



# PRACE

Institutu  
Europy  
Środkowej



Jan Muś

## **Introduction of the euro in Croatia. Challenges and opportunities**



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## ■ Résumé

Adoption of the euro as an official currency and joining the economic bloc of the Eurozone are perceived by the Croatian authorities as complementary to the European integration process. The process of adopting the single currency and related policy results to a large extent from the beliefs and determination of Prime Minister Andrej Plenković and the Governor of the Croatian National Bank, Boris Vujčić.

The economic changes experienced by other Central European countries since the 1990s – characterized by income from foreign direct investments and the restructuring of the economy - have largely bypassed Croatia. Joining the monetary union is intended to enable Croatia to catch up to these processes. It is this issue, i.e. the economic development of Croatia, that is the real subject of the dispute over the adoption of the common European currency. Sceptics believe that adopting the euro at this point in the country's economic development will have a retarding rather than an accelerating effect that supporters of joining the Eurozone believe will transpire.

The adoption of the euro is also associated with the requirement to consolidate public expenditure, but many observers see the necessity of the state's active involvement in economic stimulation. There are three factors that support such an approach: the need to reorganize the structure of the Croatian economy, which relies too much on tourism; economic stimulation after the COVID-19 pandemic; and the reconstruction of areas damaged by earthquakes that hit Croatia in 2020.

The process of effective integration of Croatia with the Eurozone is also aimed at strengthening the position of Croatia within the international arena, as well as strengthening Andrej Plenkovic himself and Boris Vujčić.

The debate on the euro in the public space is dominated by the Croatian government and the Croatian National Bank. These two entities largely determine the arguments for and against the introduction of the euro, and arguments in favour prevail. Information about the expected price increases is usually made public as examples of major negative consequences. Consequently, the citizens perceive potential price increases as the main negative effect of the introduction of the euro.

Proponents of the euro argue that joining the Eurozone will allow Croatia to strengthen its economy, attract investment, and guarantee a higher level of economic stability. They indicate that thanks to this, Croatia will be able to enter the path of sustainable development and make a thorough economic transformation in the direction marked by globalization. Lowering the cost of debt by domestic sectors of the economy, eliminating foreign exchange risk, and reducing the risk of a financial and banking crisis are important arguments used by the Croatian authorities in the debate on joining the Eurozone, as is access to additional financial assistance mechanisms.

A few institutions and organizations remain sceptical about joining the Eurozone. These are mainly people from academia who warn against the possible negative effects of introducing the euro too early. There are also people and organizations warning that Croatia is entering the Eurozone too early, without proper preparation, and with a weak economic structure. They argue that there is a lack of supranational institutions and resources at the EU level to adequately assist in crisis situations, such as the one that happened in 2008/9. However, in Croatia there are no serious and organized initiatives that oppose joining the Eurozone, call for the initiative to be postponed, or call for a referendum. This state of affairs may change in the middle of this year.



The arguments against joining the Eurozone or delaying accession relate to the loss of sovereignty in the conduct of economic policy and the lack or inadequacy of supranational instruments and intervention mechanisms designed in accordance with the principles of solidarity.

It is uncertain what position will prevail in the European Commission and the European Central Bank (ECB) as a result of the ongoing crisis. Will the austerity requirements that marked EU institutions and the actions of the ECB during the previous two crises return? Following this logic, instead of joining the Eurozone, Croatia should first strengthen its economy and only then adopt the common currency. Otherwise, it will lose its ability to develop economically and catch up with other EU countries.

Public opinion is ambivalent about adopting the euro. A deterministic attitude to international politics and an awareness of the lack of an alternative to European integration are mixed with the need to carry out reforms and ensure economic development.

## Introduction

This work deals with the problem of adopting euro as the official currency by the Republic of Croatia. The accession of this country to the monetary union will mark an important step towards deeper integration into the European economic centre. Both supporters and persons sceptical about Croatia's participation in the Eurozone want to solve the most important problem of Croatian society: the economic underdevelopment vis-à-vis other Central European countries. While euroenthusiasts see the monetary union as the answer to this problem, sceptics have advocated for imple-

mentation of reforms and strengthening the economy before joining the Eurozone, fearing that adoption of the euro will definitely halt economic transformation. What for some will mean development, recovery, creation of new, valuable jobs, for others will result in a standstill and maintaining of the status of a peripheral state.

The Eurozone discourse is about more than just a single currency issue. Such a process is pending in virtually every European country, including Poland, and focuses on whether to pursue a monetary policy on alone to try to influence economic development/recovery and stability. Taking into account the dynamics of globalization, would it not be advisable to join a group of other countries and solve problems together? What is the European Union for us – a conflict resolution tool or just a platform for dialogue and cooperation?

This text's opening chapter analyses the process of introducing the euro by the Republic of Croatia. The second part is devoted to the issue of convergence, i.e. the approximation of the level of economic development of Croatia and the Eurozone, which, according to the author, is one of the most important challenges facing the Croatian government. The convergence factor is directly linked to the participation of the Republic of Croatia in the ERM II, to which the third chapter has been devoted. ERM II is an opportunity for Croatia to enter the Eurozone, but remains a challenge, mainly due to the political need to continue costly reforms and pursue a specific monetary policy. The fourth chapter

lists the most important actors and institutions in Croatia involved in the integration of this country with the Eurozone. The fifth chapter is an analysis of public opinion on the subject, and the sixth recalls the question of a possible referendum. The seventh and final chapter is devoted to the arguments for and against adopting the euro in Croatia. The author hopes that this work will be helpful for people interested in the Eurozone and events in Croatia.

The author would like to thank those who contributed to this work. Special thanks go to Michael Faulend, vice president of the Croatian National Bank, and Matija Kroflin, chief expert of the Trade Union for Science and Higher Education. Their valuable, substantive comments turned out to be highly inspiring and significantly contributed to the development of the concept and the structure of this publication. Thanks for the scientific review as well as insightful comments and tips from professor Radosław Kupczyk from the University of Wrocław, professor Bogusław Czarny from the Warsaw School of Economics, and Dr. Andrzej Dumala from Marie Curie Skłodowska University in Lublin.



# 1.

## **The process of introducing the euro and the policy of the Republic of Croatia towards the monetary union**

### **1.1. Requirements related to the introduction of the euro**

Adopting the common currency is a formal obligation of every EU member state<sup>1</sup>. However, due to the importance and specificity of submitting to the common monetary policy, in practice each of these countries makes its own choice

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<sup>1</sup> Only the Kingdom of Denmark, as a result of obtaining the opt-out clause to the Maastricht Treaty in 1993 (confirmed by the negative result of the referendum of 28 September 2000), is exempt from this obligation. However, Denmark participates in ERM II.

when to join the monetary union. Adopting the common currency is a key step for the economy of a Member State. The exchange rate becomes “rigid” as monetary policy becomes the responsibility of the European Central Bank, which conducts it for the entire Eurozone<sup>2</sup>, regardless of the governments of individual Member States.

In 2007, Slovenia was the only country to join the Eurozone. Malta and Cyprus followed suit in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, and Lithuania one year later. In addition to Croatia, Bulgaria is also applying for admission into the Eurozone. Denmark, although it has joined the Exchange Rate Mechanism (ERM II), does not intend to join the monetary union for the time being.

The process of integration within the monetary union is the final element of European integration, as it is broadly understood. It begins in the pre-accession phase alongside the preparation of countries for membership in the European Union. Economic conditions for accession to the EU that must be met by countries, including high-quality economic governance and macroeconomic stability (including adequate price stability and stable public finances and

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<sup>2</sup> Currently, the Eurozone includes: Austria, Belgium, Cyprus, Estonia, Finland, France, Greece, Spain, the Netherlands, Ireland, Lithuania, Luxembourg, Latvia, Malta, Germany, Portugal, Slovakia, Slovenia and Italy. Under separate agreements, the euro was also introduced in Andorra, Monaco, San Marino and the Vatican. In addition, the authorities of Kosovo and Montenegro have also introduced the euro unilaterally, i.e. without appropriate arrangements with the countries of the Eurozone or the European Central Bank.

external accounts), are aimed at ensuring that a country's economy is sufficiently prepared to meet the objectives of the monetary union. These are the so-called Copenhagen criteria, adopted by the Copenhagen European Council in June 1993. They are sometimes interpreted in isolation from integration into the Eurozone. However, taking into account the fact that adoption of the common currency is the final stage of European integration, they should be considered as preliminary criteria, without which the adoption of the euro cannot be met.

