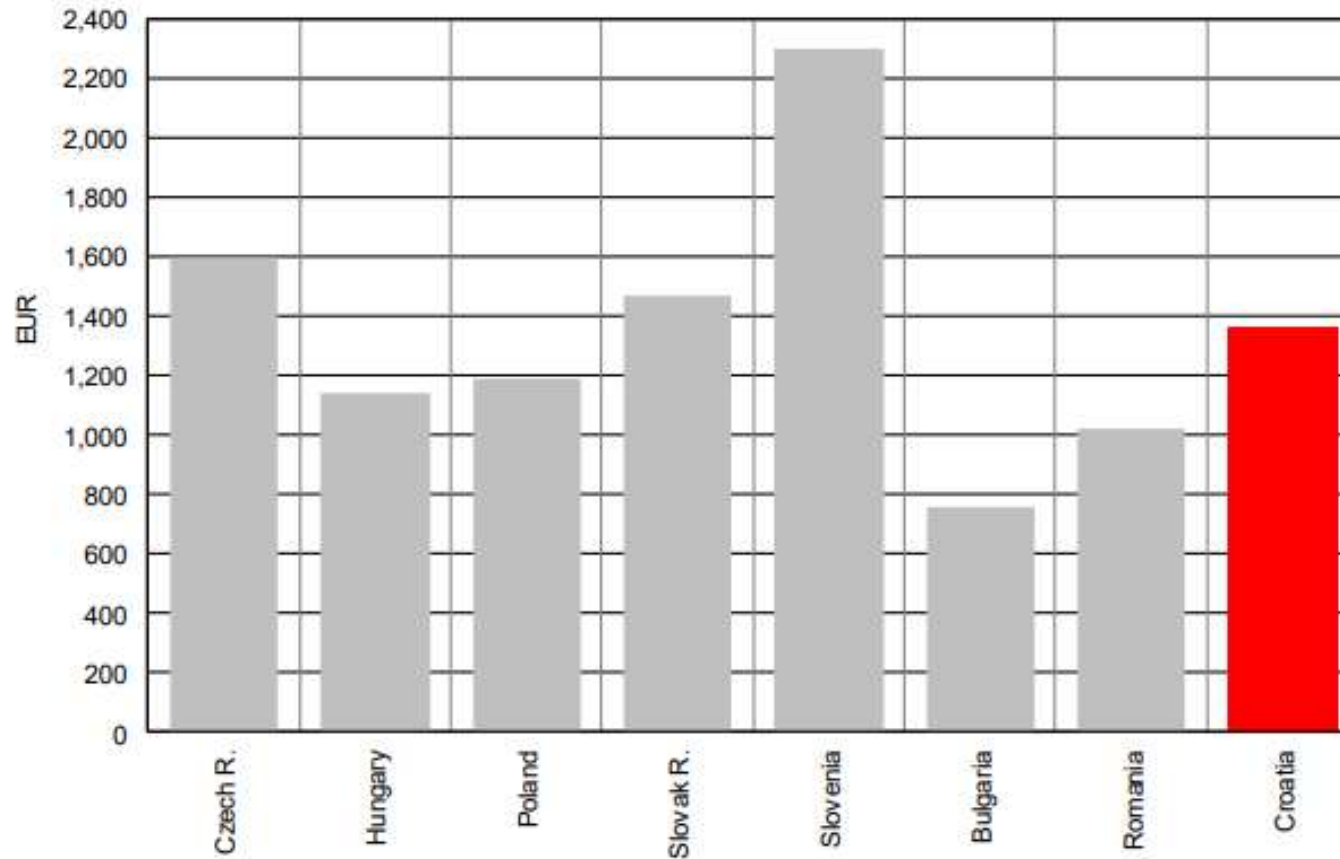


- ✓ YOU MAY BE COMPETITIVE TODAY, BUT YOU MAY NOT BE IN 5 YRS TIME
- ✓ Watch out for wage convergence across the whole Eurozone! Italian wages are close to eastern European levels; Greek wages are below much of CEE.
- ✓ Eurozone is as much about those in as it is about those that have not got in yet!
- ✓ MORE AND MORE TITAN COMPANIES HAVE PROFOUND IMPLICATIONS
- ✓ The polarisation of corporate balance sheets and the crowding out of SMEs in the long run undermine employment, productivity and voters' sentiment.
- ✓ There is a need for a new competition strategy, to address the balance sheets "imbalance".
- ✓ FISCAL POLICY: NOBODY WANTS TO TOUCH IT, BUT IT DOES NOT WORK NOW!
- ✓ There is a need for a more coherent fiscal strategy, one that does not lend itself to overheating in good times and impossible structural adjustments in bad times.
