

CROATIA: THE EXPERIENCES OF OTHER COUNTRIES AS A GUIDE TO THE EURO AREA ACCESSION PROCESS



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Abstract

After short introduction author gives review and analyses experiences of Croatia in a process of euro area accession. It is pointed that the conditions for entry into the Euro Area remained unchanged, so Croatia followed the path to the euro based on the criteria set out in the Maastricht Treaty. This paper examined with an overview of the experiences of Croatia in a process of euro area accession by giving a review of Croatian National Bank with relation to European Central Bank with section explaining the process of acquiring experiences from other eurozone member states. After the section on outcomes related to the introduction of the Euro and banking union special focus is given to the participation in the exchange rate mechanism – ERM II with described process of established close cooperation between the ECB and the HNB. The role of the HNB in the unified supervisory mechanism with Single Resolution Mechanism and the Croatian responsible national authorities chapter is central part of the paper. It is emphasized that ERM II was important preparatory phase towards euro adoption in Croatia. Concluding remarks are about positive effects of adopting the euro in Croatia in a short-term, with message on the long-term effects that depend on the domestic capability for changes.

Keywords: *Croatia's euro area accession, HNB, ECB, exchange rate mechanism*

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1. Introduction

Euro area accession is an open and rule-based process. Specifically, it requires the fulfilment of four economic convergence criteria, sometimes referred to as the Maastricht criteria, regarding price stability, sustainable public finances, exchange rate stability, and nominal long-term interest rate convergence. A country's national legislation on monetary affairs must also align with the Treaty on the Functioning of the European Union (TFEU).¹ The latest assessment of the progress of non-euro Member States in converging towards adopting the euro was published in the Commission's 2022 Convergence Report on 1 June 2022. This assessment found that Croatia fulfilled all the convergence criteria, paving the way for the Council's decision on 12 July 2022 to offer the country membership in the euro area as of 1 January 2023. With its accession, Croatia became the 20th member of the euro area. This paper presents the key considerations underpinning Croatia's Eurozone accession process.² The Croatian economy is expected to benefit from the elimination of currency risk as well as lower transaction and borrowing costs. After accession to the EU in 2013, Croatia made significant progress in addressing macroeconomic imbalances and achieving convergence towards the Eurozone. It must continue these reform efforts to fully obtain the benefits of the euro and allow adjustment mechanisms to operate efficiently within the enlarged currency area.³

Since the conditions for entry into the euro area remained unchanged, Croatia followed the path to the euro based on the criteria set out in the Maastricht Treaty. According to these rules, the European Central Bank (ECB) and European Commission publish convergence reports once every two years for euro area candidate countries. The convergence reports published between 2014 and 2020 showed that, while Croatia met the inflation and interest rate criteria, it needed to make obvious efforts to meet the criteria related to public finances. Since 2018, Croatia has made additional efforts to meet these criteria and adopt the euro. It was ultimately accepted into the exchange rate mechanism (the ERM II), the forerunner of the Eurozone, in 2020, together with Bulgaria. This extended its accession by one year until 2024. The Convergence Report for Croatia, published by the European Commission in June 2022,⁴ specifies that the country meets the criteria for adopting a single currency, except for its high level of debt. At the end of June, the members of the European Council approved Croatia's entry into the eurozone, and this decision was confirmed on 12 July 2022 by the Council of the European Union. Croatia adopted the euro on 1 January 2023 when it entered the Schengen area.

1 Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326, 26.10.2012, pp. 47–390.

2 Perić and Reut, 2022.

3 Falagiarda and Gartner, 2022.

4 European Commission, 2022b.

Generally, the adoption of different currencies in any country has a significant impact on the economy. Since 1994, Croatia has had its own currency, the kuna.⁵ Becoming a member of the European Union (EU) was Croatia's strategic goal; in particular, this goal was anchored in Croatia's desire to further its social development. Further, the adoption of the euro in the Croatian market was seen as a very important strategic decision. This has been discussed from different viewpoints of stakeholders, including the government, monetary policymakers, bankers, scientists, and the public. The period of Croatia's journey to join the European Monetary Union (EMU) and adoption of the new currency were used to research the impact of adopting the euro in countries that were already using this currency. This provided solid ground for policymakers to learn from their experience and make precise predictions.

Croatia, as a small and open EU member country, has its own specifics; however, it still learned from the experiences of other EMU Member States. Indeed, each country preparing to adopt the euro has an advantage because of its previous experience with similar countries; therefore, it is useful to recognize countries comparable to Croatia and their relationship with a single currency as special.⁶ For a long time, Croatia was defined as a country with a mostly 'euroised' economy.⁷ In the process of accession to the EMU, the most likely candidates to introduce the euro were Croatia, Romania, and Bulgaria. It is important to note that nations experience an increase in their gross national products after adopting the euro; for example, Austria, Belgium, Finland, Luxembourg, Germany, Spain, France, Ireland, Italy, the Netherlands, and Portugal, which introduced the euro in 1999, experienced an intensive rise in their GNPs after introducing it.⁸

As suggested above, euro area accession is an open and rule-based process that requires the fulfilment of the Maastricht criteria on price stability, sustainable public finances, exchange rate stability, and nominal long-term interest rate convergence. A country's national legislation on monetary affairs must also align with the TFEU. The latest assessment of progress made by non-euro Member States on converging towards adopting the euro was published in the Commission's 2022 Convergence Report on 1 June 2022. This assessment found that Croatia fulfilled all the convergence criteria, paving the way for the Council's decision on 12 July 2022 to make Croatia the 20th member of the euro area as of 1 January 2023. This paper presents the key considerations underpinning Croatia's Eurozone accession process.⁹ Achieving close

5 The modern kuna was introduced on 30 May 1994, launching a period of transition from the Croatian dinar, introduced in 1991, which ended on 31 December 1994. One kuna was equivalent to 1.000 dinars at a fixed exchange rate. The kuna was fixed to the German mark from the start. A long-time policy of the HNB was to keep the fluctuations of the kuna's exchange rate against the euro (or, previously, the mark) within a relatively stable range. Since the introduction of the euro in 1999, the exchange rate between the two currencies rarely fluctuated to a substantial degree. For more details, see: Mance, Drazenovic, and Nikolaj, 2019, p. 153.

6 Tokarski and Funk, 2019, p. 2.

7 For example, around 75% of assets and 67% of liabilities were denominated in euros.

8 Barbosa and Alves, 2011.

9 Perić and Reut, 2022.

cooperation between the monetary authorities, that is, central banks, like Croatia's Hrvatska Narodna Banka (HNB), and the ECB, was a prerequisite for entry into the ERM II – the first formal step in a nation's process to adopt the euro as its official currency. The process of Croatia's integration into the euro area is defined by two key events – Croatia's accession to the EU and its introduction of the euro as its official currency – which initiated a series of changes to the HNB and its operations.

