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The Impact of COVID-19 on Croatia's Euro Adoption Strategy

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Introduction

Is the euro a golden goose laying golden eggs? Well, certainly not, if one asks an average Greek or Italian whose countries have consistently faced lower GDP per capita levels than the level they last recorded back in 2008. On the other hand, is the euro a stinging viper? Surely not, if one poses this question to an average Slovene or Slovak whose countries boast rapid economic catch-up with the EU's average level of economic development, especially since both of them introduced the common European currency in 2007 and 2009. Not only are their countries more prosperous, but the euro also enjoys high social support. The aforementioned and diametrically opposite experiences show that the euro is at times, and especially during economic downturns, an issue which arouses many controversies.

In contrast to both eurosceptics and euroenthusiasts this policy paper will take a middle ground. In that regard, the euro adoption

will be portrayed as a very positive step towards further economic integration, which offers far more benefits than costs for a small and open economy such as Croatia. However, we will also show that the euro is necessary but not a sufficient condition for Croatia to achieve real economic convergence or the reduction of economic gap betwen its own development level and that of the more developed member states.

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In order to attain the latter goal it is not just enough to internalise nominal convergence criteria prior to euro adoption and keep them more or less under control after embarcing the common currency. Nominal convergence refers to the convergence in nominal variables like inflation, interest rates, budget deficit, public debt and exchange-rate stability. With the aim of reaping the full benefits of eurozone membership one has to put even more emphasis on the issue of structural convergence. This process engenders structural reforms essential for enhancing country's productivity, innovation capacity, sophistication of political and economic institutions, as well as its competitiveness. Normally, this process consists of continuous commitment to market-compatible reforms in a gamut of complex social systems such as: education, healthcare, pension, public administration, judiciary and SOE (state-owned enterprises). Hence, only the combination of a continuous commitment to both nominal and structural convergence criteria can leverage the euro adoption for achieving a broader structural tranformation of the Croatian economy. This is also important from the point of legitimacy and long-term popular support for the euro since the lack of it makes it a very convenient scapegoat, as was already evident from the recent eurozone debt crisis. Unfortunately, in times of economic expansion the virtues of euro are taken for granted and not appreciated enough.

In the following pages we will deeply analyse efforts on behalf of the Government of the Republic of Croatia and the Croatian National Bank to adopt the euro as early as 2023 through the prism of COVID-19 impact on Croatian economy. In terms of costs and benefits of euro adoption, there are several important remarks. Given the fact that Croatia is informally highly euroised economy and more than 55% of all bank deposits and loans are denominated in the common currency, euro adoption will more or less formalise this underlying situation without demanding high political sacrifices from Croatian policy-makers, while offering them a lot of advantages. In case of

less euroised countries euro adoption implies the loss of independent monetary policy as the biggest sacrifice. Nonetheless, sticking to expansionary monetary policy in a highly euroised economy such as Croatia is impaired by the ineffectiveness of the monetary policy transmission mechanism. Small and open economies, such as Croatia, inevitably suffer from the limited effectiveness of the interest rate channel to achieve output growth or fall by means of interest rate cuts or hikes on the part of the central bank. In this case, it is impossible to set interest rates independently in opposition to the interest rate policy of the ECB as one of the world's three largest monetary blocks. In addition, other costs of medium significance to Croatia arising from the euro adoption are costs of conversion and participation in future crisis rescue operations via European Stability Mechanism.

In contrast to the aforementioned costs, the biggest benefits that weigh in for Croatia's euro adoption comprise: currency risk elimination and a lower risk of currency and banking crisis which positively affects cross-border trade and investments, lower interest rates, higher credibility of macroeconomic policies and the voting power beyond the capital key on the ECB's Governing Council, which refutes the often espoused narrative of various populists that EU integration necessarily entails that small countries always fall victim to the larger ones.

