

Reflections on Croatia's Accession to the Euro Area

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Abstract

Accession to the Economic and Monetary Union, although a historical process, is always a current and dynamic one, its challenges being each time complex and distinct due to the different circumstances in which this event occurs. The article's objective is to identify the degree of fulfilment of the nominal economic convergence criteria for Croatia and the potential effects generated by its accession to the Euro Area. Our results show that over the last two years, Croatia has fulfilled three of the five nominal economic convergence criteria, with inflation and public debt being the indicators exceeding the reference values. Based on the analysis, some challenges are identified that can become subjects for future research.

Key words: European integration, nominal economic convergence, inflation reference value

J.E.L. classification: E31, E42, F45

1. Introduction

Although European integration and accession to the Euro Area already have a history of over twenty years, the process is always topical, with complex and different challenges each time, because of the different conditions under which the respective countries join the Euro Area.

Croatia is also included in this framework, given the period in which it became a member of the Economic and Monetary Union (EMU), a period marked by the COVID-19 crisis and the war in Ukraine, but also by the changes previously caused by the global financial crisis and the debt crisis sovereign in Europe. Moreover, the latter induced a feeling of reluctance and caution regarding joining the Euro Area, even on the part of the candidate states (Criste, 2018). Therefore, approaching such a subject is challenging and requires more extensive and detailed analyses.

The article's objective is to identify the state of fulfilment of Croatia's nominal economic convergence criteria at the end of 2022 and the potential effects generated by its accession to the Euro Area.

The second Section of the present paper presents a general presentation of the historical landmarks and important data related to the process of Croatia's accession to the European integration framework. Based on the methodology presented in the third Section, in the fourth Section, an analysis of the dynamics of nominal economic convergence indicators is carried out, mentioning specific potential effects engendered by euro adoption. The analysis is followed by some conclusions drawn in the fifth Section, emphasising some challenges regarding the European monetary integration process.

2. Theoretical background

Following a referendum, the Croatian Parliament declared independence on June 25, 1991. In December 1991, European foreign ministers recognised the former republics of Slovenia and Croatia as independent states effective January 15, 1992. However, a long war of independence followed, fought with Serbia from 1991 to 1995. In 1996, Croatia joined the Council of Europe.

Croatia became a member state of the European Union on July 1, 2013; at that moment was the 28th member state of the European Union. Croatia applied for this status in 2003 and conducted negotiations between 2005 and 2011, signing the accession treaty on December 9, 2011. On January 22, 2012, a referendum was held in which 66.27% of Croatians voted to support the accession to the European Union.

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 the rules, the European Central Bank and the European Commission publish once every two years convergence reports for the candidate countries for the Euro Area. The convergence reports published between 2014 and 2020 showed that while Croatia met the inflation and interest rate criteria, it still needed to meet those related to the public finances and the compatibility of legislation. Since 2018, additional efforts have been made to meet these criteria and adopt the euro as quickly as possible. Thus, Croatia was accepted into the exchange rate mechanism (ERM II), the forerunner of the eurozone, in 2020 (July 10), together with Bulgaria, which extended the moment of accession by one year until 2024.

The Convergence Report for Croatia published by the European Commission in June 2022 (European Commission, 2022) states that the country meets the criteria for adopting a single currency, except for a high level of debt. At the end of June, the member of the European Council approved Croatia's entry into the Euro Area. On July 12, 2022, the Council of the European Union, comprised of the finance ministers of the Euro Area countries, consented.

Croatia, a country of 3.89 million inhabitants, adopted the euro on January 1, 2023, when it entered the Schengen area.

