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Croatia: Another year of recession

Economic activities have continued to decline in 2010, but at a slower pace than in 2009: GDP fell by 2.5% in the first quarter of the year. Domestic demand developments were again the main reason for this decline. Private consumption shrank by 4.1% in real terms, mainly as a consequence of rising unemployment, declining wages and stagnating credit activities. The latest consumer confidence survey conducted by the National Bank suggests that many consumers are still postponing their purchases of consumer durables and do not intend to increase their spending in the short run. Given, among other things, the limited scope of public investments due to fiscal constraints, gross fixed capital formation contracted by 14%.¹ Net export growth should have contributed positively to GDP growth. Growth of industrial production, which was slightly positive in the first quarter of the year, turned negative again in April. In March domestic orders were down 60% while foreign orders had increased by one quarter compared to a year earlier.

The worsening trend on the labour market prevailing in 2009 has continued during the first months of 2010. According to the Croatian Pension Institute (HZMO) the number of employed fell by 5% during the first quarter of the year. Employment cuts were most pronounced in construction and manufacturing with the number of workers down by 12% and 8% respectively. Based on registration data the unemployment rate rose to over 18% in March, but slowed somewhat thereafter. By comparison, the unemployment rate obtained from the Labour Force Survey is at about 10%. The large discrepancy between the two measures may indicate rising informal sector activities. Nominal wages fell for the first time since the mid-1990s with above-average declines in manufacturing and construction. In the first quarter of 2010 average net wages were down by 1.7% in real terms.

Household loans fell by 3% during the first quarter of 2010, with the largest drop in any-purpose loans and car purchase loans. By contrast, corporate loans showed a slight increase during the first months of the year. The share of bad loans doubled within a year

¹ This was mainly felt by the construction industry, reporting an output decline by 19%.

and reached 7.8% at the end of 2009, bad corporate loans accounted for 12.8% of total loans. According to the National Bank this trend is likely to continue in 2010 and may only improve in 2011 provided a resumption of economic growth.

In mid-April the Croatian government presented an economic recovery programme which is a combination of short-term and structural measures. As one of the short-term measures, tax brackets for personal income tax will be reduced from currently four to three. Tax reliefs will be abandoned which should help to simplify the tax administration. On the other hand, the lower rate of crisis tax (2% tax on income between HRK 3000 and 6000) introduced in August 2009 will be abolished. In addition, public sector reforms have been announced: employees will not be given holiday bonuses this year and employment is to be reduced by about 5% – the latter being a medium-term goal of the government. Plans for downsizing public administration as well as employment in state-owned companies should be elaborated by the end of 2010. Furthermore, the pension system should undergo a number of changes: for instance, access to early retirement should be limited and certain categories of privileged pensions (e.g. for war veterans) are envisaged to be cut by 10%. Tax-related measures and the reduction of pensions become effective as of 1 July 2010. The budget revision in July is expected to bring new measures made necessary by rising expenditures (for pensions in particular) and falling revenues during the first months of the year. Thus, the target of fiscal consolidation as foreseen in the initially adopted budget for 2010, envisaging a narrowing of the deficit to 2.9% of GDP, will not be met – mainly because of declining revenues that will consequently lead to a stronger rise in public debt. At the end of 2009 total public debt amounted to 34.5% of the GDP or 50.4% if including government guarantees.

The second round of the privatization of Croatia's state-owned shipyards, issued on 15 February, closed with four valid bids for the three shipyards offered – unlike the first attempt, which closed with only one offer. Three bids were submitted by local companies for Brodosplit, Brodotrogir and 3 May. For the latter also Crown Investments (Germany) submitted an offer. Restructuring of the heavily indebted and subsidized shipyards is one of the preconditions for further progress in Croatia's negotiation talks with the EU. One of the major obstacles to Croatia's joining the EU was removed when Slovenia in a referendum held on 6 June voted in favour of an arbitrage deal to settle a twenty-year old border conflict (Bay of Piran) between Croatia and Slovenia. The findings of the arbitration panel will be binding. Thus, Croatia may complete the negotiation process with the European Union at the beginning of 2011, which would imply accession in late 2012, or even only in 2013.

Data available from customs statistics indicate an increase in goods exports (4.8%), but a further contraction of imports by 10%, leading to a narrowing of the trade deficit as compared to the first quarter of 2009. A breakdown of exports by commodity groups shows an overall increase in manufacturing exports, of which most notably exports of other transport equipment (ships), chemicals and pharmaceuticals. On the import side, manufacturing imports fell by 13.4%, with car imports down by 36%; strong import declines were also registered for machinery and electrical equipment. Tourist overnight stays fell during the first months of the year, implying a reduction of the traditional surplus in services trade. Owing primarily to the diminishing trade deficit, the current account closed with a lower deficit than in previous years, at some EUR 1.4 billion. In February 2010 foreign debt stood at EUR 44 billion, about EUR 600 million less than in December 2009. The decline in external debt is largely a consequence of a reduction of banks' and government borrowing, while direct-investment related debt (borrowing of enterprises from their foreign owners) rose only modestly and enterprise borrowing remained nearly unchanged. In 2010 Croatia has to repay (refinance) close to EUR 10 billion, which is slightly less than in 2009.

GDP will decline by another 1-2% in 2010. Fiscal constraints and high foreign debt obligations represent a major obstacle to financing public investment projects. Employment will continue to contract, translating into rising unemployment or even inactivity. This may trigger a further decline in household consumption. The current account deficit will remain at the previous year's level, at about 5% of GDP, in 2010 and increase gradually thereafter. A rebound in GDP growth may be expected only in 2011 provided a strengthening of foreign demand both in goods and services. The servicing and/or restructuring of the high foreign debt will remain one of the major challenges in the near future. Prospects of joining the EU in the coming two years may help to strengthen Croatia's standing vis-à-vis foreign creditors.