COVID-19 impact on Croatian economy and the prospect for a fastrack euro adoption

According to the Eurostat data Croatia had one of the sharpest economic downturns among the EU-27 sample in 2020. Preliminary estimates point to the contraction of the real GDP growth rate to the tune of - 8,4%. Only Spain, Greece and Italy are expected to experience a sharper recession. At the same time, there was only 13,000 less persons in employment in December 2020 than in the same month in 2019. Short-term working schemes and income support for workers that have been worst affected by epidemiological restrictions have shielded employment. Even in February 2021 almost 180,000 workers received some kind of support, down from the peak of more than 630,000 in 2020. In that regard it is easier to understand why Croatia still has approximately 150,000 more people in employment than in 2014, when the 6-year long recession ended.

Meanwhile, in order to cover the record-breaking fiscal deficit of the magnitude of 8% of GDP incurred in 2020, Croatian public debt has skyrocketed above 87% of GDP. Nevertheless, Croatia managed to finance and re-finance its financial obligations relatively favourably in February 2021, despite the fact that at the end of 2020 only Greece, Italy, Portugal, Spain, Cyprus, France and Belgium had higher debt-to-GDP rations than Croatia. According to the Eurostat,

in February 2021 long-term government bond yields for Croatia were more favourable than those of Hungary, Czech Republic, Romania, Poland and Italy, sometimes by a wide margin (e.g. Croatian rate of 0,59% vs. Hungarian of 2,22%). Surprisingly, Croatia managed to issue a bond with a 20-year maturity for the first time in its history. In spite of the fact that Croatia enjoys less favourable lending conditions than Slovenia and Slovakia which are both eurozone members, Croatia's ambition to adopt the euro has been apparently welcomed by creditors. This is the result of a two milestone events than happened in 2020.

In April last year ECB and Croatian National Bank set up swap line to provide euro liquidity, with the size of swap line set at €2 billion. This was extremely important decision on behalf of the ECB because foreign exchange market had been quite jittery in the second half of March and early April, temporarily resulting in a worrisome depreciation of the Croatian kuna. On top of that, on 9th July Croatia entered Exchange Rate Mechanism (ERM II) as a waiting room for the euro adoption and currently there are no external obstacles to Croatia's EU membership, unless Croatia itself deviates significantly from the nominal convergence criteria. It remains to be seen whether Croatia will manage to keep fiscal deficit below 3% of GDP in 2021, which will then have a major impact on the timing of Croatia's euro adoption initially scheduled for 2023. Unless the budgetary discipline won't be restored and the expected growth rate of over 5% in 2021 does not materialise, Croatia will be able to introduce euro in 2024 at the earliest. In addition, it is quite difficult to expect that eurozone leaders shall allow the additional watering down of nominal convergence criteria, on top of the already activated escape clause of the Stability and Growth Pact until 2022. In that regard, Croatia will have to keep inner momentum in attaing the goal of eurozone membership and stick to prudent fiscal policy.

However, under the assumption of an effective roll-out of vaccination campaign until summer months and of the improved coordination with regard to the pan-European freedom of travel so important to the well-being of Croatian tourism, rapid economic recovery is fully within reach. Furthermore, recovery efforts will be aided by the planned massive influx of EU funding to Croatian economy. Croatia still awaits the influx of almost €6 billion from the MFF 2014-2020 paired with €22 billion of the new NGEU + MFF 2021-2027 allocation to the tune of €22 billion euro. Those €22 billion euros allocated to Croatia are composed of RRF pay-outs to the tune of €9,4 billion and of the long-term budget totaling €12,6 billion. Out of €9,4 Croatia will receive €6,3 in grants, while the rest of the allocation will be extended as loans to the country. It is noteworthy to mention that there is no single EU member state that will receive greater percentage of their GDP in EU funding in any given year until 2026. Hence,

in the medium run, Croatian aggregate demand will be strongly buoyed by access to EU funds.

Key challenges to leveraging euro adoption for a broader economic transformation: the political economy of structural reforms

As was already stated in previous paragraphs, medium-term aggregate demand won't constitute a major bottleneck to the euro adoption in Croatia. However, the ultimate potential of eurozone memberhip is only possible if Croatian economy embarks on an ambitious journey of overhauling the very structure of it statist economy. In the EU, there were several prominent episodes of unsustainable nominal and real convergence such as those observable in Greece and Italy during the last eurozone debt crisis.

