THE POLITICAL ECONOMY OF EURO INTRODUCTION TO CROATIA: A GOLDEN GOOSE OR A STINGING VIPER?

by Kristijan Kotarski

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INTRODUCTION

Euro adoption in Croatia has become a very salient public and political issue, especially since the launch of the Strategy for the Adoption of the Euro under the auspices of the Government of the Republic of Croatia and the Croatian National Bank (CNB) in late 2017. This publication continues to cover this delicate and often contentious debate and is structured as follows. The first section analyses the impact of the euro on Croatia's macroeconomic framework, primarily focusing on the availability and effectiveness of policy levers for aggregate demand management in the Croatian context, such as: monetary, exchange rate, fiscal and macroprudential policy. It also considers structural issues pertaining to aggregate supply. The second section sheds light on the cost-benefit analysis of euro adoption, and connects the pros and cons with the key societal and political actors. Here we also briefly touch upon the fears of joining the eurozone and its still unfinished architecture. We posit that the eurozone needs to be fortified by the elements of a banking union that are yet to be integrated. However, its viability does not require the renunciation of the principle of national sovereignty within the confines of a future fiscal or political union. The third section provides a detailed account of the most important political and social actors in Croatia, and their respective

Eurozone membership offers more benefits than costs, and serves as a generational opportunity to transform Croatia's unbalanced and unsustainable political economy

stances towards the euro. Finally, we conclude that euro adoption in Croatia is metaphorically neither a golden goose nor a stinging viper. Eurozone membership offers more benefits than costs, and serves as a generational opportunity to transform Croatia's unbalanced and unsustainable political economy. Hence, it is a necessary, though in and of itself insufficient, condition to deliver greater levels of prosperity and stability. The fulfilment of the latter goals requires the continuous commitment of policy-makers to secure macroeconomic stability and institutional adaptation, both before and after securing EMU membership.

It is a necessary, though in and of itself insufficient, condition to deliver greater levels of prosperity and stability

1. THE IMPACT OF EURO ADOPTION ON CROATIA'S MACROECONOMIC FRAMEWORK

Aggregate demand management is an important feature of contemporary economies. Analogous to the human body, which suffers in case of excessively low or high body temperatures, the same can be said about the state of the economy. Excessive inflationary or deflationary swings cause serious complications to the economic vitality of both large and small economies. However, the impact of major demand shocks, such as financial crises or recessions imported through foreign trade and/or financial channels, can be attenuated through the prudent use of several macroeconomic levers available to policy-makers. Fiscal policy, monetary policy, exchange rate policy and macroprudential policy all play an important role in crisis prevention and mitigation. However, the availability and effectiveness of these levers depend on the political economy context of each individual economy. Introduction of the euro to Croatia has posed several very important and delicate questions on how to manage aggregate demand in the case of demand shocks, especially when monetary integration makes monetary and exchange rate policies unavailable for policy-makers in combating future crises.

One important caveat is that these levers display their full utility only if applied under the circumstances of demand-induced shock and when applied at the right time during the business-cycle, while supply-side shocks such as oil shocks or trade wars severely limit their firepower. However, the story of supply-side reforms should not to be lost from the viewpoint of responsible policy-makers, especially when favourable economic conditions prevail, allowing them to diminish the political voice of powerful interest groups clinging to the *status quo*. Structural reforms or non-economic factors behind rising productivity and competitiveness also increase long-term flexibility and positively affect economic resilience once a major crisis hits. Economies cannot thrive on rigid and inefficient institutions. In the long run, aggregate demand and aggregate supply hysteresis together constitute a dual and inseparable issue.[1]

Therefore, this section will primarily address macroeconomic tools for aggregate demand management in the Croatian context, and give a brief overview of the structural factors important for successful accession to the eurozone. Our goal is to show that the euro has been credited too many times with taking effective macroeconomic adjustment off the table and making crises more damaging. Unfortunately, the euro often seems to be an 'orphan' who picks up the blame for policy errors committed by national governments of EMU members as 'orphan custodians', where these errors might have been avoided in the first place through better macroeconomic coordination (Sandbu, 2017). To the contrary, policy-makers are not powerless puppets in this grand act of monetary integration, as anti-euro populists might claim. Euro adoption diminishes certain policy options at the national level, while at the same time, it more than compensates this process with the expansion of the range of stabilization and growth-enhancing options for eurozone members.

1 Hysteresis is the dependence of the state of a system on its history; e.g. the tendency of the unemployment rate to remain stubbornly high and above a system's equilibrium, regardless of its ultimate cause on the demand or supply side.

1.1. The role of fiscal policy in Croatia prior to and after joining the EMU

In order to delve deeper into past and current issues pertained to fiscal policy in Croatia, let us first give a vivid analogy from the Book of Genesis. In Genesis, Joseph interprets the pharaoh's dream of seven fat and seven lean cows to symbolize years of abundance and famine. Joseph advises the pharaoh to store food in abundant years in preparation for years of poor harvests. This story metaphorically captures the very first historic description of an economic cycle, followed by advice to conduct Keynesian anti-cyclical fiscal policy (Sedlacek, 2011). When we extend this logic to the contemporary fiscal framework, this means it is great to be Keynesian, with one essential caveat - to be Keynesian during both halves of the cycle. Budget deficits and public debt increases are not an negligible nuisance that can be jacked up regardless of the consequences. They constitute a real problem if they occur in the expansionary phase of the business cycle, as they make economies vulnerable during times of crisis. Similar to the role of the capital cushion that increases an enterprise's ability to survive financial losses when they occur, the possession of an adequate fiscal capacity by states enable policy-makers to generate higher deficits in the downturn. However, they are not possible without generating enough of a fiscal surplus in the upturn.

Procyclical fiscal policy accelerates existing economic downturn by excessively cutting public expenditure and/or raising taxes when stimulus would constitute an appropriate answer (restrictive procyclical fiscal policy). It also contributes to inflation and overheating when public expenditure rises faster than the GDP growth rate, or when collected taxes and social contributions fall too fast in relation to the very same growth indicator (expansionary procyclical fiscal policy). On the other hand, stimulating the economy by expanding the social safety net or public investments in the downturn and/or lowering taxes can be defined as an expansionary anti-cyclical fiscal policy. The opposite stance of building up fiscal capacity by slowing public expenditure increase to less than the GDP growth rate in the upturn can be defined as a restrictive anti-cyclical fiscal policy. Anti-cyclical fiscal policy acts as a major lever to reduce business cycle volatility, while procyclical fiscal policy enhances volatility, something akin to driving a car uphill and downhill while pressing the gas pedal.