Table no. 1 Euro adoption in Croatia

Key facts
➤ Date of introduction of the euro in Croatia: January 1, 2023.
➤ Exchange rate: 7.53450 Croatian kuna (HRK) for 1 euro (EUR) – the same as the level of the current central rate of the kuna set through the exchange rate mechanism (ERM II).
➤ Dual display of prices: September 5, 2022 - December 31, 2023.
➤ Dual circulation of EUR and HRK: two weeks after introducing the euro.
➤ The market value of shares listed on the stock exchange: will be automatically converted to EUR on the date of adoption of the euro by the Zagreb Stock Exchange by applying the official exchange rate.
➤ Bank accounts: all amounts in HRK from bank accounts will be automatically recalculated in EUR by applying the official exchange rate without changing the bank account number.
➤ Financial statements: for the year 2022, in HRK for companies whose commercial year corresponds to the calendar year, and in EUR for companies whose commercial year differs from the calendar year and whose last day of the economic year occurs after the euro's adoption date.
➤ European Central Bank: following the cooperation agreement signed on October 1 2020, between the European Central Bank and Hrvatska Narodna Banka (National Bank of Croatia), the European Central Bank became responsible for directly supervising eight significant institutions and overseeing fifteen less significant ones.
➤ Prohibition of price increases: to protect consumers, it is prohibited to increase prices based only on adopting the euro.

Source: authors' contribution

3. Research methodology

Starting from the presentation of the official (*de jure*) stage of meeting the criteria of nominal economic convergence, according to the latest Convergence Report of the European Commission, published in June 2022, an analysis of the degree of preparation for joining the eurozone of Croatia is carried out, from the perspective of the nominal economy, during the last eight years. The five convergence indicators provided for in the Maastricht Treaty and the reference values corresponding to the inflation and long-term interest rate criteria are calculated for 2015-2022, considering the

January-December interval. This method was chosen to provide some consistency in comparability for each year. The convergence reports specifying the reference values corresponding to the two criteria are not issued annually but every two years. In addition, the European Commission calculates the reference value by taking different time intervals. Namely, the reference values for 2016 are calculated considering the interval May 2015-April 2016, for 2018 – April 2017-March 2018, and for 2020 – April 2019-March 2020.

4. Findings

4.1. Developments regarding the nominal economic convergence indicators

According to the latest Convergence Report published by the European Central Bank in June 2022, which takes the period of analysis from May 2021 to April 2022 as a reference, Croatia met the criteria for nominal economic convergence, except for government consolidated gross debt (see Table no. 2).

Table no. 2 Criteria for nominal economic convergence in Croatia based on the ECB Convergence Report 2022

Criteria	Values for April 2022	Reference Values
HICP Inflation (annual average percentage change)	4.7%	4.9%
Long-term interest rate (annual average)	0.8%	2.6%
General government budget balance (as % of GDP)	-2.9%	-3.0%
Government consolidated gross debt (as % of GDP)	79.8%	60.0%
Exchange rate kuna/euro (monthly average)	7.5577 ^{*)}	7.5345±15%

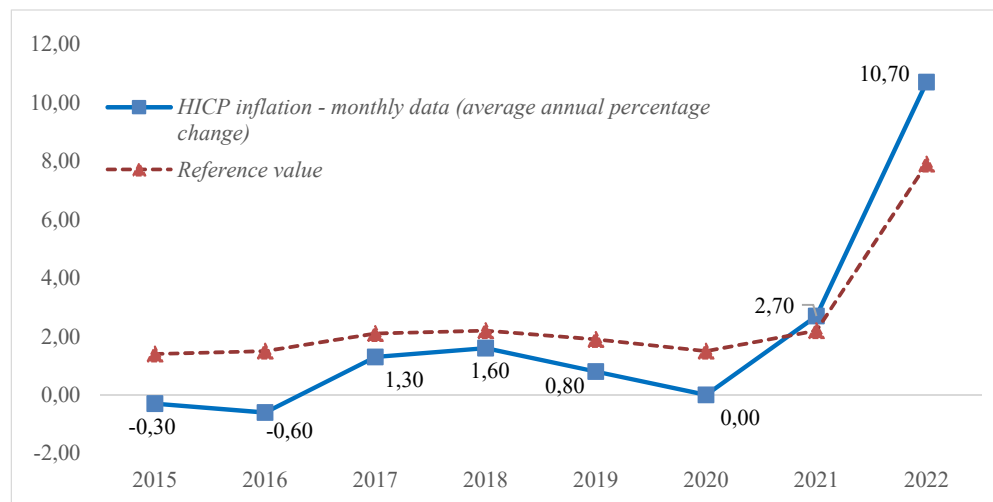
Note: ^{*)} average for April 2022, according to Eurostat data

Source: European Central Bank (2022)

By analysing the development of the indicators in the last eight years (2015-2022), a more concrete picture of the degree of fulfilment of the five nominal economic convergence criteria can be rendered.