*„As the Copenhagen criteria included the ability of the candidate countries to adhere to the aims of EMU, the Directorate General for Economic and Financial Affairs of the European Commission launched its pre-accession fiscal surveillance mechanism in 2001. This mechanism comprised screening in the area of fiscal and monetary policy with respect to EU and EMU accession requirements and was divided into an annual debt and deficit notification and a pre-accession economic programme (PEP)”<sup>3</sup>.*

In addition to meeting the Copenhagen criteria, Croatia had to amend its national legislation on the Croatian National Bank (*Hrvatska Narodna Banka*, HNB) to include the liberalization of capital movements, the prohibition of direct

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<sup>3</sup> M. Allam, *The Adoption of the Euro in the New EU Member States: Repercussions of the Financial Crisis*, EIPASCOPE 2009/1, <https://core.ac.uk/download/pdf/5084703.pdf>, p. 28 [03.01.2021].



public sector financing by the central bank, and privileged access of the public sector to financial institutions. In particular, the HNB had to remain an independent institution so that the monetary policy set by the ECB could be free from *ad hoc* political interference<sup>4</sup>.

After joining the EU, all new member states move straight to the third stage of the monetary union. However, as Member States with a derogation, they remain outside the Eurozone as long as they do not fulfill the convergence criteria. From the date of accession, the new Member States have to adopt the following assumptions: treating the exchange rate policy as a matter of common interest and in the light of expected participation in the exchange rate mechanism; avoiding excessive government deficits and adhering to the relevant provisions of the Stability and Growth Pact; participation in the European System of Central Banks; pursuing a policy aimed at a high degree of sustainable convergence and meeting the Maastricht convergence criteria (see below); and treating economic policies as an object of common interest by coordination of economic policies between Member States through participation in relevant Community procedures<sup>5</sup>.

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<sup>4</sup> European Commission, *Who can join and when?*, [https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/who-can-join-and-when\\_pl](https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/who-can-join-and-when_pl) [15.01.2021] and M. Allam, *The Adoption of the Euro...*, p. 28.

<sup>5</sup> M. Allam, *The Adoption of the Euro...*, p. 28.

It should also be emphasized that joining the Eurozone is now much more difficult than at the beginning of the century, during the so-called great enlargement in 2004-2007. Nevertheless, Croatia's decision to take a key step on the road to membership in the European Union (i.e. joining ERM II), taken in 2017/2018, was well received by the European Commission (EC) due to the favourable circumstances for Croatia at that time, namely, Croatia's initiating the process of adopting the euro at a time when the European Commission was in a relatively difficult situation. This was due to the ineffective response of the Eurozone to the global financial crisis and the subsequent debt crisis, the migration crisis, and Brexit. Many countries, such as Italy, Greece, Spain, and Portugal, saw in the structure of the Eurozone the cause of the deep economic shocks they experienced. These countries were not able to adjust their exchange rates to changing circumstances, and the supranational solidarity institutions within the EU itself were underdeveloped or dysfunctional. These states were thus forced to an internal policy of devaluation by accepting the crisis. Unable to weaken the exchange rate of their currency against the Eurozone, which should increase exports, these countries were forced to reduce production costs by reducing employment. This, in turn, had a very negative impact on their citizens' living standards and long-term growth potential. After all, at that time, citizens across Europe were increasingly showing

a Eurosceptic attitude, and the European Commission was having a financial dispute with Italy.

On the other hand, the recovery of the EU countries, which has been taking place since 2015, also spilled over to Croatia, where exports rose, wages increased, consumption increased, and economic growth returned. As a consequence, there was fiscal consolidation, GDP growth, and automatic fulfillment of the criteria for joining the Eurozone. Economic indicators and the political need within the EU have facilitated Croatia's integration into the Eurozone despite the growing reluctance on the part of Eurozone states and institutions towards adding new member states<sup>6</sup>.

It is worth emphasizing that the Council of the EU is tasked with deciding whether a country aspiring to membership in the Eurozone may introduce the common currency. The Council adopts such a decision upon receipt of a relevant proposal from the European Commission, reception of recommendations from the Eurozone member states, and carrying out consultations with the European Parliament and discussions in the European Council. The final decision consists of the positions of all the member states of the monetary union.

In practice, the candidate country must show a relatively high degree of internal consensus with regard to adopting the common currency. The very process of joining the zone

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<sup>6</sup> Interview with Matija Kroflin by the author conducted on January 20, 2021.

is based on multilateral and multi-level negotiations. This means that it requires the involvement of the Prime Minister, the Minister of Finance, and the Minister of Foreign Affairs at the political level, as well as the president and management board of the HNB and senior officials of the Ministry of Finance at the expert level. Integration with the Eurozone, and above all joining ERM II, largely depends on informal political decisions. The Croatian authorities had to convince the leaders of the Eurozone countries of their country's readiness and appropriate economic, legal, and institutional preparation to participate in the monetary union. Technical cooperation with the ECB and, above all, the European Commission is crucial when joining ERM II and the monetary union. It is the Commission, after a period of negotiations and transformation, that *de facto* confirms the achievements of the candidate country, and thus plays the role of advocate for a given country in the EU forum. The progress of integration is therefore a success for the European Commission but, as mentioned above, the final decision of the Council is often of a political nature.

Undoubtedly, the most important moment for Croatia's integration with the Eurozone was joining ERM II with the fulfilment of certain criteria. It was the point at which „there was no turning back”, as one high-ranking official put it<sup>7</sup>. For Eurozone countries, it was also a signal that Croatia was pre-

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<sup>7</sup> Phone interview conducted by the author on January 19, 2021.

pared to participate in the monetary union and determined to adopt the common currency. The decision was made by the government of Andrej Plenkovic in 2017, and the closest possible date for joining ERM II was set for July 2020. The Croatian authorities have shown determination, despite the damage caused by the COVID-19 pandemic, which is estimated at 4 billion euro. The Croatian economy also suffered from the earthquake that hit Zagreb. It incurred losses estimated at 7 billion euro. Another earthquake hit central Croatia at the end of 2020, but the damage has not yet been assessed.

Joining ERM II means that one of the four economic requirements set out in the Maastricht Treaty, i.e. exchange rate stability, has been met. In addition, the Croatian Government and the Croatian National Bank will have to ensure the following: price stability with an inflation rate of no more than 1.5 percentage points above the three most developed Member States; “healthy” and stable public finances, meaning that the state should not be subject to the excessive (60 percent) deficit procedure; and long-term interest rates no higher than two percentage points above the three best performing Member States in terms of price stability.

These are the so-called the Maastricht convergence criteria adopted in the Maastricht Treaty. While the Copenhagen criteria set the standards for a functioning market economy, the ability to cope with market pressures in the EU and to adhere to the objectives of the political, economic, and monetary union was the goal of the Maastricht criteria, which

aimed to achieve price stability and low long-term interest rates, low public deficits, and exchange rate stability. Thus, the Copenhagen criteria focus on real and legal-institutional convergence, i.e. the convergence of the structural and institutional features of economies, while the Maastricht criteria focus on the nominal convergence of inflation, interest rates, and budget deficit to GDP<sup>8</sup>. Croatia, therefore, had to prepare for two kinds of requirements. While those of a legal and institutional nature have largely been met, the “technical” Maastricht criteria are still being acted upon by the Croatian authorities.

In July 2020, the European Central Bank, in response to the request of the Republic of Croatia to join the European Exchange Rate Mechanism, unequivocally stated that by extending the package of macroprudential tools, it had fulfilled the commitment made a year earlier. A week later, on July 10, 2020, Croatia joined ERM II<sup>9</sup> (see Section 1.3).

## 1.2. Plan of adoption of euro by Croatia

The introduction of the euro as the official currency in Croatia is the flagship project of Andrej Plenković, who has been Prime Minister since October 2016, and Boris Vujčić, who has been the Governor of the Croatian National Bank since

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<sup>8</sup> M. Allam, *The Adoption of the Euro...*, p. 29.

<sup>9</sup> European Central Bank, *Croatia – assessment of ERM II prior commitment No. 2 on the macroprudential toolkit*, 03.07.2020, [https://www.ecb.europa.eu/pub/pdf/other/ecb\\_assessment\\_croatia\\_erm\\_II~f51d3boa22.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/ecb_assessment_croatia_erm_II~f51d3boa22.en.pdf) [20.01.2021].

2012. This tandem of euro-enthusiasts with a liberal attitude towards European and economic affairs is the driving force behind this process. Political decisions to apply for admission to the Eurozone were made in 2016, when Plenković was appointed prime minister. As mentioned earlier, the efforts of the Croatian authorities have resulted in admission to the Exchange Rate Mechanism.

Work on joining ERM II began in 2017. In April 2018, the policy of introducing the euro by Croatia was specified in the published document, „Strategy for the Adoption of the Euro in the Republic of Croatia”<sup>10</sup> (hereinafter: Strategy or Strategy for the adoption of the euro), prepared jointly by government experts and experts from the Croatian National Bank. This document provides an analysis of the economic costs and benefits of the introduction of the euro, an explanation of the process itself, and a list of measures and policies that need to be taken to implement the euro as the official currency in Croatia. It also reflects the enthusiastic position of the government and the HNB on the adoption of the euro, which is the subject of the following sections of this study.