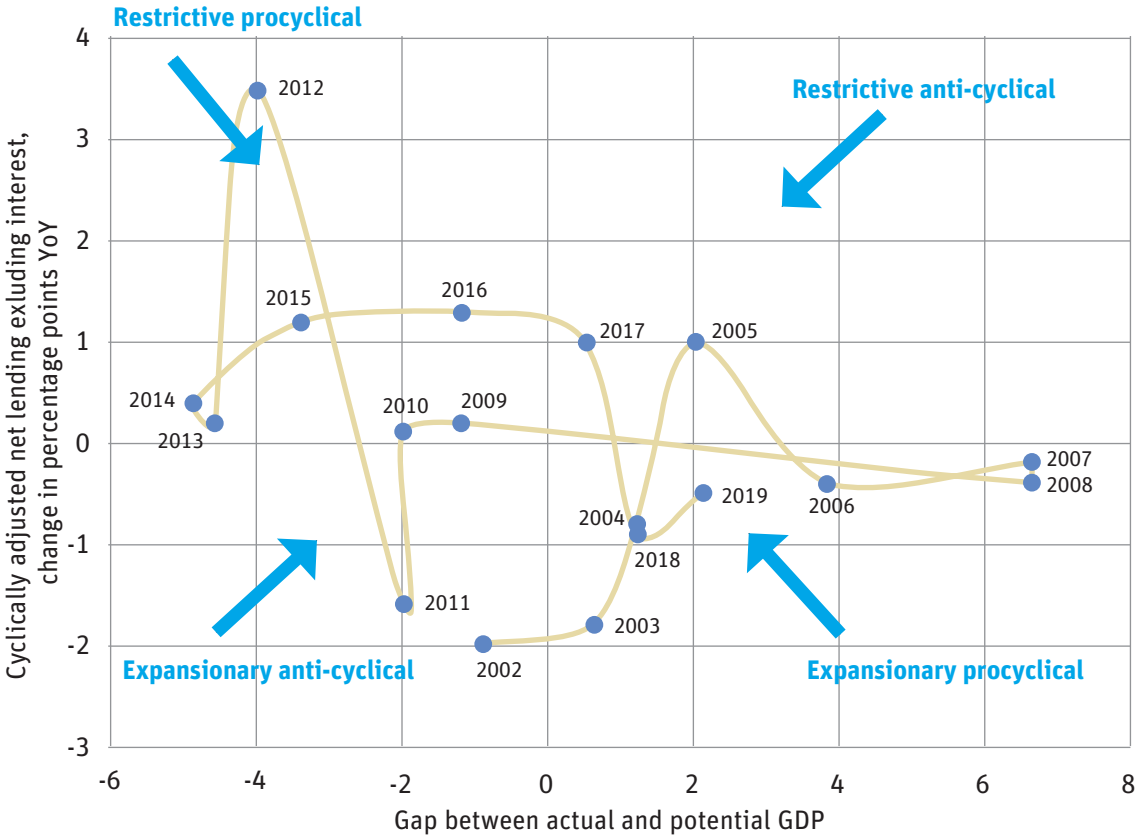
In our example, the upswing phase in the business cycle can be inferred by looking at the discrepancy between the real and potential GDP levels. The potential GDP level assumes the highest level of real GDP that can be sustained over the long-term when all factors of production are engaged in the process of production, without jeopardizing price stability.[2] The economy is in below full-employment equilibrium when its short-run GDP is lower than the potential GDP. The opposite is the case when short-run GDP is higher than the potential GDP. In Figure 1, a move towards the left along the x-axis denotes a falling real GDP level relative to its potential (cooling effect) while the opposite case is seen with a move towards the right (heating effect). The determination of an appropriate fiscal stance relative to a particular stage in the business cycle depends on the potential GDP calculation. Cyclically-adjusted net lending (+) or net borrowing (-) is the budget balance that we would arrive at when the economy is at its potential. This

2 Potential GDP calculation is occasionally subject to methodological and measurement errors though its calculation is still useful to check imprudent use of fiscal policy.

allows for a better assessment of the overall fiscal stance. If the economy is humming at its potential and the state in question continues to run a budgetary deficit, budgetary balance could only be achieved by trimming discretionary spending and not by means of additional growth (tackling structural deficit). If the opposite is true and the economy is operating below its potential, this could be alleviated by filling the gap with potential output by increasing aggregate demand (tackling cyclical deficit).

Cyclically-adjusted net lending (+) or net borrowing (-), excluding interest and measured in percentage points increase or decrease, diagnoses whether a fiscal policy possesses an anti-cyclical or procyclical character when paired with the state of the economy along the real vs. potential growth continuum. If an economy moves upward along the y-axis (net lending) when real GDP is lower than the economy's potential, then we apply restrictive procyclical fiscal policy. The opposite is true in case of a downward movement along the y-axis or expansionary anti-cyclical fiscal policy (expanding net borrowing). On the contrary, if real GDP is above the potential, then the reduction in net lending (shifting from the negative to positive y-axis) checks inflationary impulses and constitutes a restrictive anti-cyclical fiscal policy. Again, the opposite is true when shifting from the positive to negative y-axis (expansionary pro-cyclical policy or a net borrowing increase).

Figure 1: Procyclicality and anti-cyclicality of fiscal policy in Croatia



Source: AMECO database; author's calculations

How does this logic apply to Croatia? Based on the author's calculations and data provided by AMECO, we can observe that over the course of the period 2002–2019, Croatia's overall fiscal stance has been anti-cyclical in only four of 18 fiscal years. Colloquially speaking, Croatia's fiscal policy does not dance in tune most of the time. Therefore, fiscal policy effectiveness has been severely impaired in managing aggregate demand in the Croatian context. Adoption of the euro obliges current and future fiscal policy-makers to enshrine the principle of fiscal responsibility into key legislative acts and to strictly follow its letter and spirit. This will be all the more important given the fact that monetary integration can sometimes lead to difficulties in designing a one-size-fits-all monetary policy that takes the specific economic conditions of each EMU member into account. In the absence of an autonomous monetary policy that could 'lean against the wind' and lift the economy out of the doldrums, the appropriate fiscal stance requires that policy-makers in Croatia seriously take into account the fact that public debt is still excessive when compared to the rules of the Stability and Growth Pact and Fiscal Compact, and the current level of economic development and debt levels among its Central and East European peers. In order to enhance future effectiveness of fiscal policy, Croatia needs to reduce its public debt (Šimović and Deskar-Škrbić, 2019). This goal is next to impossible to achieve without seriously targeting the public expenditure side for more efficiency and transparency, especially in the present context of favourable macroeconomic conditions that finally, at the beginning of this year, permitted Croatia to cast off the status of a Member State with serious macroeconomic imbalance (in 2017 Croatia also abandoned the Excessive Deficit Procedure or EDP). It is exactly this course of action that would then lead to further tax reductions, creating a virtuous cycle of growth-*cum*-lower absolute and relative debt levels. So far, this has not been the case. In order to demonstrate this claim, we explore both the level and structure of general government expenditure in Croatia.

With regard to government expenditure, *Figure 2* and *Figure 3* depict Croatia's significant deviation from the prediction based on a simple linear regression.[3] Total general government expenditure as a percentage of GDP is too high given both Croatia's economic development level and the quality of governance score over the period 2001–2018.[4] More economically and institutionally developed EU members tend to display higher levels of government expenditure. Namely, their economies generate more material resources eligible for redistribution and their political institutions are routinely held up to higher standards of governance, which enables fair and efficient use of public funds. Nevertheless, this is hardly the case in Italy, Croatia, Greece and Hungary, which all cluster together above the regression line in *Figure 2*. Their spending levels exceed their institutional capacities to manage public funds in a transparent and efficient manner. *Figure 3* also puts Croatia significantly above the regression line, higher than expected given its economic development and the position of comparable post-Socialist Member States. Both illustrations serve as a good proxy for our claim that strongly embedded clientelistic arrangements negatively affect fiscal discipline and

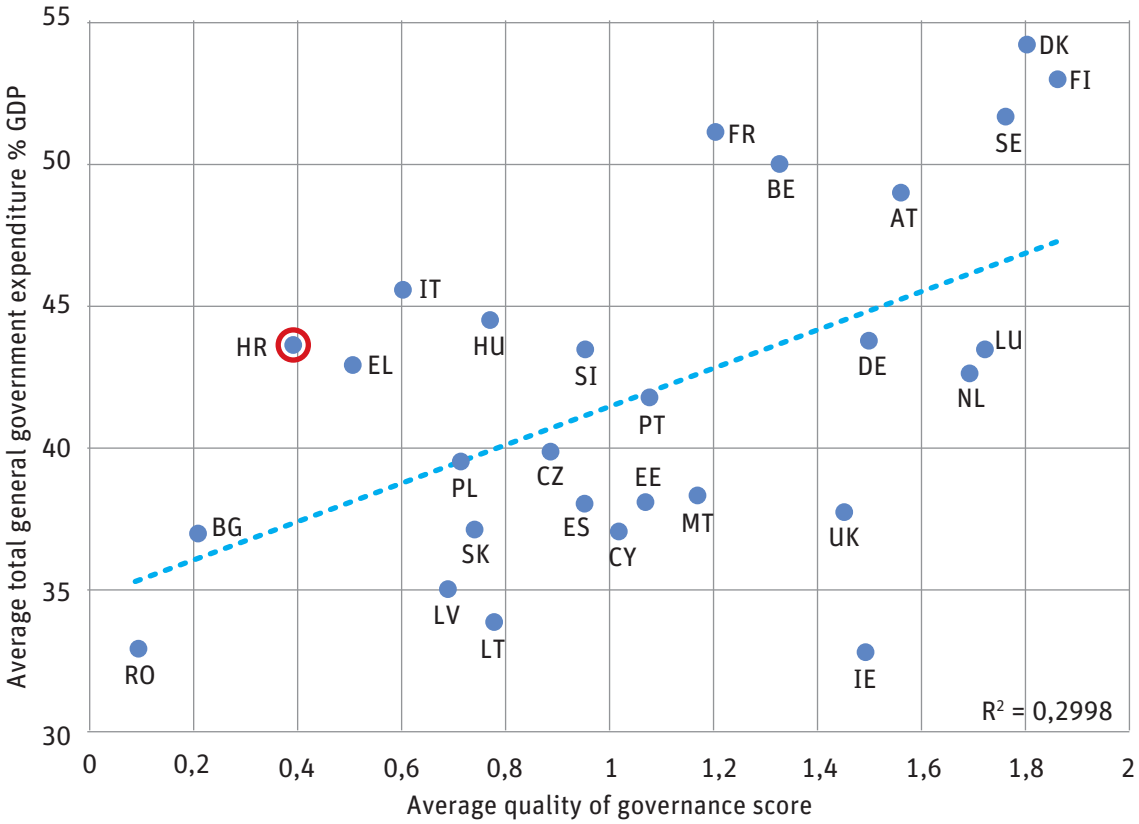
3 The simple linear regression displays a statistically significant result between the quality of governance (average WGI index) and average of aggregate government expenditure (% GDP); $p<0.05$