- ✓ There is a lot of uncertainty surrounding the 2021-2027 EU budget, with strong unknowns about the rule of law and common corporate tax base proposals...
- ✓ ...as well as the size of the next EU budget.
- ✓ At some point, Brexit may happen!

Total hourly wages and salaries costs in Euros for employers by NACE2 activity

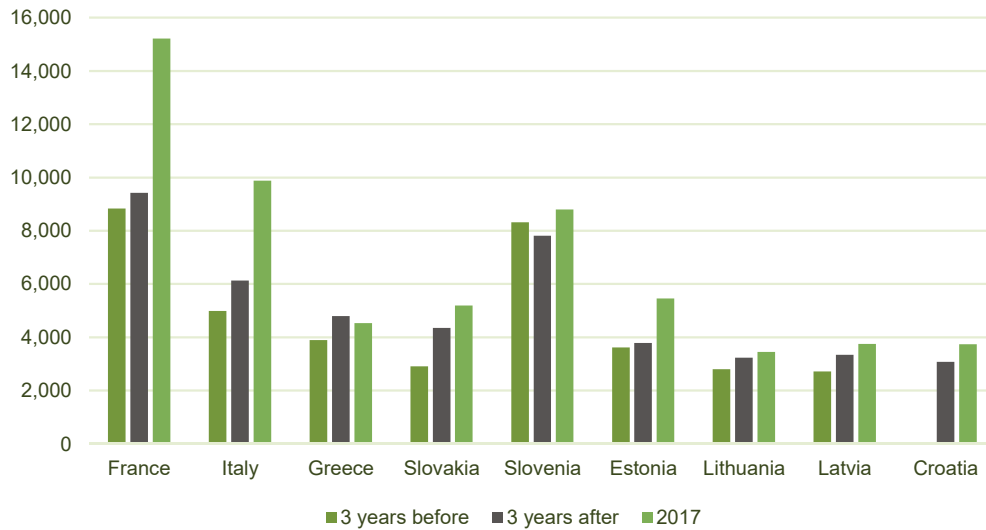
	Estonia	Greece	France	Croatia	Italy	Latvia	Lithuania	Slovenia	Slovakia
2000	2.1	8.9	:	:	:	:	1.9	7.7	2.1
2004	3.2	11.5	18.9	5.8	15.7	2.1	2.3	9.0	3.0
2008	5.8	13.5	20.9	7.7	18.2	4.6	4.2	11.6	5.2
2012	6.3	12.2	22.4	8.1	19.9	4.7	4.2	13.1	6.6
2016	8	12.1	23.3	8.1	19.9	6.1	5.3	14.1	7.5
2017	8.6	12.2	23.7	8.6	20	6.5	5.8	14.8	8
2018	9.2	12.6	24.1	9.3	20.2	7.2	6.3	15.2	8.5

