

Tamara Capeta

European Monetary Integration: The Case of Croatia

Paper presented at the 1997 ECSA Conference

Seattle, Washington, 29 May - 1 June 1997

Draft version

Comments are welcome

Tamara Capeta

Institute for International Relations, Ul. Lj. F. Vukotinovica 2, 10000 Zagreb, Croatia,

tel: --/385/1/45-54-522; fax: --/385/1/444-059; e-mail: tamara@mairmo.irmo.hr

Summary

The paper analyses the position of Croatia in the process of European monetary integration. Adjustment to the European monetary policy is seen as a precondition for inclusion in the wider process of integration in Europe. In the background of the incomplete monetary union which will be created in 1999, the paper suggests and examines possibilities of adjustment of Croatian monetary and exchange-rate policy to the ERM 2. It is concluded that Croatia can, for the moment, participate in the ERM only informally. This means unilateral peg to the euro, and non-institutionalized adjustments to the European monetary and economic policy. Having in mind the present state of Croatian economic and monetary situation, it is concluded that such arrangements are possible. Informal joining of the European monetary arrangements may, not only speed up the Croatia's integration in the EU, but may per se be beneficial in terms of keeping stable monetary situation in the country.

European Monetary Integration: The Case of Croatia

by Tamara Capeta

Introduction

One of the aspects of the integration process under way in Europe is monetary aspect. Countries of Western Europe have long history of cooperation and integration in the monetary field,¹ of which the Maastricht Treaty decision to engage in creating the monetary union is only the last step. After Maastricht, all the countries wishing to stay participants in the European integration must accept the monetary union as the next goal in the process.² That is why the Copenhagen European Council³, when deciding on the criteria which Central and Eastern European candidates should fulfil in order to be eligible as members of the EU, included as one of the criteria the requirement that a candidate country should endorse the objectives of economic and monetary union.

Croatia, like other countries of Central and Eastern Europe, aims at becoming a full member of the European Union.⁴ Since endorsing the EMU objectives is one of the criteria for the EU eligibility, preparations for the monetary union should be seen as a part of a wider strategy of integration into the EU.

¹ More about the monetary integration process in Europe see in: Capeta, Tamara. ECU i monetarna integracija u Europi. Zagreb: IRMO, 1995, 175 pp.

² The exceptions to this rule were, however, provided for the United Kingdom and Denmark.

³ European Council met in Copenhagen in June 1993.

⁴ Although there is no formal document containing Croatian strategy of international relations, the goal to become the member of the EU was repeatedly proclaimed by all the government branches, and by the ruling party and the opposition alike.

Analytical Framework

This paper will analyse how Croatia can join the monetary integration in the EU. Two aspects are important in this analysis. First, the pace of Croatia's integration in the EU. Second, the progress of monetary integration within the EU.

At the moment, Croatia has no contractual relations with the EU. It is expected that a Cooperation Agreement will be signed soon. This would open the door for the next step - association status through the Europe Agreement, which is a *de facto* precondition to become a candidate for membership.⁵ First round of accession negotiations will start six months after the closure of the IGC with the countries which have already signed the Europe Agreements. Negotiations with other countries cannot be expected before this first round of enlargement to the East is completed. Thus, it is hard to expect that Croatia's turn to become a serious candidate for membership will be any sooner than the year 2005 (this being a very optimistic prognosis).

At the moment, not being a member of the EU, Croatia enjoys full monetary sovereignty, which means that it can lead independent monetary and exchange rate policy. None of the transitory phases towards a full membership (Cooperation and Europe Agreement) impose an obligation of adjustment of its monetary policy to that of the EU. However, since it will be expected from any country which becomes serious candidate for the EU membership to adjust its monetary policy to the EU monetary policy, it is useful to examine in which way and to what extent Croatia may start such adjustments while still in the transitory phase. Some authors are of the opinion that an informal *ex ante* adjustment is "not only the right approach, but stands as the only possibility for future inclusion in the European monetary integration process."⁶

⁵ Here I assumed that the path of contractual relations building between Croatia and the EU will be the same, or at least similar to the one the other countries of Central and Eastern Europe went through. More about the development of relations between Croatia and the EU see in: Samardžija, Višnja. *Europska unija i Hrvatska, Putevi povezivanja i suradnje*. Zagreb : IRMO, 1994, 227 pp.