This study summarizes and examines Croatia's experience of euro area accession. To clarify the distribution of powers within the HNB, its relationships with other national and international bodies, and its goals and available instruments, we must first define the structures of the supranational monetary authority, the HNB, and other relevant bodies. Subsequently, the chapter turns to the relationship between the HNB and the ECB.

2. Croatian national monetary authority in relation to the ECB

2.1. The legal and institutional framework of the HNB

The institutional framework of monetary policy that enables development is provided by the Croatian National Bank Act, which is characterised by a high degree of independence in line with world experience.¹⁰ The Croatian National Bank Act defines the Council of the HNB as the highest body of the HNB and as responsible for carrying out tasks within the scope of the HNB's competence and achieving its goals.¹¹ Composed of eight members, including the governor, deputy governor, and six vice-governors, who also represent the management of the HNB, it makes decisions at monthly meetings. These decisions are made by a two-thirds majority of the members present; therefore, to hold a valid meeting, it is necessary to meet the conditions for a two-thirds majority. HNB Council members hold six-year terms in office, subject to the fulfilment of prerequisites for appointment, such as the requirement that they be citizens of Croatia with a recognised personal reputation and professional experience in the financial, banking, monetary, or legal fields.¹² Members of the HNB Council are appointed by the Croatian Parliament based on the proposals of the Committee for Elections, Appointments, and Administrative Affairs and on the basis of the opinion of the Committee for Finance and State Budget.

10 Croatian National Bank Act, Official Gazette ('Narodne novine') No. 75/08, 54/13, 47/20.

11 Croatian National Bank Act, Art. 4.

12 For more details, see: Croatian National Bank Act.

The law also prescribes certain restrictions regarding the appointment of a person as a member of the HNB Council to ensure impartiality in the Council's work. Thus, some of the legal restrictions regarding the appointment of members of the HNB Council are reflected in the fact that a representative in the Croatian Parliament, a member of the Government of Croatia, or a person who performs some other duty to which he was appointed may not be appointed as a member of the HNB Council by the Government of Croatia or the Croatian Parliament. This restriction extends to persons holding positions in the bodies of trade union organisations, political parties, and local and regional self-government bodies. Furthermore, this restriction also applies to persons holding shares or management, functional, or ownership positions in legal entities for which the HNB issues work authorisations or whose operations it supervises. Moreover, for legal entities that require work approvals from HNB or are subject to its supervision, such as audit firms and other legal entities related to these entities at the management and ownership levels, a member of the HNB Council may not serve as a member of their governing bodies, external collaborator, employee, attorney, procurator, or person with special powers. The restriction also applies to performing the aforementioned functions in other legal entities where the access of a member of the HNB Council to information classified as a business secret could provide a specific advantage to said legal entities.

The purpose of such statutory restrictions, which are realised not only in the form of impartiality in the work of the highest body of the HNB, but also in the prevention of threats to institutional independence in the form of conflicts of interest, lies in the correlation of regulations governing the work of bodies and organizational forms of the HNB. Conflicts of interest, in addition to privileged information and the prohibition of receiving benefits, relate to the rules found in the Code of Ethics for employees of the Croatian National Bank. The provisions of Directive (EU) 2015/856 of the ECB for establishing the principles of the ethical framework of the unified supervisory mechanism (ESB/2015/12) were applied.¹³ At the same time, the HNB is included as a participant in the unified supervisory mechanism, with the consequent application of the ethical standards established by the aforementioned directive in relation to all central banks participating in the unified supervisory mechanism. The powers of supervision over the implementation of the rules prescribed by the Code of Ethics, as well as an associated educational and advisory role for the purpose of developing a stronger understanding of the implementation of the ethical principles themselves, belong to the Business Compliance Office, an organization within the HNB that reports directly to its governor.

The HNB governor is responsible for managing the HNB's operations and implementing the decisions of the HNB Council, which he also chairs. The governor also participates in the work of the bodies of the ECB; that is, he is a member of

13 Guideline (EU) 2015/856 of the European Central Bank of 12 March 2015 laying down the principles of an Ethics Framework for the Single Supervisory Mechanism (ECB/2015/12), OJ L 135, 2.6.2015, 29–34.

the General and Governing Council of the ECB. Furthermore, he is authorised to represent and present the HNB; appoint and dismiss persons with special powers and responsibilities in the HNB; pass acts regulating the functioning of the HNB; and pass bylaws, general acts, and decisions within the scope of the HNB, which are not placed under the jurisdiction of the HNB Council by law. The expansion of the governor's power refers to the area of macroprudential policy, along with the powers resulting from the HNB's participation in the Single Resolution Mechanism (SRM) and close cooperation with the ECB, which were achieved during the aforementioned period. According to the provisions of Art. 43, the governor of the HNB also has the right to implement macroprudential policy and pass bylaws, decisions, and recommendations in the same area. In addition to issuing decisions on the procedure of remedial supervision of credit institutions, the governor also prescribes the method of implementation and determines the conditions of remedial supervision in more detail. In the remedial supervision procedure, the governor is authorised to impose measures against credit institutions. In cases where there is no quorum of the Council of the HNB or if a certain decision is not made during the Council's decision-making, the governor has the authority to determine whether, due to the absence of the same, it is possible to ensure normal work in the HNB or the implementation of tasks. The established tasks and jobs of the HNB are distributed among sectors and offices that report directly to the governor, deputy governor, or vice governors in accordance with the established structure. The governor of the HNB, as the President of the Council of the HNB, is replaced by the deputy governor when absent. The deputy governor assumes the powers and duties of the governor prescribed by Art. 43 of the law in cases of temporary illness, death, absence, or expiration of the governor's mandate until his return or the appointment of a new governor.

2.2. The HNB as part of the European System of Central Banks and the Eurosystem

The European System of Central Banks (ESCB) consists of the ECB and the national central banks (NCBs) of all EU Member States. The parallel presence of these two systems will be in effect as long as there are EU Member States that have not introduced the euro – that is, as long as these states remain outside the Eurozone. As one of the institutions of the EU, simultaneously representing the core of the Eurosystem and the ESCB, the ECB was established along with the ESCB based on the Statute of the European System of Central Banks and the European Central Bank on 1 July 1998.¹⁴ The headquarters of the ECB are located in Frankfurt am Main, Germany. In accordance with international public law, the ECB has a full legal personality. Notably, its decision-making authority belongs to three bodies: the Governing Council, Executive Board, and General Council. These bodies also manage the ESCB and Eurosystem.

¹⁴ Ioannidis, 2020.