The strategy is a comprehensive document and indicates the key areas of involvement by the Croatian authorities.

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<sup>10</sup> Strategy of Adoption of Euro in the Republic of Croatia available at the website <https://euro.hnb.hr/documents/2070751/2104255/h-strategija-za-uvođenje-eura-kao-sluzbene-valute-u-HR.pdf/69a1c208-c601-4df3-95f6-d336f-665b5f9> [17.01.2021].

As such, it provides for the continuation of prudent fiscal policy aimed at balancing the budget, reducing public debt, and creating a fiscal space for the period of crisis (anti-cyclical action). At the same time, the problem of convergence has been addressed – the need to carry out structural reforms aimed at reducing macroeconomic imbalances, creating jobs, and achieving sustainable economic growth. It is primarily about liberalizing the tax system (see Chapter 2 of this study), reforming education, administration, and the judiciary system, as well as the pension system and obtaining and using the EU funds.

On December 23, 2020, the government adopted the „National Plan for the Changeover from the Croatian Kuna to the Euro”<sup>11</sup> (hereinafter: Exchange Plan, Plan). It was another important document in the process of joining the Eurozone. Like the Strategy adopted two years earlier, the Plan is also descriptive and reflects the optimistic position of the government and the central bank towards the introduction of the euro in Croatia. The main points of this document are the following: the legal basis for the introduction of the euro; duties and tasks of individual participants in the process; consumer protection; the process of converting the kuna into the euro alongside an information campaign. Adequate

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<sup>11</sup> National Plan for the Changeover from the Croatian Kuna to the Euro available at the Croatian National Bank, <https://euro.hnb.hr/-/hp13112020> [17.01.2021].



committees chaired by senior government officials have been established for each area (see Chapter 4).

The Exchange Plan describes the main operational measures needed for the smooth conversion of the national currency into the euro, as well as its most important elements, such as the rules for converting prices and other values, converting the value of deposits and loans, and adjusting floating interest rates. The plan is based on the Eurostrategy and, nominally, its main principle is consumer protection. According to the authors of the document, this process must be free for the consumer, i.e. the consumer cannot be in a less favourable financial situation than if the euro had not been introduced.

### **1.3. Participation in the Exchange Rate Mechanism – ERM II**

The first, formal step directed towards the introduction of the euro is joining the Exchange Rate Mechanism, which Croatia did on July 10, 2020. Accession to ERM II depends on gaining political support at the EU level and achieving consensus on the domestic political scene. Under the ERM II regime, a country aspiring to membership in the Eurozone must keep its currency at a fixed exchange rate for at least two years. The exchange ratio was set at 1 euro = 7.53450 kuna, which corresponded to the ECB reference rate on 10 July. The permissible fluctuation of the kuna exchange rate against the euro is  $\pm 15\%$  around the adopted parity.

By joining ERM II, Croatia is required to undertake numerous institutional and operational steps to participate in the monetary union. Most of them will start after the EU institutions have concluded that the criteria for adopting the euro have been met. They are a transposition or development of the Maastricht criteria presented in Chapters 2 and 3 of this study.

Initially, however, Croatia had to take preparatory steps to join the banking union (as it did on July 10, 2020, when joining ERM II) and sign an agreement to include strict fiscal rules in its legal framework. The mandatory operational adjustments include the purchase of euro banknotes and coins, supplying euro banknotes and coins to banks, establishing control mechanisms to prevent unjustified increases in consumer prices, and the harmonization of legislation to make the euro the official tender in Croatia.

Following Croatia's accession to the banking union, the European Central Bank established close cooperation with the Croatian National Bank, making it part of the Single Supervisory Mechanism prior to joining the Eurozone. Consequently, the ECB assessed and decided which Croatian banks meet the criteria for classification as the so-called significant institutions, and from October 1, 2020, it has also conducted direct supervision of these institutions. The positive assessment obtained by the five largest Croatian banks after the ECB's inspection in May and June 2020 leaves no

doubt that this element of integration with the Eurozone will take place without significant obstacles.

By establishing close, interbank cooperation, representatives of HNB became members of joint supervisory teams at the ECB and therefore exercise direct supervision over important institutions in the Republic of Croatia. Less important banking institutions are directly supervised by the HNB, although on behalf of the ECB. The president of the Croatian National Bank also sits on the General Council.

In addition, the Republic of Croatia participates in the Single Resolution Mechanism, which aims to ensure that the restructuring and winding-up of failing banks are carried out at minimum cost to taxpayers and the economy. In other words, the resolution mechanism is designed to ensure that the collapse of one financial institution does not result in panic withdrawals of capital from other related institutions.

## 2. Problem of convergence

The introduction of the euro depends on nominal convergence criteria that Croatia has to meet after joining ERM II. Croatia will receive a positive assessment of nominal convergence if it meets the Maastricht criteria, i.e. manages to maintain price and exchange rate stability, demonstrate public finance discipline, and achieve the required level of long-term interest rate convergence. The problem is that Croatia, like other new Central European, EU member states, has to choose between the sustainability of public finances

and bridging the gap in the economic development of the “old” Union and its own<sup>12</sup>.

Among the nominal convergence criteria, the biggest obstacle for Croatia until recently was the sustainability criterion of public finances, i.e. public debt exceeding the reference value of 60 percent of GDP. It increased from 57.8 percent in 2010 to 84.7 percent four years later, then began to decline. In 2015, it was already 84.3 percent GDP, and 73.2 percent in 2019. Such a dynamics of decline made it possible to assume that public debt, despite the fact that it exceeds 60 percent, will not become an obstacle to Croatia's accession into the Eurozone. This is due to the fact that, according to EU rules, the criterion of sustainability for public finances may be met even when debt exceeds the reference level (60 percent) on condition that it will decline through satisfactory dynamics. If public debt continues to decline with the necessary dynamics, and if indicators for the other criteria remain within acceptable limits, Croatia could meet all formal criteria for the introduction of the euro shortly after joining ERM II. However, in practical terms, this means cutting back on public spending and increasing private sector investment.

The Strategy, adopted before the COVID-19 pandemic, links the adoption of the common European currency with a country's economic development. The document stresses

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<sup>12</sup> See: M. Allam *The Adoption of the Euro...*

that structural reforms ensuring productivity gains are key to achieving higher rates of potential economic growth. The current economic growth rate of Croatia (between August 2017 and January 2020, between 2.2 and 3.6 percent of GDP, and – 15.1 percent in the second quarter of 2020<sup>13</sup>) is not sufficient to allow for accelerated convergence with the dominant income level in developed economies of the Eurozone.

As a result, the government plans to continue comprehensive activities aimed at improving the business environment, reducing tax burdens, and increasing the efficiency of public sector enterprises. The year 2020 brought with COVID-19 a painful revision of these assumptions. The reduction in real GDP for the entire year might amount to 8.4 percent of GDP. The inflation rate is expected to fall to 0.2 percent in 2020, mainly due to the significant drop in energy prices (especially petroleum products) compared to the previous year. In foreign trade, after a significant reduction in the current and capital surplus in the balance of payments in 2020 due primarily to a significant decline in tourism revenues, a surplus is expected in 2021, primarily from a revival of this segment of economy<sup>14</sup>. The gross debt-to-GDP ratio is

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<sup>13</sup> Data from: tradingeconomics.com and the Statistical Office of the Republic of Croatia, <https://tradingeconomics.com/croatia/gdp-growth-annual> and <https://www.dzs.hr/> [15.01.2021].

<sup>14</sup> Croatian National Bank, *Projekcija monetarne politike za 2020. i 2021. godinu*, <https://www.hnb.hr/-/smanjenje-bdp-a-u-2020.-oko-9-posto-u-2021.-godisnji-rast-oko-5-posto> [18.12.2020].

expected to increase in 2020 due to the COVID-19 pandemic and its aftermath to 85.3 percent<sup>15</sup>.

The current policy led by Andrej Plenković and Boris Vujčić is to reassure the ECB and the Eurozone countries that public debt will decline and public spending is kept under control. As expected, the budget deficit in 2021 will be reduced below the critical level of 3 percent of GDP and public debt-to-GDP ratio restored to a downward trajectory to meet the Eurozone fiscal criteria<sup>16</sup>.

The Plenković-led government introduced five circles of tax reforms. The last two of them will be presented below. They are an extension of the three previous circles, and, as such, they reflect the purpose of the entire reform package, which was aimed at reducing the tax burden on entrepreneurs.

