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Policy Issue

Trust in the Currency – The Case of the Euro Introduction in the Croatia*

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I. Croatia and the Eastern Expansion of the Euro

On January 1, 2023, Croatia was accepted to become the 20th member of the Eurozone. The way to the Euro was "not a race, but a responsible political decision", as the Council of the European Union has stated on July 12, 2022, when Croatia had adopted the final three legal acts that enabled the country to introduce the Euro. The conversion rate of the old Croatian currency was 7,5340 Kuna for one Euro. Due to the historic experiences of other countries who had adopted the Euro previously, prices in Croatia had to be marked both in the new currency Euro and in Kuna at the same time until December 31, 2023, in order to prevent unjustified price increases during the transition process.

In contrast to other Eastern European countries like Poland or Hungary who still reject the membership in the Eurozone, Croatia followed an ambitious process to qualify for the Euro. Also the European Central Bank confirmed the successful way of Croatia and supported their request for membership. A special advantage for Croatia and their support for the Euro application was the fact that more than 400.000 Croats live in Germany, but still maintain very close ties to their home country. A lot of Croats have been sending money home to their relatives so that many people were already used to the new currency. The fact, that tourism is the number one industry in Croatia also contributed to that transition process.

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A very difficult detail of the currency conversion from Kuna to Euro were the extremely high inflation rates in 2022 in both currencies – in Kuna even higher than in Euro. It was the first and up to now only time that a new currency was introduced under such difficult circumstances. But the monetary authorities in Frankfurt and in Zagreb staid with their time table – probably also knowing that most of the price increases were caused by soaring energy prices. The development of the current inflation rate back to values below three percent (December 2023) confirms the decision of the ECB and the National Central Bank of Croatia.

Now, almost one year after the introduction of the Euro in Croatia, the citizens and also the tourists developed trust into the new monetary environment and the Euro has successfully expanded into another country of Eastern Europe.

II. Monetary Stability and Trust: Central Pillars of Economic Growth

Currency stability is the most important precondition for every economy to ensure high living standards and reliable investment opportunities for companies and investors. To use an old saying of central bankers: "Monetary stability is not everything, but without monetary stability everything is nothing". While the young and middle aged generation in Central Europe has never made the experience of serious inflation for almost seven decades – until the very special circumstances after the energy crisis 2022 – people all over the world are still suffering from inflation and currency defaults (see *Reinhardt/Rogoff* 2009): The current inflation rate in Argentina (October 2023) has again topped the 140 percent – another sad record in the inflation history of the country.

The European Union and the common currency Euro is a unique and unprecedented experiment in world history (see *Wentzel* 2012). Following the Treaty of Maastricht, several European countries – meanwhile 20 – have decided to use one currency and shift the authority for monetary policy to a supranational level – the European Central Bank in Frankfurt. Therefore, having a union of many countries with the same currency under one roof further increases the necessity to ensure monetary stability in every country over a long period of time. As laid out in the Treaty about the Functioning of the EU (Art. 127), the ECB has only one single goal: price stability[1].

[1] Price stability as a main goal is visible also in the perspective explained by *Martin* (2015, 21; according to *De Grauwe* 2013a, 1 – 3), since monetary policy capacities are embodied in the Central Bank, but without fiscal policy and financial regulatory, being a monetary union without a political union. Therefore, *Martin* (2015, 21) defines the Euro as a "currency without a country".

As it is well known in monetary theory, the size, the location and the economic structure of a country are important to find the right monetary regime and an appropriate exchange rate at the same time. Especially in countries that are geographically and economically small and highly dependent on imported goods and services, the currency regime is of paramount importance. It is not surprising, that the first idea for a single European currency came in 1970 from Pierre Werner, the Prime Minister of a very small country: Luxembourg. The question of currency stability plays a major role in the everyday life of people, impacting their standard of living and opportunities. Therefore, it is a necessity to emphasize: Unstable currencies will negatively impact the economic policy of countries and change citizens trust in currency and (European) institutions as a consequence. Monetary stability is almost like a fundamental human right that is connected with the switch from Croatian Kuna to the Unions currency Euro. But is this insight really common knowledge in all countries of the EU – also in Eastern Europe?

The aim of this paper is to survey the Croatian case of the Euro introduction and trust in currency, since Croatia is the newest member of the Eurozone. Six further states (Vatican, San Marino, Andorra and Monaco – the so-called micro states, plus Kosovo and Montenegro) have adopted the Euro one-sided, even though they are not even members of the European Union. They seem to trust the Euro more than a possible alternative of having their own (micro) currency. But how can this trust in currency be measured and tested?

