The economic stakes of Croatia's EU membership

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Croatia at the accession: Some introductory facts

On July 1 Croatia became the 28th member of the European Union.

Membership entails an obligation for the country to also work towards eventual adaption of the euro, including a two-year transition period with fixed exchange rates[1].

This paper examines Croatia's economic situation at the time of EU entry, and its outlook in terms of economic and monetary integration in a time of general political and economic instability in the EU.

Croatia applied for EU membership in 2003 and achieved candidate status in 2004, and the accession process has thus taken a full ten years, including a temporary freeze amid hunt for generals indicted by the international tribunal for war crimes. Croatia is the second ex-Yugoslav republic to become EU member, following Slovenia's accession in 2004, and likely the last one to do so for yet several years.

A referendum in early 2012 yielded a two-thirds majority in favour of membership, though the only 44% voter turnout was a clear signal of moderate enthusiasm. With the EU being in the midst of an economic crisis, Croats have realised that such membership is not necessarily the solution to all problems, although membership brings along a large welcome package; financing available to Croatia in the period 2014 – 2020 from *Structural Funds* and *Cohesion Fund* amounts to EUR 8 billion; equal to almost 3% of expected GDP over the period.

[1] This period is referred to as ERM2.

Croatia's population stands at four and a half million, which would make Croatia among the smallest members of the EU, about the same size as Ireland, though more than twice as large as its rival Slovenia. Croatia experiences the same problem as the rest of Europe with an ageing population, the 50-54 years interval representing the largest demographic group for both genders, and with a consistent low fertility rate over the last decades, currently at 1.50. The consequence will over time likely be reduced unemployment, but also a falling per capita productivity and increased pressure on pension systems. A slight positive migration, peaking at 7 000 people in 2007, compensates only somewhat.[2]

The political turmoil of the 1990s left Croatia's economy in tatters. Yet with the tourist industry as a primary vehicle, the rest of the world gradually came to realize Croatia was no longer a war zone and economic conditions improved quickly. Economic growth was more than 5% as late as in 2007, when the World Bank classified Croatia as a 'high-income market economy'.

However, the 2008 downturn impacted Croatia as heavily as elsewhere, and GDP dropped by a full 7% in 2009. The economy stabilized in 2011, but has as of 2012 been in recession again, with the latest estimates indicating almost 2% contraction.

[2] Sources: Croatian Bureau of Statistics (http://www.dzs.hr/Hrv_Eng/CroInFig/croinfig_2012.pdf).

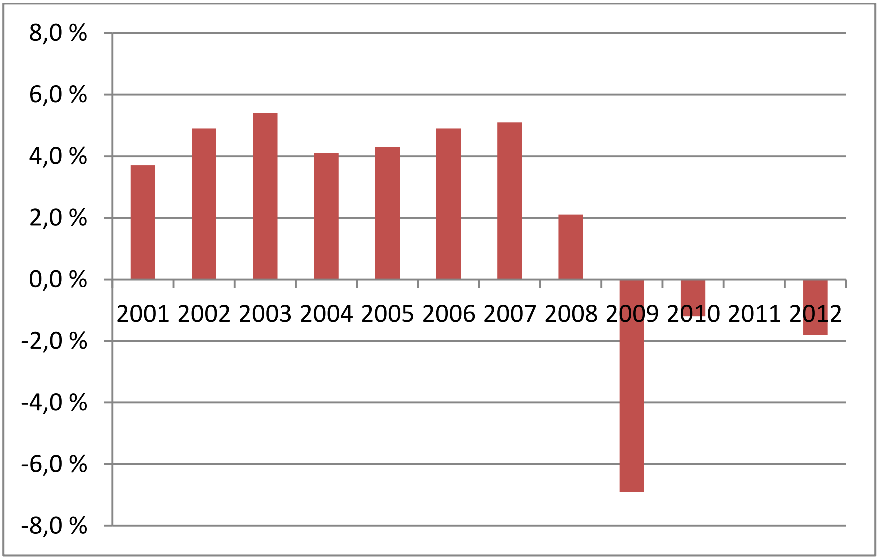

Figure 1: GDP, real year-on year rate of growth

GDP per capita currently stands at slightly above 10 000 euro, which is approximately 60% of the EU average. Croatia is well ahead of the Union's current stragglers, Romania and Bulgaria, and at about the same level as Poland, Hungary and the Baltic states, but short of all other EU countries.[3]

[3] Sources: Croatian National Bank (HNB), Eurostat.

The European Union

Among the aims of the European Union is to cement and strengthen economic integration between its member states. In the evolution of the union since the 1950s, physical and financial trade barriers have steadily been removed, allowing and encouraging the benefits of comparative advantages in production, with positive effects for producers as well as consumers.

The introduction of a single currency came as a natural culmination of the economic integration process, eliminating costs of conversion as well as risk of currency fluctuations. One was hoping for this to further enhance intra-EU trade, obviously at the expense of trade with outside countries. Empirical studies demonstrate this did indeed happen, though perhaps not quite as much as the most eager eurozone architects anticipated.

Another objective in the establishment of a single currency was to further pave the way for a fully integrated political union, with some central authority monitoring states' foreign and monetary policies and ensuring convergence and a common pan-European strategic direction. This has not quite materialised in the way the architects wanted, and where it has been established, it seems to have come about as result of crisis management rather than an organic process of political consensus.

A monetary union is something more extensive and dramatic than a customs and labour market union. Individual states use monetary policy in order to stimulate their economy in desired direction. For instance, if public debt should happen to grow out of hand, currency devaluation would be a natural remedy. Cuts in the interest rate can be used in order to stimulate investments when such are needed. The same goes for printing of money, so-called quantitative easing, of which the US Fed has undertaken a number of rounds, with certain effect.

When entering the eurozone, individual states voluntarily give away these instruments; pan-European monetary and interest rate policy decisions are now passed in Brussels, with each state having only marginal influence.

A Member State generally has the need for such instruments if, in a macroeconomic sense, it differs from its surrounding areas and trading partners. For instance, if inflation is high in your country, then a higher interest rate and a weakening trend of your currency is to be expected. With this logic in mind, it was natural that the EU at the outset required all eurozone-joining member states to comply with the *Maastricht Convergence Criteria*:

- Public deficit must be no more than 3% of GDP;
- Net public debt must be no more than 60% of GDP;
- Inflation must be no more than 1.5% above the average of the three existing eurozone countries with the lowest inflation rate;
- The long-term interest rate (10-year bonds) must be no more than 2% above the average of the three existing eurozone members with the lowest interest rate.

Whereas all current eurozone states at some point did adhere to these frames in order to be accepted as members (or at least managed to convince Brussels they did), the recent recession has put most member states in considerable breach with the debt criteria. The debt crisis aside, the general macroeconomic picture within the eurozone at large is increasingly heterogeneous, leading to different states and regions requiring different types of monetary policy remedies, whereas the European Central Bank can only execute one unified policy, and it is apparently becoming more and more difficult for that one size to fit all.