Average monthly compensation per employee in 2018

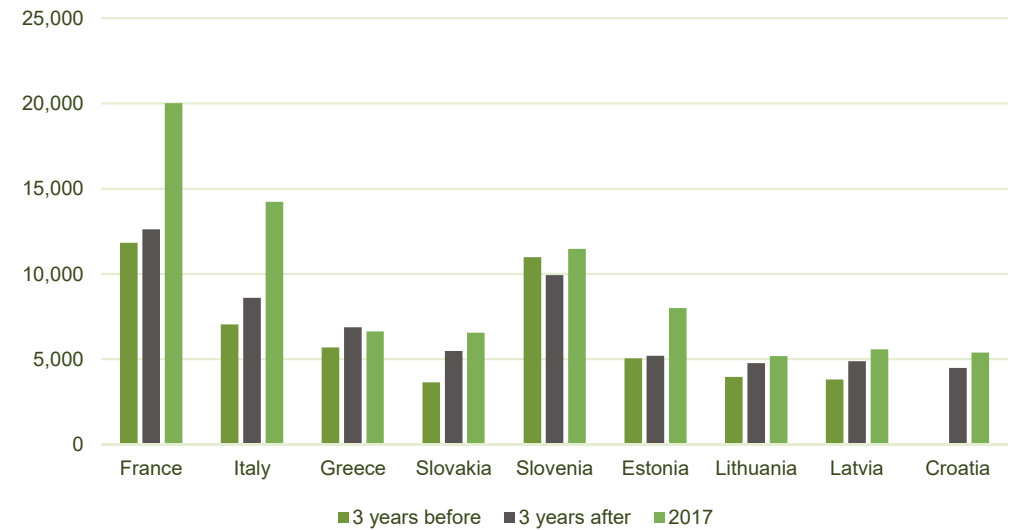


Top cut-off points in Euros

First quintile

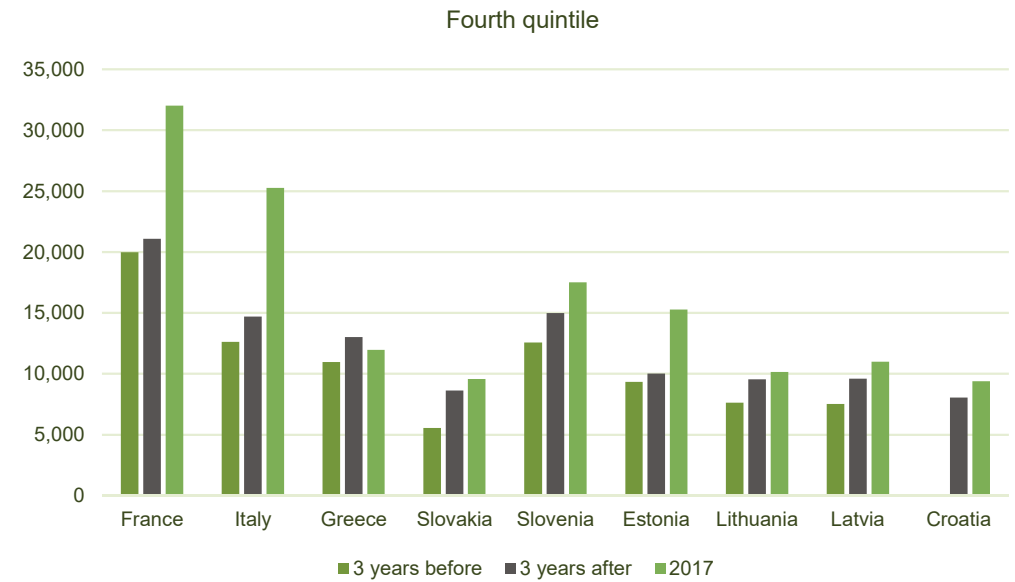
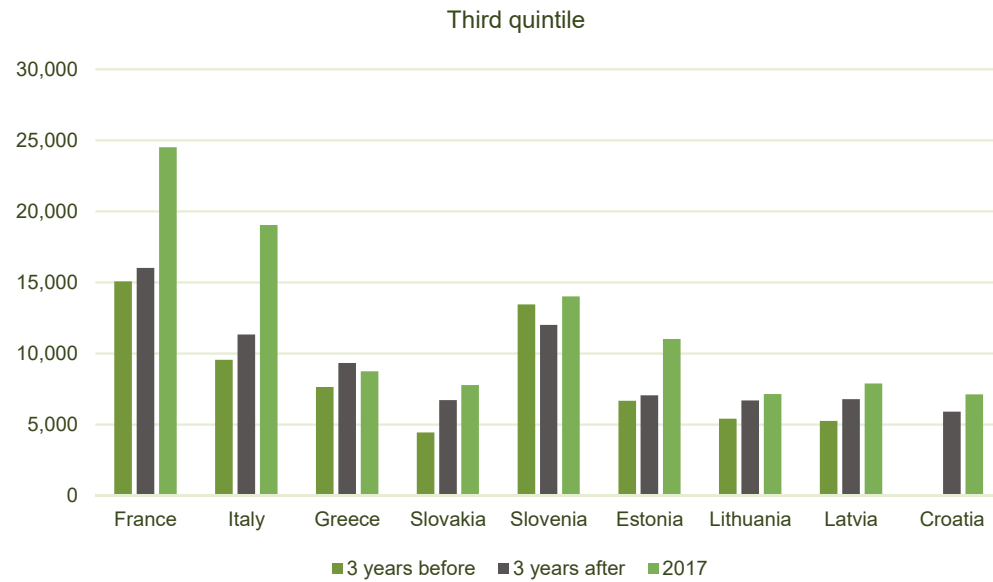