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More importantly, during the first few years of their EMU membership those countries enjoyed both real and nominal convergence paired with pronounced structural divergence. This mainly referred to their sharp deterioration in productivity growth, diverging macroeconomic indicators such as foreign and domestic debt and lingering institutional sclerosis. In short, institutional sclerosis refers to the lack of judicial reforms and privatizations, onerous business regulations and inefficient public administration. So far, Croatia has missed an opportunity for raising real convergence both in absolute and relative terms and risks repeating the very same mistakes committed by Italy and Greece. Croatia has fared significantly worser in terms of real convergence as compared to other post-socialist member states. In short, for those with no economics background, real convergence or β-convergence postulates faster economic growth for lower income countries as compared to their more developed peers due to diffusion of technology and of efficient business models. The main reason for Croatia's disappointing performance is to be found in the fact that institutional quality that is so decisive for economic prosperity has been largely absent over the last two decades. By that we mean the dismal state of Croatian judiciary, the existence of a hostile environment for new businesses, corruption and the opaque and non evidence-based policy-making process, that have been behind subpar economic growth.

In that regard, there are two main reasons of why the awaited EU funding won't work its magic on its own and lift Croatia's potential growth rate as a consequence of its structural

transformation which spans: inventing and applying new technologies, adopting more efficient organisational structures in both private and public sector, winning new markets for its products and services, etc. The first reasons of why inertia is a self-defeating proposition is to be found in recalling the experience of MFF 2014-2020, where Croatia can be spotted at the bottom of the list when it comes to absorbing EU funds. Even more important, those percentages say nothing about the efficiency of that spending, especially since Croatia's spending could have been more targeted at boosting human capital and R&D, especially when compared with the overall design of operational programs by comparable member states. The second reason referrs to Croatia's poor CSR implementation score under the European Semester. Unfortunately, EU spending has a mixed record of avoing corruption and inefficient spending decisions in many member states, especially in those that lack high-quality institutions such as an independent and efficient judiciary institutions to control corruption or those do not have in place business-conducive regulatory framework, which is still the case in Croatia.

In spite of the announced economic conditionality for sealing the €1,834 billion deal at the European Council meeting on 21st July 2020, it seems that the odds of hard-conditionality being wired into the European Semester – Next Generation EU nexus is anything but reasonable to expect. On the one hand, the European Commission will not have an incentive to veto National recovery and resilience plans in order to enhance its chances for ensuring a long-term increase in own resources. On the other hand, the majority of member states can be found on the receiving end of the deal and any significant obstacle to payouts might dampen their support for any kind of similar deal in future crises. That means that PM Andrej Plenković's Government will not face insourmountable hurdles to tapping into EU funding in terms of external conditionality. Hence, the very reform agenda necessary to set in motion structural convergence, that goes in tandem with the euro adoption, will critically hinge on the willingness of incumbent government to spend political capital in tailoring structural reforms. In that regard, the government will have to resist the temptation to label spending plans as 'green, social and digital' just in order to please the European Commision, since this will only allow for payouts with little benefits in terms of structural transformation.

It is quite dissapointing that the scarcely available information pertained to the content of the NRRP envisages the allocation of a tiny portion of RRF funds to private businesses

affected by the COVID-19 crisis, while the bulk of it is earmarked for already vast and less efficient entities in the public sector. At the moment, large and politically-sponsored infrastructure projects are preferred over spending money on more nimbler SMEs, as if nothing has been learned from the MFF 2014-2020, where large infrastructure projects had been mostly programmed and executed with big delays. Furthemore, the still unknown content of the NRRP has been created without proper inclusion and input from various stakeholders.