The bodies of the ECB and other organizational forms are complex. The Governing Council, Executive Committee, and General Council are the bodies of the ECB responsible for decision making. These bodies receive expert support from the committees, sub-committees, and working groups of the ESCB and Eurosystem. Each of the aforementioned organizational forms is characterised by specialisation in relation to a specific ESSB activity, and their members are experts from the ECB and NCMs. The scope of the aforementioned decision-making bodies also includes the management of the ECB with the participation of other organizational forms, which are reflected in the level of internal and external control and participation of the Audit Committee.

The Governing Council of the ECB is the main decision-making body, consisting of six members of the Executive Board and governors of the NCMs of the Member States that introduced the euro. The Governing Council makes decisions at meetings, which are usually held twice a month at the ECB's headquarters. Specifically, these decisions are related to monetary goals, guidelines for their implementation (i.e. the monetary policy of the euro area), and guidelines necessary for the performance of duties established by the ECB and the Eurosystem.

The Executive Board of the ECB consists of the president of the ECB, the vice-president of the ECB, and four other members who have been appointed for a mandate period of eight years based on the decision of the European Council (passed by a qualified majority). It is not possible to renew members' mandates after their expiration. Furthermore, as an operational body of the ECB and Eurosystem, the Executive Board is responsible for the implementation of decisions made by the Governing Council of the ECB – that is, the implementation of the monetary policy of the euro area. In addition to managing the day-to-day affairs of the ECB, the Executive Board is also responsible for preparing meetings for the Governing Council.

The General Council of the ECB consists of the president and vice-president of the ECB as well as the governors of the NCMs of all EU Member States. The possibility of participating in General Council meetings is also open to other members of the Executive Board of the ECB, one member of the European Commission, and the President of the Council of the EU, under the condition that the aforementioned persons do not have the right to vote in the decision-making process. The General Council is a transitional body of the ECB and will be dissolved based on the Statute of the European System of Central Banks and the European Central Bank at the time of the introduction of the euro as the official national currency in all EU Member States. Some functions of the General Council are reflected in its contributions to the advisory functions of the ECB, compilation of the ECB's annual report, collection of statistical information, and establishment of the rules necessary for standardising accounting records and reports related to the work of NCMs.

The HNB independently performs tasks and does so in accordance with joint procedures in cases where the same are foreseen within the framework of the Eurosystem. Namely, the HNB was included in the ESSB with Croatia's accession to the EU, and became a component of the Eurosystem on the day of the introduction

of the euro as Croatia's official national currency on 1 January 2023. The HNB participates in the definition and implementation of the EU's common monetary policy based on the TFEU, Statute of the European System of Central Banks and the European Central Bank. Furthermore, the HNB is responsible for ensuring the smooth functioning of the payment system, its improvement, and the execution of foreign exchange transactions in accordance with Art. 219 of the TFEU.¹⁵ Existing regulations include a series of legislative regulations for the functioning of payment transactions. A payment system is a key element of a country's financial system, along with other elements such as the national currency, financial markets, financial institutions, and institutions that act as regulators and supervisors of the work of the aforementioned elements. Price stability is the fundamental goal of monetary policy, and the independence of NCMs is a necessary precondition to achieving the same, as per Art. 130 of the TFEU.

Central bank independence is manifested in emerging forms of financial, institutional, personal, and functional independence. Financial independence is reflected in the determination of income and expenditure according to the nature of the monetary policy; that is, it excludes cases in which the influence is reversed. Institutional independence implies that the central bank is independent in the decision-making process; put differently, its decisions must not be influenced by other bodies and institutions. Personal independence includes the exclusion of conflicts of interest; the guarantee of protection for HNB employees in relation to potential external pressures; and a clear definition of the conditions for appointing and dismissing members of the HNB Council, including the governor. Functional independence reflects a precisely defined goal and autonomy when choosing the instruments and measures necessary to achieve it. The HNB submits reports on its work to the Croatian Parliament.

The stability of the entire state economy, as the purpose of the tasks under the auspices of determining and implementing monetary and foreign exchange policies, certainly places this task at the top of the HNB's scope of work. However, the day of the introduction of the euro also marked Croatia's entry into the Eurosystem and the transfer of its authority in monetary policy. With this transition, Croatia has the authority to make decisions as a member of the Governing Council of the ECB and implement them through its NCB as a Member State that uses the euro within its territory. The introduction of the euro also marked Croatia's transition to the ECB's minimum reserve system from the HNB's previous mandatory bank reserve system – a monetary policy through which the regulation of the amount of money in circulation is achieved through the prescription of mandatory bank reserves, which represent a part of bank funds expressed as a percentage intended to be allocated to a special account managed by the central bank. In case of irregularities during allocation, an obligation to pay a certain fee to the central bank arises. Setting a higher reserve requirement ratio reduces banks' potential to generate

¹⁵ See: Art. 219 of the TFEU.

loans and simultaneously reduces the money available to legal and natural persons. This is one of the means to which central banks resort, for example, in periods of inflation, which threatens the Eurosystem's basic goal for monetary policy, price stability.

The ECB's minimum reserve system is characterised by the allocation of a certain amount of funds from Eurozone banks as reserves on the accounts of NCBs during the reserve maintenance period. The duration of the reserve maintenance period extends from six to seven weeks, and the amount of allocated funds, called 'the minimum mandatory reserves', is calculated prior to the start of a particular maintenance period based on the respective balance sheets. That is, what is relevant is the average amount of reserves that the bank keeps in the account with the central bank within the reserve maintenance period – put differently, the average amount must meet the set amount of minimum mandatory reserves, which negates the need for the full amount to be kept in the NCB account for the entire period. This gives banks the agency to take certain actions in connection with short-term movements in the money markets, which can positively affect the market.

The HNB is authorised to issue and revoke approval and consent and to issue other decisions in accordance with the laws governing the operations of credit unions, credit institutions, issuers of electronic money and payment systems, payment service providers, payment transactions, operations of authorised exchange offices, foreign exchange operations, and issuance of electronic money. HNB approvals include granting loans to credit institutions and, in relation to credit institutions, the HNB is responsible for opening accounts, receiving funds from credit institutions, and making payments on these accounts. The HNB also performs tasks related to the rehabilitation and supervision of credit institutions within the SRM and SSM frameworks. The subject of HNB supervision includes the operations of credit unions, issuers of electronic money and payment systems, payment service providers, and payment transactions. Credit institutions represent the backbone of Croatia's financial system, as they are the most represented financial institutions according to the criterion of the share of an individual intermediary in the financial system's assets.

