

CROATIA: EURO INTRODUCTION IN 2023



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Event

The Croatian Parliament overwhelmingly approved the law preparing for the introduction of the euro in 2023. On 1 June, the European Commission and European Central Bank confirmed that Croatia is ready to adopt the euro as from next year. In July, the European

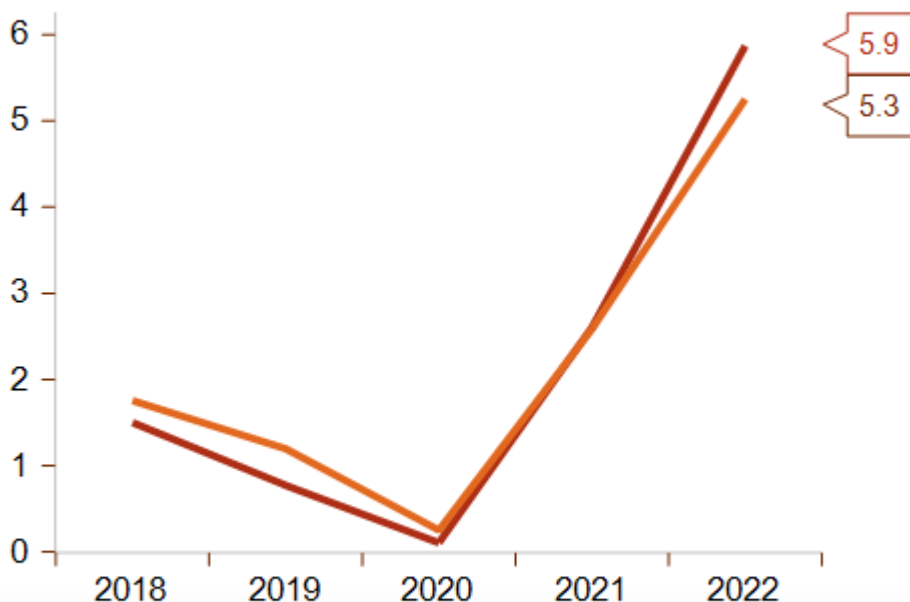
Council will take a final decision and very likely confirm this latest conclusion – which was not yet certain as high inflation was complicating the government’s plan to meet the “convergence criterion” of price stability. However, government adjustments through economic policy measures and the currently high inflation in the Eurozone, driven by external factors, helped Croatia meet its goal of becoming the 20th member state of the Eurozone in 2023.

Impact

The EU green light to Croatia will allow the country to join the Eurozone in 2023. Indeed, the latest Croatian parliamentary vote regarding the introduction of the euro highlighted broad political support and determination to reach the 2023 target. This implied to address the key issue of price stability – which is hindered by high inflation, caused by high food and energy prices. In April, inflation reached a record 9.4% on an annual basis, i.e. above the Euro area’s rate of 7.4%. In order to fight those pressures, the government cut VAT on energy and food products, capped energy prices and tightened its monetary policy. Last month, the IMF expected an average inflation of 5.9% for Croatia this year, i.e. still slightly above the 5.3% expected in the Euro area. Moreover, another increase is still possible by the end of the year. This explains why some uncertainty remained about the introduction year. Nevertheless, the European Commission and the European Central Bank showed understanding in their assessment as the energy and food price crisis is not specific to Croatia but has become a global issue.

Inflation, Average of Period, Change Y/Y

Percent



Besides inflation, Croatia is meeting other convergence criteria: sustainable public finances (i.e. fiscal deficit and public debt should be respectively under 3% and 80% of GDP this year), a stable kuna exchange rate against the euro (since Croatia joined the Exchange Rate Mechanism II in 2020), and long-term interest rate convergence.

Given its high reliance on tourism (mainly from surrounding EU countries), Croatia will benefit from the euro as a legal tender. In fact, besides tourism, the euro is already widely used in Croatia in the banking sector or in external debt denomination. The introduction of the euro should be a positive factor in raising Croatia's liquidity, attractiveness for investments and in lowering interest rates. Those benefits will be welcome, as the economy has been sharply affected by the pandemic, especially by the huge global tourism crisis. After a real GDP contraction of 8.6% in 2020, the economy rebounded by 10.4% in 2021, partly thanks to a strong revival of its travel industry. Prospects for this year's tourism season are supported by the end of Covid-19 restrictions and could allow GDP growth to pick up by 2.7%. This figure integrates the fallout of the war in Ukraine, i.e. mainly high commodity prices, which are affecting consumer confidence and producer prices in Croatia. However, the conflict might also have a negative impact on holiday plans because of higher costs of living across Europe, the security dimension (Croatia being at less than 1,000 km from Ukraine) and the risk of a spreading conflict. Moreover, persisting supply chain disruptions and, now, the risk of a recession within the EU are weighting on Croatia's upcoming economic performances. Hence, weaker domestic and external demand will affect the outlook. This might also keep the current account into a small deficit, particularly via a heavier import bill, as Croatia is a net fuel importer, before returning into surplus as from 2023. This forecast will fundamentally depend on tourism, as it accounted for more than 30% of total current account receipts prior to the pandemic. In the near term, Credendo's risk ratings are expected to remain unchanged. Looking ahead, a stronger than expected tourism season, the euro introduction in 2023 and a larger use of EU recovery funds are upside risks to the outlook.

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