PISM POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

NO. 181 (1611), 31 AUGUST 2020 © PISM

BULLETIN

Croatia on the Way to Adopting the Euro

Tomasz Żornaczuk

In July, Croatia joined the European exchange rate mechanism (ERM II)—the step prior to membership of the euro area. The government, like the opposition and the majority of the public, sees more benefits than threats in the common currency and points to the possibility of its introduction in 2023. However, despite the lack of political obstacles, that is likely to happen later because of Croatia's economic problems, mainly excessive public debt, which have been exacerbated by the recession caused by the COVID-19 pandemic.

Croatia and the Convergence Criteria. Participation in ERM II aims to formally link the Croatian kuna's exchange rate with the euro and is one of four criteria that the country must continue to meet for at least two years before the introduction of the common currency. When this country was admitted to ERM II, the euro area countries with Denmark (a participant in this mechanism), Croatia, and the European Central Bank (ECB) set the exchange rate at 7.5345 kuna per euro. A permanent requirement is that the exchange rate fluctuation should not exceed 15%. All ECB reports (biennial, first in 2014) since Croatia joined the EU have shown that the fluctuations to date have not exceeded 1%. This proved the stability of the kuna. Therefore, after Croatia submitted its application for ERM II admission in July 2019, the European Commission (EC) already in November indicated the possibility of achieving this goal in the second half of 2020.

Croatia also meets two other convergence criteria. Inflation, which may not exceed the average of the three most stable EU countries by more than 1.5 percentage points (pp; in 2020 this threshold is 1.8%), has in recent years not been higher than 1.3%. Croatia has also been dealing well with long-term interest rates for years, which may be at most 2 pp. higher than in the three most price-stable EU countries (in 2020 this limit is 2.9%). This year, interest rates in Croatia are at 0.9%.

The condition that Croatia does not fulfil concerns the long-term sustainability of public finances. Under the rules, a country's budget deficit may not exceed 3% of GDP, and public debt, 60% of GDP. The last two ECB reports show that Croatia has recorded a slight budget surplus (less than 1%) but public debt remained excessive, although—thanks to financial discipline and economic prosperity—it fell from 86.7% of GDP in 2016 to 73.2% in March this year. Before the outbreak of the pandemic, the government assumed it would continue to decline thanks to expectations of increased competitiveness and higher productivity as well as the rapid GDP growth amounting to 2.9% in 2019. However, a budget amendment from May assumes an increase in debt by 13.5 pp., and thus to the level of 2016. This may not be the final value, as the EC in July raised the expected decline in Croatian GDP in 2020 to 10.8% from the 9.1% forecasted in May. In addition, Croatia must meet the legal convergence criterion, that is, introduce provisions guaranteeing the independence of the central bank from political influence.

Domestic Consensus. Adopting the euro, in addition to joining the Schengen area, has been a priority of Croatian governments' European policy since the country's accession to the EU in 2013. In May 2018, the cabinet of Andrej Plenković from the conservative Croatian Democratic Union adopted a strategy for introducing the euro. This party's victory in the parliamentary elections in July and the appointment of Plenković's second government determines the continuation of these activities.

The Croatian parliamentary opposition—despite occasional sceptical statements—is not opposed to the introduction of the euro but criticises the government for its pace of action. The largest opposition grouping, the Social Democratic Party of Croatia, accuses Plenković of being sluggish. Miroslav Škoro's national conservative Homeland Movement, in turn, calls on the government to exercise restraint and to conduct public consultations culminating in a referendum. The need

for a nationwide discussion is also pointed to by two other opposition parties: the liberal Bridge of Independent Lists and the green-left We Can coalition.

The adoption of the euro is supported by the majority of Croatian society. According to an Ipsos poll from March, 41% of the respondents were in favour of it. Conditionally, the adoption of the euro was supported by a further 31% for whom the most important criterion is to maintain or improve the standard of living, and 18% of the Croatian population opposed the introduction of the common currency. A year earlier—with a straightforward question—51.7% favoured adopting the euro contrasted with 40.4% against.