The HNB, like other NCBs of Member States that have introduced the euro, is responsible for matters of consumer protection and the supervision of national regulations for the prevention of terrorist financing and money laundering. Furthermore, the HNB issues euro banknotes and coins with certain restrictions to comply with the provisions of the TFEU, the Statute of the European System of Central Banks and the European Central Bank, and the limits established by the approval of the ECB when carrying out the aforementioned activity. The remaining activities covered by the HNB include the collection and processing of data to create official statistics, the management of its financial assets and international reserves, the adoption of bylaws related to the tasks under its jurisdiction, and the performance of the duties of the fiscal agent for Croatia, in addition to other tasks established by law and other regulations.

3. Outcomes related to the introduction of the euro and banking union

3.1. Introduction to the banking union

The creation of the European Banking Union (EBU) marks a significant step toward further integration in the euro area and is important for efficient supervision and resolution, especially for the legal differentiation of cross-border banks.¹⁶ Cooperation takes place according to two EBU pillars – the Single Supervisory Mechanism (SSM) and the SRM – with authorities of non-participating Member States and third countries in cross-border contexts. Cooperation is a prerequisite for functioning mechanisms, as it represents the foundation for further integration within the EBU, consolidating equivalence with third countries.¹⁷

The period of accession to the EU and the introduction of the euro as the official currency fulfilled the requirements for harmonisation with the *acquis* of the EU. Croatia became a member of the EU on 1 July 2013 following the conclusion of negotiations from 2005 to 2011. The introduction of the euro as Croatia's official currency was the ultimate goal of Croatia's integration into the EU.¹⁸ For this purpose, the Government of Croatia, in cooperation with the HNB, adopted a strategy for introducing the euro as the official currency in Croatia on 10 May 2018.

To achieve this goal, it was necessary for Croatia to first commit to joining the European exchange-rate mechanism.¹⁹ Croatia was committed to submitting an application for entry into the European Exchange Rate Mechanism (ERM II) with the additional condition of ensuring the close cooperation of the HNB with the ECB based on Art. 7 of Council Regulation (EU) No. 1024/2013 on the assignment of certain tasks to the ECB in connection with credit institutions' prudential supervision policies.²⁰ Croatia's official request to establish close cooperation was sent to the ECB on 27 May 2019. The decision to closely cooperate with the HNB was made by the Governing Council of the ECB on 10 July 2020. Furthermore, one of the requirements is the implementation of a single recovery mechanism in accordance with Regulation 806/2014 on the establishment of uniform rules and procedures for the rehabilitation of credit institutions and certain investment companies within the framework of a uniform rehabilitation mechanism and a uniform rehabilitation fund,

16 For more studies on the EBU, see: Gutiérrez-López and Abad-González, 2020; Howarth and Quaglia, 2020; Högenauer, Howarth and Quaglia, 2023.

17 Petit, 2023.

18 Published in the Official Gazette – International Contracts No. 2/12.

19 Government of the Republic of Croatia, Croatian National Bank, 2018.

20 European Central Bank, no date; Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89.

and on the amendment of Regulation 1093/2010.²¹ Croatia has been a participant in the SSM since 1 October 2020 and simultaneously became a participant in the SRM, according to Regulation 806/2014. Namely, the process of establishing close cooperation includes the detailed assessment of credit institutions, the implementation of which precedes participation in the unified supervisory mechanism, that is, the implementation of supervision. The aforementioned assessment procedure resulted in the supervision starting later on: Croatia participated in the SSM from 1 October 2020 in relation to the decision to establish close cooperation with the ECB, which was made in May of the same year. As already mentioned, in addition to recommendations and cooperation with the EU, it was necessary to harmonise national regulations, including activities under the jurisdiction of the HNB. Necessary changes were accordingly made to the Croatian National Bank Act²² in 2020.²³

3.2. Participation in the exchange rate mechanism: The ERM II

Participation in the ERM II is part of the convergence criteria derived from Art. 140, para. 1 of the TFEU and the Protocol (No. 13)²⁴ on convergence criteria. These criteria are used to limit particular economic risks for the Member State and the euro area during the Member State's transition to the euro; that is, to ensure the Member State is adequately prepared for the transition. The Eurozone includes the territories of EU Member States that have introduced the euro as an official monetary unit, and approximately 350 million citizens living in the 20 Member States.

Regarding the convergence criteria, we may distinguish between criteria for economic convergence and those for legal convergence. Economic convergence criteria are divided into four categories subject to more detailed regulation: price stability, healthy and sustainable public finances, exchange rate stability, and long-term interest rates. The price stability criterion assumes that the country's inflation rate does not exceed 1.5% of the rates of the three-Member States that achieve the best results. To meet the criteria of healthy and sustainable public finances, the state must not be in the process used in the case of an excessive deficit. The exchange rate stability criterion is met if a country participates in the ERM II, the aim of which is to demonstrate whether the country's economy can operate efficiently without excessive currency fluctuations. When a country that is not a member of the euro area joins the ERM II, its national currency is pegged to the euro at the central exchange rate agreed upon by the euro area Member States, the countries that do not belong to the euro area, but already participate in the ERM II and with the ECB, with the

21 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010, OJ L 225, 30.7.2014, 1–90.

22 Croatian National Bank Act, Official Gazette No. 47/2020.

23 For more information, see: Nieto and Singh, 2021b.

24 Mangiameli, 2021.

participation of the Commission in the same procedure. Regarding the criterion of exchange rate stability, it is necessary for the state to participate in the mentioned mechanism for a period of at least two years and achieve particular results. In other words, significant deviations from the ERM II central exchange rate are undesirable. Currency fluctuations within the standard limit of 15% above or below the set central exchange rate are permissible. The long-term interest rate criterion assumes that the country's interest rates do not rise above two percentage points of the rates of the three Member States that achieve the best results in terms of price stability. Legal convergence implies the harmonisation of the national legislation of the country that seeks to become part of the Eurosystem and the ECB's euro area. In several reports, called Convergence Reports, the ECB emphasised the need for Croatia to further harmonise certain legal provisions before introducing the euro to fully comply with the conditions of legal convergence; specifically, the ECB presented these views in reports from 2014, 2016, and 2018.

3.3. Establishment of close cooperation between the ECB and the HNB

The decision to establish close cooperation was made by the ECB at the request of a Member State whose official monetary unit was not the euro. The Member State requested drafts of relevant regulations to achieve close cooperation between the ECB and its own national competent authority (NCA).²⁵ The establishment of close cooperation is based on the adoption of a decision by the ECB under fulfilled conditions, with close cooperation achieved by supervising credit institutions through the SSM. A full assessment of credit institutions is one of the two important parts of the process of establishing close cooperation between the ECB and HNB. The second part of the process involves adjusting the regulatory framework. The evaluation of institutions, which usually lasts for six to twelve months from the completion of the adaptation of the relevant national regulations, includes credit institutions and branches of credit institutions based in countries other than Croatia that operate in Croatia. To fulfil the legislative prerequisite, that is, the adjustment of the regulatory framework as one of the components in the process of establishing close cooperation, Croatia submitted a draft of the proposed amendments to the legislation on credit institutions.