⁶ See Lavrač, Vladimir, *Monetary and Financial Integration in the European Union - the Case of Slovenia*. Paper presented at the Conference "Assessment of the Implementation of Europe Agreement in Poland", Sopot, October 26-27, 1995, p. 2.

If we agree that early adjustment is useful, if not even necessary, the question which follows is what Croatia should adjust to. This brings us to the second aspect mentioned above: the rhythm of monetary integration within the EU. At present, it seems that the schedule decided by the Maastricht Treaty will be followed, and that the monetary union will be created on 1 January 1999 (second, compulsory date envisaged by the TEU). According to the scenario for changeover to the Single Currency, approved by the Madrid European Council in December 1995, the single currency, under the name of euro, should be introduced by 1 January 2002, at the latest. However, and such possibility was envisaged by the TEU, not all present EU members will fulfil the criteria for the entry in the monetary union by 1999. These countries, called "pre-in" countries,⁷ will at the outset, remain outside the monetary union.

Therefore, two things relevant for present analysis are almost certain. First, that the European Monetary Union will be created before Croatia becomes the member of the EU. And second, that not all the current EU Member States will enter the monetary union at the outset. This second fact means that a transitory arrangement linking their currencies to the euro, and their monetary and exchange rate policies to the European Central Bank monetary policy, will have to be created for the "pre-in" countries.

At the European Council in Dublin (13 and 14 December 1996) the ECOFIN Council and the European Monetary Institute presented reports on preparations for stage 3 of the EMU.⁸

⁷ The countries which will not fulfil the conditions for the entry into the monetary union at the outset are called the "pre-in" countries, in order to differ them from the "in" countries (or countries which will create monetary union), and at the same time to avoid calling them "out" countries, being a politically sensitive issue. TEU refers to these countries as member states with a derogation (see Art. 109k TEU).

⁸ The text of the ECOFIN and EMI Reports to the European Council in Dublin may be found on the Internet: <http://europa.eu.int/en/record/dublin/dub-en2.htm>

Although these are not final decisions (the final proposition will be presented at the next European Council), they are firm indicators on how the future monetary system and its exchange rate mechanism will look like. The report stated that the purpose of the new mechanism (called ERM 2) would be to preserve exchange rate stability, thus providing for the stability on the single market, but also to ensure that "pre-in" Member States orient their policies toward stability which will at the end enable them to adopt the single currency.

If the goal of adjusting Croatian monetary policy is to prepare it in advance for the European Monetary Union,⁹ then the logical solution is to adjust to the policy which the "pre-in" EU Member States will follow in order to achieve the same goal.

Exchange Rate Adjustments in Croatia

Under the following title I will examine the necessary changes if Croatia wants to adjust its exchange rate policy to the ERM, and whether such regime is sustainable in view of the present economic situation in Croatia.

Formal change of the Exchange-rate regime

Since the beginning of the stabilization program in October 1993, the exchange rate policy of the National Bank of Croatia (NBC) has been based on the managed floating exchange rate regime. The currency - kuna is formally floating, but the NBC intervenes at the foreign exchange market, maintaining the fluctuation margins, although the intervention points were never formally announced. The reason for choosing such a regime was to alleviate the inflationary pressures of

⁹ The future potential EU membership is not the only, and probably not even the most important argument for Croatian monetary adjustment. Tying the monetary policy to a mechanism which promises stable monetary relations is in itself beneficial for a country.

the foreign currency inflow. The NBC thus tolerated, to a certain extent, the appreciation of currency caused by the excess supply of foreign currency.

Adjustment to the exchange rate policy in the EU under proposed scenario of incomplete monetary union, would require the fixing of the exchange rate of kuna to the euro, with the obligation to intervene at the agreed intervention points (this is under assumption that ERM 2 will be accepted to regulate relations between the euro and the "pre-in" countries' currencies¹⁰). Although this means the change in philosophy behind the exchange rate - from the floating to a fixed exchange rate - accepting formally the ERM regime does not in fact present an important change when compared to the present exchange rate policy of the NBC. Namely, the ERM regime requires fixed but adjustable exchange rates, while the present system in Croatia is floating but managed. Thus, in both versions the predetermined intervention margins, which the monetary authority promises to maintain, exist.

