JOINING THE EURO: STERN ADVICE FOR THE CROATIAN GOVERNMENT

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As Croatia's lawmakers enter the final stretch toward euro membership, it is essential that they understand exactly what happened in Greece, and why. In five short years, 2009-2014, the Greek economy imploded: one quarter of it vanished. This was a direct result of the austerity packages that the EU and the ECB forced upon the government in Athens. What will Croatia do to avoid ending up in the same trap as Greece?

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Come 2023, the euro zone will welcome a new member, as Croatia ditches its kuna for the euro. The announcement from the European Commission that it has recommended Croatia for euro membership was followed by a variety of laudatory statements. Euronews.com quoted an anonymous "EU official" as praising Croatia for "strong political determination" to join the euro.

They also quoted EU Commissioner Paolo Gentolini, who referred to the common currency as "a rock of stability in these turbulent times." The implication is that currency-union membership will make small, open economies like the Croatian more resilient in times of economic turbulence.

What he did not mention is that Croatia is now setting itself up for a Greek-style debt crisis.

Losing policy independence

Joining the euro is a big step, with major consequences for a country's political sovereignty. It is not a decision to be rushed through any parliament, yet it is easy to get the impression that the Croatian government is trying to fast-track euro membership. This is unfortunate, especially since there does not seem to be much debate in Croatia over how the country can avoid ending up in the hellish debt trap that Greece found itself in a decade ago.

The consequences for fiscal policy should actually dominate any discussion about euro accession. It is difficult to identify any substantial economic advantages of the currency union; the academic literature on euro-zone accession can best be summarized as a draw between benefits and losses.

When the euro recently celebrated its 20th birthday, the evaluations were equally mixed. Existing problems are mostly related to specific sectors, which I identified in my own two-part examination. I noted that the euro actually contributed to the financial crisis by obscuring market-based risk signals, and that it failed to prevent a crisis in sovereign debt.

This does not mean that Croatia will not see economic benefits, but it does mean that such benefits—just like the downsides—are likely going to be insubstantial. The major impact of joining the euro is instead on the economic policy side: by definition, a country completely loses control over its monetary policy, but what is less often recognized is that its fiscal-policy latitude also shrinks.

The effects of this became painfully visible during the Great Recession and its epidemic debt crisis. Greece, the hardest hit country during that recession, is still living with the consequences of having lost their fiscal-policy independence to the currency union.

A long time coming

Croatia joined the European Union in July 2013. Despite a fair amount of internal political turmoil in the years immediately after EU accession, in July of 2020 they joined the European exchange-rate mechanism ERM II. This effectively made Croatia a euro-zone candidate.

At the time, the Governor of the Croatian National Bank, Boris Vujčić, expressed confidence that the country would be able to meet the euro-admission criteria, and to do it possibly as early as January 2023. There were concurring voices: in October 2020, *Osservatorio Balcani e Caucaso Transeuropa* quoted two Croatian analysts who expressed support for the Croatian euro-zone ambitions. One of them, Višnja Vukov with the University Pompeu Fabra in Spain, explained that

> *the decision to join the Eurozone is just a continuation of a long-standing policy of monetary stability, and is actually a logical step considering the high level of debt euroisation in Croatia.*

Her reference was to the high rate of euro-denominated or euro-secured loans that Croatian banks have issued to private-sector customers in recent years. Vukov also noted that with the long-standing fixed exchange rate between the kuna and the euro, and with the high level of euro penetration of the Croatian economy, the central bank in Zagreb has already lost a large part of its monetary-policy independence.

A dissenting view came from Ljubo Jurčić, professor with the Faculty of Economics at the University of Zagreb (translated):

> *[His] well-known thesis is that this exchange rate, i.e., the strong kuna, has*

> *destroyed Croatian industry, exports and the economy as a whole, and that because of the 7.4 kuna-to-euro exchange rate [Croatia] will be at the very back of the European Union.*

Jurčić also pointed out that the Croatian National Bank has pegged the kuna against the euro (and ECU, its predecessor) since 1994. As a result, Jurčić explains, it is not true that the euro "will bring us great benefits." The fixed exchange rate is too high to make domestic industries competitive:

> *That is why the last 25 years have been marked by investing in shopping malls, not in industry, because foreign goods are cheaper precisely because of this exchange rate, while in our country it is not worth producing at all.*

It is difficult to independently verify Jurčić's claim over the longer term. There are no comprehensive international databases that provide the appropriate data. Eurostat, e.g., only tracks industry development back to 2008 for Croatia and comparable economies.

Based on this limited time period, it does not appear to be correct that the alignment of the Croatian economy with the criteria for euro-zone membership has been negative for the country's manufacturing industry. The alignment has created other economic problems, but as a review of Eurostat industry data shows, the Croatian manufacturing industry has recovered almost all of the production value that was lost during the Great Recession a decade ago.

This resiliency is visible in both employment and profitability.