Table HR

Croatia: Selected Economic Indicators

	2006	2007	2008	2009 ¹⁾	2009 1st quarter	2010 1st quarter	2010	2011 Forecast	2012
Population, th pers., average	4440	4436	4435	4429	.	.	4435	4435	4435
Gross domestic product, HRK mn, nom.	286341	314223	342159	333063	77867	76504	334600	349800	365700
annual change in % (real)	4.7	5.5	2.4	-5.8	-6.7	-2.5	-1.5	2	2.5
GDP/capita (EUR at exchange rate)	8800	9700	10700	10100	.	.	10300	10800	11300
GDP/capita (EUR at PPP - wiiw)	13500	15000	15500	14400	.	.	.	.	.
Consumption of households, HRK mn, nom.	172744	188952	202194	189638	46474	45079	.	.	.
annual change in % (real)	3.5	6.2	0.8	-8.5	-9.9	-4.1	-3.5	1.5	2
Gross fixed capital form., HRK mn, nom.	74792	82386	94281	82259	19644	16079	.	.	.
annual change in % (real)	10.9	6.5	8.2	-11.8	-12.4	-13.9	-5	4	5
Gross industrial production ²⁾									
annual change in % (real)	4.2	4.9	1.2	-9.2	-11.0	-0.5	0	3	3.5
Gross agricultural production									
annual change in % (real)	4.4	-3.9	8.0	.	.	.	.	.	.
Construction industry, hours worked ²⁾									
annual change in % (real)	9.4	2.4	11.8	-6.5	-0.3	-18.6	.	.	.
Employed persons - LFS, th, average	1586	1615	1636	1605	1608	.	1570	1570	1590
annual change in %	0.8	1.8	1.3	-1.9	1.0	.	-2	0	1
Unemployed persons - LFS, th, average	199	171	149	160	167	174	.	.	.
Unemployment rate - LFS, in %, average	11.1	9.6	8.4	9.1	9.4	10.0	10.5	10	9
Reg. unemployment rate in %, end of period	17.0	14.7	13.7	16.7	15.0	18.4	17.5	17	16.5
Average gross monthly wages, HRK	6634	7047	7544	7711	7707	7637	.	.	.
annual change in % (real, net)	1.9	2.2	0.8	0.2	1.8	-1.7	.	.	.
Consumer prices, % p.a.	3.2	2.9	6.1	2.4	3.8	0.9	2	2.5	2
Producer prices in industry, % p.a. ³⁾	2.9	3.4	8.4	-0.4	1.1	3.6	.	.	.
General governm.budget, nat.def., % GDP ⁴⁾									
Revenues	39.2	40.3	39.4	38.5	.	.	.	.	.
Expenditures	41.6	41.5	40.3	41.6	.	.	.	.	.
Deficit (-) / surplus (+) ⁵⁾	-2.6	-1.2	-1.0	-3.2	.	.	-3.5	-3	-2.5
Public debt, EU-def., in % of GDP ⁶⁾	35.7	33.1	33.5	37.7	.	.	40	41	42
Discount rate of NB, % p.a., end of period	4.5	9.0	9.0	9.0	9.0	9.0	.	.	.
Current account, EUR mn	-2717.1	-3236.1	-4337.8	-2447.8	-1844.7	-1404.6	-2000	-2700	-3500
Current account in % of GDP	-6.9	-7.6	-9.2	-5.4	-17.5	-13.4	-4	-6	-7
Exports of goods, BOP, EUR mn	8463.6	9192.5	9814.0	7690.5	1928.5	2017.1	7900	8300	8900
annual growth rate in %	17.2	8.6	6.8	-21.6	-13.4	4.6	3	5	7
Imports of goods, BOP, EUR mn	16807.8	18626.5	20607.8	15088.5	3660.3	3305.7	14000	14600	15600
annual growth rate in %	14.0	10.8	10.6	-26.8	-23.6	-9.7	-7	4	7
Exports of services, BOP, EUR mn	8526.8	9114.7	10090.6	8453.9	773.4	787.8	8200	8400	8800
annual growth rate in %	5.9	6.9	10.7	-16.2	-8.6	1.9	-3	3	5
Imports of services, BOP, EUR mn	2824.2	2847.3	3132.7	2778.3	638.6	664.1	2800	2900	3000
annual growth rate in %	3.3	0.8	10.0	-11.3	-14.6	4.0	0	2	4
FDI inflow, EUR mn	2764.8	3678.6	4195.4	2096.0	437.2	434.2	1000	.	.
FDI outflow, EUR mn	208.2	266.9	988.8	918.7	28.7	-38.5	.	.	.
Gross reserves of NB excl. gold, EUR mn	8725.3	9307.4	9120.9	10375.8	8869.5	10008.1	.	.	.
Gross external debt, EUR mn ⁷⁾	29273.9	32929.2	39950.2	44574.8	40308.3	44564.2	.	.	.
Gross external debt in % of GDP ⁷⁾	75.1	76.8	85.5	97.8	88.8	97.2	.	.	.
Average exchange rate HRK/EUR	7.3228	7.3360	7.2232	7.3398	7.4070	7.2854	7.3	7.3	7.3
Purchasing power parity HRK/EUR	4.7861	4.7223	4.9838	5.2321	.	.	.	.	.

Note: Gross industrial production and construction output refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) Domestic output prices, from 2009 according to NACE Rev. 2. - 4) On accrual basis. - 5) Including change in arrears and non-recorded expenditures. - 6) According to ESA'95, excessive deficit procedure. - 7) From 2008 new reporting system (estimated data for non-financial enterprises).

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.