Not being a member of the EU, means that the participation of Croatia in the ERM 2 can only be informal.¹¹ This further means that Croatia will have to bear the costs of adjustments alone, and will not have a possibility to benefit from the intervention and credit facilities created to help the ERM members to sustain determined exchange rates. On the other hand, such informal arrangement, lacking compulsory element makes Croatia's position much more flexible.¹²

¹⁰ According to the ECOFIN Council Report to the European Council in Dublin, the new ERM will replace the old one on 1 January 1999. The membership will remain voluntary, but the "pre-in" countries will be expected to join the mechanism. It will be based on central rates vis-a-vis the euro, around which the margins of fluctuations will be set. Intervention at the margins will be obligatory for both the ECB and the Central Bank of other fluctuating currency.

¹¹ However, it is interesting to note that present Resolution which created the EMS, provides for the possibility for the countries not members of the EC, but having close economic and financial relations with the Community, to join the exchange rate mechanism (Art. 5.2. of the Resolution). Although the similar solution was not proposed in the report of the ECOFIN Council to the Dublin European Council, the possibility that similar solution might be accepted for the countries having associated status with the EU is not to be excluded.

¹² Unilateral devaluation is forbidden in the ERM. As Croatia will not formally be a member of the ERM, the unilateral devaluation of the currency, although not advisable and although not in "European spirit", will stay at the disposal of the Croatian authorities as a legitimate instrument of monetary and economic policy.

Sustainability of Croatia's participation in the ERM

As we have seen, in formal terms the adjustment to the ERM should not present a problem for Croatia. However, "participation" in the ERM does not mean only fixing the exchange rate of kuna to the euro, but also the ability to keep such exchange rate within the allowed fluctuation margins.

The ECOFIN Council Report stated in paragraph 8 that "lasting convergence of economic fundamentals is a prerequisite for sustainable exchange-rate stability". Economic convergence in the EU is guided by the Maastricht convergence criteria.¹³ Although they were introduced in the Treaty as conditions for the entry in the monetary union, the performance of a country in terms of the Maastricht criteria is an indicator of its ability of successful participation in the ERM. Therefore, Croatia's macroeconomic performance in terms of Maastricht criteria (especially inflation and interest rates) can lead to the conclusion showing whether Croatia is capable of sustaining kuna's exchange-rate within the ERM regime.

The most important condition for the maintenance of the fixed exchange rates within the ERM is the similarity of the inflation rates among participants.¹⁴ In Croatia, the Stabilization programme of October 1993 succeeded in reducing inflation from the four digit number

¹³ Maastricht Convergence Criteria:

- 1) Inflation rate - the average inflation rate must not exceed for more than 1.5 percentage points the average inflation rates of the three best performing countries in terms of inflation (inflation is measured using the consumer price index).
- 2) Interest rates - the average nominal long-term interest rates must not exceed by more than 2 percentage points, the interest rates in the three countries with the lowest inflation rates (interest rates are measured on the basis of long-term government bonds or comparable securities).
- 3) Budget deficit - the annual government budget deficit must not exceed 3% of gross domestic product (GDP)
- 4) Public debt - total outstanding government debt must not exceed 60% of GDP.
- 5) Exchange rates stability - currency has to participate in the ERM, keeping the fluctuation margins without severe tensions for at least two years before entering the monetary union.

¹⁴ See Lavrac, Vladimir, *op. cit.*, p. 5.

(1149.72%) in 1993 to only 3.75% in 1995, and 3.1% in 1996 (September data).¹⁵ Thus for the last two years the inflation in Croatia converges with that in the EU - EU average in 1995 was 3.0% and in 1996 2.6%.¹⁶

The same is not true for the interest rates. Until recently, the interest rates in Croatia were very high. The downward trend started in the end of 1995, after the signing of the Dayton Peace Agreement and the start of the programme of rehabilitation of banks. The money market interest rate fell to 8% in summer 1996 (from 32% in the spring same year). Lending interest rates of commercial banks followed the downward trend. Providing the successful reform of the financial sector in Croatia, the interest rates should continue to fall towards reaching the levels in the EU Member States.¹⁷