Inflation in Croatia, represented by the harmonised index of consumer prices (HICP), registered values below the reference value during the selected period. After 2020, it increased exponentially, surpassing the European Union reference value (see Figure no. 1).

Figure no. 1. Inflation development in Croatia and the reference value



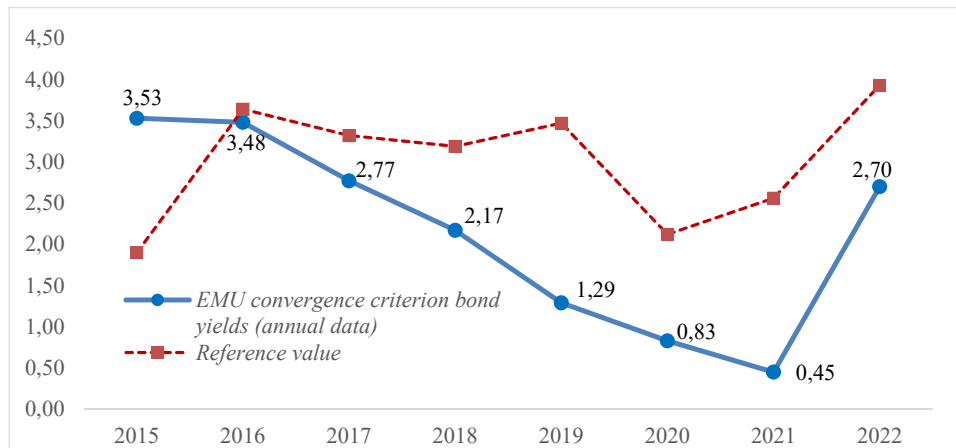
Source: Eurostat data

Compared to April 2022, the moment considered a benchmark for evaluating the degree of readiness for Croatia's accession to the Euro Area, the inflation level was below the reference one. However, it should be noted that this situation is due to the operation of some interpretable adjustments in selecting the countries that recorded the best levels. Such adjustments have been criticised as being discretionary (Darvas, 2022).

After the outbreak of the war in Ukraine and the increase in the prices of energy and other commodities, inflation was the biggest challenge. However, this is present throughout Europe, including the Euro Area.

The criterion regarding the long-term interest rate is easily met during 2016-2022, the values recorded in this interval being below the reference level (see Figure no. 2). From 2021, the downward trajectory of this indicator is suddenly interrupted.

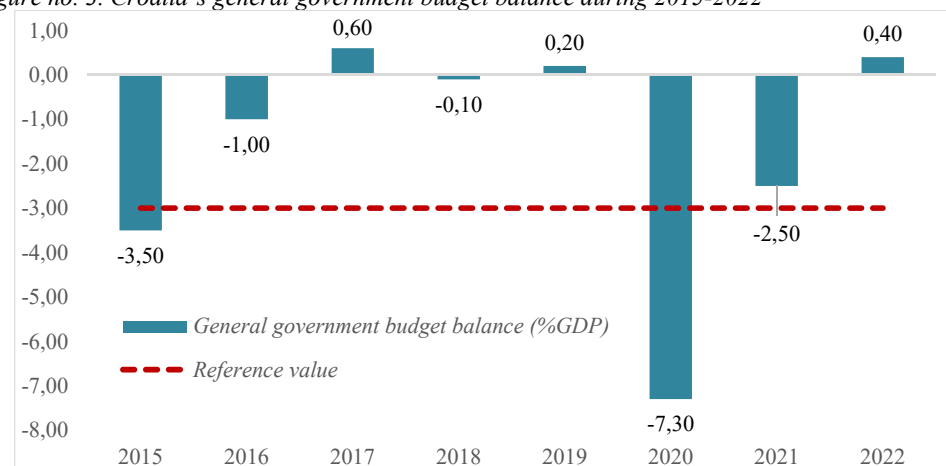
Figure no. 2. Long-term interest rate development in Croatia and the reference value



Source: Eurostat data

The criterion regarding the budget deficit recorded a significant and continuous improvement in the period 2015-2019. Still, the COVID-19 crisis strongly affected this evolution; in 2020, a budget deficit of 7.3% (as a share of GDP) was recorded, the highest level (see Figure no. 3). This situation reflects the fiscal measures adopted in order to mitigate the economic impact of the pandemic crisis. However, in the last two years, the general government budget balance has seen a noticeable improvement, also marked by the criterion fulfilment (Figure no. 3).

