Consequences of the Adoption of the EURO Currency in Croatia

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Introduction

Nine years after joining the EU (European Union) in 2013, on December 31, 2022, Croatia and its four million inhabitants gave up their national currency named the kuna for the euro. The kuna has been the official currency of the Republic of Croatia since May 30, 1994.

By joining the European monetary zone, Croatia became the 20th country to adopt the single European currency in the hope of making its economy stronger, more stable and improving the standard of living of its population. Croatia became also the 27th European state to join the Schengen area. The Schengen area is vast area within which more than 400 million people can travel freely without internal border controls of some countries of Europe.

Each step such as entry into the euro zone and Schengen brings benefits of integration. Croatia is poorer than the other countries in the euro zone such as Germany (Eurostat data: Croatia in comparison: 2023), but thanks to increased integration, it will be able to strengthen itself and converge towards the other Member States participating in the single European currency.

There is broad popular support in Croatia toward the access to the euro zone. It was not always the case in other CEE countries, History shows that support for the single currency tends to increase once the switch is made and people are reassured. The current skepticism of part of the population stems from a fear of an inflationary surge. The government must convince the population that this fear is unfounded.

The drivers of the Accession of Croatia to the Eurozone.

Two drivers regarding the accession of Croatia to the eurozone can be underlined. First, the place of Croatia in the European monetary zone has a long history. Firstly, from the 1980s and 1990s, the Croatian economy was strongly linked to the deutsche mark, then to the euro. When Croatia gained independence in 1991, most bank deposits were already denominated in Deutsche Marks. This strong relation with foreign currencies has enabled Croatia to keep inflation very low for almost thirty years, the kuna, it has not varied by more than 10% up or down since 1994 and till 2021. Secondly, Croatia's economic trajectory has been marked by a relatively high degree of euroization of credits and deposits – and thus by the de facto use of the euro alongside its national currency as a means of payment, unit of account and store of value. This led to a fragmented monetary space and a currency mismatch that proved perilous, especially for indebted households, including those who took out loans in Swiss francs. In search of more affordable home loans and consumer credit, many households found themselves having to juggle two or even three currencies, as they received their income in the national currency, the kuna, while paying their installments. miscellaneous loans and credits in euros and other foreign currencies which represent up to 90% of loans (Dumičić, Ljubaj & Martinis: 2018: 3).

The appreciation of the Swiss franc following the global economic crisis of 2008 plunged many Croatian households into deep financial disarray. Indexation clauses and adjustable rates came into play and turned previous loan agreements into veritable vehicles for bankruptcy. These effects of currency fragmentation have made credit and exchange rate risks more tangible. The idea that Croatia's membership of the euro zone would eliminate a substantial part of these risks became a powerful argument, reiterated time and again as regulators prepared the population for the change in monetary regime. The Croatian National Bank based in its capital city named Zagreb indeed launched a promotional campaign on the subject in 2018, with high-profile officials playing an overtly political role. Throughout this period, joining the Eurozone was presented as a major economic and political achievement, as well as a guarantee of future economic prosperity (Dumičić, Ljubaj & Martinis: 2018: 2).

Secondly, when it came to the issue of the euro, there was a tacit agreement between the main parties of the political spectrum of Croatia. There is a political consensus that a policy of full European integration, including membership of the European Monetary Union, must be the basis of any political program which aims to be realistic and pragmatic, which of course implies that only fringe parties can afford the luxury of being skeptical about the nature and direction of the European Union.

This consensus is further reinforced by a growing reliance on EU funding programs and an unthinking acceptance of EU governance and oversight mechanisms, as well as a general belief that the EU, despite its imperfections, remains the engine of peace, prosperity, and solidarity between its Member States. It is therefore not surprising, that any discussion regarding the well-founded principle of the euro did not take place and were rather replaced by a few promotional campaigns from the National Banque of Croatia and the Ministry of Finance.

Economic and Trade Consequences

The adoption of the euro has various consequences for the Croatian economy. By adopting the Euro currency, Croatian authorities are helping Croatian companies which will be able to access the single market, especially the markets of the euro zone countries, without exchange risk. More than half of the goods exported by Croatian firms are destined for the euro zone and nearly 60% of Croatian imports come from the euro zone. Joining the Eurozone and Schengen will further facilitate trade between Croatia and Eurozone countries and Croatian companies will be further integrated into the value chains of the European Monetary Union. Croatia is us a country of tourism and 70% of the tourists we welcome are from Eurozone countries, so the euro currency will be an additional driver for individual tourists who would visit this country in the future. This will positively the growth of the GDP in the future years (Gauret: 2023).