3.3.1. Fundamental pillars of the banking union

The SRM, the SSM, and the European Deposit Insurance Scheme (EDIS) are the three fundamental pillars of the EBU, which constitutes a unique system of bank reintegration and supervision at the EU level. The EBU includes all Eurozone

²⁵ 2014/434/EU: Decision of the European Central Bank of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (ECB/2014/5), OJ L 198, 5.7.2014, 7–13.

Member States and EU Member States outside the Eurozone that decide to join. Member States that do not belong to the euro area are given the opportunity to join the EBU by establishing an agreement to engage in close cooperation. Such a financial framework in the territory of the EU was created as a reaction to the financial crisis that hit world markets in 2008 and 2009, which pointed to certain shortcomings in the euro area.²⁶ By 2015, the crisis had deepened in some European countries. In particular, this framework includes unified rehabilitation, supervision, and deposit insurance for all credit institutions operating in the euro area. Through these mechanisms, efforts are being made to more deeply integrate the banking system, given the special interdependence of euro area countries, which the financial crisis highlighted. In particular, efforts are being made to prevent – or at least limit – the future negative effects of financial crises in ways that increase the general level of banks' resilience. Specifically, this is being done by reducing market fragmentation by harmonising the financial sector rules, reducing the transfer of undesirable effects resulting from problems in the balance sheets of banks on public finances and vice versa, using a Single Fund for the rehabilitation of banks and financial burden-sharing among owners and creditors, and avoiding situations in which taxpayers' money will be used for the rehabilitation of failing banks.

A unique monitoring mechanism, the SSM, came into force on 4 November 2014 after the Regulation on the Single Supervisory Mechanism of the Council of the EU was adopted on 15 October 2013 following the conclusion of negotiations between the Council of the EU and the European Parliament. The SSM represents a common framework with regard to banking supervision in the EU. Through the establishment of continuous supervision, the SSM aims to raise the general level of credibility, security, and stability of the EU banking system. Participants include the ECB and relevant national supervisory authorities.²⁷ The ECB is responsible for the efficient and uninterrupted operation of the single supervisory mechanism. It performs its tasks through the direct supervision of significant institutions through its exclusive competence in relation to all banks in the Eurozone. Less significant institutions are subject to direct supervision by national supervisory bodies that cooperate with the ECB to perform tasks within their jurisdiction.²⁸

Within the framework of cooperation between the ECB and national supervisory authorities, joint supervisory teams are formed, composed of employees of the ECB and of certain national supervisory authorities.²⁹ Supervision by direct control teams involves individual risk areas, corporate governance, and internal control systems.

26 On shortcomings, see: Bańkowski et al., 2021; Bénassy-Quéré and Weder di Mauro, 2020.

27 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89.

28 Heldt and Mueller, 2021.

29 Chiamonte, et al., 2022.

Due to the need to adopt important supervisory measures with a focus on areas such as liquidity risk, capital risk, and business model and internal management, the above-mentioned supervisory verification and assessment procedure is carried out.³⁰ The ECB continuously examines the institutions of the countries participating in the unified supervisory mechanism.³¹

3.3.2. The role of the HNB in the unified supervisory mechanism

In matters of supervision, the HNB has exclusive jurisdiction over areas regulated by the Credit Institutions Act³² and bylaws adopted by the HNB. These areas include provisions for exposure classification and accounting, consumer protection, methods of determining losses caused by credit activities and restrictions regarding investment in tangible assets. Additionally, as one of the supervisory bodies, along with prevention bodies and criminal prosecution bodies, it includes provisions for operating within the framework of the financing prevention system for terrorism and money laundering. In addition to the HNB, the competence to supervise within this system belongs to several other institutions. The jurisdiction of the aforementioned institutions derives from legal provisions that regulate their rights, duties, and mutual cooperation. The HNB cannot investigate potential offenders of criminal acts among the bank's clients; instead, such actions are completed by a criminal prosecution body, such as the police, the state attorney's office, or the judiciary. Within the framework of the system for suppressing such criminal activities, the HNB monitors whether banks implement all adequate measures to prevent the use of the banking system for money laundering in compliance with law. Banks, like brokers, currency exchanges, insurance companies, and organisers of games of chance, play the role of prevention bodies within the system for preventing money laundering and terrorist financing. Such a regulatory solution at the EU level will require Croatia to implement further regulations and manage risks that manifest themselves in areas under the jurisdiction of the HNB, which have proven to be important, especially during financial crises. The competence of the HNB for supervision in areas that are not covered by the SSM regulation is provided for in Art. 1.³³ The same article establishes the authority of the ECB to supervise credit institutions and thus at the same time limits and foresees competence in supervisory tasks that are not entrusted to the ECB by national supervisory authorities. The assessment of solvency is based on an exhaustive analysis of the balance sheet and other reports from the institution and includes analyses of past and future conditions.

30 Howarth and Quaglia, 2021.

31 Gortsos, 2020.

32 Credit Institutions Act, Official Gazette No. 159/13, 19/15, 102/15, 15/18, 70/19, 47/20, 146/20, 151/22.

33 Karagianni and Scholten, 2018.

3.3.3. The Single Resolution Mechanism and the responsible Croatian authorities

The SRM, one of the pillars of the EBU, includes national resolution bodies and the Single Resolution Board (SRB), whose task is to plan the resolution of entities under their jurisdiction. The SRB is the central resolution authority within the EBU, which currently comprises 20 Eurozone countries, including Bulgaria. Together with the national resolution authorities, it forms the SRM. The SRB works closely with the European Commission, ECB, European Banking Authority, and national authorities to ensure the orderly resolution of failing banks and protect taxpayers from state bailouts, which promotes financial stability. This mechanism seeks to adequately assimilate weakening banks and minimise consequences by preventing the effects of the implemented procedures from spreading to both taxpayers and the entire economy. Further, the SRM is designed to facilitate efficient and independent centralized remedial decisions, which are especially reflected in situations involving cross-border institutions that need to be remedied and those in which the coordinated action of numerous remedial bodies is necessary for remediation.