Things do not look quite as good at the macroeconomic level. Adjusted for inflation, Croatia's gross domestic product increased by only 1.2% per year, on average, from 2010 to 2019. This is actually less than the euro area average (1.4%), and Croatia's neighbor

Slovenia (1.9%). It trails Hungary (2.8%), one of Europe's absolutely strongest economies, but it is better than perennially weak Greece (-2.8%).

Fiscal alignment and economic stagnation

Here is where the problems begin. The weak growth rate in the Croatian economy is directly relatable to the country's efforts to qualify for the currency union. When a country enters the euro zone, it comes under the heavy boots of austerity worn by the European Central Bank and the EU.

In order to qualify for euro-zone membership, a candidate country must show a clear ambition to meet the fiscal criteria enshrined in the EU's constitutional Stability and Growth Pact. There, it says that a member state must bring its sovereign debt within 60% of GDP and its deficit below 3% of GDP.

While the Stability and Growth Pact formally applies to all EU member states, in practice it has only been enforced against euro-zone members. The reason for this is that a currency union member that deviates too far from the Pact's criteria, risks ending up in a situation where secession from the euro becomes an attractive option. This was the case with Greece a decade ago, and—at least informally—one reason why the ECB and the EU enforced such heavy austerity requirements against Greece. If Greece brought its budget into balance, the reasoning went, it would have nothing to gain from leaving the euro and returning to a devalued drachma.

Croatia has worked hard to make the fiscal adjustments needed for euro-zone membership. Its ratio of taxes to GDP—a key indicator of both the size of government and of trends in fiscal policy—fell from above 50% in the mid-1990s to 41.1% in 2011. After that, it began climbing again, exceeding 46% since 2019.

The first period could be referred to as the "growth period:" the Croatian gross domestic product grew by an average of 3.7% per year, adjusted for inflation. By contrast, during the second, fiscal alignment period, the average growth rate declined to 1.2%.

As if to reinforce the policy difference, during the growth period the budget deficit averaged 2.6% of current-price GDP. After the Great Recession in 2009-2011, when the country's tax-to-GDP ratio started rising, the budget deficit fell steadily. By 2017, the consolidated Croatian government boasted a balanced budget, which it maintained until the artificial economic shutdown in 2020.

The stark message in these numbers is that the Croatian government has already demonstrated what will happen when the country goes into the next recession. If the Croatian government is not well prepared, a new debt crisis, which is no more than two years away, could wreak havoc on the Croatian economy just as the last one did on Greece.

But wait—is it really bad to balance government finances? Has not Germany done this with great success?

No, they have not. It is true that Croatia has followed the German path to fiscal balance, but that does not mean the strategy has been successful. Just as Croatia has experienced a decline in economic growth, so has Germany. Theirs is a life in virtual economic standstill.

To further imitate the German strategy, Croatia has relied on its exports industry for growth. As share of GDP, Croatian exports remained relatively stable in the 2000s, while increasing from 34% in 2009 to 51% in 2019.

Again following Germany, this reliance on exports has not paid off. The larger exports become relative to GDP, the slower the economy grows. The reason is related to fiscal policy, if exports are promoted in order to stimulate growth in a high-tax economy. Unfortunately, the laws of economics still apply: high taxes prevent exports-driven growth from spreading through the economy.

There is yet more evidence of this growth-suppressing fiscal policy. Gross fixed capital formation, a.k.a., business investments, amounted to 21% of GDP in the ten years from 1998 to 2007 (just before the last recession). From 2010 to 2019, that share averaged 19%.

There is nothing problematic per se with a steady ratio between capital formation and GDP. The problem is that when the economy is stagnant (1.2% growth per year is *de facto* stagnation), a capital stock that grows at the same pace will not generate any new growth. All it will do is maintain the growth rate the economy currently has.

Croatia: A Greek tragedy in the making?

Once the euro has replaced the kuna, Croatia will be in the same situation as Greece was in 2009, when its fiscal crisis exploded. This is not a rhetorical comparison—it is a substantive one. As mentioned, Europe will probably face another debt crisis within the next two years, whereupon the European Union and the ECB could implement the same budget-balancing enforcement measures against Croatia as they did against Greece.

As Croatia's lawmakers enter the final stretch toward euro membership, it is essential that they understand exactly what happened in Greece, and why. In five short years, 2009-2014, the Greek economy imploded: **one quarter** of it vanished. This level of economic destruction was a direct result of the series of austerity packages that the EU and the ECB, together with the International Monetary Fund (IMF), forced upon the government in Athens. The result was a series of crippling tax increases and, in many ways, a destroyed welfare state.

What will Croatia do to avoid ending up in the same trap as Greece?

Pointing to the fiscal alignment that has taken place in recent years will not do. It simply does not matter what measures Croatia has taken to meet the fiscal criteria for the euro zone. Greece was also able to meet the fiscal criteria when they joined the currency union.

Once Croatia joins the euro zone, its fiscal-policy hands will essentially be tied. If a debt crisis comes, the room for independent policy making will be very limited. The time to prepare for a Greek-style debt crisis is now.

If the taste of the austerity pill is too bitter, then perhaps Croatia's lawmakers should slow down its euro accession, at least until the country's political leadership has had time to thoroughly discuss all the consequences of joining the currency union.