"Trust in currency" is an old concept dating back to 1966, when the economist and empirical social scientist *Günter Schmölders* conducted an interesting survey with students. *Schmölders* asked probands if they believe that the Deutsche Mark is a stable currency and – not surprisingly at that time, the majority of (German) probands in 1966 confirmed that notion. In the same questionnaire, *Schmölders* asked the probands if they believe that prices will rise and inflation could be a threat. Again the probands answered that they believe that the prices will go up: "Everything gets more expensive". The result of this survey was surprising and – at least for economists – a contradiction in itself. Economists measure the stability of a currency in the rise (or decline) of prices, but for non-economists, there seems to be a trust (or not) in stable prices and – at the same time – a trust (or not) in a currency in general. *Schmölders* concluded that there is a fundamental difference between trust in currency and trust in price stability (see *Wentzel* 1995 and 2019).

III. Theoretical Perspective on Trust in Currency

When do people think it is the right time to switch to a new currency? When do people believe that a new currency (the Euro) is a better alternative compared to an old national currency (e. g. the Croatian Kuna)? Academic literature exists since 1992, the year of the Maastricht Treaty, about the challenges of the introduction of the Euro – in small countries like Luxembourg or Estonia – or in big countries like France or Spain. Interesting experiences were made – for example in Slovenia, in the Baltic States, in Malta and Cyprus – countries who were not on the initial list of countries who started the Euro in 2002. In any case, it is a dynamic challenge to introduce a new currency in regular times – and not after a political disaster like World War II in Germany or a hyperinflation like in Argentina.

Having only one transnational currency issued by a supranational ECB instead of 27 different national currencies from small and big countries was a novelty in monetary economics. Looking backwards, the stability performance during the first decade of the single European currency was "better than expected": The Euro was closer to the 2 percent inflation goal than the Deutsche Mark in historical and empirical perspective which still serves as a kind of benchmark measuring the stability of the Euro. Since 2008 – the beginning of the financial crisis – and 2010 – the beginning of the sovereign debt crisis, the Euro was tested repeatedly and showed remarkable resilience (see *Lane* 2021). The major challenge came in 2020 with the repercussions of the pandemic shock, when the ECB was trying to support the general economic policy of the EU by providing enormous amounts of liquidity at low (zero) interest rates – like the Pandemic Emergency Purchase Program (PEPP) or the Asset Purchase Program (APP) (see *Nagel* 2023)[2]. At this point, fighting a possible deflation was more an issue than fighting inflation. The new challenge of a skyrocketing inflation came up immediately after the beginning of the Russian war against the Ukraine in 2022, causing soaring energy prices and disrupting supply changes and food supply. And now the view goes directly to Croatia, who's entrance into the Eurozone was planned for January 1, 2023. How should the officials in the ECB and in the Central Bank in Croatia react to these unfortunate and unexpected circumstances? Would people in Croatia accept the new currency Euro despite high inflation rates?

When analyzing the single European Currency, the standard economic approach is the "optimum currency area (OCA)" approach following Canadian Nobel laureate *Robert Mundell*. In that understanding, common monetary policy may be preferable if shocks are mostly common and symmetric among the

[2] Both programs, PEPP and APP, were stopped in 2023 as a credible measure to fight inflation in the Eurozone (see *Nagel* 2023).

member states – and even more preferable, if there is high economic and financial interdependence among member countries (see *Lane* 2021). From the opposite perspective: If countries are extremely heterogeneous, they should stay with separate currencies and use the exchange rate as an adjustment tool for trade imbalances. *Mundell* made also the first proposal for a European Currency; therefore, he is sometimes called "the father of the Euro" (*Braunberger* 2021).

Another issue is how to pursue an independent monetary policy in the long run under a system of pegged exchange rates and free capital mobility (*Tavlas* 2004, 90), affecting countries that are part of the European Union, but still not part of the Eurozone (Denmark, Sweden, Hungary, Poland, or the Czech Republic). These countries "opted out" (Denmark and Sweden) or they simply reject to introduce the Euro – mainly for emotional and sociological factors.

The Euro and non-Euro area countries already have a high correlation and synchronicity in key interest rates and business cycles (*Deskar-Škrbić/Kunovac* 2020). Low independence of monetary policy means low cost of joining the Eurozone. Monetary authorities of Sweden and Denmark follow the lead of the ECB much more than the Czech Republic, Hungary, and Poland (*Bednar/Kaderabkova* 2022). Denmark is a legally accepted exception and therefore not mentioned together with the other four member states countries (European Union 2023).