The fundamental goal of the unified reintegration committee is to ensure the continuous functioning of the SRM with simultaneous cooperation between resolution institutions at the national level and other institutions of an international character of the same nature. The board can be defined as an independent EU agency and regulatory body for the banking sector. Regulation 806/2014 established the SRM, which grants power to the SRB³⁴ in matters of resolution within the framework of the EBU. In addition to the general function of ensuring the smooth operation of the SRM, the SRB is authorised to dispose of the Single Resolution Fund, draw up resolution plans, and make decisions regarding the resolution of credit institutions or groups of credit institutions that have been assessed as significant or directly supervised by the ECB. The Board also makes remedial decisions related to ‘other cross-border groups’, which are defined as groups in which the parent credit institution and at least one daughter credit institution have headquarters in two different participating Member States. The SRB performs the aforementioned functions in simultaneous coordination with the ECB, recovery, and supervisory bodies at the level of participating countries, ministries, the European Banking Supervisory Authority, and many other institutions that perform activities of the same nature in the territory of the EU, as well as in third countries. The SRB assumes direct responsibility for certain credit institutions based in Croatia due to Croatia’s accession to the SRM, with the exception of institutions for which the SRB will cooperate with recovery bodies at the national level; that is, in relation to which it is not directly responsible.

34 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30.7.2014, 1–90.

Resolution authorities at the national level are responsible for credit institutions that are not members of EU groups. An exception is provided for the direct responsibility of national resolution authorities in relation to credit institutions that belong to groups in the EU. However, the parent company of the group in which they are included is not located in a Member State of the EBU. The SRB became the competent resolution body for banks with headquarters in Croatia and which belong to groups of credit institutions in the EU, and in relation to which it performed the same function in the period before the accession of Croatia to the SRM.

The direct competence of the SRB includes actions related to the preparation of restoration plans, defining the minimum requirements for regulatory capital and liabilities for some of the largest banks in Croatia, and assessing the need for rehabilitation. To ensure the accuracy of the relevant data for the successful undertaking of the aforementioned actions and to assess the potential effects of actions undertaken to ensure Croatia's financial stability, representatives of the HNB and all other recovery bodies from the participating Member States, if they the relevant banking group conduct business.

The SRB makes decisions during executive and plenary sessions. Both types of meetings are attended by the same members; namely, the president of the SRB, four members of SRB management, and representatives of the national resolution bodies appointed by each Member State of the EBU. In plenary sessions, decisions are made by a simple majority, and each member has voting rights. In executive sessions, efforts are made to reach a consensus among all members, and if this is not possible, decisions are made by majority. In the event of a tie, the presidential vote is decisive.

The fundamental difference lies in the nature of the issues that are decided in each session. While plenary sessions make decisions on issues such as the annual work program, annual budget, investments, and use of the resources of the SRF in certain circumstances, executive sessions make decisions regarding rehabilitation issues. Thus, within the scope of the executive sessions, the rehabilitation plans are completed – that is, they are prepared, evaluated, and approved. Then, in the executive sessions, when certain conditions are met, decisions can be made on the establishment of simplified obligations, the minimum requirements for regulatory capital and acceptable obligations can be determined, rehabilitation programs can be incorporated, and the European Commission can be informed.

In Croatia, remedial powers are divided among the Croatian National Bank, Croatian Deposit Insurance Agency (HAOD), and Croatian Financial Services Supervision Agency (HANFA). Ensuring the continuous and efficient functioning of a single recovery mechanism is the goal, the realisation of which rests on the national recovery bodies in such a way that they harmonise with the SRB at the working methodological and political levels and achieve cooperation through the monitoring of guidelines, instructions, recommendations, and warnings issued by the SRB. This ensures the equal treatment and application of equal rehabilitation criteria to credit institutions in Croatia, over which the SRB does not have direct jurisdiction. Since

Croatian legislation has been gradually harmonising with EU regulations for years, after joining the SRM, there were no significant changes in the operation of the HNB as a recovery body. This may have been because a certain level of operations and communication had already been established. A more significant change lies in the fact that upon joining the aforementioned mechanism, representatives of the HNB will directly participate in the work and decision-making of the SRB in such a way that they will attend and have the right to vote in its sessions and participate in the work of working groups formed within the SRB framework.

The years leading up to the adoption of the amendments of the Croatian National Bank Act³⁵ and the introduction of the euro as the official currency of Croatia are marked by particular goals. These goals essentially shaped the direction of the HNB's consequential strategy and, more broadly, state policy. In the context of monetary policy, certain changes have been made to implement negative interest rates, which play an important role in the work of central banks due to their effects on the money market and liquidity. Negative interest rates were not used in the past because of the limitations of domestic legislation.

The new amendment to the law was also designed to align with the application of the Directive on the legal framework for accounting and financial reporting in the European System of Central Banks³⁶ (ESB/2016/34) (hereinafter: Directive of the ECB) and to support the introduction of the euro as the official currency through the improved presentation of relevant data in the financial statements submitted by the HNB. Simultaneously, this will bring about convergence with certain standards in the field of accounting similar to those of other EU members. The application of the ECB Directive was scheduled for 1 January 2021.

A series of requirements that had to be met in the mentioned period, including the introduction of the ECB Directive, resulted in the amendment of existing legal articles; that is, in regulatory adjustments on a wider scale. The introduction of the euro as the official currency in Croatia and the closing of one chapter in this European journey were preceded by the last phase, which included the implementation of a series of activities that began with the adoption of the Euro Act³⁷ in 2022. In June of the same year, the European Council supported the introduction of the euro in Croatia on 1 January 2023. This move followed the adoption of a recommendation by the Eurogroup and the Council of the EU on the issue. Furthermore, the Council of the EU adopted a decision on the introduction of the euro in Croatia and a regulation on a fixed conversion rate on 12 July 2022. This was followed by a series of activities to implement the same decision. Some of the included activities were the pre-supply of banks and other relevant institutions with euro banknotes and coins

35 Amendments of Croatian National Bank Act, Official Gazette No. 47/2020.

36 Guideline (EU) 2016/2249 of the European Central Bank of 3 November 2016 on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), OJ L 347, 20.12.2016, 37–86.

37 The Law on the introduction of the euro, Official Gazette No. 57/2022.

and the beginning of the obligation of dual price reporting. The euro was scheduled to be introduced in Croatia on 1 January 2023.³⁸

4. The ERM II: The preparatory phase of Croatia's adoption of the euro³⁹

The Croatian kuna was included in the ERM II on 10 July 2020. This inclusion marked a milestone towards the enlargement of the euro area, highlighting the important role of the ERM II as a preparatory phase for the adoption of the euro. Participation in the ERM II may lead to a regime shift in the concerned countries; that is, it may alter the incentives of international and local investors and national authorities. Indeed, there is evidence that a 'regime shift indeed occurred in the central and eastern European countries (CEECs) that joined this mechanism between 2004 and 2005. If supported by sound economic policies, this shift may have positive consequences, such as accelerating the convergence process'. To fully reap the benefits of monetary integration and ensure smooth participation, countries need sound policies, governance, and institutions which allow them to address risks with adequate macroeconomic, macroprudential, supervisory, and structural measures.