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The final problem on Croatia's road to structural convergence represents the newly adopted 2030 National Development Strategy (NDS), which lacks ambitious targets, clear key performance indicators (KPI) and time trials. There are also two other major downsides to it. Firstly, the 2030 NDS does not provide any reasonable course of action to reduce Croatia's excessive reliance on the income stream from tourism and the country needs to hedge against potential volatility in tourism by creating a conducive institutional framework for other sectors to thrive. Secondly, the 2030 NDS dedicates only three short paragraphs to fighting corruption and does not mention clientelism at all. As is evident from the paragraphs above, the main challenge in front of Croatian policy-makers is not the lack of funding or a hostile external environment, but its country-specific political economy considerations, which imply the hard trade-off between interests of powerful proponents of the *status quo* and the heterogenous rest of society longing for change.

Popular support for the euro adoption and the main risks associated with formal euroisation

According to the latest *Eurobarometer 487* 54% of Croats considered that other states that had adopted the euro have generally profited from their eurozone membership. At the same time, 56% of Croats supported the euro adoption in their own country. This represents a significant increase as compared to 2019 when the support amounted to 49%. Nevertheless, 64% of Croats think that Croatian economy is still not ready for this leap into this form of deep economic integration. If we look at the political support

for euro adoption, Croatian Democratic Union (HDZ) is the strongest political party in the country with approval rating of 30,9% as of February 2021 and its leadership constitutes the staunchest euro advocate. The second strongest political party is Social Democratic Party of Croatia with the 17,2% of support. It views EU integration highly positive but their support for the rapid euro adoption is rather lukewarm. The leftist platform *Možemo*! as the third strongest political party with 9,3% support considers that the eurozone membership should be at least postponed until the eurozone is reformed. The fourth and fifth political parties in size, *Most* and *Domovinski pokret*, embody the conservative part of the political spectrum and they enjoy the relative support of 8% and 6,8% of voters respectively. Their position on the euro adoption is that the euro membership should be preceded by an obligatory referendum and they mostly portray euro as a threat.

The key risks to euro adoption process are to be found in the depth of the COVID-19 induced crisis which might catapult political forces that are wary of euro adoption, both on the left and right of the political spectrum. Furthermore, despite Commission's March 2020 proposal to activate the general escape clause of the Stability and Growth Pact (SGP) as part of its strategy to tackle the COVID-19 slump, and that was also endorsed by the Council of the EU, this escape clause does not imply that countries willing to adopt the euro should not stick to the nominal convergence criteria. In that regard, Croatian government will have to keep its budget deficit below 3% of GDP if it wants to ensure the smooth euro adoption in 2023. Currently there are no signs that nominal convergence criteria will be watered down due to COVID-19 but having in mind economic recovery in 2021, it is highly likely that Croatia will not have problem satisfying those criteria. These are two biggest medium-term risks on Croatia's journey toward the eurozone. However, the biggest risks in the long-term, and at the same time the risk that has been mostly underappreciated on behalf of the government, and extensively discussed in previous paragraphs, is the lack of structural convergence as a prerequisite for achieving real economic convergence.

Conclusion

The euro adoption is a unique opportunity to catalyze the long-postponed structural reforms, both of which will push Croatian economy forward into the league of prosperous Euroepan economies. Eurozone enlargement is definitely not designed as a trap that allows larger member states or corporations to 'devour' the smaller ones, a popular trope often

espoused by populist politicians of various stripes. On the contrary, Croatia will finally have the opportunity to sit at the common decision-making table and given equal voting rights of every eurozone member within the Governing Council of the ECB, regardless of their size, it will have the chance to punch significantly above its weight. Therefore, the euro is a generational opportunity to simultaneously transform Croatia's unbalanced political economy and to enjoy long-term benefits of exchange-rate risk elimination, lower interest rates and access to the eurozone's new crisis fighting mechanisms created during the last crisis, to name just a few.

Nevertheless, if Croatian Government is seriously interested into taking the rudder of Croatia's economic ship into its hand and being proactive and effective in shaping its policies instead of only being shaped by external circumstances, then there is simply no political alternative to ambitious and vigorous reform agenda, aligned with the strategy to adopt the euro. The only unpalatable alternative is the prolonged post COVID-19 recovery that will incapacitate economy's both real and structural convergence, as well as accelerate the already worrisome trend of emigration and population loss. Whether Croatia's political elite is ready to show ownership of the reform process and provide a new overarching vision is to be seen.

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