4 The QGI index represents a composite governance index calculated by multiplying each country's yearly score in every category with equal weight. This procedure is conducted across all six categories (rule of law, regulatory quality, control of corruption, government effectiveness, political stability and voice & accountability). Finally, scores are added for every subcategory, for every given year and country, in order to produce a cumulative score that proxies the overall quality of governance. The average QGI simply means that the average was calculated based on yearly scores encompassing the period 2001–2017. 2017 was the last year for which the data needed for calculating QGI were accessible. On the other hand, real GDP per capita in EUR data were obtainable throughout the period 2001–2018.

effectiveness. It is very indicative that the sum of government expenditure for intermediate consumption,[5] compensation of government employees and public subsidies in Croatia amounts to a staggering 20.8% of GDP (2001–2017 average). This result puts Croatia in 4th place among the EU-28 sample (only behind the Scandinavian countries), while it simultaneously occupies 26th place for the average QGI index score and 27th place for economic development (author's own calculation).

Upon joining the EMU, fiscal policy definitely becomes the most important stabilization and growth-enhancing policy lever. In the case of Croatia, this is already evident due to serious limitations on monetary policy autonomy, which will be outlined in detail in the next section. Some economists and politicians claim that EMU membership also takes fiscal adjustment off the table in dealing with future crises. However, this is far from the truth. Several studies focusing on the impact of fiscal expansion in Croatia show that fiscal stimuli have a very limited and often negative effect on GDP growth if increased budget expenditure arise in the

Figure 2: Government expenditure vs. quality of governance (2001-2017)



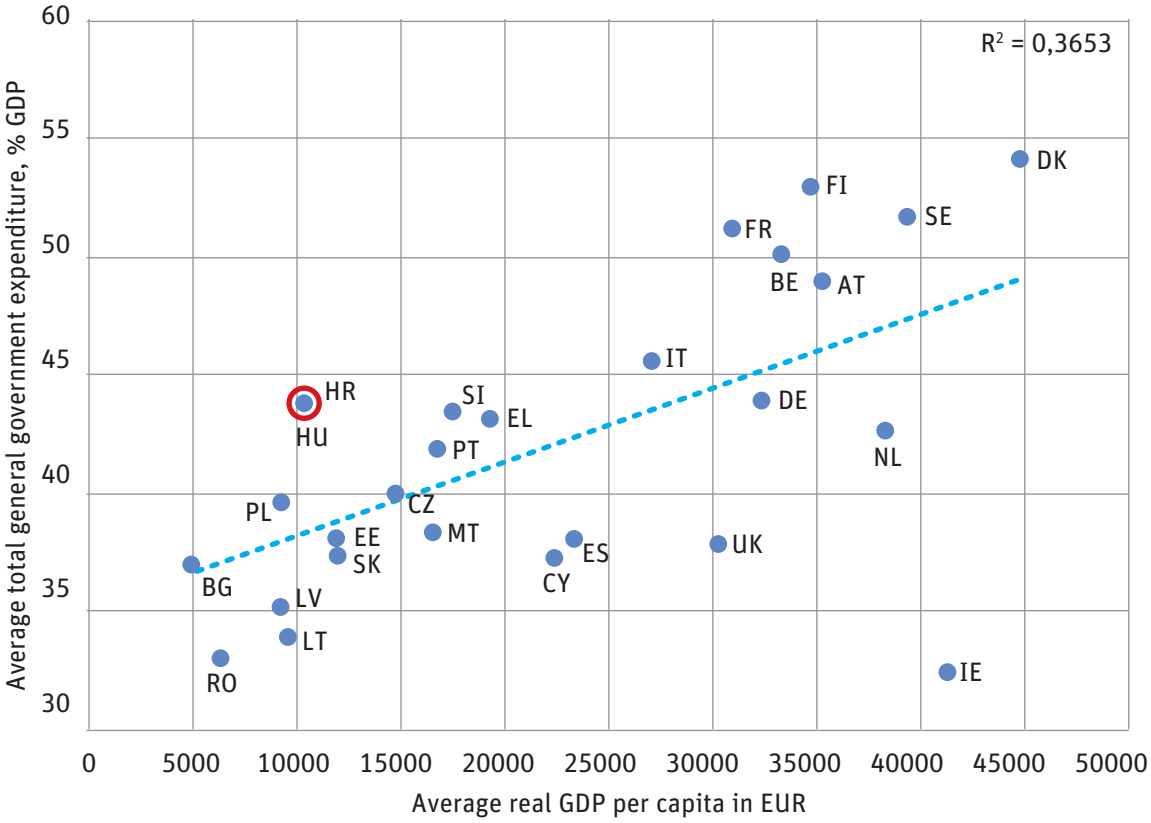
Source: Worldwide Governance Indicators and Eurostat; author's calculations

5 Intermediate consumption measures the value of goods and services consumed as inputs for public services. This elevated level this of expenditure category is a very good proxy for corrupt practices (see Vuković, 2019)

domain of subsidies and compensation of public employees. On the other hand, higher capital expenditure boost economic activity (Deskar-Škrbić, 2018). Unfortunately, following the logic of political business cycle, productive spending has been often trimmed at the expense of less-productive spending in order to ensure political support among important constituencies, which seriously hampers fiscal policy effectiveness.

While it is reasonable for Croatian policy-makers to advocate for the introduction of a very limited central fiscal capacity at the eurozone level based on the eurozone's overall fiscal stance and not only of its individual members, the reliance on domestic fiscal capacity should remain the cornerstone of policy-making. This becomes an especially important feature since a large common budget is not in the cards. However, the build-up of this capacity entails significant change, both in the composition and the level of total government expenditure, as outlined above. Instead of just relying on the existing EDP rules, which are complex, politically divisive and hard to enforce, future Croatian governments should pioneer the simple rule that government expenditure must not grow faster than long-term nominal output, and should grow at a slower pace in countries that need to reduce their debt-to-GDP ratios. Unfortunately, the latest budget rows in October 2019 and the ensuing increase in the sum of payments to public employees in 2020 is an antidote to the desired and optimal policy-course.