These data, especially low and stable inflation rates, allow the conclusion that National Bank of Croatia might sustain the exchange-rate of the kuna within the ERM 2. The additional argument for such conclusion is the present stable exchange-rate of kuna. In the period since December 1993 to April 1996, the fluctuation of the kuna in relation to the D-mark was 1.4%. During 1995, the average monthly fluctuation in relation to D-mark was 1.3%.¹⁸ As the D-mark is within the present ERM informally the anchor currency, observing the narrower, 2.25% margins indicates that maintaining the wider (+/-15%) margins towards D-mark or towards the euro in the ERM 2 should be possible.¹⁹

The longer-term sustainability of the exchange-rate towards the euro is possible if the good results of the 1993 stabilization programme are maintained. In this respect, imposing the

¹⁵ Data from: The Republic of Croatia : A Presentation to Standard & Poor's on Credit Ratings, Zagreb, November 1996.

¹⁶ Data from: 1996 Broad Economic Policy Guidelines, European Economy, No. 62, European Commission, DG for Economic and Financial Affairs, 1996.

¹⁷ After rehabilitation of the three Croatian banks, the interest rates on the money market fell. In 1996, one of the biggest Croatian banks - Privredna banka - entered into the process of rehabilitation, which, if completed successfully, should lead to the further decrease in the interest rates.

¹⁸ See Annual Report of the National Bank of Croatia for 1995, p. 22.

¹⁹ The wider margins are in force within the ERM since the summer 1993. They were widened by the decision of the EC finance ministers in an effort to terminate the currency crisis which started in autumn 1992. The ECOFIN Council Report suggested that the fluctuation band in the ERM 2 shall

Maastricht criteria as a goal of the Croatian economic policy can help in this task. It is especially advisable to observe the Maastricht limit on government financial position. The biggest problem in fulfilling the Maastricht criteria for majority of the EU countries are ceilings on budget deficit and public debt. These two Maastricht criteria are at the moment met in Croatia. In 1995 the public debt presented only 21.87% of the GDP. In the same year, the central government budget deficit was 0.8% of the GDP, and with the addition of five extra budgetary funds for Pensions, Health, Employment, Child Benefit and Water Management, the total deficit in 1995 amounted to 0.4%. Due to the capital spending required for the reconstruction of the devastated parts of the country and the investment in infrastructure, the 1996 central government budget allowed for a higher deficit of 2,21% of GDP.²⁰ As Croatia is presently not very indebted country, accepting the Maastricht limits as the national economic policy orientation may help avoiding the difficulties that present EU members have in fulfilling these two criteria. While exceeding by a small percentage the inflation rate limit should not be very difficult to sanction in the short run when the time of entering the monetary union comes, the indebtedness of a country is a long-term and difficult problem to be solved. So, if the disease might be prevented, it is always better choice than the post cure.

Other Requirements of the European Monetary Integration Process

The Delors Report on economic and monetary union²¹ mentions three preconditions which a country has to meet in order to be eligible as a member of monetary union. These are:

remain relatively wide, like the present one, allowing closer exchange-rate arrangements on the bilateral basis (see points 11 and 13 of the Report).

²⁰ Data from The Republic of Croatia : A Presentation to Standard & Poor's on Credit Ratings, Zagreb, November 1996.

²¹ Report on Economic and Monetary Union in the European Community. Luxembourg : Committee for the study of economic and monetary union, 1989.

- complete and irreversible convertibility of currency;
- full liberalization of capital market and integration of banking and other financial markets (with markets of other members of the monetary union); and
- elimination of the fluctuation margins (in relation to other currencies which form the monetary union), which will in turn enable the irrevocable fixing of the exchange rate.

The Maastricht criteria, although a useful indicator of a country's potential to maintain exchange rate stability within the European monetary system, were introduced in the TEU as the exam the country has to pass in order to enable the operationalization of the third Delors condition - elimination of fluctuation margins. This condition and the Maastricht criteria as a formal requirement become relevant only when the inclusion in the monetary union becomes actual (which is not, and will not very soon be Croatian reality).²²

For the other two preconditions a country should start preparing much in advance. Thus, Croatia should not only prepare for the monetary union through informal adjustments to the ERM 2 and through aiming at fulfilling the Maastricht convergence criteria, but it also needs to achieve current and capital account convertibility of its currency, and adjust its financial market to the EU rules and practices.²³ The following passages will examine the current and capital account convertibility of Croatian currency. The other criteria which a country has to fulfil on the way to monetary union's membership, such as the legal and actual independence of the Central bank, shall not be examined in this paper.