It is also worth remembering that, even with satisfactory convergence as per the Maastricht criteria, one should in general be cautious with setting up a monetary union across a domain with heterogeneous industrial structure. Although the needs in terms of monetary policy might at the outset be uniform, such needs would be at a greater risk of diverging in the future, pursuant to production-specific economic shocks.

Norway, being a natural resource-intensive economy, can serve as an example here. Even if Norway might have been macroeconomically similar to the rest of Europe today, this could change if the oil price suffered a shock, leading to divergences and, consequently, a need for country-specific fiscal policy measures, for which we require our own currency.

Croatia’s performance relative to the convergence criteria

Most eurozone members are currently in breach of one or more of the Maastricht criteria. This fact does not, however, seem to lower the threshold when it comes to potential new members’ required compliance with them. Croatia did in fact comply with the criteria in 2006, but things have changed since then, and an updated assessment is obviously going to have to be made before ERM2 commences. Let’s see how Croatia presently fares on the convergence criteria:

Public debt (threshold: 60% of GDP)

According to statistics from the Ministry of Finance as of October 2012, Croatia’s public debt amounted to EUR 23.2 billion, or 52.1% of GDP. Somewhat more than half of this debt is owed to domestic actors.

Hence, for the time being, Croatia complies with the debt convergence criterion as one of the best pupils in class. However, public debt has been on a steady rise in recent years; it was as low as 30% in 2008, and the criterion is likely to be breached within a year or two if this trend continues.

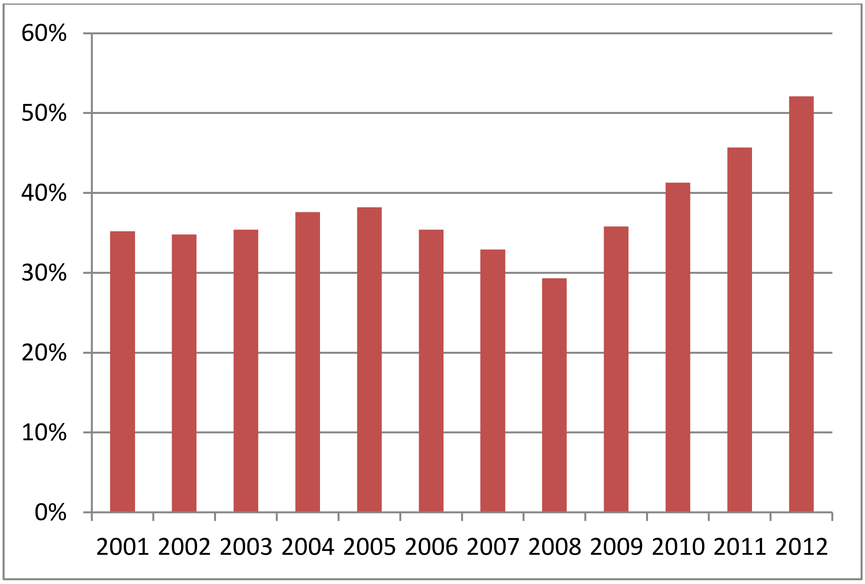

Figure 2: An increasing trend of public debt as % of GDP

Budget balance (threshold: -3%)

Public deficit soared following the 2008 economic crisis, but has in the last couple of years stabilized at 4-5%; in other words, not too far off the 3% benchmark. In order to curb the deficit, austerity measures[4] have been undertaken, pursuant to advice and/or

[4] The most important austerities introduced by the centre-left government in early 2012 include an adjustment of income tax rates tailored to favour the middle class at the expense of the wealthy, a tax on dividend payments, dismissals in the public sector, and reduced subsidies for the agricultural sector. The general VAT rate has been increased from 23 to 25%, and a 5% VAT has been levied on goods and services that were earlier exempted from such. Furthermore, the government intends to privatize the last two state-controlled financial companies, *Postanska Banka* and the large insurance company *Croatia Osiguranje*, during the course of 2013. Combined, the two companies are worth an estimated 270 million euro.

instructions from the EU in lieu of the forthcoming membership. Spread occurrences of protests have been sparked by such measures.

Inflation (current threshold: 2.6%)

Consequent to a worsening economic situation and a general downturn in demand, inflation has stayed moderate in recent years. It however rose significantly during the course of 2012.[5] The year-on-year inflation rate was around 5% until March 2013, but has dropped again in the latest months.[6]

Figure 3: Historical inflation rates.

[5] This rise in inflation is partly caused by increases in VAT rates, as well as a weakening trend of the kuna against the euro during the last year.
[6] Source: Trading Economics, http://www.tradingeconomics.com/

Interest rate on long-term government bonds (current threshold: 4.9%)

Both Moody’s and Standard & Poor’s recently cut Croatian government bonds to junk status, citing stalled recovery, lack of budget discipline, and vulnerability to external shocks.[7]

However, this does not seem to have raised the yield on such bonds dramatically. The long-term yield has stayed close to 6% over several years, and a ten-year 1.5 billion USD bond issued in late March 2013 achieved a lower than expected yield of only 5.625%. Propelled by the EU entry, willingness to utilize idle liquidity is apparently high enough to offset Croatian-specific risk.[8]

[7] Inflation and interest rate thresholds fluctuate, as they are set on the basis of averages of the three best-performing EMU countries. http://www.moodys.com/research/Moodys-downgrades-Croatias-government-bond-rating-to-Ba1-from-Baa3--PR_265054

[8] Source: EU Candidate and Pre-Accession Countries Economics, http://ec.europa.eu/economy_finance/db_indicators/cpaceq/documents/cceq_2013_q1_en.pdf

Other indicators

Although performance is decent on the Maastricht criteria, three other indicators are noteworthy in this context, raising concerns about the general health and temperature of the Croatian economy:

Foreign direct investment

The current level of foreign direct investment (FDI) is around 1 billion euro per year (2011-2012), comparing to 4 billion per year in the peak years 2007-2008.

This dramatic downturn is an obvious spillover from the European recession and has obviously been feeding the Croatian one.

While FDI has particularly plummeted in financial intermediation and wholesale and commission trade, the one sector in which the figure continues to rise is real estate. Austria is the biggest country of origin for FDI in Croatia.[9]

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[9] Source: Croatian National Bank (HNB)