Figure 3: General government expenditure level vs. economic development (2001-2018)



Source: Worldwide Governance Indicators and Eurostat; author's calculations

1.2. The role of monetary and exchange-rate policy for macroeconomic adjustment prior to and following euro adoption in Croatia

In terms of major costs of euro adoption and the subsequent loss of monetary sovereignty, Croatia would not suffer a significant downside. Sticking to expansionary monetary policy in a highly euroized economy such as Croatia is impaired by the ineffectiveness of the monetary policy transmission mechanism.[6] 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 the context of capital mobility within the Single Market, this would inevitably lead to rapid depreciation or appreciation of the national currency, which is then countered by the domestic monetary policy that annuls its initial intention; e.g. expansionary policy leads to currency depreciation (domestic and foreign savers trigger capital outflows due to depreciation expectations) soon followed by the central bank's foreign exchange intervention to purchase domestic currency to stabilize its exchange rate and shrinks its supply in the market. This divergence in interest rate cuts and exchange rate movement in emerging economies has often been labelled the 'original sin'. The opposite is the case when the central bank tackles inflation with interest rate hikes. This leads to currency appreciation due to rising capital inflows (foreign and domestic entities move capital in due to higher yield and appreciation expectations). The central bank follows suit with foreign exchange intervention and sales of domestic currency, which then might create excess liquidity in the system and compromise the inflation target. Fortunately, since 2000, the CNB has implemented an anti-cyclical monetary policy in all years, and has not allowed for price stability to erode (Government of the Republic of Croatia and CNB, 2017).

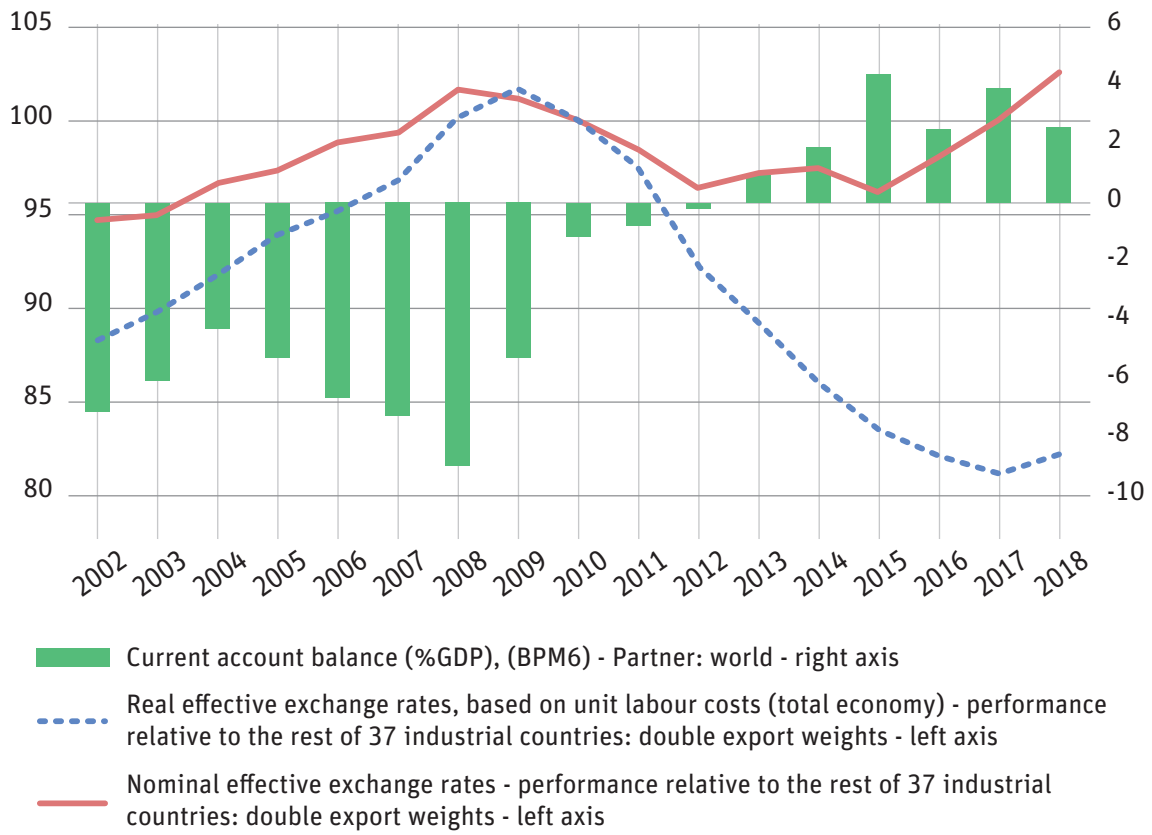
Metaphorically speaking, large monetary blocks create large monetary waves that always reach the shallows of a small and open economy. Finally, more than 70% of the Croatian banking system, measured in asset size, is owned by parent banks that have their business headquarters in the eurozone. This level of financial integration significantly narrows the impact of a domestic interest rate channel. A study of the relationship between interest rates and GDP in Croatia shows that interest rates do not represent an effective transmission mechanism of monetary policy, and only a few industries react to changes in interest rates as compared to fiscal policy changes (Tkalec and Vizek, 2009). Furthermore, the unemployment rate is insensitive to changes in the level of monetary aggregate M1 in both the short and long run.

The CNB also faces major limitations in terms of using the exchange rate channel to improve the country's competitiveness by nominal depreciation. Namely, payments for loans denominated in foreign currency would go up, thus impairing debtors, mostly households. Approximately 75% of the total domestic and

6 The historical legacy of hyperinflation episodes in the 1980s and 1990s made citizens and corporations skeptical towards the domestic monetary anchor. This distrust pushed them to save in foreign currency (first the German mark and then the euro), which propelled deposit euroization to very high levels, normally above 80%. Having foreign currency on their liability side made banks match their currency positions on the asset side as well, leading to high credit euroization, normally around 75%, which reached lows of 50% only recently due to a strong rise in domestic deposits held in kuna.

foreign currency debt on the part of state, households and corporations, amounting to almost 140% of Croatia's GDP, is indexed to the euro (Government of the Republic of Croatia and CNB, 2017). Croatia is the most euroized of all the non-euro EU Member States, especially in comparison to Hungary or Czech Republic. Given that the percentage of imports and exports coming from and going to the eurozone is even higher than in the Baltic states, Slovenia or Slovakia, EMU membership comes as a natural step for Croatia to abolish currency mismatch both in the trade and financial domain. Furthermore, Mikulić's (2018) input-output analysis shows that approximately 40% of Croatian exports and investments, as parts of final consumption, depend on imports. Hence, significant nominal currency depreciation would severely and negatively affect price stability due to exchange rate pass-through to inflation. Besides, it is more than probable that nominal currency depreciation would lead to a decline in investments and personal consumption, forces that might offset any potential increase in net exports. *Figure 4* and *Figure 5* show that Croatia's successful turnaround from the depths of external imbalances in the 2000s has been primarily due to real effective exchange rate depreciation.[7] This comes as a strong rebuke to the prophets of external devaluation via nominal exchange rate depreciation against the main trading partners. Since 2010, Croatia has significantly improved its competitiveness vis-á-vis all

Figure 4: Real and nominal exchange rate vs. current account balance (%GDP)

