EUROPE, FINANCIAL MARKETS AND THE BENEFITS OF JOINING THE EURO

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KEY MESSAGES

• Euro 25 years - a great success
• Euro Area and Euro weathered Euro crisis and pandemic well
• Resulted in a stronger Financial and Banking architecture
• Globally – a stronger safety net as well
• ESM is the world’s largest regional financial arrangement
• Since 2010, 4 countries joined the Euro – Croatia in January 2023
• Great benefits of adopting the Euro
• More volatile world – Euro area stronger and more resilient
UNITED FISCAL AND MONETARY RESPONSE MADE EURO AREA STRONGER AND CALMED MARKETS

Source: ECB and ESM
ESM WITHIN THE EUROPEAN FINANCIAL ARCHITECTURE

PRESERVING FINANCIAL STABILITY IN THE EURO AREA

MONETARY POLICY
Monetary policy instruments and fragmentation tools

GROWTH AND INVESTMENT
Project finance, growth and public good: NGEU, REPowerEU, EU Budget, EIB

EA RESCUE FUND
Backstop to Euro Area sovereigns

SUPervision (ESFS)

* Ratification of the Amending Agreement to the ESM Treaty ongoing
THE ESM IN THE MULTILATERAL CONTEXT: THE GLOBAL FINANCIAL SAFETY NET (GFSN)

GFSN provides insurance against crises, financing to mitigate their impact, and incentives for sound macro-economic policies to ensure long-term prosperity.

At the **global** level, the IMF provides a financial backstop;

At the **regional** level, protection comes from the Regional Financial Arrangements (RFAs);

At the **bilateral** level, there are swap lines concluded bilaterally among countries;

At the **national** level, countries can self-insure against external shocks using foreign reserves or fiscal space.

**GFSN layers and their functions**

**GFSN firepower expansion (trillions of USD)**
ESM IS THE LARGEST REGIONAL PLAYER IN THE GLOBAL FINANCIAL SAFETY NET

Future shocks make a strong case for enhanced cooperation between the regional rescue funds and the IMF

1. **Annual High-level Dialogue between RFA and IMF leaders** initiated by ESM, FLAR and AMRO in 2016 fosters policy exchanges

2. **Technical cooperation: joint research projects and regular expert interactions** help strengthen institutional capacity

3. **Exploring complementarities** between IMF’ and RFA’ toolboxes and lending frameworks

RFAs around the world and their maximum lending capacity
CROATIA BECOMES 20\textsuperscript{TH} MEMBER OF THE ESM

- By joining the euro area on 1 January 2023, Croatia also became eligible for membership in the ESM. Croatia officially joined the ESM on 22 March 2023.

- The minister of Finance of Croatia is now a member of the ESM Board of Governors, which takes all the important decisions regarding the ESM.

- Each Member contributes to the ESM authorised capital based on its respective share of the EU total population and gross domestic product (GDP). Croatia will benefit from a temporary correction period of 12 years, during which its initial capital subscription to the ESM will be lower, thus leading to a temporarily lower paid-in capital contribution.

- Croatia now benefits from the solidarity that comes with ESM membership, with access to financial assistance tools, which is a signal of protection for investors.

Further reading: https://www.esm.europa.eu/blog/croatia-makes-euro-20-nations-strong
ANTICIPATION OF JOINING THE EURO MADE CROATIA CONVERGE TO GERMANY IN BOND MARKETS

Figure 1. Croatia 10-year bond yields converge vs German Bunds as euro adoption loomed

(in basis points)

Note: Data for Croatia is only available from mid-2015.

Sources: Bloomberg and ESM

Read more: https://www.esm.europa.eu/blog/croatia-makes-euro-20-nations-strong
ADVANTAGES TO EURO ADOPTION – CROATIA EXAMPLE

• Country becomes wealthier upon convergence Euro Area
• Meeting convergence criteria – rating upgrades
• Euro-denominated debt no-longer foreign debt
• Join second largest reserve currency globally: enhance investor base, market access and potentially lower funding cost
• Increase investment inflows to local economy
• Payments easier and cheaper, removing transaction fees
• Voting power in ECB, Eurogroup and ESM Board of Governors
• Euro area crisis management framework will give safety net in the event of future crises, with the ESM as its shield

Read more: https://www.esm.europa.eu/blog/croatia-makes-euro-20-nations-strong
BULGARIA OUTPERFORMING BOTH HIGHER AND SIMILARLY RATED NON-EURO AREA RATED PEERS

- A composite BBB rating did not prevent Bulgaria perform vs much higher (A- Poland and AA Czech) non-EA rated peers...
- ...having also outperformed similarly rated non-EA peers (BBB- Hungary) over time...
- ...particularly, over elevated market stress episodes, as in mid-end-2022...
- ...quickly recovering in spread terms.

Source: Bloomberg, ESM
BULGARIA CONVERGING TO HIGHER RATED EA SOVEREIGNS AS DID RECENT EA JOINER CROATIA

- Although still lagging similarly rated sovereigns (Croatia, also BBB) ...
- ...- that recently joined the EA and closed a ~200bps gap vs Bulgaria since 2016-...
- ...especially, during the mid-end-2022 elevated market stress episodes,...
- ...Bulgaria has also largely closed a spread gap vs higher rated EA sovereigns (Latvia A-, Slovakia A).

Source: Bloomberg, ESM
A MORE VOLATILE WORLD FOR 2024 AND BEYOND
KEY MESSAGES FROM IMF/WB MEETINGS IN MARRAKECH

• Geopolitics top of the agenda
• Higher for longer interest rate risks
• Monetary and fiscal policy mismatch
• Political and electoral uncertainty
• More innovation needed in the market
• Environmental, social, and governance agenda needs refocusing

Upside: A stronger and more resilient Euro Area