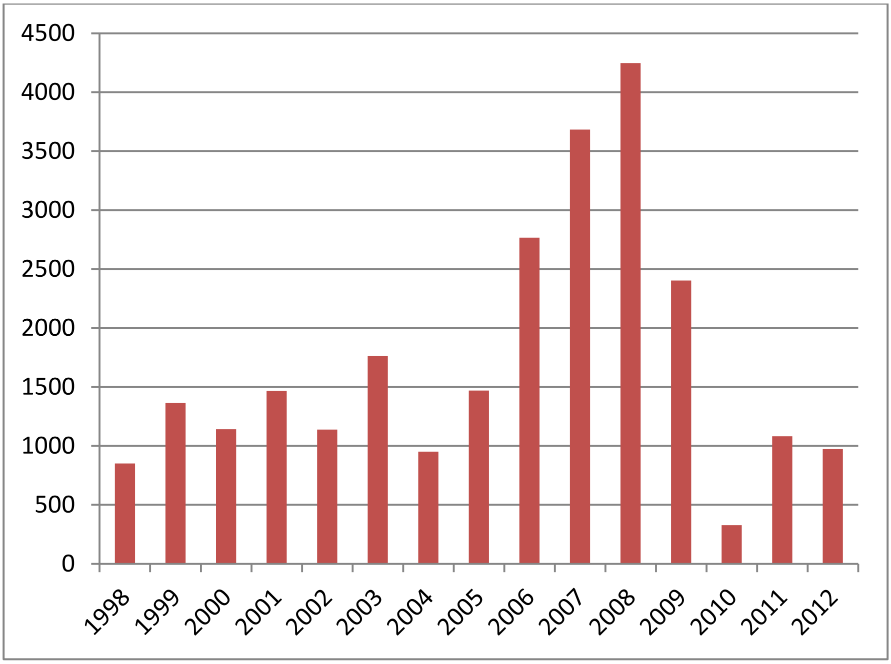

Figure 4: FDI in Croatia, million euro

Unemployment

At the turn of the century, official unemployment was closer to 20%, whereas the real figure most likely was even higher.[10] Visible improvements occurred thereafter, but following the post-2008 downturn, more than one-tenth of all industrial jobs have disappeared, and the situation is now back to early-2000 levels. This places Croatia third from the bottom in the new EU-28 club, with only Spain and Greece trailing. Actual youth unemployment is more than 40%. The rate is subject to visible seasonal trends, and typically at least 2% lower in summer than in winter.

[10] Source: Trading Economics, Croatian Bureau of Statistics.

Trade balance

Related to the labour market situation is the trade balance, which has for several years, also before the downturn, shown considerable deficit. Import per capita has traditionally been around twice the size of export.[11] In other words, Croats consume more than they produce, and this can only lead to increased external debt.[12] Before 2008, the official trade deficit amounted to some 10 billion euro yearly, equal to almost a quarter of GDP, but the figure has been somewhat reduced thereafter, due to reduced domestic demand and a consequent drop in import of goods, whereas exports have not fallen that much.

Being the clearly most essential trading partner, EU-27 executes around 60% of Croatia's imports as well as exports:

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[11] Source: Croatian Bureau of Statistics.

[12] External debt (i.e. what Croatia as a country owes to foreign banks and institutions) has doubled since 2005. This trend was actually most marked during the first years of the said period. Such debt now stands at almost 45 billion euro, slightly more than one full GDP (see figure 5 below), and is at end 2012 structured as follows (source: HNB):

- External debt of the central government: 11.8 percent of total external debt (5.15 billion euro),
- Foreign direct investment: 16.1 percent (7.37 billion),
- Banking sector: 22.7 percent (9.89 billion),
- Corporate sector and households: 49.4 percent (21.52 billion).

Towards eventual ERM2 launch, the convergence criterion regulates not *external* debt, but *public* debt; i.e. what the government owes, domestically or abroad. It does not, interestingly enough, care about the level of indebtedness of other sectors.

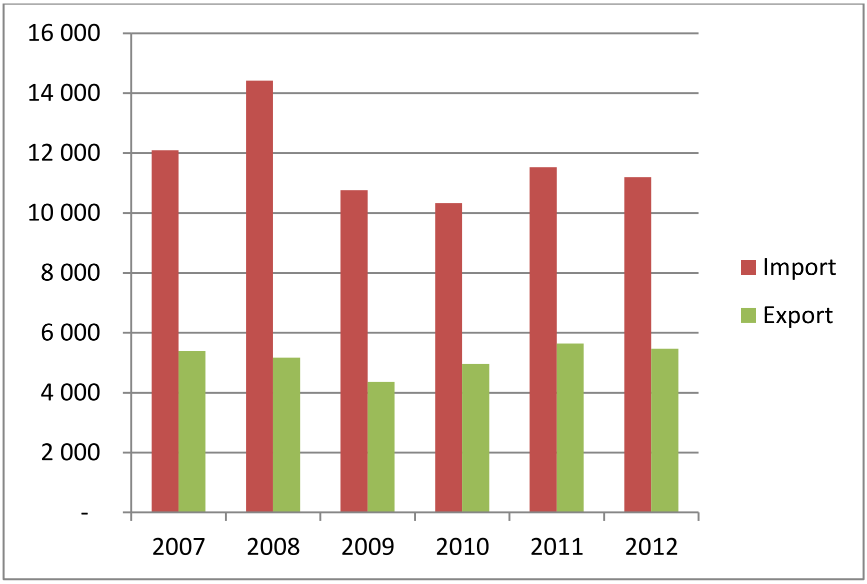

Figure 4: Croatian merchandise trade with EU-27, million euro

The abundance of labour force, and reasonably cheap such, could suggest that the other production factor, capital, is the prime bottleneck for export production.[13]

On a biannual basis, the European Commission issues a report on progress achieved by countries yet to adapt the euro. Apart from the Maastricht criteria, this report also takes into account unemployment, investment level, trade statistics and other factors relevant for convergence.[14]

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[13] Average net (after-tax) monthly salary in Croatia is around 800 euro, considerably lower than the EU-27 average, but comparable to peripheral members.
[14] See http://ec.europa.eu/economy_finance/publications/european_economy/2012/conve

These factors are not part of the formal convergence criteria. Nonetheless, the eurozone door guards can hardly be expected to look away when it comes to Croatia's currently somewhat dubious performance on these indicators.

What is for certain is that we are curious to see how the EU membership, now that it has finally been achieved, is going to play out on these dimensions of the Croatian economy over time.

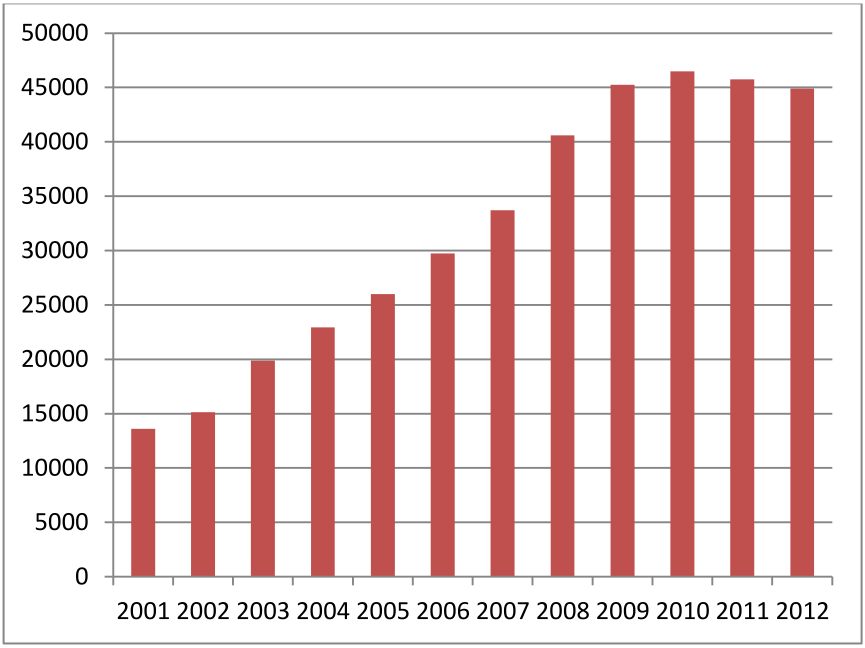

Figure 5: Total external debt, million euro

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rgence-report_en.htm. The next convergence report is due in 2014 and will also cover Croatia.