Second quintile



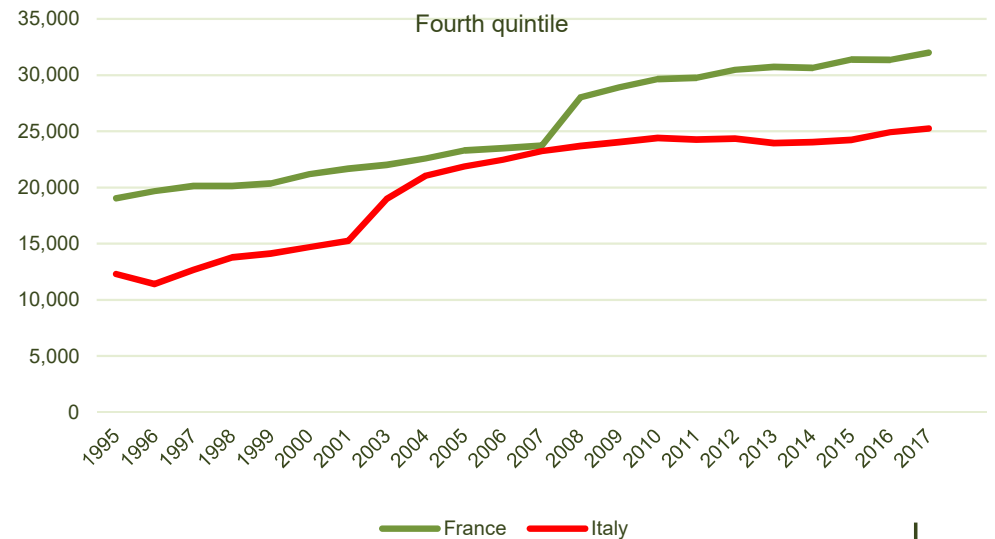
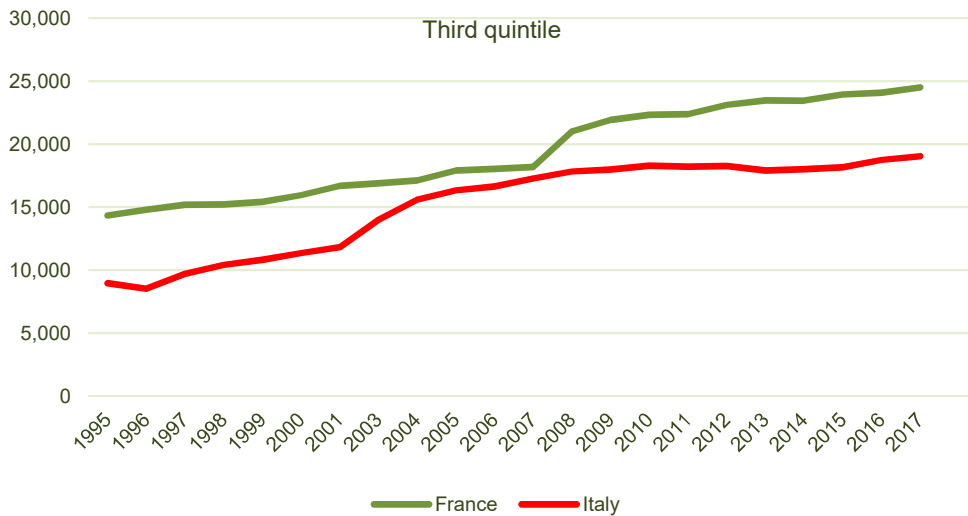
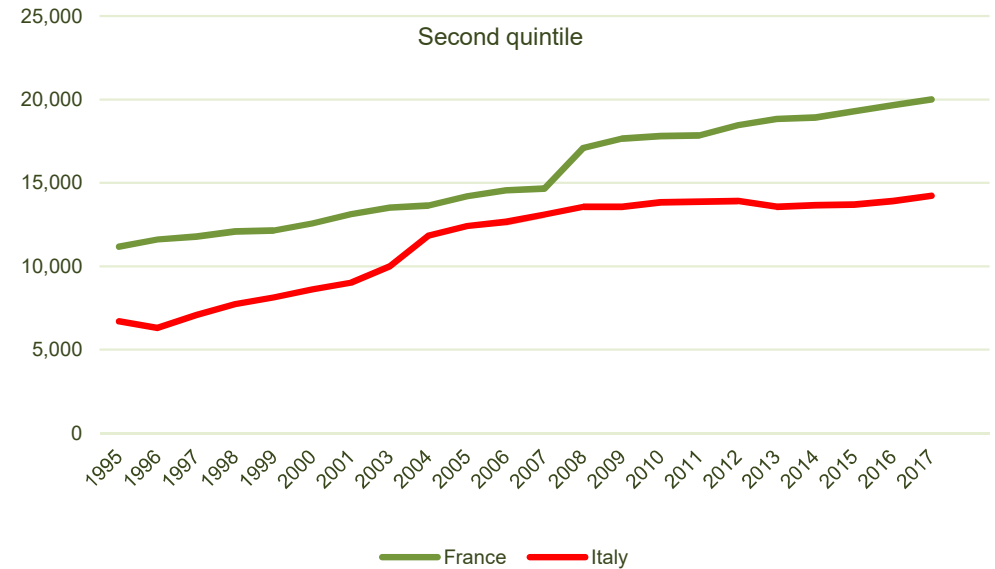