The penultimate of them, the fourth circle of reforms, was presented on July 26, 2019. The introduced changes assumed primarily the reduction of the basic level of VAT from 25 to 24 percent. The then applicable 20 percent CIT rate was reduced to 12 percent for entrepreneurs whose annual income was below 1 million euro (previously the threshold was 400 thousand euro), and whose number in Croatia is

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<sup>15</sup> Data from: Novac.hr/HINA, *Javni dug dosegnuo rekord: njegov udjel u BDP-u narastao na 85,3 posto*, 14.10.2020, <https://novac.jutarnji.hr/novac/aktualno/javni-dug-dosegnuo-rekord-njegov-udjel-u-bdp-u-narastao-na-85-3-posto-15025143> [15.12.2020].

<sup>16</sup> National Plan for the Changeover from the Croatian Kuna to the Euro.

estimated at around 10,000 (approx. 93 percent of all enterprises in Croatia). The tax exempts other costs incurred by employers for the benefit of employees – e.g. payments for kindergartens for the children of employed persons or part of the costs of national leave (330 euro off-season), as well as the costs of additional health insurance. Workers under the age of 25 are exempt from income tax, and workers between the age of 25 and 30 pay half the normal tax rate. On the other hand, the excise tax on alcohol, tobacco products, and beverages with a high sugar content was increased.

On December 4, 2020, the Croatian parliament adopted four legislative proposals of the government prepared under the fifth circle of the tax reform. They brought, among others, changes in the acts on income tax from natural and legal persons, taxes on goods and services (VAT), and fiscalisation in cash transactions. According to the data presented by Deputy Prime Minister and Minister of Finance Zdravko Marić, the new cycle of tax changes will reduce the tax burden by another 450 million euro, and the total combined effect of the previous four circles of the tax reform is over 8.2 billion kuna (over 1 billion euro), which would remain at the disposal of taxpayers.

In addition, changes to the act on financing local government units were introduced, which will record, due to lower taxes, a significant decrease in revenues. The amendment increases the share of municipalities, cities, and regions in the distribution of income tax benefits and changes the



rules of co-financing from state funds in such a way as to compensate for losses caused by lowering taxes.

This current line of the liberal economic policy of the government and the Croatian National Bank will be put to a hard test in the fight against the consequences of COVID-19, which has hit the country exceptionally hard. In 2020, Croatia's GDP contracted by 15.1 percent compared to the second quarter of the previous year. Household spending fell by 14 percent compared to an increase of 0.7 percent in the previous quarter, and fixed capital formation fell by 14.7 percent, after an increase of 3.1 percent. In addition, government spending increased by 0.7 percent. In the first quarter of 2020, net foreign trade had a negative impact on growth as exports fell by 40.6 percent (compared to minus 3 percent in the first quarter of 2019), and imports fell by 28.1 percent<sup>17</sup>.

Representatives of trade unions also point to these problems. According to Matija Kroflin, chief economist of the Trade Union of Science and Higher Education, if the government of the Republic of Croatia, regardless of the difficulties of 2020, remains committed to the introduction of the euro in early 2023, it will have to either reduce aid to entrepreneurs affected by the COVID-19 crisis, delay helping citizens rebuild their earthquake-damaged homes and

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<sup>17</sup> Trading Economics, data available at: <https://tradingeconomics.com/croatia/gdp-growth-annual> [15.01.2021].

infrastructure, or cut public spending sharply on key public services such as health, education, science, etc.<sup>18</sup>

According to Eurostat data published in December 2020, Croatia is in the penultimate position among the EU Member States in terms of actual individual consumption (AIC) and GDP per capita. Table no. 1 shows the change of these indicators in Croatia in comparison with other countries of similar size, countries of South-Eastern, Central, and Western Europe, and Poland.

Such a situation, along with a liberal tax policy, may pose a serious challenge for the Plenković government, especially since the strategy to combat COVID-19 is based on state intervention and use of European funds. Cutting back state spending is one thing, but the Croatian state continues to struggle with inefficient public administration. In the corruption ranking (CPI 2019), Croatia (47 points out of 100) is closer to Montenegro (45 points), Belarus (45 points), Greece (48 points), and Hungary and Romania (44 points) than to Poland (58 points), Slovenia (60 points), and the Czech Republic (56 points). Scandals related to representatives of regional and local authorities discovered by local anti-corruption services may be part of a campaign aimed at, on the one hand, punishing corrupt politicians, and, on the other hand, mobilizing regional leaders to act more effectively in the area of obtaining and using European funds.

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<sup>18</sup> Interview with Matija Kroflin conducted by the author on January 20, 2021.

Table no. 1: AIC and PKB in Europe

	AIC per capita			PKB per capita		
	2017	2018	2019	2017	2018	2019
EU	100	100	100	100	100	100
Eurozone	106	106	107	107	107	106
Croatia	64	65	66	63	64	65
Poland	77	78	79	70	71	73
Slovenia	80	81	83	86	87	89
Romania	70	74	79	64	66	70
Bulgaria	55	57	58	50	51	53
Slovakia	68	69	69	71	71	70
Hungary	65	66	67	69	71	73
Ireland	95	95	95	185	191	193
Austria	120	119	118	127	128	126

Source: Eurostat, *Consumption per capita in purchasing power standards in 2020*, Eurostat News Release, 18/12/2020, 15/12/2020, [https://ec.europa.eu/eurostat/documents/default\\_file\\_entry/29955212-15122020-BP-EN.pdf/cd31cb0f-faee-40ce-0916-9ba3ac231210](https://ec.europa.eu/eurostat/documents/default_file_entry/29955212-15122020-BP-EN.pdf/cd31cb0f-faee-40ce-0916-9ba3ac231210) [23.12.2020].

High hopes are associated with Natasza Tramišak, appointed as the Minister of Regional Development and EU Funds. This new HR policy, however, will bear fruit only in the next two years.

The use of EU funds by Croatia also leaves much to be desired, although the trend is definitely positive and encourages optimism about the future. The issue of sufficiently high economic development and the maintenance of a sufficiently low level of public debt continues to be a challenge for the Plenković's government. Although certain facts allow us to be optimistic about the prospect of using EU funds and efficient state management by the administration, a common practice in the South-Eastern Europe region shows that expectations should be kept to a minimum.



# 3.

## Reforms arising from joining ERM II

In July 2019, Croatia, as it was submitting the application for ERM II admission, undertook additional obligations to implement appropriate measures to bring it closer to the Eurozone. They include the following: 1) strengthening the anti-money laundering framework (implementation of the 5th AML Directive, which prevents the use of the financial system for money laundering or terrorist financing); 2) reducing the administrative and financial burden of the private sector by further simplifying administrative procedures and reducing parafiscal and non-tax benefits; 3) improving corporate governance in state-owned enterprises

by auditing and harmonizing regulations and practices in line with OECD guidelines on corporate governance in state-owned enterprises; 4) strengthening the national insolvency framework in line with Directive 2019/1023 of the European Parliament and the Council of 20 June 2019 for a framework for preventive restructuring, debt relief and prohibitions, and measures to increase the effectiveness of restructuring, insolvency proceedings, and debt cancellation.

Additionally, Croatian authorities have committed to taking further steps in line with Directive 2018/843 to strengthen the anti-money laundering and terrorist financing framework and to take measures to reduce the risks and threats already identified with money laundering and terrorist financing. The Croatian government adopted its first action plan in 2017 to reduce the identified risks of money laundering and terrorist financing. Following the implementation of relevant actions, a project to update the national risk assessment was launched in 2018 as part of the mandate of the Interinstitutional Working Group on Money Laundering Prevention and Terrorist Financing, with the participation of academics and the private sector (reporting entities). At its meeting on June 25, 2020, the Government of the Republic of Croatia adopted the „National Money Laundering and Terrorist Financing Risk Assessment in the Republic of Croatia”, together with an action plan to reduce the identified risks. The Croatian supervisory authorities (Croatian National Bank, Financial Inspectorate, Croatian Financial

Services Supervisory Agency, Tax Administration) will continue to cooperate closely in supervising and monitoring taxpayers and exchanging information with the Office for the Prevention of Money Laundering (an institution and an intelligence agency).

Another challenge in joining ERM II is to create a cheaper and simpler business environment for the private sector by further reducing administrative burdens and parafiscal and non-tax benefits. In addition to the tax reforms presented in Chapter 2 of this study, the government also decided to simplify and digitize administrative procedures and reduce the fiscal burden on the economy by further reducing parafiscal charges. In addition, administrative fees paid to the state budget will be reduced or abolished, as well as fees for vocational examinations.

In this area, the Croatian authorities have undertaken well-defined and quite ambitious tasks: the implementation of the „Action Plan on Administrative Reliefs in the Economy by March 2022” (ten types of administrative proceedings with an estimated administrative relief of 686 million kuna, i.e. approx. 90.9 million euro); and the implementation of the „Action Plan to reduce non-tax and parafiscal benefits” (33 measures that concern the reduction of parafiscal and non-tax benefits and include the elimination or reduction of selected administrative fees, and another 17 measures concern the reduction of fees for vocational examinations). All activities are to be implemented by September 2021.