Benefits and Threats. The Croatian government points out that applying for membership of the euro area is an economic decision, not a political one. Among the advantages, it sees the stabilisation of public finances and the banking system, which, in turn, is expected to boost foreign investment. It also emphasises lower transaction costs thanks to the elimination of currency conversion. This is important because the euro is widely used in Croatia as, for example, numerous loans and savings are made in this currency, and tourism—the most important sector among services—also uses it. The prime minister also sees the opportunity to participate in the European Stability Mechanism and in aid programmes as an advantage. He explicitly pointed out that in the conditions of the pandemic, Croatia could more easily stabilise its economy if it were a member of the euro area. The government also emphasises political benefits such as strengthening the country's reputation and joining the banking union, which it estimates should increase Croatia's influence in the EU.

At the same time, the government argues that the benefits of adopting the euro significantly outweigh the dangers of giving up the kuna. Among the disadvantages it lists the loss of direct control over monetary policy and the possible increase in the prices of consumer goods. However, it emphasises that a large part of the costs will be one-off, for example, those resulting directly from the currency exchange.

Conclusions and Perspectives. Croatia's admission to ERM II in July results from the planned implementation of the authorities' strategy and does not constitute an attempt to accelerate its accession to the euro area due to the effects of the COVID-19 pandemic. The year 2023, as indicated by the government, is actually the earliest possible date for euro adoption. This is because of not only the need to meet the criteria for two consecutive years but also the time needed for other procedures. Croatia's acceptance in the euro area will be decided by a qualified majority of the European Council (within the zone's member states) not later than six months from the submission of such a request by the European Commission. This decision will be related to the establishment of a final exchange rate of the kuna to the euro.

Political difficulties in the process of Croatia joining the euro area are unlikely. A possible change of cabinet will not discontinue these efforts, including those related to the implementation of the legal convergence condition, which is a technical issue. The lasting internal consensus results not only from the significant presence of the euro in the Croatian economy but also from with the desire to strengthen the country's regional position through closer integration within the EU. On the one hand, this is calculated to at least equate the political importance of Croatia with the smaller Slovenia and strengthen it vis-à-vis the larger Visegrad countries. On the other hand, it aims to increase its advantage over the neighbouring countries of the Western Balkans, above all over Serbia, the largest country in the region. Moreover, no euro-area country has raised the issue of Croatia failing to meet "real convergence", which appears in the debate on the membership of Bulgaria—a country the Austrian government considers to be underdeveloped and therefore likely to pose a risk to the stability of the zone.

However, Croatia will face economic barriers. The persistence of excessive public debt, increasing in the wake of the recession accompanying the pandemic whose end cannot yet be predicted, will delay the country's accession to the euro area. In the past, the failure to meet one or several criteria meant that participation in ERM II had to be extended by the Baltic countries (the least by Estonia at six years, and the most by Lithuania at 10 years) and Slovakia (to three years). Slovenia, Malta, and Cyprus, which joined the euro area earlier, participated in the mechanism for the required two years.

The accession of Croatia—along with Bulgaria—to the exchange rate mechanism means that five EU countries remain not interested in joining the euro area: Czechia, Denmark, Hungary, Poland, and Sweden. Romania wants to adopt the common currency and plans to join ERM II in 2024. It also means that more and more countries of the Central European cooperation area perceive more benefits of membership in the euro area. After the accession of Croatia and Bulgaria, most of the Three Seas Initiative countries will be included in it, which will simplify for them the implementation of joint projects. The political consequence of closer integration of most countries in the region within the EU will be that in the debate on the economic challenges of the Union, they will more often share the views of the euro area countries than of the three Visegrad countries remaining outside it.

Editors: Sławomir Dębski, Patrycja Sasnal, Rafał Tarnogórski, Sebastian Płóciennik, Justyna Szczudlik, Daniel Szeligowski,
Jolanta Szymańska, Marcin Terlikowski, Karol Wasilewski, Szymon Zaręba, Tomasz Żornaczuk