Peer Review

Review of: "Testing Monetary Sovereignty and Structural Inflation Shifts: Evidence from Croatia's Euro Transition (2000–2024)"

Viktor Shevchuk[1]

1. Cracow University of Economics, Krakow, Poland

Please find a review with figures in the attached file.

Review

of the article titled **Testing Monetary Sovereignty and Structural Inflation Shifts: Evidence fromCroatia's Euro Transition (2000–2024)**

by Zdravko Sergo, Jasmina Gržinić, Anita Silvana Ilak Peršurić

Summary. The article deals with the problem of Croatia's transition from monetary sovereignty to euro adoption in 2023. The topic addresses one of the fields in monetary economics, known as the Modern Monetary Theory (MMT), which rose to prominence in the aftermath of the world financial crisis of 2008-2009. Also, it is of interest in the context of eurozone accession, which is a subject of discussion in several Central and Eastern European countries, Czechia and Poland in the first place, which are considering the pros and cons of monetary sovereignty versus joining a monetary union. The research is based on an informative literature review and employs sophisticated statistical methods, such as Panel ARDL and Hybrid Bayesian Structural Time Series (BSTS) models. However, there are a few problems to address with respect to the identification of functional monetary sovereignty in the pre-euro period (see below). As I have no experience in dealing with the Hybrid Bayesian Structural Time Series (BSTS) model, it is not possible to assess the reliability of the decomposition of inflation responses into structural, sectoral, and regime-specific effects.

Major points

Point #1. It does not seem convincing to interpret the results of a Panel ARDL for a few CEE economies to conclude that there is a lack of relationship between the budget deficit and consumer price inflation in Croatia. For a proper assessment of policy implications for a given country, country-specific estimates are needed. Unfortunately, I do not have Croatia's budget balance time series at hand to provide empirical estimates. However, it is possible to address another argument, very popular in the context of the MMT framework, that the housing market has served as a source of anti-inflationary pressure. For country-specific estimates in an environment with structural shifts, an estimator with time-varying parameters (TVP) is better suited for the identification of any structural changes in the relationship between house prices and consumer inflation. Actually, the TVP estimates with the Kalman filter suggest that a positive effect of house prices on consumer inflation with a quarter lag has indeed strengthened since 2023 (Fig. 1). More exactly, there is a weak indication of the inverse relationship between house prices and consumer inflation in the present period, while coefficients on *estate*(-1) are positive. However, a lagged effect becomes much stronger and statistically significant since the beginning of 2023. If we add the value of present and lagged coefficients on house prices, it becomes clear that a price-dampening effect of house prices had been observed from 2013 to 2019, but it has been reversed since then, with a tendency to strengthen over the last two years.

Fig. 1. Estimates of the house price effects on consumer prices (in differences of log-level)

Note: point estimates are presented within the band of ±2 standard deviations.

If it is assumed that the real estate market is a 'liquid sink' for excessive money supply, the increase in real property prices in 2023-2024 (Fig. 2) should be considered a continuation of this mechanism. However, the adoption of the euro has not had any dampening effect on house prices, which has materialized in higher consumer prices, not in a 'liquid sink' effect.

Fig. 2. Real residential property prices for Croatia

Although it is claimed that without autonomous policy instruments, tourism-related capital inflows transform housing into a speculative rather than stabilizing channel, it is not a feature of countries with a floating exchange rate regime either. If we assume that house price inertia is an indicator of speculative behaviour, as it is assumed in the literature, there is no sign that something like that has happened in Croatia since 2022. The coefficient on *estate*(-1) has been fluctuating between 0.26 and 0.28 since 2013, with no significant changes over the 2023-2024 period. On the other hand, the coefficient on *estate*(-1) is almost three times higher for Czechia, a country with a floating exchange rate regime.

a. Croatia b) Czechia

Fig. 3. Estimates of the house price inertia in Croatia and Czechia

Note: time series for Czechia are available for the 2008-2025 period

Point #2. The euro adoption could be spuriously correlated with a post-COVID surge in inflation, being a combination of both an expansionary demand-side shock and a contractionary supply-side shock. It is worth noting that inflationary inertia made a comeback in 2022 as well, although it has been on a decline since then.

Fig. 3. Estimates of the house price inertia in Croatia

In such a context, it sounds correct that Croatia's post-2021 inflation had been driven by pandemic-related supply-side disruptions plus energy shocks, and demand-side wage adjustments, but the argument of euro adoption as a source of inflationary pressure seems not to be relevant. Actually, inflationary inertia has been on a decline since 2022.

Point #3. Even if we assume that the adoption of the euro contributes to the rechanneling of inflationary pressure from asset-based to consumption-based sectors, specific mechanisms are worth outlining. Obviously, the real estate market is not a good choice for explaining the abovementioned rechanneling of inflation.

Minor points

1. Following eurozone accession, a core-periphery inflation divergence can be explained by a mix of a lower cost of government borrowing and self-confidence, which stimulates expansionary fiscal policies. If so, fiscal dominance is of secondary importance.
2. Absorption of real and nominal shocks is dependent on the exchange rate disconnect. If there is a strong exchange rate pass-through (ERPT) to consumer prices, any benefits of supporting a floating exchange rate regime are rather marginal.

Under a fixed exchange rate regime, sterilization of excessive capital inflows can be done with fiscal tightening. In the example of Greece in the 2000s, it was the profligate fiscal policy, not capital inflows, that caused the acceleration of inflation and the worsening of international competitiveness. Ultimately, an immense debt crisis in the public sector had emerged, and it was blamed for entering the eurozone, not irresponsible fiscal policy.

Attachments: available at https://doi.org/10.32388/2B9892

Declarations

Potential competing interests: No potential competing interests to declare.