The third obligation of joining ERM II is the management of SOEs. The aim of this activity is to prepare a review of corporate governance in Croatian state-owned enterprises and to analyse the deviations of existing regulations and practices in this area in relation to best international practices. In addition, the recommendations for review of the corporate governance regulatory framework identified in the study will be implemented. The implementation of these recommendations and the alignment of the regulatory framework with international best practices will create preconditions for a more active role of ownership bodies in setting the financial and operational objectives of SOEs and better coordination between national competent authorities. In implementing the relevant recommendations, the government of the Republic of Croatia will work to strengthen the institutional capacity in relevant parts of the Croatian state administration through training. Strengthening human resources is one of the specific goals of the State Property Management Strategy 2019-2025, which was adopted by the Croatian Parliament on October 2, 2019.

The Croatian government will also have to undertake the strengthening of the national insolvency framework in line with the relevant Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019, to improve the existing legal framework for trustees and data collection. In this area, the government envisages measures to strengthen the institution of the bankruptcy trustee and to

establish an efficient and centralized system for collecting and publishing data in the areas of restructuring, bankruptcy, and debt relief.



## 4. ● Main actors and institutions

The main actors of Croatia's accession to the Eurozone are Prime Minister Andrej Plenković and HNB Governor Boris Vujčić.

Andrej Plenković has been the leader of the ruling Croatian Democratic Union (HDZ) and prime minister of the government since 2016. One of his strategic goals has been and still remains Croatia's entry into the Eurozone. He is consequently of the opinion that Croatia has committed to adopting the euro as its official currency upon signing the treaty of accession to the European Union.

From the macroeconomic perspective, Andrej Plenković views the adoption of the euro primarily as an opportunity for Croatia. He assessed the green light for Croatia to join ERM II in July 2020 as a positive decision „which will certainly help Croatia in terms of its reputation in the international financial and economic markets, will be a strong signal to entrepreneurs and investors in our bonds and all that, which credit rating agencies will take into account”<sup>19</sup>.

Boris Vujčić, like Andrej Plenković, is a staunch supporter of the introduction of the euro as the official currency of the Republic of Croatia. During his presidency, HNB has been actively involved not only in the preparation of the Croatian financial system, but also in PR activities related to Croatia's accession to the Eurozone. “Adopting the Euro is our strategic goal and the sooner it is achieved, the better. Joining the Eurozone is much more difficult today than fifteen years ago, mainly because the requirements of the first step, i.e. joining ERM II, are much more stringent. Nevertheless, we will continue to meet all the criteria and I believe that we will be successful thanks to the high-quality macroeconomic indicators achieved, the support of our European partners

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<sup>19</sup> Andrej Plenković website, *Zastoj u provedbi svih ovršnih postupaka proizveden je za tri mjeseca*, 16.07.2020, <https://www.andrejplenkovic.hr/article.php?id=3612&naslov=zastoj-u-provedbi-svih-ovrsnih-postupaka-produzen-je-za-tri-mjeseca> [18.01.2021].

and the support of the Croatian citizens”<sup>20</sup>, said Vujčić at the conference „5 years with the euro” organized in 2019 by the EC in Riga.

The Plenković-Vujčić duo is of key importance for the shaping of financial and monetary policy, and they essentially determine the pace and method of integration with the Eurozone. The economic and political importance of this move, however, will require the approval of the president of the republic, Zoran Milanović, who comes from ranks of the Social Democratic Party (SDP), which remains the main opposition. Milanović is to be perceived as a supporter of the Euro-debate before the introduction of the common currency. The President may also speak in favour of holding a referendum in the future, especially since he defended the Croatian kuna during the election campaign, and his voters (see chapter 5 of this study) are much more sceptical about the introduction of the euro than those supporting the HDZ and Plenković government. However, the constitution of the Republic of Croatia does not give the president of the state the right to organize and hold a referendum on his own. Although Milanović is currently against such a solution, divided public opinion in Croatia may nevertheless provide arguments in favour of calling for a referendum.

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<sup>20</sup> Croatian National Bank, *Euro brings stronger economic growth and higher living standard*, 07.01.2019, <https://www.hnb.hr/en/-/s-eurom-dolazi-snazniji-gospodarski-razvoj-i-visi-zivotni-standard> [15.01.2021].

In Croatia, the National Council for the Introduction of the Euro was established in 2018<sup>21</sup>. It is composed of the prime minister, the head of the Croatian National Bank, members of the government, a representative of the Croatian Employers' Union, and a representative of the trade union headquarters. From its creation in April 2018 to December 2020, i.e. within two and a half years, the Council met eight times. On December 31, 2020, the Steering Committee for the implementation of the kuna replacement plan was appointed, headed by the Prime Minister's advisor, Zvonimir Savić, as the main coordinator. The Steering Committee also included Stipe Župan, Secretary of State from the Ministry of Finance, and Michael Faulend from the Croatian National Bank. The relatively lower rank of the committee members means that its work will be more technical, but also that the task will be carried out more efficiently, without as much political burden.

Several coordination committees at the Council have also been established, and the most important directions of work were indicated at the same time. These are the Cash Exchange Committee, the Legislative Coordination Committee, the State General Adjustment Committee, the Economic

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<sup>21</sup> Government of the Republic of Croatia, *Odluka o osnivanju Nacionalnog Vijeća za uvođenje eura kao službene valute u Republici Hrvatskoj*, Narodne Novine 832, 10.05.2018, [https://narodne-novine.nn.hr/clanci/sluzbeni/2018\\_05\\_43\\_832.html](https://narodne-novine.nn.hr/clanci/sluzbeni/2018_05_43_832.html) [15.02.2021].

and Consumer Protection Committee, and the Communication Committee<sup>22</sup>.

The most serious arguments against the introduction of the euro as a common currency, although not against the very idea of European integration, were raised by the Independent Union of Research and Higher Education Employees of Croatia (*Nezavisni sindikat znanosti i visokog obrazovanja*). Its representative, Vilim Ribić, is also a member of the Association of Croatian Trade Unions (*Matica hrvatskih sindikata*) and the National Council for the Introduction of the Euro.

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<sup>22</sup> Government of the Republic of Croatia, *Ciljni datum uvođenja eura i dalje ostaje 1. siječnja 2023*, 31.12.2020, <https://vlada.gov.hr/vijesti/ciljni-datum-uvodjenja-eura-i-dalje-ostaje-1-sijecnja-2023/31189> [2.01.2021].





## 5. Public opinion

Public opinion on the introduction of the euro in Croatia is not entirely clear. According to the Al Jazeera portal, which is popular in the region and in December 2020 cited HNB data, 56 percent of Croatian citizens support the introduction of the euro<sup>23</sup>. However, the March 2020 data published by HNB point to a different trend: while 41 percent of citizens support the introduction of the euro, 18 percent strongly oppos-

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<sup>23</sup> Al Jazeera, *Nastavak krize može ugroziti uvođenje eura u Hrvatskoj*, 23.12.2020, <https://balkans.aljazeera.net/news/balkan/2020/12/23/nastavak-krize-moze-ugroziti-uvodenje-eura-u-hrvatskoj> [15.01.2021].

es it, and as much as 31 percent conditions its position on the impact of introducing the euro on their standard of living<sup>24</sup>.

According to a public opinion poll conducted by the Eurobarometer in November 2019, 50 percent of respondents in Croatia were positively in favour of the monetary union and the single currency, while 44 percent were against it (the EU average was then 62 and 29 percent, respectively). In 2018, 40 percent were in favour of the introduction of the single currency and 56 percent were against. In 2017, these numbers were 43 and 52, respectively, but a year earlier the opposite – 52 percent for and 43 percent against. In 2015, 56 percent were for, and 36 percent against<sup>25</sup>.

In 2015-2020, the percentage of people who believed that joining the Eurozone would have negative effects for Croatia fell from 53 to 48 percent, and those with a positive opinion increased from 40 to 47 percent<sup>26</sup>. Opinions on the effects of introducing the euro on the personal situations of respondents were slightly different. 53 percent of respondents believed that the adoption of the common currency would have a positive impact (an increase from 44 percent in 2015),

<sup>24</sup> IPSOS, *Istraživanje javnog mnijenja o uvođenju Eura Pripremljeno*, after: *Hrvatska narodna banka*, 18.03.2020, [https://euro.hnb.hr/documents/2070751/2600163/hp24032020\\_istrazivanje.pdf/abb15304-c7ed-e88f-ae40-fdb64359d177?t=1585059558655](https://euro.hnb.hr/documents/2070751/2600163/hp24032020_istrazivanje.pdf/abb15304-c7ed-e88f-ae40-fdb64359d177?t=1585059558655) [18.02.2021].