²² However, participation (even informal) in the ERM, discussed *supra*, is to be understood as a preparatory phase which will enable the elimination of the fluctuation margins when the time comes.

²³ Full capital market liberalization was the task which the EU countries had to fulfil in the first phase of the process of the monetary union building, which started on 1 July 1990, the date when the Council Directive liberalizing capital movement came into force (see Council Directive 88/361, (1988) O.J. L178/5). The second phase, which started in 1994 and will last until 1999, requires Member States to take the measures for the complete - legal and actual - independence of the national central banks.

Convertibility of kuna

The financial system of the Socialist Federal Republic of Yugoslavia formally broke up in June 1991. At the end of December 1991, Croatian Government implemented the first stage of a proposed two-staged currency reform. The Government passed a package of measures establishing the National Bank of Croatia (NBC), and introducing Croatian dinar, as a transitional currency replacing Yugoslav dinar as the medium of exchange.²⁴ The introduction of a permanent currency was made dependent on the macroeconomic stabilization, especially reduction of inflation, and on the acquirement of sufficient foreign currency reserves by the NBC, which after the breakup of Yugoslavia had no foreign currency reserves.

In October 1993, Croatian Government started the stabilization program, which included a tax reform, expenditure limits to close the budget deficit, monetary stringency, wage control and internal convertibility of Croatian dinar. The devaluation of dinar was also part of the stabilization package, but the success of other parts of the programme, resulted in actual appreciation of dinar in relation to D - mark.²⁵ The stabilization programme succeeded to break inflation in one month. The foreign currency reserves of the Central Bank rose, and the confidence in the domestic currency was established.²⁶ This enabled the second stage of the currency reform to be implemented. On 31 May 1994, a new currency, Croatian kuna was introduced at the value equivalent to 1000 Croatian dinars.

²⁴ See Jankov, Ljubinko. *Monetary Policy and Inflation in Croatia*. Zagreb : IRMO, 1994 (Reform Round Table Working Paper, No. 10)

²⁵ See *Country Report on Croatia, Bosnia-Herzegovina, Macedonia, Serbia and Montenegro, and Slovenia*. London : The Economist Intelligence Unit, 2nd quarter 1994.

²⁶ Jankov, Ljubinko, *op. cit.*, p. 4.

One of the aims of the stabilization programme was to achieve the current account convertibility of domestic currency. In October 1993, the Law on the Foundations of the Foreign Exchange System, Foreign Currency Operations and Gold Trading²⁷ was passed. It initiated

liberalization of the foreign exchange system. The most important elements of liberalization were the establishment of the interbank currency market, definition of the intervention role of the NBC, abolition of obligatory foreign currency cession, and the liberalization of the right of physical persons to buy foreign currency for the purposes of the current account transactions.²⁸

According to the IMF criteria,²⁹ Croatian currency was still inconvertible, and enjoyed the transitory arrangement under Art. XIV of the IMF Statute. By the end of 1994, Croatia eliminated all foreign exchange restrictions prohibited by Art. VIII of the IMF Statute. Thus, a *de facto* current account convertibility was achieved. On 29 May 1995, Croatian Government notified the IMF that it accepted all the obligations imposed by the Art. VIII, sections 2, 3 and 4 of the IMF Statute, by which Croatian kuna became convertible also *de iure*.³⁰

As the status of convertibility under IMF Art. VIII is irreversible, *i.e.* any new restrictions of the foreign exchange regime may not be introduced unilaterally, but are subject to the approval by the IMF under specified conditions, it may be concluded that Croatia met the first precondition for the entry into monetary union, namely full and irreversible current account convertibility of the domestic currency.

However, several capital transfer restrictions still exist.

²⁷ Narodne Novine, 91A, 11.10.1993.

²⁸ See Annual Report of the National Bank of Croatia for 1995.

²⁹ Croatia is member of the IMF since December 1992.