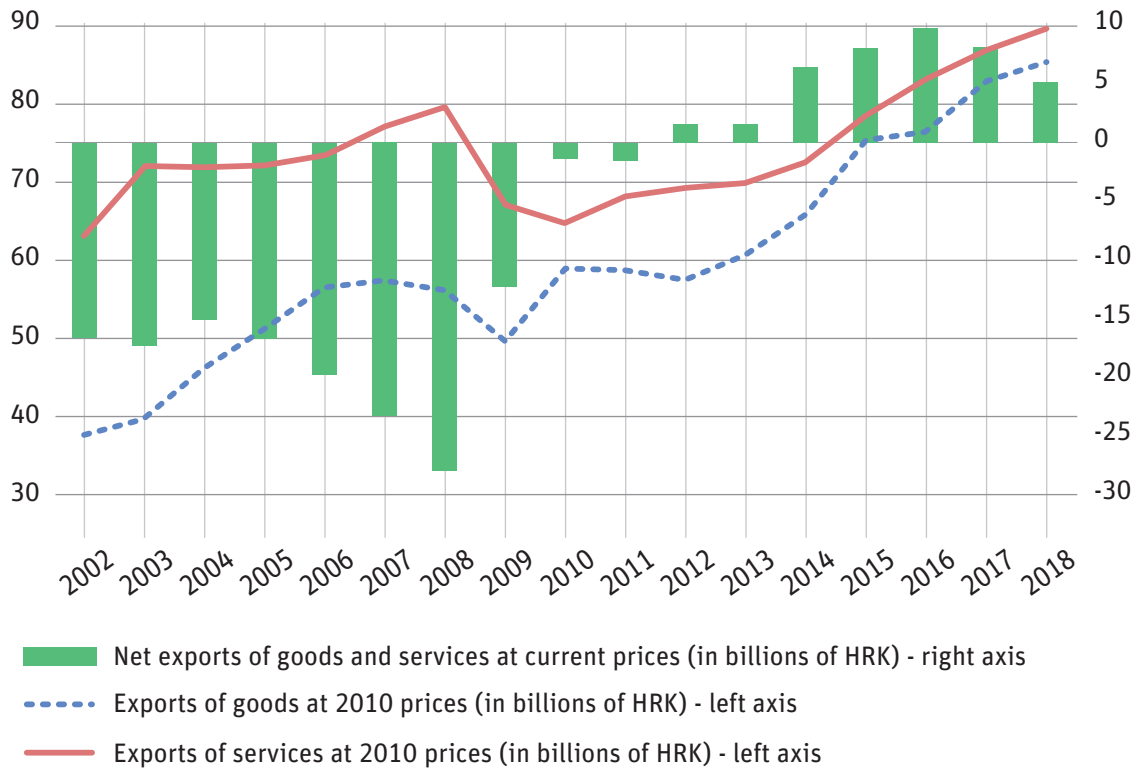


Source: AMECO database; author's calculations

7 Real effective exchange rate (REER) aims to assess a country's price or cost competitiveness relative to its principal competitors in international markets. Changes in cost and price competitiveness depend not only on exchange rate movements but also on cost and price trends.

of its competitors in Central and Eastern Europe. As opposed to currency depreciation cheerleaders and advocates of lower nominal wages, the third approach suggests that lower unit labour costs (ULC) are the most important factor of national competitiveness.[8] Hence, raising the productivity per worker is crucial in preventing future external and internal imbalances. This will be addressed in Section 1.4.

Figure 5: Croatia's export performance



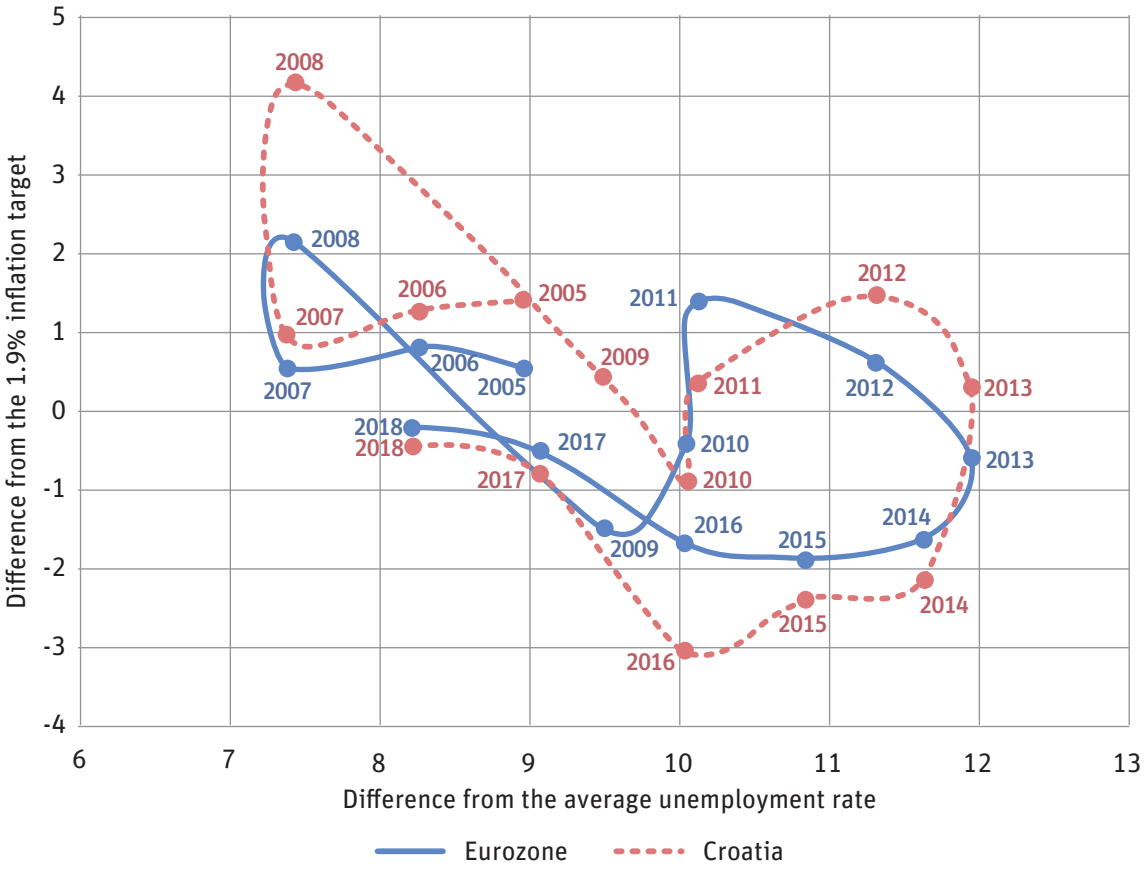
Source: AMECO database; author's own calculation

After pondering the above, we can conclude that CNB has a very limited lender-of-last-resort role and faces major constraints upon exchange rate and interest rate transmission channels of monetary policy. It comes as no surprise that foreign exchange intervention is the most important monetary policy tool in Croatia. The exchange rate serves as a nominal anchor of stability as opposed to interest rate or monetary aggregate anchors. Furthermore, the synchronization of the Croatian business cycle with that of the eurozone gives an additional impetus for EMU membership (Kotarski and Tkalec, 2019). *Figure 6* shows a relatively high degree of business cycle synchronization between Croatia and the EMU. Both inflation and unemployment rate trajectories are closely aligned and there is no great danger of being subjected to the EMU's procyclical monetary policy from the perspective of the Croatian economy. The existing difference between average inflation and unemployment rates in our cases primarily lies in Croatia's institutional uncertainty, including a weak legal system, rigid labour market and irresponsible fiscal policy. These are the main reasons why

8 ULC measures the average cost of labour per unit output.

Croatia is the second-worst EU Member State after Greece in terms of years spent in recession in the period from 2007 to 2018 (Greece spent a total of 8 years and Croatia 6 years in recession). All of this gives a strong incentive for formal euroization or euro adoption.

Figure 6: Business cycle synchronization - Eurozone vs. Croatia



Source: World Development Indicators, author's calculations

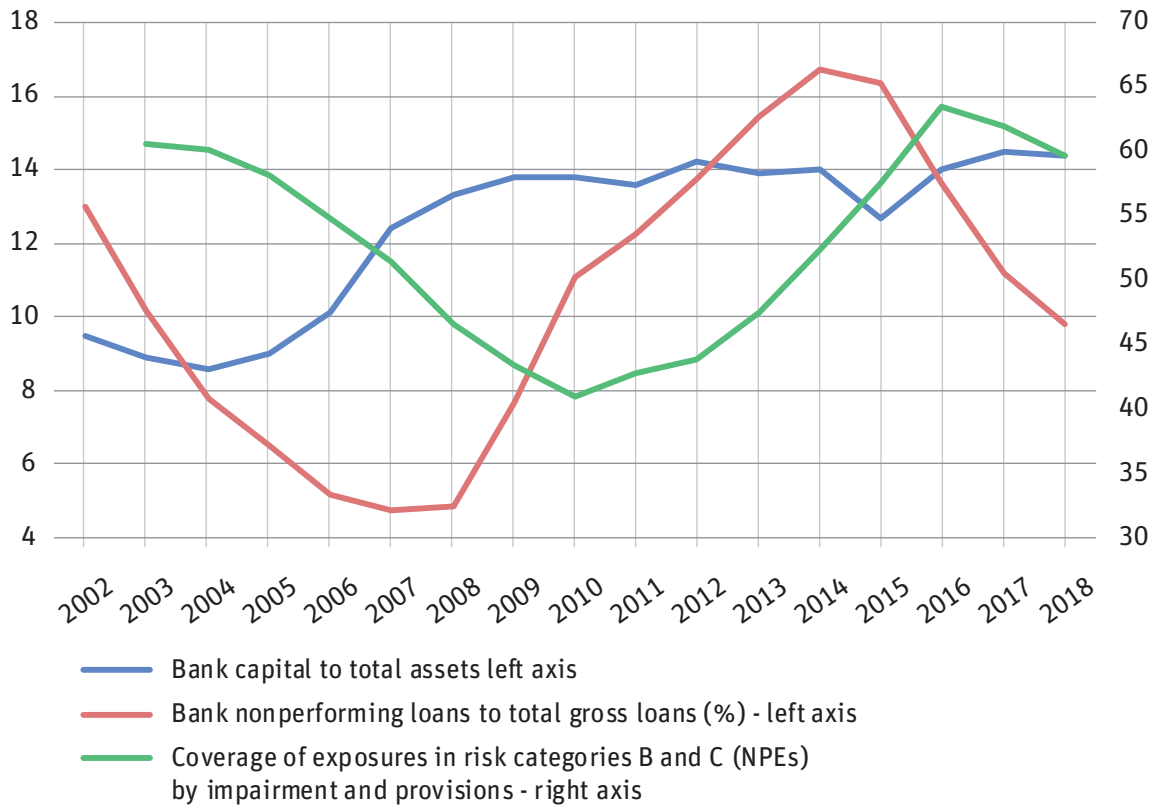
1.3. The role of macroprudential policy or banking regulation after joining the EMU