<sup>25</sup> European Commission, *Flash Eurobarometer 487*, Report Fieldwork May-June 2020, Publication: July 2020, [https://ec.europa.eu/info/news/eurobarometer-487-introducing-euro-seen-positive-euro-area-countries-2020-jul-27\\_en](https://ec.europa.eu/info/news/eurobarometer-487-introducing-euro-seen-positive-euro-area-countries-2020-jul-27_en) [18.02.2021].

<sup>26</sup> European Commission, *Flash Eurobarometer 487*..., p. 25.

and 41 percent believed that it would have a negative impact (44 percent 5 years earlier)<sup>27</sup>. It is difficult to explain the fact that, despite the relatively good assessment of the euro, as much as 38 percent wanted the euro to be introduced as late as possible or never, and only 20 percent as soon as possible<sup>28</sup>. At the same time, 49 percent of respondents assessed that with accession to the monetary union, Croatia would lose the ability to shape its own economic policy (48 percent were of the opposite opinion)<sup>29</sup>, and as many as 57 percent said that Croatia would lose part of its identity (42 percent thought the opposite)<sup>30</sup>.

Eurobarometer surveys from May and June 2020 show that the information campaign conducted by HNB is paying off. The percentage of people informed about joining the Eurozone increased from 42 percent to 52 percent between April 2014 and May 2020, while the percentage of the uninformed fell from 57 to 47 percent during this period. At the same time, compared to 2019, in 2020 there was a visible, 14 percentage point increase in confidence in HNB as an institution informing the country about the adoption of the euro. In May 2020, it remained at the level of 57 percent. For comparison, 46 percent of respondents had confidence in European institutions, 50 percent consumer organizations,

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<sup>27</sup> European Commission, Flash Eurobarometer 487..., p. 27.

<sup>28</sup> Ibidem, p. 29.

<sup>29</sup> Ibidem, p. 40.

<sup>30</sup> Ibidem, p. 43.

and only 35 percent government and local government institutions, 25 percent trade unions, and 21 percent journalists<sup>31</sup>.

When asked what issues should be raised during the debate on the introduction of the euro, the highest percentage of respondents in Croatia indicated the value of the euro in relation to the Croatian kuna (73 percent) and ensuring compliance with the rules when converting the currency (66 percent). Croats were also interested in the way the euro would be introduced in their country, as well as the appearance of the European currency (63 percent of respondents each) and the impact of introducing the euro as the common currency on the value of wages (58 percent). The last topic on the list of interests was the social, economic, and political implications of adopting the euro (51 percent)<sup>32</sup>. The author of this study believes that such an approach to such an important process as the adoption of the euro results from a high degree of determinism in terms of politics, rooted in the minds of Croats. In the political culture of the inhabitants of Croatia, there is a conviction that certain political processes are inevitable and remain beyond the will of the nation.

Between 2015 and 2020, the percentage of Croats believing that their country is ready to adopt the euro increased from 20 percent to 32 percent. The percentage of respondents who thought otherwise remained high, although it fell

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<sup>31</sup> European Commission, Flash Eurobarometer 487..., p. 14.

<sup>32</sup> Ibidem, p. 16.

from 77 percent to 64 percent anyway<sup>33</sup>. Among the biggest worries about adopting the euro, the Croatians mentioned the increase in prices (79 percent).

Research conducted in April 2019 for the Croatian Radio and Television by the Promocija and a market and public opinion research agency shows a much more negative attitude of respondents towards Croatia's accession to the Eurozone. As much as 53.4 percent of respondents are against the introduction of the euro, and 39.3 percent were in favour of a single European currency. 7.3 percent remains undecided on this issue.

When asked whether Croatia should join the monetary union and introduce the euro instead of the kuna, 12.8 percent of respondents say it should do so as soon as possible; 18.7 percent agreed, but only if Croatia is ready; 23.7 percent of respondents said they do not want the euro until the economy is fully operational; and 23.1 percent believed that the kuna should always remain the Croatian currency. Of the voters of the ruling HDZ, 46.3 percent were in favour of the introduction of the euro, but as many as 48.8 percent were against it. As for the main opposition party, Socialdemocratic Party supporters were 38.4 percent in favour of the introduction of the euro, and 56.3 percent were against<sup>34</sup> it.

<sup>33</sup> European Commission, Flash Eurobarometer 487..., p. 23.

<sup>34</sup> M. Šimić-Mrzlečki, *HRejting: 53,4% anketiranih protiv uvođenja eura*, HRT Vijesti, 23.04.2019, <https://vijesti.hrt.hr/507372/hrt-ekskluzivno-534-anketiranih-protiv-uvoenja-eura> [18.02.2021].

Public opinion polls on the adoption of the euro show a moderate advantage of supporters of this initiative. If the government manages to maintain an advantage in the public debate on this subject, this result should be maintained. A referendum on this matter may be a threat to a smooth adoption of common currency by Croatia (see next section). Nevertheless, the current trends are a positive signal to Croatian authorities.

# 6. Referendum

The topic of a referendum on the introduction of the euro as the official currency in the Republic of Croatia reflects political divisions. Both the HDZ leadership and HNB representatives are against holding a referendum. They explain that by joining the European Union, the Republic of Croatia has committed itself *de facto* and *de jure* to joining the monetary union. Holding a referendum is therefore exposing citizens to unnecessary costs. According to this logic, Croatia is introducing the euro as the last stage of integration with the EU. The Croatian authorities also take this position because they assess its economic and social consequences as



favourable. They are afraid that holding a referendum or a public political debate on the euro will lead to an increase in nationalist and anti-EU sentiment.

The already quoted Matija Kroflin pointed out that it is debatable whether the moment when the government of the Republic of Croatia initiated the euro adoption procedure was the most favourable, regardless of whether Croatia committed to adopting the euro upon accession to the EU.

The leaders of the largest opposition party, the SDP, and the Presidential camp maintain that although the adoption of the euro is beneficial and desirable, the significance of adopting the single currency requires an honest debate. Such a debate would be risky for the government camp and the HNB. According to a 2020 Eurobarometer survey, 84 percent of Croats believed that the economic situation in their country was bad<sup>35</sup>.

The greatest opponents of the introduction of the euro remain concentrated around the anti-systemic Fatherland Movement by Miroslav Škoro. According to them, adopting the euro and leaving the kuna will mean the destruction of the last bastion of Croatian sovereignty. Therefore, they are calling for a referendum on this issue.

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<sup>35</sup> European Commission, *Standard Eurobarometer 93 Summer 2020*, July-August 2020, p. 28, [https://data.europa.eu/euodp/en/data/dataset/S2262\\_93\\_1\\_93\\_1\\_ENG](https://data.europa.eu/euodp/en/data/dataset/S2262_93_1_93_1_ENG) [18.02.2021].

# 7.

## Public discourse on adopting the euro as the common currency in Croatia

At the beginning of this study, a few problems and questions were identified by economist Ivo Bićanić: can Croatia have its own currency? What are the alternatives to the introduction of the euro and what *real* alternatives are there? Why would anti-cyclical monetary policy in the Eurozone hurt Croatia? And will there be convergence in the Eurozone?<sup>36</sup> These and other questions will be answered in the consid-

<sup>36</sup> I. Bićanić, *Može li u Hrvatskoj biti kvalitetne rasprave o euru? Malj državnih institucija i slobodni strijelci*, Ideje.hr, 31.03.2019, <http://ideje.hr/moze-li-u-hrvatskoj-biti-kvalitetne-rasprave-o-euru-malj-drzavnih-institucija-i-slobodni-strijelci/> [15.12.2020].

erations below. The arguments, doubts, plans, and remarks presented below represent the opinions and views of participants in the debate on the introduction of the euro in Croatia and were presented as such by the author of this study.

### **7.1. Arguments for joining the Eurozone**

The arguments that appear in public debate on the introduction of the euro are largely conducive to a currency change-over. They are essentially contained in the Euro Adoption Strategy, which both answers the most important questions and dispels fears arising from the plans to introduce the single currency.

An important argument in favour of adopting the common currency is the high degree of integration of the Croatian economy with the Eurozone, which is reflected in the high harmonization of business cycles. A significant proportion of domestic savings (75 percent) and total debt obligations (67 percent) are linked to the euro. The Croatian banking system is dominated by the banks of the Eurozone. As a result, the possibilities of conducting monetary policy by Croatia are limited. In practice, therefore, the adoption of the common currency is an indisputable necessity.