³⁰ International Monetary Fund Annual Report 1996.

Capital and financial market

Capital market liberalization is not only a precondition of being accepted to monetary but is one of the four single market freedoms. Although at the moment Croatia is not under legal obligation towards the EU to liberalize capital market, once it acquires the association in the EU, this will become its legal obligation.³¹

Croatian kuna has already achieved partial capital account convertibility (some types of foreign capital transactions are free of restrictions). Transfer of capital both in and from Croatia is free for non-residents. On the other hand, the transfer of capital abroad by the residents is in some cases restricted.³² The aim of such policy is clear: attract foreign capital to Croatia, and prevent the flight of the capital abroad.

The process of gradual liberalization of capital account transactions is probably going to be included in the new three year structural arrangement with the IMF, which is under negotiation. Providing the continuation of the stable macroeconomic environment, it is evaluated that the liberalization may be implemented in a three to five-year period.

³¹ This is under presumption that the association is based on the similar instrument to the Europe Agreements, Associated status would also mean inclusion of Croatia in the Pre-accession strategy, within which the adjustment to the single market is guided by the EU. See the Paper - Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union, COM(95) 163 final, 10.5.1995.

³² Direct investments in Croatia are completely free from any restrictions. The same is true for portfolio investments in Croatia by non-residents, although there exists the legal possibility to restrict this type of investments. The transfer abroad of the capital resulting from the investments in Croatia is free for the non-residents. Non-residents are free to open bank accounts in domestic or foreign currency, and to transfer this capital to foreign bank accounts. Transfer of capital from domestic bank accounts of non-residents to foreign currency bank accounts of non-residents is restricted to prevent the money laundering (effective foreign currency may be transferred to the account in Croatian bank free up to a certain amount, while for the higher deposits the approval of the NBC must be obtained). On the other hand, the direct investments of Croatian residents abroad are subject to the permission of the Ministry of Economy. Portfolio investment of domestic physical persons abroad is subject to the approval by the NBC, while it is completely prohibited for legal persons. Domestic persons are free to open credit abroad free of any restrictions, with the obligation of registering it by the NBC. Opening of bank accounts abroad is subject to the approval of the NBC, except for the banks. More information on capital restrictions in Croatia see in: Radošević, Dubravko, *Konvertibilnost valuta po kap*

This process requires the parallel reform of the financial sector in Croatia. There is at present more than 50 banks operating in Croatia (24 of them existed before 1989). The banks have been restructured and privatized according to the same scheme as other companies. The legislative framework, including the system of prudential supervision is in large parts adjusted to the EC legislation. All limitations to the foreign ownership of banks were removed in 1993. However, the role of foreign capital is still limited, but its share is increasing. Although the conditions for the strengthening of the financial sector exist, the "old" banks, which are also the biggest banks and have the largest share of the market, inherited some problems from the former socialist system (in the ownership structure - bank debtors are in the management of the bank, or inherited illiquidity). Thus, in late 1995 the Government started with the bank rehabilitation programme. Rehabilitation is conducted on the case by case basis. So far, three banks undergone the rehabilitation process: Slavonska, Rijecka and Splitska. The consequences were felt on the market - in the fall of the interest rates. At the end of 1996, the second biggest bank in Croatia - Privredna banka - entered the rehabilitation process.³⁴

Conclusions

If Croatia's aim is to become a member of the European Union, this also implies its membership in the Monetary Union, which should be already established by the date Croatia becomes the EU member. Although the new members would probably not be required to join the monetary union simultaneously with their membership in the EU, it is necessary to direct monetary policy towards achieving requirements of the EMU while still in the transition period. Adjusting to

³⁴ Data from Republic of Croatia : A Presentation to Standard & Poor's on Credit Ratings, Zagreb, November 1996. More about the banking sector in Croatia, see in: Sonje, Velimir. Kraft, Evan. Dorsey Tom. Monetary and Exchange Rate Policy : Capital Inflows and the Structure of the Banking System in Croatia, Paper presented at the Second Dubrovnik Conference on Economies in Transition, 1996.

monetary union, should not be seen only as a goal to be achieved for the purposes of the successful inclusion in the EU. It is also a strategy that, if implemented properly, promises a stable monetary situation in the country and stable exchange rate relations with the countries which are Croatia's main trading partners.³⁵ Simultaneously, tying the monetary and exchange rate policy to the European policy may help in accelerating the process of Croatia's integration in the EU.