A stable exchange rate policy

The kuna has a long track record of stability against the euro. The exchange rate has remained around 7.30 kuna to the euro for more than a decade, and it is a stated objective of the Croatian National Bank (HNB) to retain this stability through 'managed floating'.

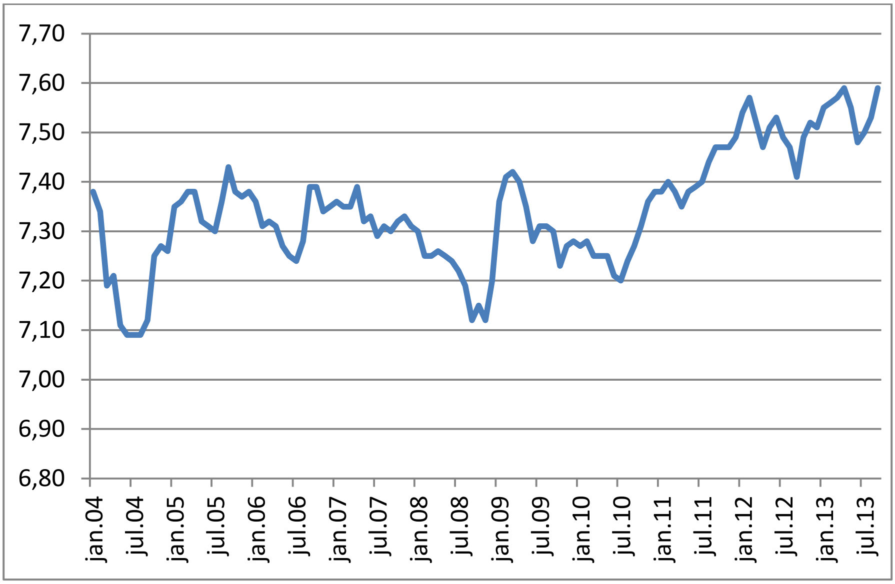

Figure 6: HRK/EUR exchange rate, 2004-13. Source: www.oanda.com

To this end, the bank from time to time intervenes in the foreign exchange market as required. The kuna seems to be subject to a downward pressure, and recent interventions of the HNB have consisted of selling foreign exchange in order to strengthen the kuna, more often than the opposite.[15] Despite these interventions, the kuna retains a somewhat weakening trend against the euro, and at the time of accession, it trades at around 7.50.

Exchange rate stability is, along with the four Maastricht criteria mentioned above, also a precondition for eventual eurozone entry, culminating with the two-year ERM2. However, the stability objective of the HNB may not only be a cosmetic measure for this purpose, as will be shortly discussed further.

The trade deficit is a clear indicator that Croatia is insufficiently competitive. The downward pressure on the kuna testifies to this understanding. With free floating exchange rates, the kuna would likely have been weaker against the euro than it currently is.

Such weakening is not only good news; for instance, it would make imported goods more expensive for the end consumer. However, the most notable positive effect is that competitiveness of domestic industry is enhanced, and production for export hence stimulated. A devaluation is like a slap in the face, really, making it painfully harder for people to consume imported goods, but pulling them up from the sofa and to work. A weaker kuna means that Croatian-made products would become cheaper in Europe, and an increased demand for such products would most certainly lead to increased investment. Factories would be popping up, generate jobs, and

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[15] From mid-2010 to end 2012, the record of HNB interventions shows a net sale of foreign exchange worth 10.7 billion kuna. A nonetheless weakening exchange rate suggests the recession exercises an intensifying downward pressure on the kuna.

contribute to a reduction in the current trade deficit and increasing debt level.

As mentioned above, such devaluation is exactly what Italy repeatedly did with the lira, in order to enhance competitiveness. Were Greece to leave the eurozone, the consequence would be an instant devaluation of the new drachma. Heck, even the greater powers of the world are in constant competition against each other to weaken their currencies, exactly for this reason. China is more or less universally condemned for keeping its currency artificially weak.

So what’s so special with Croatia, in that it apparently struggles so hard to avoid the kuna dropping against the euro?

Industrial sectors and a divided economy

A closer look at the production landscape and breakdown of GDP seems to support the idea.

The trade deficit is particularly large when it comes to industrial goods, such as fuels and mining goods, machinery and transport equipment, chemicals, textiles, and agricultural products. All such ‘manufacturing sectors’ would benefit from a weakened kuna, so as to enhance competitiveness and productivity.

On the other hand, the trade balance is in fact positive when it comes to commercial (i.e. excluding government) services. Croatia exports well more services than it imports. In fact, the Croatian economy is strongly service-driven; more than two-thirds of GDP consists of services (increased from 54% twenty years ago), whereas conventional industry counts for 27%, and agriculture for only 6% (compared to 10% in 1991).[16] Total export of commercial services amounts to some 9 billion euro yearly.

[16] This is quite similar to the euro area, with the exception of the agricultural sector which counts for only 2% of the EU’s GDP. Source: DG Trade.

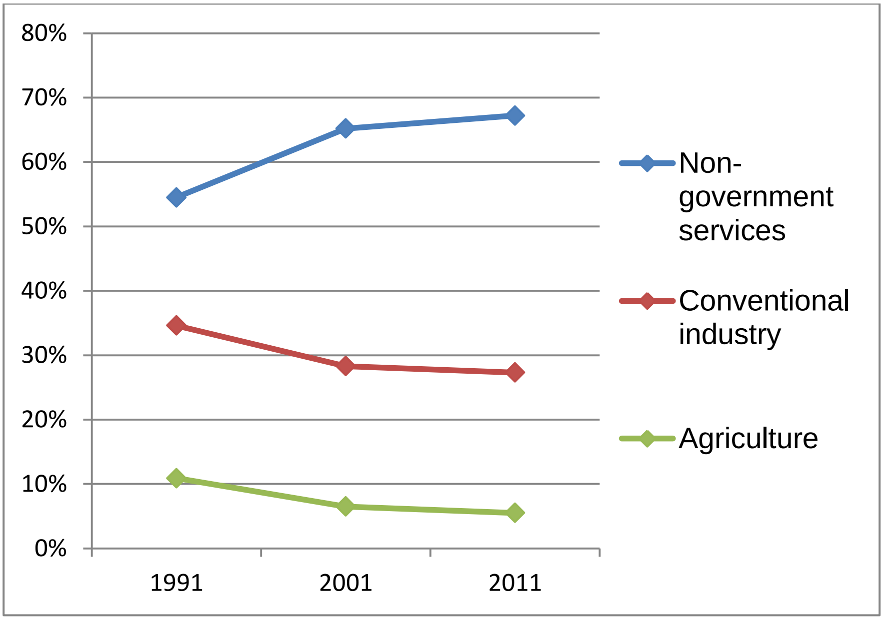

Figure 7: Breakdown of GDP on production sectors. The portion of GDP generated by services has gradually increased after independence was achieved in 1991.