Two Member States, Bulgaria and Croatia, joined the ERM II on 10 July 2020. The process began in 2017 and integrated lessons from the experiences of other countries.⁴⁰ For Bulgaria and Croatia, the ERM II served not only as an exchange rate arrangement but also as a preparatory phase for euro adoption.⁴¹ The ERM II acts as an arrangement for managing exchange rates between participating currencies. In addition, the purpose is to assist the convergence assessment provided for in the TFEU with regard to the adoption of the euro by non-euro EU nations; that is, the ERM II offers a testing ground before the adoption of the euro – it serves as a market and policy test.⁴² Looking back at the history of the exchange rate mechanism (ERM) brings to mind that the original ERM, which had been part of the European Monetary System since 1979, was replaced by ERM II with the introduction of euro on 1 January 1999.⁴³

The ERM II was established by the European Council Resolution of 16 June 1997, which provided that 'The euro will be the centre of the new mechanism'.⁴⁴ While the

38 Falagiarda and Gartner, 2022.

39 Dorrucchi, et al., 2020; For more information, see: Nieto and Singh, 2022.

40 Detken, Gaspar, and Noblet, 2004, p. 9.

41 See, for example: Kordić, 2023.

42 Lefterov, 2015.

43 Eckert, Lindner and Nölke, 2020.

44 Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union, Amsterdam, 16 June 1997, OJ C 236, 2.8.1997, 5–6.

ERM II is referred to in the Treaty as an integral part of the Maastricht exchange rate convergence criteria, its procedures and agreements are not based on the Treaty, as they are intergovernmental.⁴⁵ Decisions regarding participation in ERM II – in particular, whether a country's currency can be included in the mechanism with a certain central rate and fluctuation band – are made by mutual agreement between the finance ministers of euro-area countries, the ECB, and the finance ministers and central bank governors of non-euro-area Member States participating in the ERM II at any given time.

Participation in ERM II is a precondition for the eventual introduction of the euro. Further, there must be a consensus that the concerned Member State is pursuing effective stability-oriented policies consistent with smooth participation in the mechanism. The full benefits of euro adoption can only be enjoyed if adequate policy measures are in place, including those at the national level. A 'high degree of sustainable convergence', as established by Art. 140 of the TFEU, is the most important precondition for the successful adoption of the euro.

Notably, participation in the ERM II affects the expectations and economic incentives of international and local investors, as well as of local policy authorities.⁴⁶ Following the accession of selected CEECs to the EU, the countries that participated in the ERM II experienced a more noticeable international financial flow cycle than those that did not. At the same time, the results suggest that EU accession is not relevant to recorded financial inflows; specifically, differences in gross international financial inflows between the CEECs participating in the ERM II and other CEECs are largely driven by bank lending. After joining the mechanism, ERM II participants experienced a stronger expansion in domestic credit and lower real interest rates than CEECs that did not join the ERM II after their accession to the EU.

Regarding Croatia, it is notable that ERM II participants may benefit from the increased availability of capital but may also face an increased risk of a build-up of macroeconomic imbalances. Historical experience suggests that factors such as resilient economic structures, the quality of institutions, and governance reduce the risk of economic imbalances and enhance a country's capacity to cope with shocks. Therefore, a given currency's participation in the ERM II requires the proper framework and conditions at the national level.⁴⁷ Croatian authorities made several policy commitments in 2018 and 2019 in areas highly relevant to a smooth transition into and subsequent participation in the ERM II. After fulfilling prior policy commitments, Croatia entered the ERM II and the EBU simultaneously on 10 July 2020.

When Croatia first expressed interest in joining the mechanism, ERM II parties considered three fundamental issues.⁴⁸ During the informal phase, a dialogue was held between ERM II parties and Croatian authorities on potential risks and how to

45 Nieto and Singh, 2021a; Dorrucchi et al., 2021.

46 Kordić, 2023; See also: Jerković, 2022.

47 Deroose and Baras, 2005.

48 Gronkiewicz-Waltz, 2023.

mitigate them. After this phase, the last step in the roadmap was marked by formal requests for the inclusion of the Croatian kuna in the ERM II, which were sent the day before the decision was made.⁴⁹ Some policy commitments were completed by the time Croatia formally entered the ERM II as ‘prior commitments’. In line with past practices, other commitments had to be completed after joining the ERM II as ‘post-entry commitments’.⁵⁰ Adequate monitoring was established by the ECB and European Commission within their respective remits to verify compliance with both prior and post-entry commitments. The ECB focuses on commitments related to the banking sector, including banking supervision and macroprudential issues. Meanwhile, the Commission focused on commitments to structural policies. It is important for fiscal policies to be governed by the Stability and Growth Act. Prior commitments were made by Croatia in the summer of 2019 and completed before joining the ERM II on 10 July 2020. The completion of the ERM II policy commitments was related to structural policies, and in letters to the ERM II, Croatia⁵¹ committed to implementing several policies related to structural policies before joining. The European Commission was mandated by ERM II parties to monitor Croatia’s implementation of these prior policy commitments. Monitoring was facilitated by regular technical exchanges between the Commission and the Croatian authorities. The European Commission provided regular progress updates to the ERM II parties. Simultaneously, the ECB reported on the implementation of policy measures related to banking supervision.

Specifically, the Croatian authorities made commitments related to (i) the anti-money laundering framework, (ii) statistics, (iii) public sector governance, and (iv) the business environment. The final assessment reports were published together with the ECB Decisions to include the Croatian kuna in the ERM II. In June 2020, the Croatian authorities informed the ERM II parties of prior commitments and asked them to invite the Commission and ECB⁵² to assess their effectiveness. Both institutions confirmed that the policy commitments in their respective areas of competence were fully implemented.⁵³

Post-entry commitments were also made by Croatia – and Bulgaria – upon joining the ERM II. Specifically, the Croatian authorities made commitments to implement specific policy measures on the anti-money laundering framework, the business environment, state-owned enterprises and the insolvency framework. The inclusion of Croatian kuna in the ERM II was also subject to standard fluctuation margins.⁵⁴ When assessing the central rates of the Croatian kuna within the ERM II, it was

49 Ćorić and Deskar-Škrbić, 2017.

50 For details, see: Gronkiewicz-Waltz, 2023; Nieto and Singh, 2021b.

51 Nieto and Singh, 2021b.

52 See: Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, 63–89.

53 Nieto and Singh, 2021a.

54 Dorrucchi et al., 2021.

determined that Croatia maintained nominal exchange rate stability for more than two decades.⁵⁵ The HNB rarely intervenes in foreign exchange markets, with interventions historically focused only on supporting or weakening the currency. Until the COVID-19 shock, the HNB mostly intervened to counter appreciation pressures. The ERM II parties decided to set the central rate of the Croatian kuna at the prevailing market rate of 7.53450 HRK/EUR, corresponding to the level of the reference exchange rate (as published by the ECB based on daily consultations between European central banks) ahead of its inclusion.