Apart from the above argument, the logic behind adopting the euro as the official currency in Croatia is based on a sense of Croatia's economic backwardness vis-à-vis other Central European countries. The processes of economic reforms and the attraction of large and massive investments

experienced by the Baltic states and the Visegrad group bypassed Croatia. At the same time, the development of tourism, which provided Croatia with 15-25 percent of GDP, enabled relatively good functioning of the state without the necessity to carry out politically and socially costly reforms. Consequently, as a country that is commercially integrated with the EU and dependent on tourism, Croatia is extremely vulnerable to shocks within the EU. Joining the Eurozone attempts to solve most of these problems by attracting investment, helping restructure the economy, and providing the country with greater economic stability.

The main benefit identified in the Strategy is the elimination of the currency risk associated with exchange rates, to which the Croatian economy is extremely vulnerable. All sectors of the domestic economy, with the exception of banks, have mismatched currency positions in assets and liabilities and are exposed to currency risk. The total gross foreign currency debt of all sectors of the national economy exceeds 500 billion kuna, which in 2019 was about 125 percent of Croatia's GDP. The high level of gross foreign currency debt is largely due to deep integration with the Eurozone. Banks, despite the adjusted currency positions, are also indirectly exposed to currency risk. Integration with the Eurozone and the related currency risk of maintaining its own currency impose the need to take macroprudential measures to protect the system against this risk. With the introduction of the euro, currency risk will almost com-

pletely disappear as all debts currently linked to the euro will become local currency debts.

Second, the reduction of the cost of debt by domestic sectors of the economy is emphasized in the Strategy. With the introduction of the euro in Croatia, interest rates should approach the level of interest rates in the centre of the Eurozone, which will increase the competitiveness of the Croatian economy. The positive impact of the introduction of the euro on interest rates is also confirmed by the dynamics of the yields on long-term government bonds of the new Eurozone member states. The introduction of the euro opens up additional space for lowering the interest rates of banks in Croatia.

Another argument is to reduce the risk of currency and banking crises. Owning currency in a small open economy carries with it the possibility of currency crises. The risk of a currency crisis or an increase in the deficit in the balance of payments is associated with the risk of a bank and/or financial crisis. With the introduction of the euro, the likelihood of costly bank crises will decrease, and the risk of a currency crisis will almost completely disappear.

Another benefit is the reduction of transaction costs. With the introduction of the euro, the transaction costs of exchanging kuna into euro and vice versa disappear. Moreover, with the introduction of the euro as the national currency in Croatia, a reduction in fees for domestic and cross-border payments in euros can be expected.

HNB experts also point to the stimulation of international exchange and investment which the adoption of the common currency should encourage. The use of the euro can contribute to an increase in international trade turnover and investment by strengthening competitiveness and reducing the vulnerability of the national economy. The high representation of Eurozone Member States in Croatian trade, foreign investment, and tourism contributes to the expected benefits of the introduction of the euro in Croatia. The introduction of the euro may slightly increase trade, but relatively less than joining the European Union. The positive impact of the introduction of the euro on tourism is also expected. A single currency could help attract foreign direct investment by reducing exchange rate uncertainty and other informal barriers to investment.

The share of the Eurosystem's profit also provides an additional argument in favour of adopting the single currency. Following the adoption of the euro by Croatia, HNB will be entitled to participate in the annual distribution of monetary income at the Eurosystem level, which should positively affect the excess of income over HNB's expenditure paid to the state budget. Positive expectations about the impact of the share in the distribution of the Eurosystem's profit result from the specific structure of the foreign trade balance and the significant integration of the Croatian economy with the Eurozone.

Finally, integration with the Eurozone will allow access to additional financial assistance mechanisms. By joining the monetary union, Croatia gains access to the European Stability Mechanism (ESM), which helps countries struggling with financial difficulties. The total creditworthiness of the ESM is 500 billion euro, and the funds from the ESM are raised on the financial markets by issuing securities. The ESM also serves temporarily as a common backstop for the banking union in case of insufficient capacity of the Single Resolution Fund. The added value of access to the ESM is reduced by the fact that Croatia continues to have access to EU financial assistance under the medium-term balance of payments facility.

## **7.2. Arguments against joining the Eurozone**

The authors of the Euro Adoption Strategy list a number of problems related to the adoption of the common currency, along with available solutions and possible consequences for the Croatian economy.

The Strategy identifies the loss of an independent monetary policy as among the costs of joining the Eurozone. With the introduction of the euro as the national currency, Croatia will completely lose its independent monetary and exchange rate policy. The main limitations of monetary and exchange rate policy in small economies result from their sensitivity to international capital flows, borrowing in foreign currencies, and the pass-through of exchange rate

fluctuations to consumer prices. However, according to the authors of the Strategy, the loss of an independent monetary policy for Croatia is not a significant cost because the space for active use of monetary and exchange rate policy is significantly limited.

In addition to the policy of a stable exchange rate of the kuna against the euro, HNB also aims to conduct an anti-cyclical monetary and macroprudential policy. The risk of membership in the monetary union lies in the fact that a common monetary policy does not have to meet the cyclical needs of the economy of a member state. However, the business cycle in Croatia is in line with that in the Eurozone, so the common monetary policy of the ECB should not have a negative impact on the Croatian economy. The loss of an independent monetary policy places even greater emphasis on the need to adopt an appropriate fiscal policy.

Another problem is the rise in price levels due to conversion, which 79 percent of respondents cited as a major concern<sup>37</sup>. According to the authors of the Strategy, the impact on the growth of consumer prices due to the conversion of the national currency to the euro is generally very mild. Analyses show that the impact of euro introduction on aggregate inflation was relatively small (0.23 percentage points on average in the new Member States) and transient (most pronounced during the months before the start of con-

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<sup>37</sup> European Commission, *Flash Eurobarometer 487...*, p. 36.



version and in the month intended for conversion). Survey results for other countries show that price increases due to conversion were recorded in the services sector and in less frequently purchased products. In line with the experience of other EU Member States, the impact of the currency conversion on overall consumer price inflation in Croatia is expected to be mild. While the introduction of the euro has had very little effect on overall inflation, most citizens of the Eurozone Member States believe that the introduction of the euro has resulted in a significant increase in prices.

Another risk related to the adoption of the common currency is the risk of an excessive inflow of capital and the accumulation of macroeconomic imbalances. The experience of Eurozone peripheral member states after 2002 shows that they may be exposed to too strong an inflow of capital and the emergence of internal and external imbalances. In the post-crisis period, new mechanisms of economic policy coordination were created and should guarantee much greater stability of the monetary union in the future. In addition to improving the framework for economic policy coordination in the EU, steps have been taken to reduce risks to financial stability. The implemented reforms institutional framework reforms of the monetary union, as well as its own experience with the inflow of capital in the pre-crisis period, should reduce the probability that Croatia will suffer the fate of other peripheral member states.

One-off conversion costs are another issue. There will be one-off costs for changing the currency immediately before and shortly after the introduction of the euro. The experience of the Member States that have adopted the euro so far can be used to estimate the expected level of one-off costs in Croatia. One-off conversion costs in the Member States that first introduced the euro in 2002 are estimated to be around 0.5 percent of GDP. As for Croatia, the costs of some necessary actions and adjustments are expected to be slightly lower compared to new Member States that have already adopted the euro.

The one-off costs of the Croatian National Bank joining the Eurosystem are another anticipated problem. Upon joining the Eurosystem, HNB will have to pay the remainder of the ECB's subscribed capital, transfer part of its international reserves to the ECB, and pay a specified amount as a contribution to the ECB's reserves. While the amount of the payments is known, there are also costs which vary depending on the macroeconomic and market conditions at the time of the central bank's accession to the Eurosystem.

The last cost of Croatia's adoption of the euro is, according to the HNB, its participation in providing financial assistance to other Member States. On the one hand, Croatia, by joining the monetary union, obtains the right to access the financial assistance facility for the Eurozone, it is also obliged to contribute to the costs of solidarity assistance for other Eurozone members. Each Member State's share of the

capital of the ESM is determined according to the key for subscription to the ECB's capital. The cost of participation in assistance mechanisms for the Eurozone countries, assuming Croatia joining the Eurozone in 2016, would amount to approximately 425 million euro.

Apart from the above-mentioned arguments against the introduction of the euro, articulated and essentially neutralized by HNB, there are also other arguments raised by independent centres.

As mentioned in chapter 2, joining the Eurozone is associated with the risk of limiting public spending. The Trade Union of Science and Higher Education believes that the adoption of the single currency is certainly not worth the possible consequences, and they argue that Croatia should not consider meeting the fiscal conditions of joining the Eurozone in the coming years. They argue that Croatia was not ready for the introduction of the euro even before the COVID-19 pandemic and the earthquakes Croatia experienced in March 2020 and early 2021. Croatia has a relatively weak and uncompetitive economic structure, relying heavily on tourism and simple services such as catering. Industrial production is very weak, as is the share of exports of goods in GDP. The export of goods is also based on technologically uncomplicated products. The Croatian tax system is unsustainable due to the enormous impact of a very volatile value added tax that affects the poorest social groups the most. Taxes on wealth, real estate, and inheritance do not exist

or are negligible as a source of tax revenue. State property and, in general, the public sector is poorly managed. Key segments such as education, science, and health care are not properly managed, are poorly funded, and have adopted poor-quality strategic documents. Trust in state institutions is extremely low and emigration has increased rapidly since joining the EU. To sum up, Croatia has many problems and is not economically successful<sup>38</sup>.