A large portion of these services is produced by the part of the sector representing Croatia's greatest competitive asset: its beautiful coast, consisting of some 1800 islands out of which 48 are permanently inhabited. Each year, some 12 million foreign tourists visit Croatia, and spend close to 60 million nights there; these figures increasing by some 5% each year. The tourist industry accounts for some 20% of GDP, and is for the most part considered export, hence greatly reducing the trade deficit.[17]

[17] Source: Croatian Bureau of Statistics.

It seems clear that the tourist industry would indeed be *the* comparative advantage of Croatia in an open European market. This sector stands well on its own feet already, and will do so even better as the integration moves ahead and the market comes closer. Infrastructure is well-developed, investment-strong foreigners are present, etc. It is not unreasonable to believe that the tourist industry will continue to grow now that the EU membership is realized, removing any remaining technical obstacles to visits and investments by European citizens.

This industry is also less likely to be subject to ordinary vulnerability to economic cycles, as the 'market' consists of wealthy tourists with strong purchasing power, which was demonstrated by the fact that the number of tourist nights did not drop significantly during the post-2008 recession.[18] Assuming no new Balkan wars, it is difficult to imagine sector-specific shocks.

A weakened kuna would be good news also for the tourist 'export' industry. Each euro brought to the country by foreign tourists would purchase more kunas. Vacationing in Croatia would hence become cheaper and (even) more attractive for them.

[18] The one sector in which FDI has *not* dropped significantly since 2008 is real estate, obviously to a large extent consisting of foreigners purchasing property on the coast. This testifies to the relative resilience of this market segment against the ongoing recession.

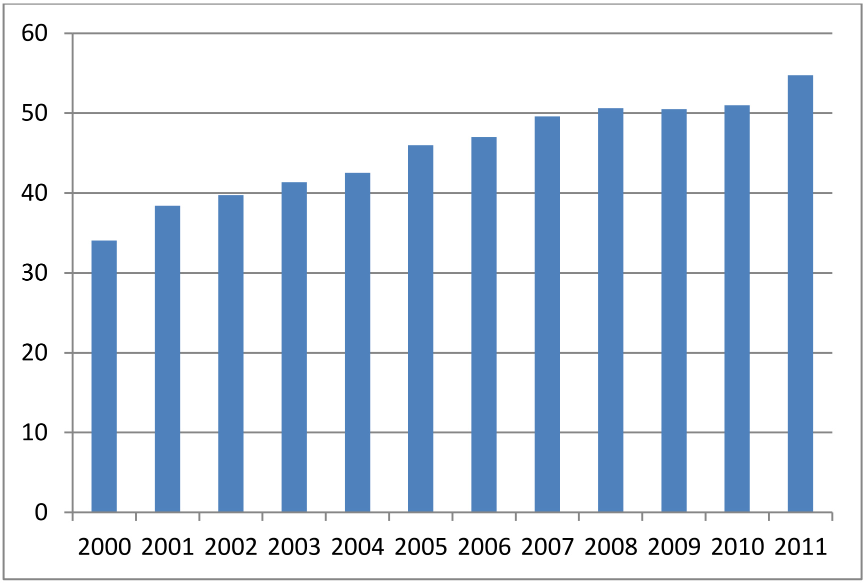

Figure 8: Tourist nights per year, million (non-Croatian citizens only). Not bad for a country with 4.4 million inhabitants!

At the same time, one should be reminded that the tourist industry is unevenly distributed and naturally concentrated at the coast. But Croatia is much more than the coast. For instance, Istria county counts for a full one-third of all tourist nights, and Primorje-Gorski Kotor has 20%. At the other end of the 22-county list, the five counties of Pozega-Slavonia, Bjelovar-Bilogora, Koprivnica-Krizevski, Virovitica-Podravina, and Slavonski Brod-Posavina all count for less than 1% of incoming tourist nights. Unless thorough revenue redistribution mechanisms, the rest of the country hence does not reap its share of the tourist industry benefits, while at the same time, it is left struggling with the aforementioned lack of productivity in other production sectors.

This suggests regional inequalities are likely to have increased along with the emergence of the tourist sector.

Adding to this concern is the fact that research[19] indicates Croatia has a grey economy amounting to almost 30% of GDP. Out of the current 27 member states, only Lithuania, Estonia, Romania and Bulgaria are matching this figure. Although this does improve the otherwise sad official trade balance[20], it also means that a great deal of income is not made subject to various forms of taxation and redistribution mechanisms, hence likely to leave social inequalities greater than suggested by official statistics.

There is furthermore reason to believe that a relatively large share of this grey economy occurs in the tourist industry, where products consist of services such as (well-priced) budget accommodation, restaurant services, taxis and excursions, purchased by foreigners on private holiday who often pay in cash and don't request proper invoices. Another industrial area with a historically large grey economy is the construction sector, which is also tourist-heavy.[21]

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[19] ATKearney: *The Shadow Economy in Europe, 2013*. Croatia has a grey economy estimated at 13 billion euro per year, on top of an official GDP of 45 billion.

[20] While Croatia's trade balance runs a clear deficit, the current account balance is close to zero; an indicator suggesting that a great deal of incoming transfers represents grey economy revenue.

[21] EU citizens are heavily represented as purchasers of the services in question, so the EU has good reason to assume some responsibility to coordinate with the Croatian government and push for measures to tidy up in the shadow economy.

The actual difference in wealth between the touristic areas and the rest of the country is hence likely to be greater than what can be seen from official figures.[22]

While in the eastern parts of the country, production mainly consists of retail goods and agricultural products. In these sectors, there is an undisputed trade deficit and, consequently, rising public and private debt levels. Croatia is certainly a 'divided' economy, less industrially and macroeconomically homogenous than many other EU countries.[23]

Small and medium-sized firms are crucial as drivers of economic growth in Europe. The EU seems to understand the need to arrange schemes to boost youth employment and investment in such firms in many areas in its periphery, especially in its southern member states. Croatia and especially its non-touristic regions shall prove no exception.

For the purpose of enhancing competitiveness in small and medium-sized firms in the non-tourist industries, we suggest the following areas of priority when the welcome package is distributed:

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[22] Croatia's overall Gini coefficient (after taxes and transfers) has increased from 0.23 at the end of socialism, and is now officially 0.32 (Croatian Bureau of Statistics). This seems quite similar to mainstream EU. However, we believe the actual degree of social inequality in Croatian society is somewhat larger.