Besides single currency acceptance, trust in currency is important. *Bergbauer* et al. (2020) emphasize existing divergence in trust in Euro and trust in ECB. Therefore "net trust in the ECB remains negative, while net support for the Euro has been increasing steadily since 2013 and reached a record high in autumn 2019".

Inflation is the most important threat to economic stability. Together with usual relevant indicators in central bank analysis, inflation expectations of households are relevant as a feedback of monetary policy. Fighting inflation means always trying to influence expectations. When individuals and companies expect higher inflation, potential wage-inflation spirals are more likely. When individuals see a credible reduction of inflation and trust their central banks effort to reduce inflation and to anchor price stability, they will also be willing to accept moderate wage increases – and therefore cut into the vicious circle of second round effects like wage-inflation spirals. *Schadler* (2005) mentions that the adoption of the Euro can play an important role in achieving one key goal of European enlargement which reduces the income gap in the existing Euro area. A precondition to achieve it is to provide a careful preparation of each economy for the Euro acceptance.

Alessina/Giavazzi (2010) explain why certain countries are behind others for decades – it is their reluctance to prepare for these necessary preconditions. Therefore, the central point is to know that countries who want to be part of the

Eurozone need reforms: Are these reforms and the perspective of becoming a member of the Eurozone enough to continue the path of the economic change? In the context of the "Eastern monetary expansion", *Backé/Wójcik* (2004) question the appropriate time for monetary integration and fast unilateral Euro introduction. According to the Flash Eurobarometer results the proportion of respondents who think that their country is ready to introduce the Euro is the highest in Croatia (37 %), while the lowest proportion is found in Bulgaria and Hungary (both 23 %). Respondents find that social, economic or political implications of the Euro are essential (83 %). Information about the value of one Euro, practical implications of the Euro (all 81 %) and information on how to ensure that the rules for the currency conversion into Euro are respected (76 %) are also essential.

Skaggs (2006) emphasizes the importance of trust in a properly functioning monetary system. He underlined that the value of money depends only on the willingness of economic agents to accept it; it is less important, what material money is made of. Therefore, he developed a credit theory of money, claiming that money originated as debt claim against society. *Evans/Krueger* (2009) say that trust is connected to the implications in economic exchanges and Nobel laureate *Kenneth Arrow* (1974) states that "trust is a lubricant for social system". Trust allows a society to invest more capital and conduct transactions with greater efficiency. Or, in an easier form: Trust means you accept risk because you believe you can avoid negative outcome.

IV. Lesson to learn from the Croatian Case

The "Psychology of Money", developed by *Schmölders* in 1966, was a great starting point to survey the Croatian EMU entry. Trust needs time to be developed, as stated by *Wentzel* (2019), but it can be lost easily. Therefore, a moment to join the EMU should be chosen carefully. Croatia is the first country in the history of the European Currency Union that has replaced the old currency and introduced the new currency during an unprecedented time of high inflation – in both the old and the new currency at the same time. As a consequence of the Russian war against the Ukraine and – therefore – the explosion of energy prices, all currencies worldwide and of course also of the Eurozone came under high inflationary pressure. Also the old Croatian currency Kuna was suffering under inflation rates of approximately 20 %.

During the previous introductions of the Euro in Eastern European countries, e. g. Slovakia or Slovenia, the inflation rate of the Euro was close to the benchmark of two percent and the old local currencies had been channeled and prepared to a low inflation rate with the so-called convergence criteria. But – nevertheless, after the introduction of the Euro, some private individuals and business companies were raising prices of their goods and services without any additional specific reason – just to take advantage of an opportunity and using the new currency as a scapegoat for these activities. In Germany for example, that negative perception of rising prices ("Der Euro ist ein Teuro") gave the Euro a difficult start in public opinion. Based on this experience, the Croatian Euro introduction from January 1, 2023 tried to keep prices in Euros equivalent to previous prices in Kuna by using both prices in restaurant menus. That has led to very unusual "twisted" prices like 1,24 Euro for a beer, but at least it had restricted the opportunities to round up prices to a higher level. Nevertheless, after that first transitional period, most of the prices rose slightly.

Every country that introduces the Euro has different economic, political, geographical and cultural parameters. In the case of Croatia, a small and open economy already "bonded" with the Euro area is an example where the Euro introduction should not be a question. Therefore, the risk of an unforeseen exchange rate crisis is eliminated completely. From that perspective, it is understandable that even non-EU-countries like Kosovo or Montenegro have introduced the Euro one-sided. Countries where the Euro plays a dominant role as a parallel currency (so-called "Euroization") are in a similar situation. The appropriate timing for the introduction of the Euro should be considered based on the pros and cons of a common currency – and for small countries, economists usually see more positive externalities than potential costs.

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