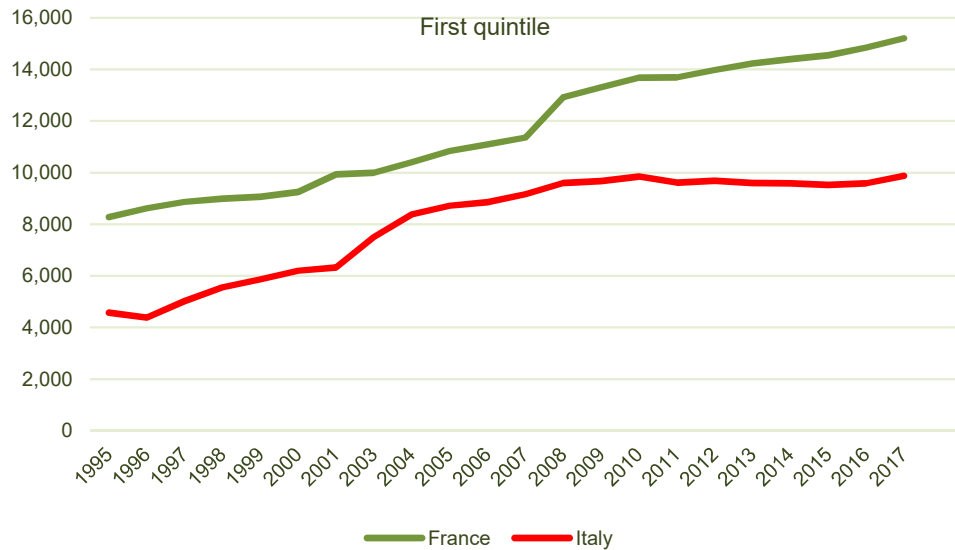
*Data for Croatia represents 2013's value first (the year of EU accession), and 2017's value last