[23] Such economic division does entail a potential for 'resource conflict', i.e. disagreement as to the extent to which the tourist industry revenue should be distributed also to those citizens who don't contribute to it, likely to increase as the coast continues to boom. This tension might well be easier to manage when it is being placed under the auspices of a greater political and monetary union.

- Conventional export industry needs modernisation. To this end, capital seems to be the bottleneck, not labour.[24]
- Facilitate those investments which today are needed but lacking. Prioritise new machinery for factories and the agricultural sector, to enhance resource utilisation and productivity.
- This should occur in concert with increased emphasis on R&D and technological development.[25]
- Continue the simplification process for founding of new companies and self-employment.
- Entrepreneurial skill is an important factor for innovation and competitiveness. To this end, one should also increase awareness about the benefits of lifetime education.

It should also be mentioned these not-so-competitive sectors and regions are likely to suffer from the EU membership erecting new tariff walls. When entering the EU, Croatia is forced to leave the CEFTA free-trade treaty with the other ex-Yugoslav candidate states. There is considerable trade with these countries (Bosnia-Herzegovina in particular). This is bad news for businesses on both sides.[26] Furthermore, more than being excited about access to sell their products on the European market, the majority of farmers and

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[24] Croatian access to the European credit market is a good thing for this purpose. However, in this regard, the 1st July membership hardly brings about anything revolutionary new, due to the already highly euroized banking and financial sectors.

[25] Croatia has committed to raise investment in research and innovation to 1.4% of GDP by 2020, which should be facilitated by the welcome package and participation in the European Commission's *Horizon 2020* research framework programme.

[26] Such trade barriers would also risk having an adverse effect on (still ongoing) post-conflict normalization processes.

factory owners rather seem to fear the entry of competing and subsidized products from Hungary, Austria and elsewhere. There was ample opposition against EU entry from these actors.

In the eventual case of full eurozone membership, any prospects of currency weakening, for the benefit of export production, would obviously be buried for good.

So, again, why is the government so reluctant to allow a weakening of the kuna, prior to such membership?

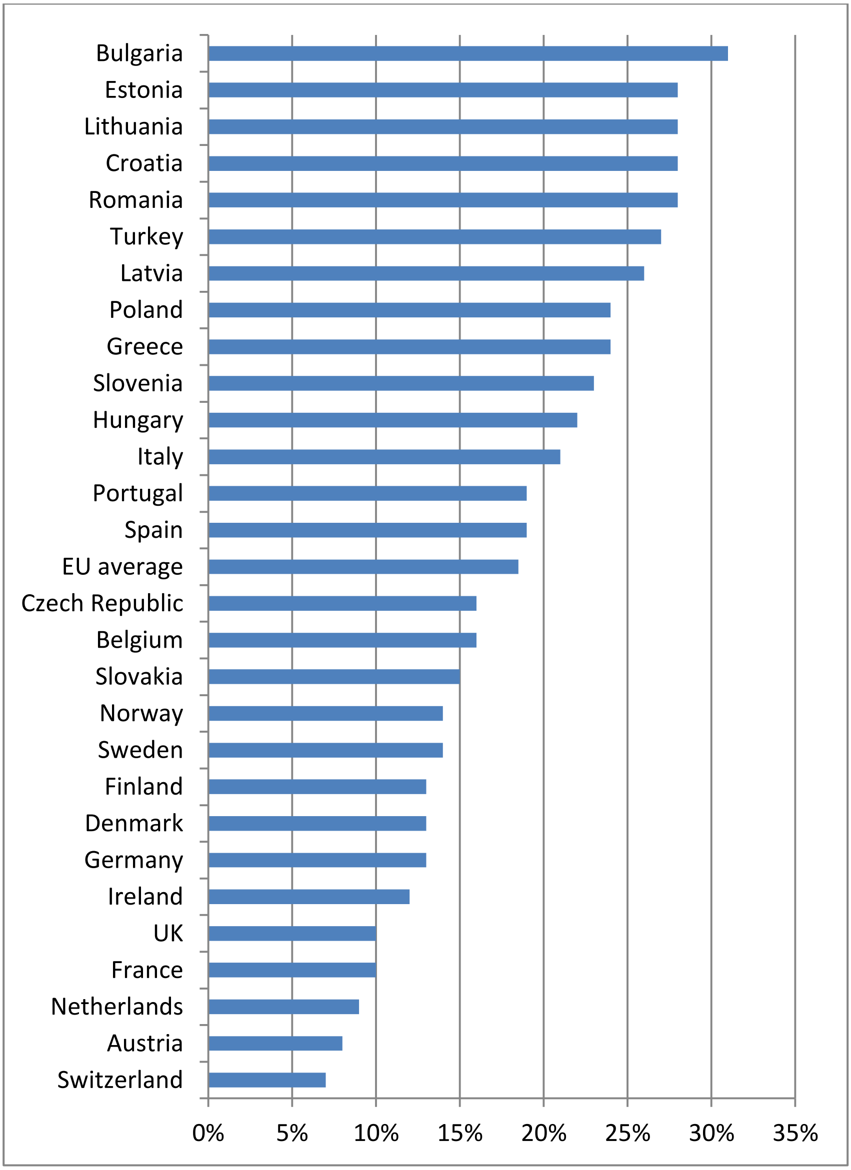

Figure 9: AT Kearney's estimated size of the shadow economy in various European countries.

Euroized indebtedness

The answer may lie in the fact that the Croatian economy already is greatly euroized; notably, the credit market.

The Croatian private sector is indebted like the rest of Europe[27], with gross debt of corporations and households amounting to 124% of GDP.

For several years now, banks have offered credits with euro denomination, at favourable terms. The interest spread is around 2.5% smaller for euros than for kunas, obviously as a result of the banks having access to cheap euros from the ECB (almost all banks in Croatia are branches of foreign banks[28]). The interest rate on kuna loans is hence more than 2% higher than on euro loans.[29]

The market has duly responded. Approximately 65% of government debt, 68% of the debt of the corporate sector, and 77% of that of households, is as of early 2013 denominated in euros.

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[27] As far as private sector indebtedness is concerned, Croatia won't at the outset be a particularly black sheep in Europe. Comparing to the rest of the EU, we observe that the Croatian figure is similar to Estonia, France, Italy, Latvia, Germany and Hungary, and significantly inferior to only Lithuania, Poland, Romania, Slovakia and the Czech Republic. The worst European cases are Ireland, Cyprus, Denmark, Netherlands, Portugal, Sweden and Spain, where private sector debt amounts to more than 200% of GDP. Sources: HNB, Eurostat.

[28] These foreign banks are mainly Austrian and Italian ones. In recent years, Russian and Turkish capital has also been penetrating aggressively in Croatia (Sberbank and Kent bank).

[29] According to the National Bureau of Statistics, average credit rates are 9.35% (kuna) and 7.15% (euro).

We can now gather it is not only the traditional inconvenience of increased domestic inflation that compels the central bank to maintain a stable HRK/EUR exchange rate. A scenario has namely emerged where **credit takers are heavily exposed to currency fluctuations**.