Generally speaking, the historical evolution of the Croatian banking system produced both a favourable level of financial deepening, measured by the total credit to GDP ratio, and managed to avoid costly banking crises since 2000. Since the large-scale privatization in 1999/2000, the basic structure of the Croatian banking system has not been determined by political imperatives. The only remaining alternative for rent-seeking opportunities on the part of the political elite and their clients has been tied to the domain of fiscal policy and operation of state-owned enterprises. A study by Deskar-Škrbić *et al.* (2019) showed that the CNB's regulatory framework has proven effective as various regulatory measures affected the lending activity of banks, thus preventing the worst kind of credit bubbles before the crisis and cushioning the degree of stress on the lending market during the outbreak of the financial crisis and prolonged recession.

Being part of the EMU highlights the importance of anti-cyclical macroprudential measures, such as higher capital and regulatory requirements when there is a surge in lending activity, and national policy-makers have the full autonomy to act in this direction. *Figure 7* shows that despite a spike in the percentage of non-performing loans (NPLs) in the period 2008–2014, there was a remarkable absence of a systematic banking crisis and corresponding rescue operations financed by taxpayer money. In 2017, Croatia had the highest ratio of bank capital to assets among the EU-28, which says a great deal about the banking system's resilience and its strong macroprudential framework (Statista, 2019).

There is no reason to doubt that the current policy framework will be additionally strengthened after joining the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) as the cornerstones of a banking union. As a banking union member, Croatia should remain committed to upholding the goals of financial integration and financial stability, both of which are incompatible with the absence of a common financial supervision structure. Furthermore, the further build-up of a banking union by boosting the Single Resolution Fund's capacity and implementing the European Deposit Introduction Scheme (EDIS), after risk-reduction steps in the peripheral country's banking system, would make deposits across the eurozone safer and protect taxpayers from future costly bailouts. Finally, the EMU's credible and waterproof sovereign debt-restructuring mechanism would impose market discipline. It would also remove the pressure from establishing a perpetual transfer union within the EMU or relying on debt-monetization.

Figure 7: Banking system's resilience in Croatia

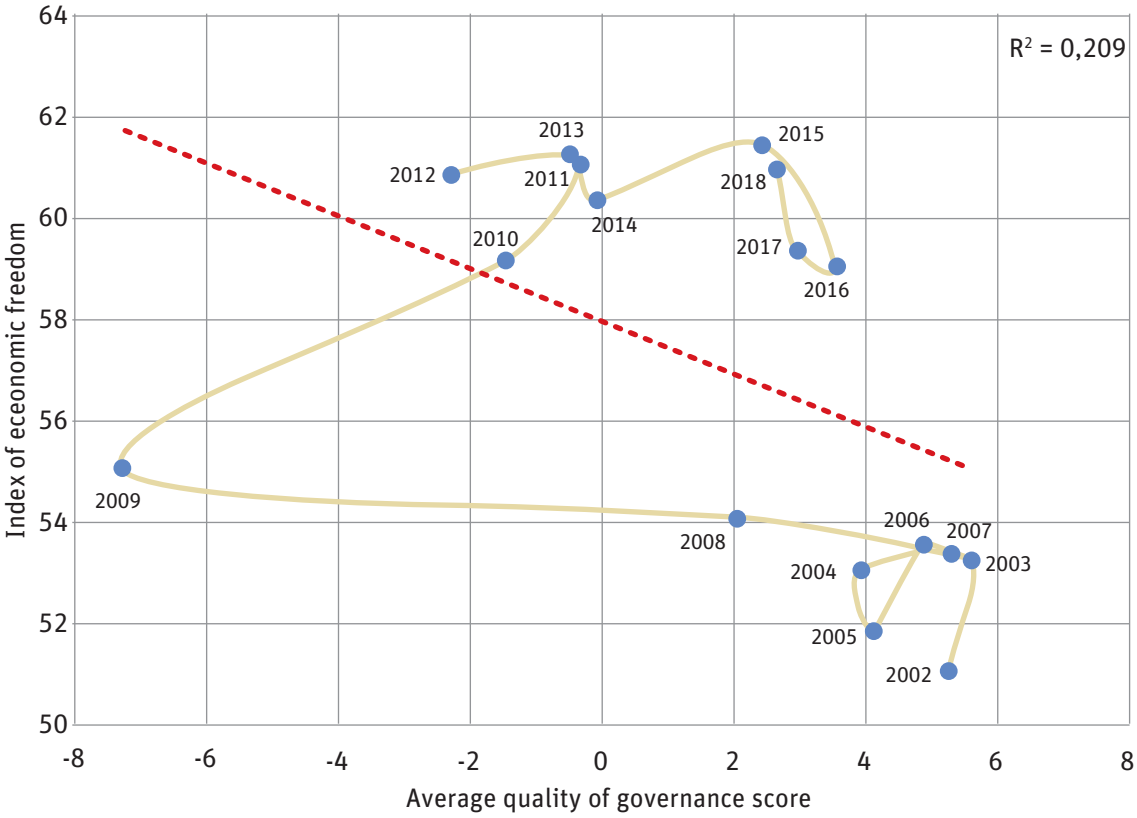


Source: World Development Indicators, Croatian National Bank (2019); author's calculations

1.4. The role of structural reforms after joining the EMU

Upon analysing product market competition, collective bargaining, financial sector development, social protection and education indicators, Kotarski and Petak (2019) stated that Croatia has developed a typical Southern European variety of capitalism. These findings were corroborated by Deskar-Škrbić's (2018) cluster analysis, whereby Croatia belongs to the EMU periphery together with Portugal, Cyprus, Italy and Spain. In order to reap the full benefits of monetary integration and achieve long-term aggregate demand and supply equilibrium, a state needs to show continuous commitment to reform agenda, especially during the economic upswing. *Figure 8* shows that Croatian policy-makers implement reforms that positively impact economic freedoms mostly in years when growth rates are lower than in the previous year (negative