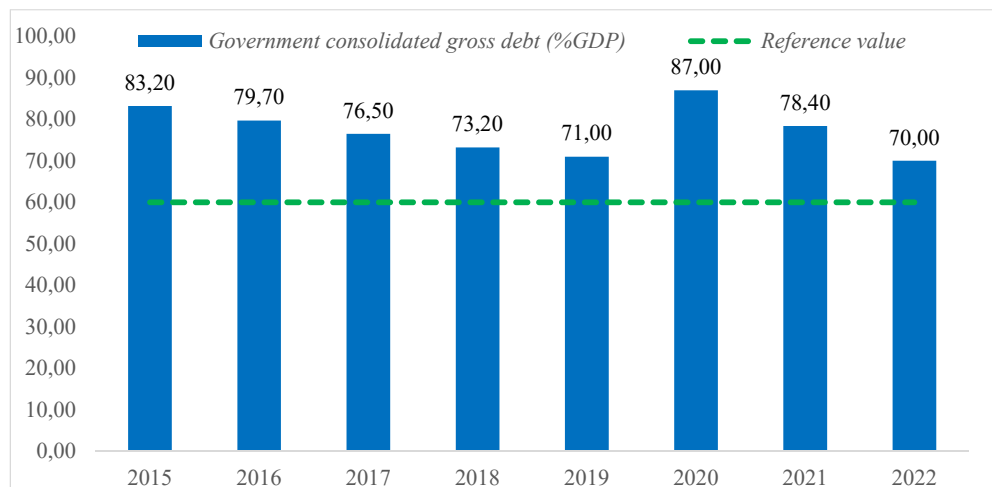
Figure no. 3. Croatia's general government budget balance during 2015-2022



Source: Eurostat data

In the analysed period, the values for the general government gross debt constantly exceed the limit of 60% of GDP. However, Croatia was accepted as a member state of the Euro Area, considering that the indicator values are already on a downward slope (see Figure no. 4). According to Figure no. 4, since the beginning of the period, the trajectory given by these values is downward, with values starting from 83.5% in 2015 and reaching 71% in 2019. However, the COVID-19 crisis also leaves its mark on this indicator, so in 2020, the level of public debt reached 87% of GDP. The development for the last two years is again downward.

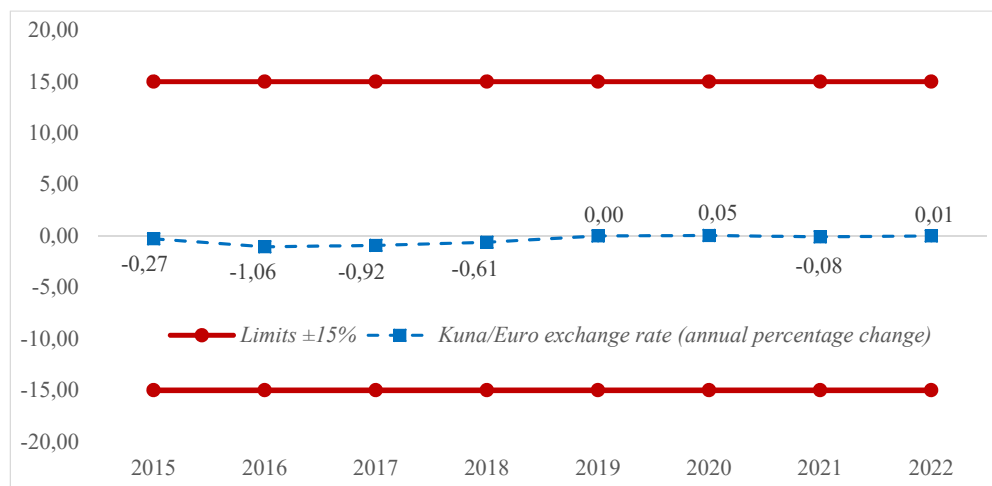
Figure no. 4. Government consolidated gross debt in Croatia during 2015-2022