With the exception of certain segments of the tourist industry (especially the grey ones), credit takers serve their loans by means of income in local currency. A weakening of the kuna would increase the size of credits and make them harder to serve. Consequently, when the kuna now marginally weakens against the euro, private sector debt simultaneously increases by almost the same percentage. The government is also exposed.

The consequence would be increased inability to serve credits, and in turn bankruptcies and foreclosures, exactly in the sector which least needs it; namely, where export production-stimulating investments have taken place by the aid of those credits.

Furthermore, such development would likely have an anti-social effect. Those with assets and/or income denominated in euros would of course only be happy[30], but the bad news would remain with the indebted actors, hence increasing social inequalities.

One may argue that such actors must only reckon with currency fluctuations, and that they were willingly aware of the risk of such,

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[30] Deposit interest rates in banks are practically identical for kuna and euro. Nevertheless, according to the HNB, 85% of all retail deposits are also denominated in euro. The market obviously considers a depreciation of the kuna to be more likely than the opposite, despite the government's woes to keep the exchange rate stable.

at the time when they decided to take their euro credits. This being said, the sheer volume of such credit has made its holders into a strong lobbying group, rendering a change to the HNB’s currency stability policy anything but politically straightforward. The political establishment, including the governor of the central bank[31], is clearly of the opinion that competitiveness needs to be achieved by other means.

For the time being, the strategy therefore seems to eagerly await the forthcoming completion of eurozone integration, hoping it will lead to cheaper access to credits to get investments going[32], supported by the welcoming package and eventual elimination of exchange rate risk. In conjunction with such energy injection as this would represent (and this also goes for conventional production sectors), a continued boom in the tourist industry is to be expected. These two factors may lead Croatia towards a closure of the trade deficit.

In the meantime, there is the revenue from the grey sector, which often comes in euro, drives domestic demand, and eventually to some extent reaches official financial institutions and the government. Croatia’s foreign exchange reserves, amounting to

[31] See http://dalje.com/en-croatia/governor-urges-structural-reforms-consensus-on-main-goals/453848

[32] It should be noted that even full eurozone membership does not necessarily entail a reduction in the interest rate all the way down to ECB levels. The fact that the interest on euro credits in Croatia is still around 7% (and more than 9% on kuna loans) indicates a significant presence of country-specific risk, founded in the real economy where many sectors are characterized by indebtedness and lack of productivity; problems that won’t be solved overnight as consequence of such membership.

slightly more than 20% of gross external debt (or GDP), are indeed not about to run dry, ref. the figure below.

This inflow of foreign exchange facilitates the central bank's ability to regularly intervene and purchase kuna in order to keep it stable against the euro.[33]

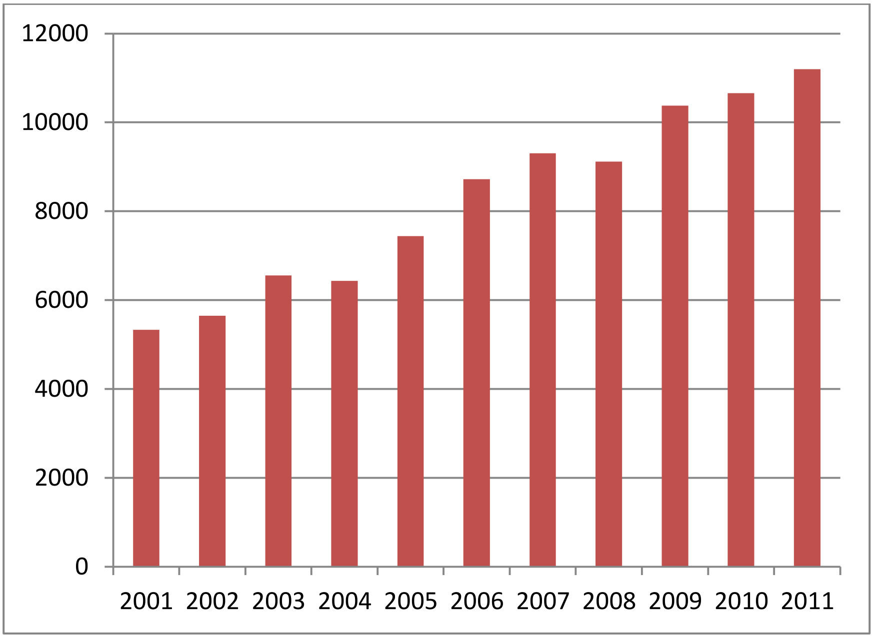

Figure 10: Gross international reserves, million EUR, at end of year

So the exchange rate policy remains stuck in the middle. On the one hand, a weakening of the kuna would be desirable, in order to stimulate investments and increase productivity. On the other hand,

[33] Over the period 2005-2012, the average exchange rate has been 7.40 in mid-winter, and 7.30 in mid-summer; reflecting the fact that inflow of foreign exchange is greater during the tourist season. Source: HNB.

exactly because of debt euroization, such devaluation would be most unfortunate news for the indebted parts of society, entailing increased frequency of credit defaults on all levels, with the well-known circular effects to all parts of the economy, including the banks. Any political signal merely *suggesting* a move towards a free-floating currency policy would trigger market reactions stimulating the kuna weakening and exacerbating such effects.

A conventional tool for mending the export sector is available, but it can't be used, because the cure is as bad as the disease.

A limbo with stagnation effects?

It hence seems that most stakeholders would indeed favour eurozone membership, without any kuna devaluation beforehand, to take effect as soon as possible.

A few examples in order to illustrate the consensus:

- Euro credit takers would like to achieve an elimination of the exchange rate risk associated with their debt as soon as possible.

- Those credit takers who still prefer kunas and accept a higher interest rate due to risk aversion would also be pleased to see such addendum disappear. Only in those cases where they have their income in euro would such credit holders want to see a kuna devaluation, but this is hardly a common scenario.

- As for depositors, a weakening of the kuna could at the outset be good news for those with assets denominated in euro, but first priority for this wealthy segment is likely to get the full integration with the European market completed as soon as possible. Any currency fluctuations will signify lack of convergence and effectively delay euro adoption, so the present stability policy is to be preferred.

- Banks are not in favour of devaluation and the increased frequency of defaults it would entail. Also for the banks, eurozone entry and elimination of currency risk is on top of the wishlist. The current risk and everyday conversion hassle likely outweighs the revenue these actors may be able to earn from foreign exchange trading.

- The EU is above all eager to get the prestigious project landed successfully. While one is well aware of the risks associated with prospective EMU members rushing their adherence unduly, Croatia's ability to maintain exchange rate stability is an indicator of readiness which is viewed favourably by Brussels, and it seems that no particular actions are likely to be imposed.

- Due to the trade deficit on consumer goods, devaluation would also have an anti-social effect. A great deal of food and textiles are imported, and devaluation would raise the local price of such imported necessities, which would hit the poor (who spend a greater deal of their household budget on such necessities) harder than the rich.

Also, public opinion on this matter doesn't seem to be much influenced by the eurozone's own financial troubles.[34]

Indeed, there does not seem to be any significant groups opposing Croatia's joining the eurozone as soon as possible, and with today's exchange rates.