Figure 8: Timing of reforms and economic growth

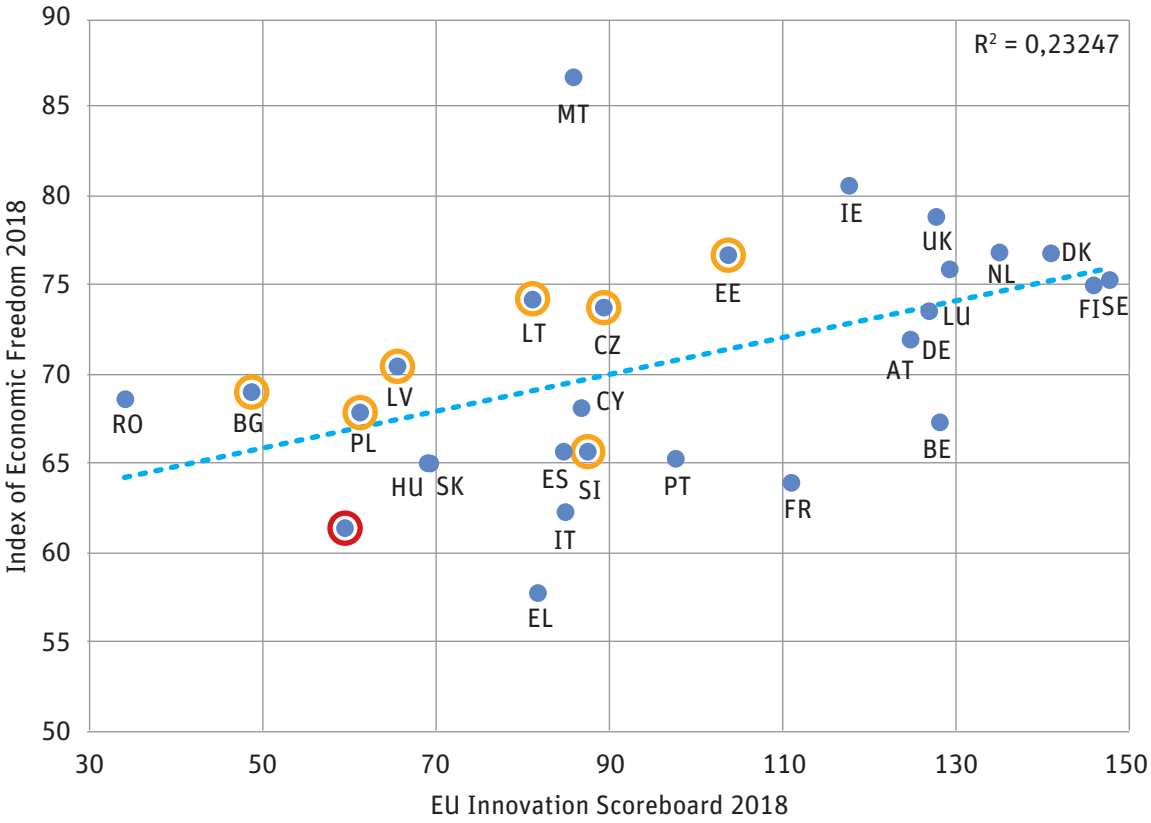


Source: World Development Indicators and Heritage Foundation

correlation). Instead of repairing the roof when the sun is shining, policy-makers tend to opt for repairs during stormy weather, when social costs are higher and negative attitudes towards the reform agenda prevail. Unfortunately, within the European Semester, Croatia more often than not constitutes an example of a slacker. When measuring the fulfilment of Country Specific Recommendations by European Commission in the period 2011–2017, Croatia has the second-worst average implementation score in the multi-annual assessment, with no or limited progress in almost 50% of cases (European Commission, 2019a). Croatia

also has one of the lowest average total factor productivity levels during the last decade.[9] This trend is also compounded by the third worst score in the national innovation capacity. *Figure 9* displays a positive correlation between the Heritage Index of Economic Freedom and the EU Innovation Scoreboard scores. As observed, Croatia fares poorly on both counts. Hence, structural reforms should aim at fostering more economic freedoms, especially in the domain of labour freedom, government integrity, government spending and judicial effectiveness, in order to enhance long-term national innovation capacity and lift potential output. Hence, the Eurogroup has correctly selected reforms of the state's role in the economy as a precondition for participation in ERM II and the banking union.

Figure 9: Economic freedom vs. innovation capacity



Source: European Commission and Heritage Foundation (2018 data), author's calculations

9 Total factor productivity refers to how efficiently and intensely inputs are used in the production process. Under certain assumptions it can be thought of as a measure of level of technology or knowledge.

2. THE POLITICAL ECONOMY OF EURO ADOPTION IN CROATIA: COST-BENEFIT ANALYSIS

Table 1 gives a short overview of the key costs and benefits of the euro adoption, and their total significance. We also attempt to match costs and benefits with particular sectors and interest groups where possible.

2.1. Euro adoption benefits

The most important benefits arising from euro adoption was extensively explained in Section 1.2 on monetary policy. Furthermore, currency risk elimination and a lower risk of currency and banking crisis are also tightly connected with trade and investment facilitation. This fosters even more trade and financial integration over time and leads to the propagation of animal spirits and thus the synchronisation of business cycles. Small shocks (negative and positive) in output are more strongly correlated among countries that are members of a monetary union. Over time this leads to even greater efficiency from having a common currency, as well as lower transaction costs. Those benefits are moderate and widely shared among households, financial intermediaries, non-financial corporates and general government.

Side by side with currency risk elimination as the biggest benefit, obtaining an approximately 5% vote share within the ECB's Governing Council that determines monetary policy for the eurozone is a major benefit for the national central bank and the whole of the economy. Given the fact that Croatia's GDP would make up only 0.4% of the eurozone's total GDP and CNB's capital subscription into the ECB only 0.2% of its total capital, obtaining a 5% vote share in the ECB's system of rotating voting rights is a major benefit (Šonje, 2019). It is exactly this institutional setup that rebuffs the view that large EMU countries always outvote smaller ones. A seat at the table enables active decision-making on the course of future monetary policy, instead of being a passive bystander on the sidelines.

Joining the eurozone's new financial architecture that emerged in the aftermath of the eurozone crisis signalizes higher credibility of macroeconomic policy and locks-in important reforms that are an inevitable part of EMU accession. For instance, Croatia has still not acceded to the full version of a Fiscal Compact that would envisage the adoption of a special law that transposes Title III and IV provisions on fiscal and economic policy, such as debt brake, into the national legislation. In the long-run, this would also lead to a lower risk profile and better credit rating, which would then enable lower interest rates. In terms of having the benefit of lower long-term nominal interest rate due to euro adoption, Croatia can be compared with Slovenia and Slovakia. The ECB Statistical Data Warehouse shows that since 2010, both of these countries that are very comparable to Croatia in terms of their economic structure have enjoyed far lower long-term rates, irrespective of the general trend in global interest rate declines. This arises primarily from the reduced risk premia and lower regulatory costs for the national banking sector. Therefore, this benefit is also shared very widely, though savers would definitely face lower returns on their savings if we take a static view, especially in the short-term.

However, Croatia's economy as a whole would significantly benefit due to long-term dynamic effects arising from cheaper sources of financing.

EMU accession would also enable the CNB to reduce its holdings of more than 17 billion EUR in foreign exchange reserves to create a sovereign wealth fund (SWF) that would be free to invest into more riskier asset classes with the goal of generating special revenue that might work as an anti-cyclical buffer in future crises. Becoming part of the European System of Central Banks (ESCB) would also enable the CNB to obtain the right to ESCB's seigniorage,[10] which would then be split between the CNB and state budget as a special revenue. Taxpayers definitely constitute the main beneficiaries of this process. Finally, only euro adoption would enable access to the ESM or a European equivalent of the IMF, an emergency fund equipped with €500 billion to help countries with temporary difficulties in borrowing from financial markets due to excessive debts. Even in the case of failure of the European Semester, EDP or Macroeconomic Imbalances Procedure, the ESM can jump in as an insurance policy in case of financial emergency.

2.2. Euro adoption costs

Section 1.2 provided a detailed account of why the loss of monetary autonomy in the Croatian case is no more than a loss on paper. We have already commented that the interest rate and exchange rate channels severely limit effectiveness of monetary policy in Croatia. Foreign exchange rate interventions are the most important monetary policy instrument in Croatia in contrast to major central banks which have a much broader and more effective set of monetary policy instruments at hand. Higher macroeconomic volatility due to surges in capital inflows and outflows are not an inevitable fixture of the EMU. We have already posited that anti-cyclical fiscal and macroprudential policy can mitigate those risks and the latest financial crisis in the EU showed that volatile capital flows were an issue facing both eurozone and non-eurozone members.

