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## **Croatia: the prospect of adopting the Euro in times of the COVID-19 pandemic and the recent earthquakes**

**Prime Minister Andrej Plenković leads the country through a series of disasters that hit Croatia last year – the COVID-19 pandemic and a series of earthquakes in Zagreb and central Croatia. Nevertheless, the project to adopt the euro as the official currency in 2023 remains a key element of his government’s program. Expected economic difficulties may, however, force Plenković to revise his plans.**

On July 7, 2020, Croatia joined the (European) Exchange Rate Mechanism, ERM II, declaring its willingness to replace the Croatian Kuna with the common European currency. Joining ERM II means that one of the four economic requirements set out in the Maastricht Treaty (exchange rate stability) has been met. In addition, the Croatian government has committed itself to: a) maintaining price stability with an inflation rate of no more than 1.5 percentage points above that of the three most developed Member States; b) ensuring that the budget deficit does not exceed 3% of GDP; (c) maintaining long-term interest rates at no more than two percentage points more than the rate of the three best-performing member states in terms of price stability. In practice, this means a policy of making budget cuts, maintaining a rigid exchange rate for the Croatian Kuna (HRK) and establishing a low rate of inflation.

The fast pace of integration with the Euro area and the ambitious reform program are complemented by plans to modernize the Croatian economy and efforts to make better use of EU funds, which were to act as a substitute for reducing public finances. In principle, this policy should attract investors and become an incentive for the development of entrepreneurship outside the tourism sector.

**Problems.** However, Croatia has experienced unforeseen difficulties that mean serious losses for the Croatian economy – the COVID-19 pandemic and the earthquakes that struck Zagreb in March 2020 and central Croatia in December 2020 and January 2021.

According to the data of the Croatian National Bank (HNB) from the end of December 2020, the reduction in real GDP for the whole year may be slightly higher than the latest forecasts and reach 8.9% of GDP. It is expected that in 2021 the pandemic will be managed relatively effectively, and thanks to the use of vaccines it will be possible to gradually revive economic activity as early as the second quarter of the year. Annual GDP growth in 2021 may amount to 4.9%. Employment fell by 1.5 percent, but the unemployment rate, although rising, remains relatively low at 7.5%. Inflation is expected to drop to 0.2% in 2021, mainly due to the significant reduction in energy prices (especially petroleum products) compared to the previous year. The balance of payments recorded a decline in the current- and capital account, mainly due to a significant decline in revenues from tourism. In 2021, the budget deficit is planned at 2.9% GDP, with an assumed GDP growth of 5%.

The Croatian government has adopted a total of 63 measures to combat the economic aftermath of COVID-19 lockdowns. First, income tax payments for legal and natural persons as well as health and pension insurance contributions have been deferred. Liquidity loans were approved to pay wages to employees. Municipalities and cities received interest-free loans. Enterprises, in cooperation with commercial banks, were allowed to operate in stand-by mode. Small business loans have been provided. There were also provisions for the tourism industry, such as fees being waived for transport companies. The Ministry of Agriculture has prepared a financial package worth approximately EUR 46 million. The efforts made were accompanied by appropriate measures by the Croatian National Bank to meet the liquidity needs of the economy.

During the pandemic, on March 22, an earthquake struck Zagreb, resulting in damage to approximately 26,000 buildings in the Croatian capital, including numerous public buildings in the city center. As a result two additional earthquakes in December, 2020 and January, 2021, virtually the entire region around Petrinje in central Croatia was destroyed and requires complete reconstruction. The earthquake was so strong that it could be felt both in Rijeka on the Adriatic Sea, in Belgrade, and other places hundreds kilometres away.

It is estimated that the losses caused by the COVID-19 pandemic will cost the state budget about EUR 4 billion, and the earthquakes in Zagreb, EUR 10.5 billion. The damage caused by the Petrinja earthquake has not yet been assessed. The EUR 700 million which Croatia received in EU aid and the EUR 11.62 billion secured in the European budget for 2021-2027 are therefore not sufficient to cover the damage incurred in Croatia last year. Moreover, the earthquake scared away some potential investors.

**Three scenarios.** Croatia's adoption of the Euro on time (2023) is therefore now under threat. There are three scenarios for the development of events in the next two years. The first assumes that Croatia would suspend the integration process with the euro area and remain in ERM II "for the time being". This would make it possible to increase public debt and to dispose of its own currency more freely. It would, however, violate the conditions that the Euro Area expects from countries aspiring to adopt the single currency. The assumption is that membership in the Euro Area would provide the state with economic and financial stability and the conditions necessary for sustainable development, as both Prime Minister Andrej Plenković and the President of HNB Boris Vujčić strongly believe. They devoted the last four years of their activity to this project. The scenario of halting integration with the euro area is therefore only likely if Plenković is forced to do so for political reasons or by a deep economic crisis.

The more likely scenario is a gradual abandonment of reforming public finances and limiting inflation in favour of the active involvement of the state in the process of economic reconstruction and transformation, even if it would mean postponing the accession to the Euro Area by a year or two. Such a scenario would enable faster economic growth. However, with a series of five tax-reducing reforms carried out, success would depend on the efficient use of European funds. Croatia is forced to attract investors, who, however, do not always correspond to the strategic assumptions of the Croatian government, which aims to modernize the country's economy. In these circumstances, the opening of the LNG terminal in Rijeka is extremely valuable as it enables officials in Zagreb to raise additional funds. An important element of this scenario is possible relaxation, even if informally, of the Euro Zone's expectations towards Croatia. Such a development of events would change the rules of the game and Croatia's prospects for adopting the common currency. These changes would result from two premises. First, the Croatian authorities and the Croatian National Bank showed high level of professionalism and determination with regard to their plans to adopt the Euro. Second, the Euro Area needs to send a positive signal to global markets.

The third scenario is the continuation of the current monetary and economic policy, the success of which was already compromised by a high degree of risk before the COVID-19 pandemic and the devastation caused by the earthquakes. It resulted mainly from the poor condition of the Croatian economy. At present, the risk of an economic slowdown, as well as rising unemployment and further emigration of the workforce to Western Europe, are even higher. Effective economic reforms can turn out to be very politically costly. This scenario is made more realistic by the fact that the next elections in Croatia are scheduled for 2024, and the government may count on a partial easing of the pressure from the Euro Area, as already mentioned above.