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[34] Croatia as eurozone member would need to contribute to the European Stability Mechanism (ESM), ref Article 136 of the Treaty. With the current dimension of such stability mechanism, this is likely to entail some €1bn one-off payment, with another 9 bn 'capital subscription', i.e. commitment to raising such contribution by means of issuance of ESM obligations for capital markets, if it should be deemed necessary by the EU.
http://www.esm.europa.eu/pdf/FAQ%20ESM%20041020121.pdf

We maintain, however, that such approach does represent a stalemating and indebting dynamic.

The trade deficit is still there, officially for the entire country, and in reality at least in the non-touristic areas. When such deficit is not mended, the only logical consequence is an increasing debt level. Notwithstanding continued growth in the tourist industry; in order to close the trade deficit and handle the increasing debt, it looks as if a kickstart of the non-tourist industry is required. Devaluation appears to be a well-deserved measure for a currently non-productive Croatian population.

However, the already far-achieved euroization of the financial market, and notably the exposure of debt to currency fluctuations, compels the central bank to combat a weakening of the local currency, at all costs. Consequently, the manufacturing industry doesn't receive the energy injection it needs, trade deficits and high unemployment will continue, and public and private debt will grow further, as will regional inequalities.[35]

As result, the desired relief, in the form of the eurozone membership everyone is waiting for, is at risk of running into complications, as this indebting dynamic will over time render it impossible for Croatia to remain in compliance with the debt convergence criterion. Although the country is at the moment nowhere near such a debt crisis as many of its European comrades suffer from, we did already

[35] We assume a certain spillover of such regional trade deficits to public balance sheets. Although the income from the large grey sector might partially offset the official trade deficit, we also assume that a larger part of such income stays with the wealthier part of the population, thus insufficiently benefiting the government and indebted private sector actors.

see various forms of debt on a clear increasing trend (ref. *Figure 2* and *Figure 5* above).

It's a paradox, really, to observe that it is exactly the already far-achieved adherence of the credit market to euroized conditions that creates a vaccination against a monetary policy which would otherwise be natural, and perhaps even necessary in order to acquire full eurozone membership.

Indebting, you said?

Prospects

Assuming that the market indeed does exercise a downward pressure on the kuna:

If eurozone membership were to be achieved without devaluation, then we would have a conversion where debt is artificially low. The cost level would similarly be too high and Croatian products would remain less competitive on the European market, but one is obviously aiming for enhancing such competitiveness by other means, and/or to defer the entire problem until intra-eurozone forces would be put in motion to correct it.

This strategy for getting away with a reduced debt burden could appear to be a viable plan when Croatia complied with the Maastricht criteria back in 2006. However, as of today, most indicators, especially the debt ones, are pointing in the wrong direction and it seems increasingly unlikely that eurozone entry can be realised by means of a continued ‘do nothing’-policy.

On the other hand, currency weakening drives inflation; another Maastricht criterion which Croatia is already periodically in breach with. This makes it intuitive to conclude the economy is simply not ready for ERM2.

Furthermore, it is difficult to see how such readiness can be achieved if the present policy continues. Monetary policy can be an effective instrument for achieving desired effects on society and economy. However, in this regard, the central bank’s hands are tied by its independent commitment to exchange rate stability, so it is insufficiently able to undertake measures needed in order to stimulate competitiveness in the manufacturing sector. As result, nothing gets mended, and essential macroeconomic arrows will continue to point away from the common currency goal.

That is, unless the very 1st July membership itself were to turn things around in a surprisingly positive fashion. We are indeed likely to see effects. Conclusions can’t be drawn for some time yet, but the membership is certainly going to represent an exciting energy injection for many sectors of the Croatian economy. This although it is not yet accompanied by what might have been even better news; namely, a proper economic recovery in the EU at large.

Following the developments ahead shall prove most interesting.

Recommendations

Exchange rate policy

- Assuming a continued policy of clinging to stable exchange rates is unviable from a debt management perspective and hence also towards eurozone membership, the central bank should consider allowing a gradual weakening of the kuna, in line with the market pressure.

- In order to ensure a ‘normalized’ conversion rate, the EU ought to consider requesting a period with a properly floating kuna, before admitting Croatia to ERM2.

The tourist industry

- Croatia’s primary comparative advantage. Policy should aim to support continued growth, while making sure the environment and ‘natural beauty’ is protected.

- Efforts to combat the grey economy should especially target the tourist industry, as this is where most windfalls can be expected.[36]

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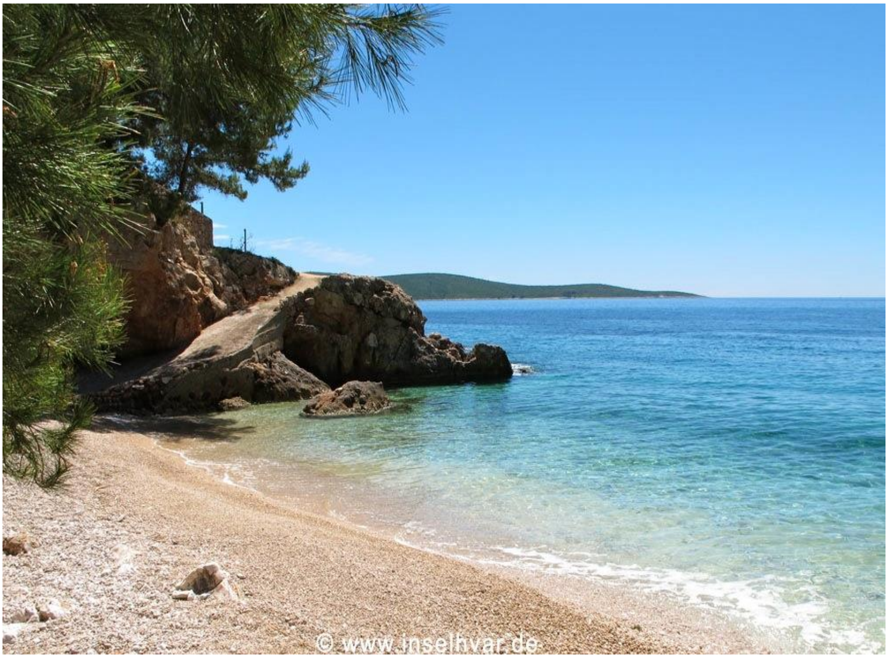
[36] For specific measures, we refer to AT Kearney’s report *The Shadow Economy in Europe 2013*. A successful reduction in the grey economy would also shift much foreign exchange revenue to official sectors and ‘legitimize’ regular kuna purchases undertaken by the central bank, rendering the current exchange rate more credible for ERM2 admission.

Productivity of the manufacturing sector

- Small and medium private enterprises are main drivers of recovery and growth, and ought to be given due priority when the welcome package is distributed.

Trade with third countries

- We recommend the EU allows operationalization of Croatia's withdrawal from CEFTA to be as soft as possible. This also in solidarity with other potential candidate countries.



No aggressive investors needed here, thanks!