In such a situation, they argue for the precondition that some of these problems have been resolved or at least mitigated before the introduction of the euro. With a hasty adoption of the euro, Croatia could add to all these difficult issues the problem of inadequate exchange rates and tight control of public spending, which could further harm an already weak economy. After all, today it is very difficult to predict the direction in which the Eurozone will develop after the pandemic and which economic policy ideas will dominate in the EC and the ECB<sup>39</sup>.

Another argument against the introduction of the euro used by the Union is the statement that the European Union is not prepared to admit new peripheral states to the monetary union. Additionally, it is argued that the policy of the Eurozone countries is subordinated to the interests of the stronger countries at the expense of the weaker countries

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<sup>38</sup> Interview with Matija Kroflin conducted by the author on January 20, 2021.

<sup>39</sup> Ibidem.

on the economic periphery of the EU. There are opinions that the EU has not built the institutions and compensation mechanisms for the Eurozone that are needed by states which are not as effective at conducting monetary, fiscal, and tax policies. The EU does not have mechanisms that guarantee normal development and growth for weaker and less developed countries. The mere accession to the European Union does not automatically solve the economic problems that Croatia is struggling with, and the same will be true of joining the Eurozone<sup>40</sup>.

The director of the Institute of Economics in Zagreb, Maruška Vizek, is of a similar opinion. In January 2019, i.e. even before the COVID-19 pandemic and earthquakes, she doubted the possibility of reducing public debt and maintaining high GDP growth at the same time. Vizek points to the broader problem of economic development and transformation, as well as increasing and strengthening Croatian exports. Adopting the euro during a recession means a total loss of adaptability, which would otherwise be allowed by the free exchange rate of one's own currency. So far, HNB has kept relatively firm control of the Croatian kuna. Nevertheless, the weakening of the home currency helps domestic

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<sup>40</sup> Nezavisni sindikat znanosti i visokog obrazovanja, *Hrvatska može biti spremna za eurozonu, ali eurozona nije spremna za Hrvatsku*, 08.07.2019, Sindikalne vijesti i socijalno partnerstvo, <http://www.nsz.hr/novosti-i-obavijesti/sindikalne-vijesti-i-socijalno-partnerstvo/hrvatska-moze-biti-spremna-za-eurozonu-ali-eurozona-nije-spremna-za-hrvatsku/> [15.12.2020].

exporters become more competitive than importers. Vizek emphasizes that this possibility will disappear after the introduction of the euro. There is also a reduction in labour costs, which means a reduction in employment and nominal wages. The less flexible the economy is, the longer and more painful it is to overcome a crisis<sup>41</sup>. According to Vizek, although the monetary union assumes that the surplus of labour from a crisis country may move to another country within the EU, in practice for a country like Croatia, it means a further outflow of people from the country<sup>42</sup>.

An economic analyst, university professor, former politician and president of the Croatian Society of Economists Ljubo Jurčić shares this view: the interest rate cut can be seen as a benefit, but also as a risk. Namely, lowering interest rates stimulates lending and economic activity. As the Croatian economy relies heavily on low-productivity activities that do not contribute to exports, lowering interest rates could lead to further strengthening of these activities, especially in the real estate and construction markets<sup>43</sup>.

<sup>41</sup> Poslovnji, *Ne trebamo srljati s uvođenjem eura, naša ekonomija to ne može podnijeti*, 23.01.2019, <https://www.poslovnji.hr/hrvatska/ne-trebamo-srljati-s-uvoenjem-eura-nasa-ekonomija-to-ne-moze-podnijeti-349281> [18.02.2021].

<sup>42</sup> M. Vizek, *Svi tvrde da smo spremni uvesti euro. Zna li koliko to košta i čime ćete to platiti?*, Tportal.hr, 07.01.2019, <https://www.tportal.hr/komentatori/clanak/svi-tvrde-da-smo-spremni-uvesti-euro-zna-li-koliko-to-kosta-i-cime-cete-to-platiti-foto-20190107> [15.12.2020].

<sup>43</sup> G. Litvan, *Ljubo Jurčić: Protivim se uvođenju eura jer Hrvatska ne prati produktivnost Europe*, Lider Media, 12.01.2019, <https://lider.media/aktualno/>

Vizek also points to the control of the public debate by the Croatian authorities. This argument has similarly been used by Matija Kroflin. The discussion on the unjustified, according to both economists, concern about price increases simultaneously prevents talking about other, much more important costs, which are not even explicitly mentioned in the Euro Adoption Strategy. According to them, the first and most important of such problems is the loss of the ability to control the rate of one's currency in order to affect the trade balance.

During the European Forum in Alpbach, Nobel Prize winner Joseph Stiglitz joined the conversation on the introduction of the euro in Croatia. According to him, the adoption of the single currency deprives Croatia of two important instruments necessary to adjust to economic shocks. It deprives the authorities of changing the exchange rate and setting monetary policy, and thus of changing interest rates<sup>44</sup>. Thus, the state cannot independently control the money supply in the market, and thus stimulate the economy. The banking and monetary union is also not the solution in this case. As some countries have been hit harder by the crisis

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ljubo-jurcic-protivim-se-uvodenju-eura-jer-hrvatska-ne-prati-produktivnost-eu-rope-37791 [15.01.2021].

<sup>44</sup> Hina, *Dobitnik Nobelove nagrade za ekonomiju: 'Trebalo li Hrvatska uvesti euro? Ap-solutno ne!'*, Jutarnji List, 29.08.2020, <https://www.jutarnji.hr/vijesti/hrvatska/dobitnik-nobelove-nagrade-za-ekonomiju-trebalo-li-hrvatska-uvesti-euro-apso-lutno-ne-15016158> [18.02.2021].

than others, the Eurozone monetary policy that fits with countries like Germany or the Netherlands may not be suitable for Croatia or Spain<sup>45</sup>.

Zoran Milanović argued in a similar way during his victorious campaign for the presidency. According to his line of reasoning at the time, several countries that had been in the European Union for a long time (the Czech Republic, Poland, and Hungary) did not enter the Eurozone. A mortgage in Greece with the euro is more expensive than in Croatia, where, in turn, mortgage rates are than in Italy. So, there are no real and undisputed arguments that the introduction of the euro is right. The President of the Republic of Croatia is currently not participating in the public discussion on the introduction of the euro in Croatia.

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<sup>45</sup> Hina, Dobitnik Nobelove nagrade za ekonomiju...





## Conclusions

Supporters and opponents of the introduction of the euro share some views on the current situation in Croatia. They point to the bad structure of the economy, the underdeveloped industry, IT, and modern technologies sector, too large a share of the tourism services sector in GDP, and negative trade balances stabilized by income from tourism, etc. The answer to these problems should be economic development. The question of how to achieve it divides enthusiasts and people sceptical about adopting the common European currency. On the one hand, maintaining greater economic independence through the possibility of creating the supply of

the Croatian kuna is undoubtedly tempting, but can a small, developing state allow itself to conduct its own, independent monetary policy in the face of actors such as Germany, Turkey, Russia, China, or the United States? By remaining outside this current of European integration, will Croatia be able to count on a sufficient inflow of investments? On the other hand, joining the Eurozone means membership in an exclusive European club, which remains a symbol of a stable and economically developed country. However, the experiences of weaker countries, such as Portugal and Greece, show that their positions as economically less developed countries is not radically improving in the Eurozone. So the choice is neither easy nor obvious.

The success of the introduction of the euro in Croatia depends on several internal and external factors. The first is the economic, administrative, and tax reforms that the current government of Andrej Plenković is pushing through. Lowering taxes, reforming the judiciary and administration, and supporting individual sectors of the economy will undoubtedly be a stimulus for Croatian and foreign entrepreneurs. The parallel preparations of the Croatian National Bank for the adoption of the euro are well assessed by the European Central Bank and the European Commission. However, the success of adopting the euro does not depend on the currency change itself, but on how the country will use its membership in the monetary union. Reforms may prove to be socially and politically costly, and the expected

recovery may come with unpredictable delays. Will Croatia enter the monetary union properly prepared, and if not, will the single currency act as a lifeline or rather as an anchor for the national economy? Further, Croatia's success depends on the behaviour of foreign investors. Will the Croatian market prove attractive enough for them? Will the pool of skilled workers, infrastructure, and consumer purchasing power be able to attract new capital? Finally, there remains the question of how the Eurozone will behave in the face of future crises.



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