The CNB would be required to pay in approximately EUR 700 million into the ECB's capital. This accounts for less than 5% of Croatia's foreign exchange reserves. A similar amount (EUR 690 million) was paid out of the national budget into the ESM over a 12-year period, according to the capital key formula based on both population and economy size. Hence, those costs are negligible and felt only marginally by taxpayers, especially when compared to the fact that Croatian banks would finally enjoy the benefit of having access to the true lender-of-last-resort (ECB), and the country as a whole would receive an additional insurance policy through the ESM for cases of financial emergencies. The major cost is the obligation to participate in future rescue operations aimed at fiscally unsound states and their fragile banking systems. However, credit issued by the ESM needs to be paid back within the country's strict adjustment programme and there are several protective layers (profit from previous operations and

10 The central bank earns interest on the money it lends, or receives a return on the assets it acquires – this is called seigniorage income.

capital subscriptions) before all members might be called upon to activate their guarantees for loans issued to a state that ended up in bankruptcy. The maximum amount can be estimated at EUR 5.6 billion (0.8% share in the ESM) and the odds of this happening are extremely unlikely (Šonje, 2019). This represents a potential cost at the taxpayers' expense.

The final set of costs are conversion costs that pertain to changing ATMs, accounting software and printing new money. Those costs are moderate in significance, are one-off and are estimated at 0.5% GDP (Government of the Republic of Croatia and CNB, 2017). The most feared consequence of euro adoption among the population at large is its potential effect on prices. However, the observation of inflation rates in Slovenia, Slovakia and Croatia since 2006 shows that inflation rates in all three comparable countries are highly correlated, and that Slovenia and Slovakia did not mark a spike in general level of prices in the years following euro adoption. Preventing sudden price increases through rounding effects by retailers, bars and hotels can be addressed by Government passing the law that mandates price quotation in both the former domestic currency and the euro during the transition period. Exactly this measure can bring about desired transparency in the market, and create a more favourable view of euro adoption.

Table 1

BENEFITS		**COSTS**	
Issue	**Significance**	**Issue**	**Significance**
Elimination of currency risk	High	Participation in future crisis rescue operations via ESM	Medium
Voting power beyond the capital key on the ECB's Governing Council	High	Cost of conversion	Medium
Lower risk of banking and currency crisis	Medium	Increased inflation and price rounding due to conversion	Low
Lower interest rates	Medium	Loss of monetary autonomy	Low
Higher credibility of macroeconomic policy	Medium	Paid-in capital into ECB and ESM	Low
Trade and investment facilitation	Medium	Higher macroeconomic volatility due to surge in capital inflows and outflows	Low
Reduced need for high foreign exchange reserve holdings and its conversion into a sovereign wealth fund	Medium	Increased inflation and price rounding due to conversion	Low
Access to ESM	Low		
Share in eurosystem seigniorage	Low		
Lower transaction costs	Low		

Source: Šonje (2019); Strategija za uvođenje eura kao službene valute u Hrvatskoj – Prijedlog (2017)

3. POLITICAL AND SOCIAL SUPPORT FOR EURO ADOPTION IN CROATIA

Political attitudes of the main Croatian political parties towards euro adoption and the related concept of fiscal discipline in the EU tend to differ in their direction and intensity. Here, we refer only to political parties that float closely around 5% electoral threshold or their support remains significantly above that level. *Table 2* lists five major political parties that aggregate preferences of 65% of the electorate, while the latest Crobarometar polls divides the remaining 35% into 7% of undecided voters and 28% of voters who opt for parties that enjoy less than 3.5% support. One can note that HDZ and SDP, as the two strongest centre-right and centre-left mainstream parties, have generally favourable views of euro adoption. However, SDP is much more lukewarm in its support for the single currency. Independent Mislav Kolakušić and the party Živi zid have taken a firm anti-euro stance. The Most party remains neutral and advocates a slowing of the process of euro adoption until Croatia achieves a certain level of economic development, and also supports a referendum concerning euro adoption.[11] Finally, among

Table 2

Political parties and Crobarometar rating in October 2019	The single European currency (euro) is a bad thing	The European Union should rigorously punish Member States that violate the EU deficit rules
HDZ (28.1%)	Completely disagree	*No opinion**
SDP (21.5%)	Tend to disagree	*Tend to disagree***
(Independent) Mislav Kolakušić (5.3%)	*Completely agree****	*No opinion****
Most (5%)	Neutral	Tend to agree
Živi zid (4.9%)	Completely agree	Completely disagree

Source: euandi2019, author's assessment

* HDZ did not reveal its stance towards this issue during euandi2019. The HDZ-led Government often boasts of the successful completion of EDP under its stewardship. However, the last two years have witnessed the comeback of a procyclical fiscal policy led by HDZ-Governments.

** SDP did not reveal its preference but by reading their EP election party manifesto, it is visible that the party criticizes HDZ-led Government subjugation of fiscal policy to the goal of fast euro adoption. One might reasonably infer that the party believes that structural problems might be addressed by fiscal policy. Austerity measures are also criticized and equated with premature euro adoption in crisis-hit countries.

*** Independent Mislav Kolakušić did not appear in the sample prior to the EP election. In his recent interview for the website Paraf.hr he stated that euro adoption is totally unnecessary and useless from the Croatian perspective and it only favours large EU economies. Independent Mislav Kolakušić has not revealed his stance towards EU-enforced fiscal discipline but has favourable views of budget cuts targeting the public administration apparatus.

11 The author of this publication was one among five country-specific experts tasked with collecting and coding party-positions prior to the latest European Parliament election in May, as a part of euandi2019. euandi2019 is a Voting Advice Application built to help citizens make an informed choice in the 2019 European Parliament elections. Several statements were collected in April, others in October 2019, while in some statements, political parties remain silent. The application can be accessed at: https://euandi2019.eu/survey/default/EN

parties below the 5% threshold are parties such as Pametno, HSLS, IDS and HNS, who look favourably upon euro adoption, the parties Hrast and Nezavisni za Hrvatsku (NZH) are Eurosceptics, while the party Milan Bandić 365 has been silent on the issue and focuses first and foremost on local issues.

The Croatian Employers' Association (HUP) and Croatian Banking Association (HUB) are very supportive of Croatia's eurozone membership. On the other hand, trade unions in the public sector are wary of premature euro adoption and how it might affect their constituency through the imposition of hard-budget constraints. Trade unions in the private sector remain silent on the issue. Finally, when it comes to society at large, the latest Eurobarometer 479 shows that a majority of respondents (49%) in Croatia support euro adoption, of which 15% have a very favourable view of euro adoption and 34% are rather in favour of its introduction. 31% of respondents were rather against while 16% are strongly against it. Society is still split with regard to the issue, though the level of support is higher than in Czech Republic and Poland, while enthusiasm is not as strong as in Hungary and Romania (European Commission, 2019b). Eurobarometer data show that respondents who feel informed about the euro are more likely to support its introduction (57% compared with 43%).

4. CONCLUSION

Given the relatively high political salience of euro adoption in Croatia and the fear of the unknown still present among a large swath of the electorate, it is extremely important for the current and future governments composed of pro-euro parties to continue informed debates about the pros and cons of euro adoption. This is essential to dispel unwarranted fears and to raise overall public support by underlining the very favourable balance of EMU's membership for Croatia's economy. Furthermore, such words should be followed by serious action, such as upholding and keeping fiscal policy in an anti-cyclical mode over the entire business cycle, ensuring financial sector stability through well-tailored

Given that the fear of the unknown is still present among a large swath of the electorate, it is extremely important for the current and future governments composed of pro-euro parties to continue informed debates about the favourable balance of euro adoption in Croatia

macroprudential policies atop the current banking union prerequisites, diligent implementation of structural reforms, and the creation of a positive narrative on the necessary steps for strengthening the eurozone's current architecture. The euro is not a golden goose that will magically solve Croatia's accumulated structural and fiscal problems, and irrevocably secure prosperity for generations to come. Nor is it a stinging viper that will inadvertently allow the large Member States or corporations to 'devour' the smaller ones, a popular trope often espoused by populist politicians of various stripes. The euro is a generational opportunity to seriously transform Croatia's unbalanced political economy and the 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.

Successful euro adoption requires keeping fiscal policy in an anti-cyclical mode over the entire business cycle, ensuring financial sector stability through well-tailored macroprudential policies atop the current banking union prerequisites, diligent implementation of structural reforms, and the creation of a positive narrative on the necessary steps for strengthening the eurozone's current architecture

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