Source: Eurostat data

For Croatia, exchange rate stability is one of the criteria consistently met throughout the analysed period. Although the Croatian currency has been participating in the Exchange Rate Mechanism II (ERM II) since July 2020, the variation of the kuna/euro exchange rate was very small even before this time (see Figure no. 5). The currency was traded at values very close to the central parity, of 7.5345 kuna/euro, established with the entry into ERMII.

Figure no. 5. The exchange rate of the Croatian currency against the euro, as annual percentage changes



Source: Eurostat data

The methodology results show that Croatia met three of the five nominal economic convergence criteria in the last two years. Inflation and public debt were the indicators that exceeded the reference values.

4.2. Discussion

Since the Croatian currency has been tied to the euro for a long time, and before that, to the German mark, no significant changes are expected after 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, namely, the reduction of both the currency risk and the transaction costs, which diminish the uncertainty, improving economic and financial stability. Joining the Euro Area can lower interest rates, boost credit ratings, and make the country more attractive to investors (Kunovac and Pavić, 2017). In this context, Croatia's gross external debt, which, according to Eurostat data, at the end of December 2022 was 46.1 billion euros (68.4% of GDP), will no longer be affected by the currency risk.

The euro currency can facilitate trade between countries that use it, and better integrated financial markets and improved economic stability can accelerate this development process. Considering that a fifth of the Croatian gross domestic product is due to the tourism sector, the changeover to the euro will positively affect this sector. A good part of the tourist activity that has already used the euro is formalised (house rentals, cars, tourist packages, restaurants, etc.). The simultaneous entry into the Schengen area also constitutes support for this sector of activity.

On the other hand, the increase in inflation during the initial period of the transition to the euro currency is already a common phenomenon. Still, the experience of the countries that adopted the euro shows that the actual effect of rounding the prices when converting the national currency to the euro was significantly lower than the results of the simulations, which assumes that all attractive prices are rounded up. Thus, in a pessimistic scenario for the Netherlands, the conversion effect on the consumer price index was estimated at around 0.7 pp (with 0.9 pp for the HICP). In contrast, after conversion, this effect on the consumer price index was shown to be much smaller, from 0.2 to 0.4 pp (Mužić and Pufnik, 2022). Experience shows that among the significant factors inhibiting the temptation to increase prices are competition between retailers and double (dual) display of prices in stores.

The effects of the euro adoption decision will be identified over time, depending on the context in which the global policy will evolve. Still, in principle, joining the Euro Area will benefit Croatia because of already consolidated economic and financial relations with this monetary union.

5. Conclusions

In general, meeting the convergence criteria has posed problems for the EMU candidate countries, mainly because of the difficult economic conditions of the last two years caused by the COVID-19 crisis, the energy crisis, and the war in Ukraine. These issues are global challenges that the Euro Area, as a whole, is also facing.

Assessing the preparation for adopting the euro currency can only be a situation at a certain point in time (Walko, 2022), but for the proper functioning of the Euro Area and in the interest of the countries joining EMU, the nominal economic convergence criteria must be pursued on a sustainable and forward-looking basis.

Over the last two years, Croatia has fulfilled three of the five nominal economic convergence criteria, with inflation and public debt being the indicators that have exceeded the reference values. However, Croatia has been accepted into the EMU based on interpretations and adjustments considered to be discretionary. Such an experience shows the need to rethink the interpretation of "the best performing" economies regarding inflation. In this respect, Darvas (2022) considers that either the average inflation rate of countries closest to the ECB's 2% target or the average inflation rate of the Euro Area would be more relevant as an inflation benchmark.

Beyond these observations, it is essential to note that based on the commercial and financial relations with Euro Area strengthened over time, Croatia has a high degree of synchronisation of the economic cycle with those of the "core" countries from the Euro Area (Criste, Lupu and Lupu, 2021) therefore, that creates positive expectations following the adoption of the single European currency.

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