Ultimately, joining the ERM II was a necessary step in Croatia's adoption of the euro. At present, 19 EU Member States have adopted a common monetary policy, with the euro as the common currency. Under the Treaty, all other EU Member States except Denmark are expected to introduce the euro once the necessary requirements have been fulfilled.⁵⁶ From a procedural perspective, decisions on euro adoption are made by the Council of the European Union in line with the relevant Treaty provisions, including the need to stay in the ERM II for at least two years.⁵⁷ From a policy standpoint, the adoption of the euro is an opportunity, albeit not a guarantee, to gain substantial benefits. The adoption of a global currency as legal tender fosters monetary stability, which in turn manifests itself in a low and stable real interest rate environment. Art. 140 of the TFEU states that a country should achieve 'a high degree of sustainable convergence' with the euro area before introducing the Euro; this means that the adoption of the euro should be sustainable in the long run. Resilient economic structures, financial stability, the quality of institutions and governance, and the progressive enhancement of the EU architecture play important roles in this regard.⁵⁸

When the ECB included the Croatian kuna in the ERM II in July 2020, it emphasised a 'firm commitment' by the respective authorities 'to pursue sound economic policies with the aim of preserving economic and financial stability, and achieving a high degree of sustainable economic convergence': Commitments made by the Croatian authorities in recent years have spurred the introduction of important measures to mitigate risks under the ERM II. Although crucial steps have been taken to address macroeconomic imbalances, there is still significant work to do.⁵⁹ Finally, policy efforts need to include measures aimed at preventing the euro changeover from being used by firms and price setters as excuses for unwarranted price escalation. In this regard, national authorities, in cooperation with the European Commission and ECB, can benefit from past experiences with the euro changeover in other countries.⁶⁰

55 Vujčić and Presečan, 1999.

56 Deskar-Škrbić and Kunovac, 2020.

57 For more details, see: European Commission, 2022a.

58 Diaz del Hoyo et al., 2017.

59 Backé, et al., 2004.

60 Pufnik, 2017.

Along with the Commission, the ECB has been fully committed to supporting Croatian authorities in promoting campaigns to prevent the rounding of prices.⁶¹

5. Summarizing thoughts

On 1 January 2023, Croatia adopted the euro and became the 20th member of the Eurozone. The Croatian economy is expected to benefit from the elimination of currency risk as well as lower transaction and borrowing costs. After its accession to the EU in 2013, Croatia made significant progress in addressing macroeconomic imbalances and achieving convergence towards the Eurozone. It must continue these reform efforts to fully reap the benefits of the euro and allow adjustment mechanisms to operate efficiently within the enlarged currency area.

In light of Croatia's deep integration with the euro area and assuming that it pursues sound fiscal, structural, and financial policies going forward, it is expected to continue to benefit from adopting the euro. Since the Croatian currency has been tied to the euro for a long time, and before that, to the German mark, no significant changes were expected after its adoption. At the same time, a good part of the Croatian economy is 'euroised', which confirms the previous position. Among the effects generated by the transition to the euro are those already mentioned in the literature and in the previous sections of this chapter; namely, the reduction of currency risk and transaction costs, which diminish uncertainty and improve economic and financial stability. The euro can also facilitate trade between countries that use it. Notably, better integrated financial markets and improved economic stability can accelerate this development process. The simultaneous entry into the Schengen area also supported the Croatian economy. Meanwhile, the increase in inflation during the initial period of the transition to the euro is a common phenomenon. Still, the experience of the countries that adopted the euro shows that the actual effect of rounding prices when converting the national currency to the euro was significantly lower than the results of the simulations, which assume that all attractive prices are rounded up. In principle, joining the euro area will benefit Croatia because of the already consolidated economic and financial relations within this monetary union.

The ECB was mandated by ERM II parties to monitor the implementation of the two prior commitments related to banking supervision and financial stability that the Croatian authorities had to complete by the time they joined the ERM II. Specifically, there were two commitments: first, to establish close cooperation between ECB Banking Supervision and the NCA under the legal framework of the SSM and, second, to strengthen the macroprudential framework and borrower-based measures.

61 Dorrucchi et al., 2020.

Notably, Croatia was the first country to join the ERM II since the financial crisis. In addition, it marked the first time a Member State joined the ERM II after the establishment of the EBU. Given that the ERM II is a preparatory phase for euro adoption, joining the ERM II also meant preparing to enter a banking union. Therefore, countries aiming to adopt the euro were advised to closely cooperate with the ECB when joining the ERM II. Croatian authorities accordingly undertook many legislative amendments and measures to create a legal basis for close cooperation with the ECB. The ECB assessed the national legal framework for compliance with the relevant conditions for establishing close cooperation. The comprehensive assessment results for Croatian banks were published in June 2020 and did not indicate any capital shortfalls for the selected banks. In July 2020, the ECB decided to establish close cooperation with the HNB⁶² following the latter's fulfilment of all supervisory and legislative prerequisites.⁶³ The Croatian authorities have committed to broadening their macroprudential toolkit, which was completed through the adoption of relevant legislation in 2018 and 2020.⁶⁴ After completing prior commitments, Croatia joined the ERM II and the EBU.

On 1 October 2020, the ECB began to directly supervise significant Croatian institutions. Credit institutions that are closely cooperative are subject to the same supervisory standards and procedures as their equivalents in the Eurozone. Establishing close cooperation is an important landmark in the development of banking unions. This was the first time that banking unions had been enlarged with EU Member States outside the euro area. Croatia, like Member States in the European Union, adopted the euro as part of the process of Europeanisation. There was already a high level of euroisation, meaning that citizens independently decided to use the foreign currency as the dominant currency. Although adopting the euro should be followed by benefits for businesses and the economy, increased costs were confirmed as a negative effect for all countries, including Croatia, in 2023.⁶⁵ Although the effects of adopting the euro in Croatia might be positive in the short term, it is obvious that the long-term effects depend on Croatia's capabilities to endure change, especially in the fields of the economy and legal security.⁶⁶

62 Decision (EU) 2020/1016 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Hrvatska Narodna Banka (ECB/2020/31), OJ L 224I, 13.7.2020, 4–6.

63 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, OJ L 176, 27.6.2013, 1–337.

64 See: Croatian National Bank Act.

65 See: *Croatian Bureau of Statistics* [Online]. Available at: <https://podaci.dzs.hr/en/> (Accessed: 15 January 2024).

66 Čehulić and Hrbić, 2019.

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