Top cut-off points in Euros

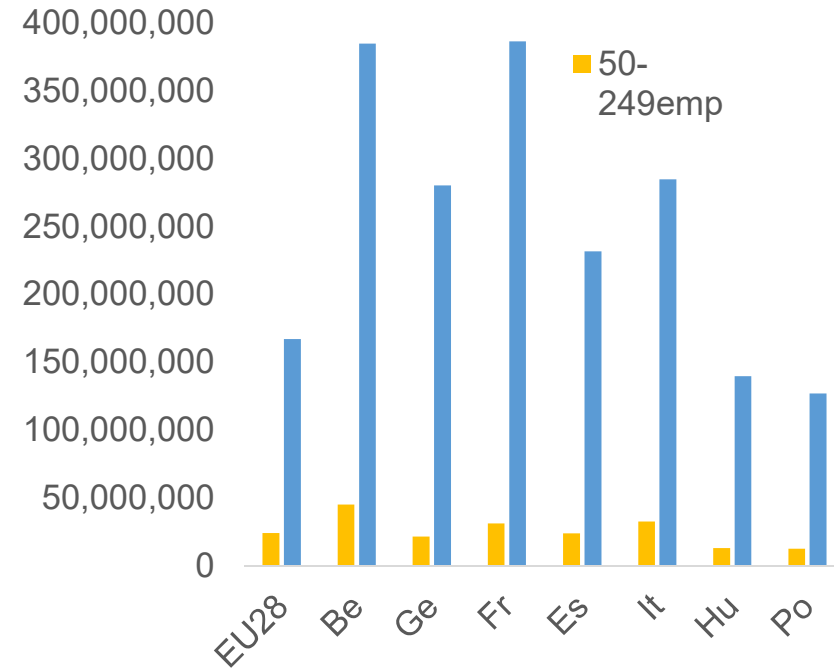
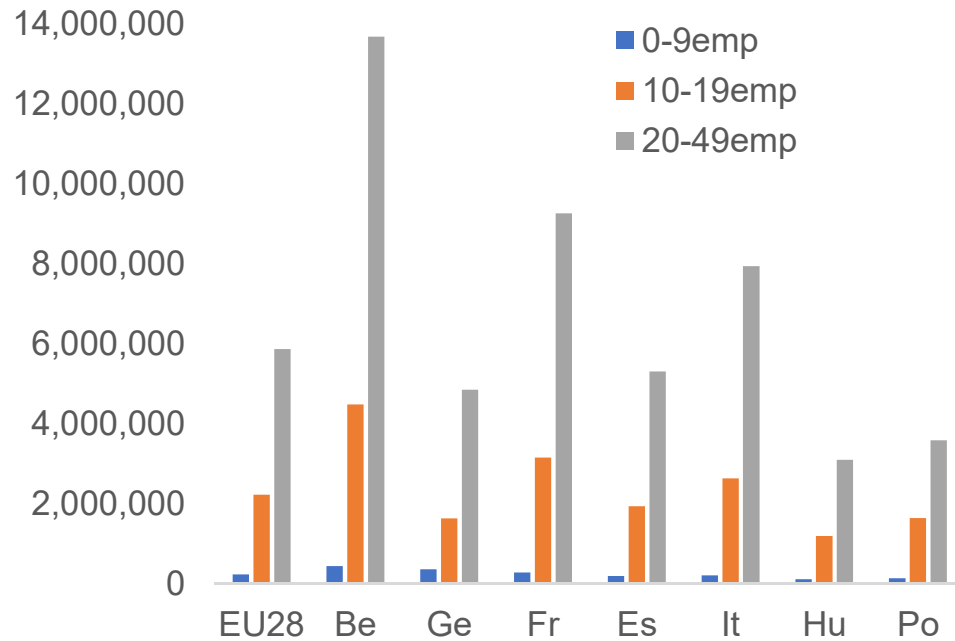


*Data for Croatia represents 2013's value first (the year of EU accession), and 2017's value last