The European Monetary Union will start among the EU countries which fulfil the Maastricht criteria, while other EU countries will at the start remain outside. Therefore, a new arrangement will have to be created within the EU itself to regulate relations between the currencies "in" and "pre-in" the monetary union. One of the aims of such arrangement will be to enable the "pre-in" countries to join the monetary union on a later date. The logical option for Croatia is, therefore, to adjust its monetary policy to the one which will be designed for the "pre-in" EU countries.

Already today there are firm indications that the new European monetary order will be designed similarly to the existing Exchange Rate Mechanism. The new ERM would probably require the peg to the euro, and the maintenance of the fluctuation margins which will be determined in the framework of the arrangement. Additionally, the progress towards achieving the Maastricht criteria will be expected from the members of the new ERM, both for the purposes of maintaining the mechanism and for the purpose of future inclusion in the EMU.

At the moment, Croatia can "participate" in the ERM only informally. Choosing this option would require accepting the fixed exchange rate regime, *i.e.* pegging the Croatian kuna to the euro, and maintaining the exchange rate within the fluctuation margins established within the mechanism. In the light of the present stable macroeconomic situation in Croatia, especially the

³⁵ According to the data of the Croatian Central Bureau of Statistics, EU 15 accounted for 58% of the total exports of Croatia in 1995, and for 62% of the total imports.

low and stable inflation rates and the stable exchange rates, accepting this option should not present major problems for Croatia.

Notwithstanding the fact that Croatia's participation in the European Monetary Union is only a long-term perspective, accepting the Maastricht criteria as a goal of the country's economic policy should be seen not only as an accelerator of Croatia's acceptance in the process of integration in Europe, but also as an instrument for achieving and maintaining the macroeconomic stability, important *per se* for every country.

Preparations for the future inclusion in the single market and the monetary union require not only the maintenance of the macroeconomic stability, but also some structural adjustments, especially in the field of capital and financial markets. Therefore, the adjustments in these fields, which are already under way in Croatia, should also be seen as part of the strategy to join the process of European monetary integration, understood as a segment of the wider process of European integration.

References

- * Annual Report of the National Bank of Croatia for 1995
- * Country Report on Croatia, Bosnia-Hercegovina, Macedonia, Serbia and Montenegro, and Slovenia. London, The Economist Intelligence Unit, 2nd quarter 1994
- * Capeta, Tamara. ECU i monetarna integracija u Europi. Zagreb : IRMO, 1995
- * International Monetary Fund, Annual Report 1996
- * Jankov, Ljubinko. Monetary Policy and Inflation in Croatia. Zagreb : IRMO, 1994
(Reform Round Table Working Paper, No. 10, 1994)

* Lavrac, Vladimir. Monetary and Financial Integration in the European Union - the Case of Slovenia. Paper presented at the Conference "Assessment of the Implementation of Europe Agreement in Poland", Sopot, October 26-27, 1995

* Radosevic, Dubravko. Konvertibilnost valuta po kapitalnim transakcijama s inozemstvom. Ekonomski pregled, No. 1-2, 1996, pp. 125-138.

* Report on Economic and Monetary Union in the European Community. Luxembourg : Committee for the study of economic and monetary union, 1989

* Report by the Council (ECOFIN) on the preparations for Stage 3 of EMU, Internet: <http://europa.eu.int/en/record/dublin/dub-en2.htm>

* Samardzija, Visnja. Europska unija i Hrvatska : Putevi povezivanja i suradnje, Zagreb : IRMO, 1994

* Sonje, Velimir/ Kraft, Evan /Dorsey, Tom. Monetary and Exchange Rate Policy, Capital Inflows and the structure of the Banking System in Croatia. Paper presented at the Second Dubrovnik Conference on Economies in Transition, 26-28 June 1996

* The Republic of Croatia : A Presentation to Standard & Poor's on Credit Ratings, Zagreb, November 1996

* 1996 Broad Economic Policy Guidelines, European Economy, No. 62, European Commission, DG for Economic and Financial Affairs, 1996