Financial Consequences

From the financial perspective, the adoption of the euro currency will also positively Croatian financial institutions. For instance, the spread of Croatian bonds vis-à-vis securities of other eurozone countries has decreased. Consequently, Croatian public administrations, businesses and households have thus been able to finance themselves at lower cost, which has helped to stimulate investment and growth potential of the country. The decision taken by the Council of the EU in July 2022 to authorize Croatia to join the euro zone also enabled the Croatian rating to be upgraded over the summer by several rating agencies. By accessing a large euro pool for financing, Croatia will also be able to diversify its investor base and broaden its access to financial markets and should benefit from lower financing costs and/or better risk management. The borrowing capacity of Croatia should be strengthened. A creditor will more easily lend to a country that has the euro. The reason is that a country that has the euro will necessarily be protected to some extent by the European Central Bank if there is a financial problem.

Regarding interest rates, markets anticipated the access of Croatia to the Euro zone: therefore, interest rates in Croatia are significantly lower than those of central European countries that have not joined the euro, such as Poland, the Czech Republic or Hungary. As in CEE countries, interest rates in Croatia have been on the rise since the invasion of Ukraine, but not as much as in the previously named countries.

Regarding inflation, no consequences are expected. The rise in prices that Croatia is currently experiencing, on energy and food, is linked to external shocks. The access to the euro zone will change a little in the short term. In December 2022, inflation reached 12.7% in Croatia, against 9.2% in the euro zone on a yearly basis (Annual inflation down to 9.2% in the euro area: 2023). CEE countries that are members of the EU but have not opted for the euro, such as Poland and Hungary, proved to be even more vulnerable to inflation.

Limits

Croatia joined the euro zone; however, it must be noted that this country did not fully subscribe to the accession criteria. To adopt the euro, EU countries must bring their national legislation in line with relevant EU law and meet specific conditions designed to ensure economic convergence. These requirements, agreed by the EU Member States in Maastricht in 1991, are known as the convergence criteria. These are defined as a set of macroeconomic indicators, which focus on price, exchange rate stability and long-term interest rates. Croatia did not fulfil the criteria related to the ration debt to GDP, which reached 70% of GDP, against a target of 60% by EU institutions (Dan 2019: 20). The inflation in Croatia did also not fulfill the EU harmonization criteria, which underlined that the average inflation cannot be more than 1.5 percentage points above the rate of the three best performing EU Member States.

Conclusion

From the point of view of European leaders, the entry of Croatia is considered an excellent political signal: this is proof that despite the 2008 and the COVID-19 Pandemic crises, the single currency still attracts. It demonstrates that the Euro currency is not only an economic or financial tool, but also the instrument of a very political European integration.

From a different perspective, the previous eurozone member was Lithuania in 2015. The next addition doesn't seem to be coming soon, although all EU members have an obligation to eventually adopt the euro. None of the seven members who still use their own currency are on track to meet the criteria anytime soon. For some, like Bulgaria and Romania, it is because their economic situation is not yet sufficiently stable. Bulgaria has affirmed its desire to officially adopt the euro as its currency on January 1, 2024, at the expense of the Lev currently in circulation. However, the European Commission and the Council of the EU have not yet given the final green light to the transition. For the time being, the country does not meet all the conditions set for countries applying for the adoption of the single currency. Romania is aiming to join the euro zone by 2028, once the economic difficulties linked to the Covid-19 pandemic have been overcome. Denmark has an opt-out clause (Tokarski & Funk 2019: 2). Others, such as Sweden and Poland, do not seem to be in a hurry to move forward, either because they do not see the economic interest or because they are reluctant to abandon a part of their sovereignty. Croatia is in some ways more like the service-sector economies of Spain and Greece than the or the manufacturing Poland (Švarc & Dabić 2019:1484) and therefore was more open to the accession to the euro zone.

From a different perspective, in the context of the war in Ukraine, the integration of Croatia to the euro zone is a sign of a shift of the center of gravity of the EU to the east of Europe. We shall also add that Ukraine, Georgia, and Moldova, which were Soviet socialist republics, formally applied to join the European Union in February and March 2022.

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