Convergence is not a given



Corporate avg turnover, eur 2015



Ranking	Country/Company	12m profits/12m NGDP in 2000, USDbn	Ranking	Country/Company	12m profits/12m NGDP in 2016, USDbn
1	United States	10,284.8	1	United States	18,036.6
2	Japan	4,887.5	2	China	11,007.7
3	Germany	1,950.0	3	Japan	4,383.1
4	United Kingdom	1,635.4	4	Germany	3,363.6
5	France	1,368.4	5	United Kingdom	2,861.1
6	China	1,211.3	6	France	2,418.9
7	Italy	1,141.8	7	Italy	1,824.9
8	Canada	742.3	8	Canada	1,552.8
9	Brazil	655.4	9	South Korea	1,377.9
10	Mexico	648.5	10	Russia	1,326.0
11	Spain	595.4	11	Australia	1,243.2
12	South Korea	561.6	12	Spain	1,193.0
13	Netherlands	412.8	13	Mexico	1,148.1
14	Australia	409.3	14	Indonesia	861.9
15	Russia	276.7	15	Turkey	859.4
16	Turkey	273.0	16	Netherlands	750.3
17	Switzerland	271.7	17	Switzerland	670.8
18	Sweden	259.8	18	Saudi Arabia	646.0
19	Belgium	237.9	19	Argentina	632.3
20	Austria	196.4	20	Sweden	495.7
21	Saudi Arabia	188.4	21	Poland	477.1
22	Indonesia	180.6	22	Belgium	455.1
23	Poland	171.9	23	Norway	386.6
24	Norway	171.3	24	Austria	377.0
25	Denmark	164.2	25	Denmark	301.3
26	South Africa	136.4	26	Israel	299.4
27	Israel	132.3	27	Ireland	283.7
28	Greece	131.7	28	Chile	240.8
29	Finland	125.5	29	Finland	232.4
30	Portugal	118.4	30	Portugal	199.1
31	Colombia	99.9	31	Greece	194.9
32	Ireland	99.9	32	Czech Republic	185.2
33	Chile	78.0	33	New Zealand	175.6
34	Czech Republic	61.5	34	WAL-MART STORES	124.6
35	EXXON	58.8	35	Hungary	121.7
36	GE	55.5	36	Slovakia	87.3
37	New Zealand	54.4	37	AT&T INC	86.9
38	Hungary	47.2	38	APPLE INC	84.0
39	MOTORS	40.6	39	VERIZON COMMUNIC	74.6
40	LVMH	37.2	40	SAMSUNG ELECTRON	70.3
41	ALTRIA	36.4	41	Luxembourg	56.8
42	FORD	35.3	42	COMCAST CORP-A	55.9
43	ATT	33.3	43	ALPHABET INC-A	55.1
44	WALMART	33.0	44	Costa Rica	54.8
45	IBM	31.9	45	BERKSHIRE HATH-A	54.5
46	Luxembourg	21.4	46	NIPPON TELEGRAPH	54.3
47	WORLDCOMM	21.2	47	MICROSOFT CORP	52.2
48	Slovakia	20.7	48	JOHNSON&JOHNSON	50.2
49	Slovenia	20.3	49	AMAZON.COM INC	47.7
50	MICROSOFT	19.1	50	NESTLE SA-REG	46.3
51	PPANASONIC	19.0	51	TOYOTA MOTOR	45.6
52	SONY	18.1	52	VOLKSWAGEN AG	45.4
53	P&G	17.9	53	UNITEDHEALTH GRP	43.4
54	PG&E	17.5	54	Slovenia	42.8
55	INTEL	17.5	55	ROYAL DUTCH SH-A	42.6
56	HONDA	16.8	56	Lithuania	41.4
57	MERCK	15.2	57	PFIZER INC	40.5
58	Costa Rica	14.9	58	IBM	38.3
59	GTE	14.4	59	FINATIS SA	38.0
60	HISTOIC TW	14.0	60	FONCIERE EURIS	38.0
61	SEARS	13.9	61	INTEL CORP	36.2
62	COCACOLA	13.8	62	DAIMLER AG	35.4
63	HP	13.7	63	ROCHE HLDG-GENUS	34.9
64	PFIZER	13.7	64	PEPSICO INC	34.6
65	BRISTOL	12.9	65	PROCTER & GAMBLE	32.5
66	PEPSICO	12.2	66	HOME DEPOT INC	32.3
67	KROGER	11.9	67	SOFTBANK GROUP C	31.5
68	BASF	11.8	68	NOVARTIS AG-REG	31.0
69	MOTOROLA	11.8	69	CISCO SYSTEMS	30.9
70	Lithuania	11.5	70	GENERAL MOTORS C	30.0

Ease of doing business rankings (countries are ranked from 1 to 190)

	2008	2012	2016	2018
Latvia	22	21	22	19
Lithuania	26	27	20	14
Estonia	17	24	16	16
Croatia	97	80	40	58
Slovakia	33	48	29	42
Slovenia	55	37	30	40
France	31	29	27	32
Italy	53	87	45	51
Greece	100	100	60	72

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