



## CROATIA: Recession continues

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**Croatia remains bogged down in recession for the sixth consecutive year. Fiscal consolidation and the overly indebted enterprise sector are the key obstacles to growth. Household consumption remains depressed owing to high and persistent unemployment and continuing deleveraging. Economic recovery will depend primarily on external demand, a revival of private sector investment and increased absorption of EU funds.**

Croatia's economy has remained in recession for the sixth consecutive year, with GDP down by 0.6% in the first half of 2014. Both household consumption and gross fixed capital formation continued to decline; government consumption, after showing an upward trend in 2013, fell again in the first half of this year. Only foreign demand contributed positively to GDP growth. The continued drop in investment has affected construction in particular, recording a decline for the sixth year in a row. After five years of contraction, industrial production stagnated in the first seven months of 2014, while manufacturing reported a modest 2% increase. Within manufacturing, above-average output growth was registered among others for the production of leather, wearing apparel, pharmaceuticals and rubber and plastic products, while the production of shipbuilding continued to shrink. Labour productivity continued to increase due to further layoffs. In mid-September the Croatian government eventually adopted a draft industrial strategy for 2014-2020 which had been announced at the beginning of the year. The document envisages a very ambitious programme: average annual industrial growth of 2.85% and the creation of 85,000 new jobs. Strategic industries identified are: generic pharmaceutical products, finished metal products, computers, electronic and optical products, electrical equipment, machines and devices, computer programming, consulting, food, and furniture.

The labour market situation has remained tight in 2014. Employment has been on the decline since 2009 and contracted, according to Pension Insurance data, by another 2.5% in the first half of the year. With the exception of accommodation, real estate and education, all sectors were affected by employment losses, mostly so manufacturing, trade, public administration, defence and social insurance. In August registered unemployment stood at 17.5%. Labour Force Survey data are not comparable with previous years: Starting from 2014 the LFS has been adjusted to the 2011 census, while previous data were based on the 2001 census. The adjustment resulted in a significant increase in the number of both employed and unemployed persons and a remarkable decline of the inactive population. Consequently employment and activity rates were revised upwards, while the unemployment rate remained almost unchanged. Both real gross and net wages have been on the decline since 2009/2010 and producer prices are on a deflationary path. Consumer price inflation is close to zero, mainly as a result of lower food and energy prices and particularly due to the low domestic demand.

Since Croatia's EU accession in July 2013, trade data have been subject to several revisions following the adoption of the Eurostat methodology in data compilation.<sup>1</sup> Hence, information on external trade has to be treated with caution as data, especially those on imports, are not comparable with previously reported figures. Based on current account statistics, the revised data indicate an increase in both goods exports and imports measured in euro terms, by 13% and 4% respectively, in the first half of 2014. As a result the trade deficit declined compared with the same period in 2013. Deliveries expanded both to EU and CEFTA countries, by 19% and 11% respectively. Detailed data show that the growth in exports was driven mainly by commodity groups such as paper, wearing apparel, textiles, rubber, chemicals and furniture, while exports of ships shrank by 60% and those of pharmaceutical products by 15%. Services trade, by contrast, reported a contraction in both exports and imports with the trade surplus remaining almost unchanged year-on-year. Differences compared to a year earlier were also recorded for the income balance, reporting a higher deficit, and the balance of transfers, showing a lower surplus. As a result the current account deficit has widened by about EUR 200 million as against the first half of 2013. With regard to FDI, both inflows and outflows were exceptionally high in the first half of 2014, suggesting that the large transactions were actually round-tripping (a Croatian company sending FDI funds to its subsidiary abroad and then channelling it back).

In January 2014 the European Council opened an excessive deficit procedure against Croatia. The Convergence Programme submitted by the Croatian government in April envisages the gradual reduction of the general government deficit to below 3% of GDP by 2016 – the deadline for the correction of the deficit. Fiscal policy implementation will be monitored not only by the European Commission but also by the newly established Fiscal Policy Commission (Fiscal Council). In order to reduce the deficit, the government approved a budget revision in April (including cuts of expenditures for investment projects and subsidies and a rise in revenues, e.g. by increasing health care contributions, withdrawals of profits from state-owned companies and energy excises) and announced that a further budget revision will become necessary during autumn. Only recently the government has announced changes in the tax system as of December 2014: the level of non-taxable income should be raised from HRK 2200 to HRK 2600, while the threshold for the highest income tax rate of 40% is announced to rise from currently HRK 8,800 to HRK 13,200 (gross). A tax on savings interest at a rate of 12% will be launched starting from 2015, while the introduction of a property tax is planned to become effective from 2016.

It is assumed that the government might launch a new Eurobond issue of at least EUR 1 billion by the end of 2014 to secure the pre-financing of the budget for the beginning of 2015 when a EUR 750 million Eurobond falls due.

At the end of June 2014 the ratio of non-performing loans to total loans was 16.6% (up from 15.7% in December). Out of the loans provided to the corporate sector, 29.6% were categorised as non-performing; the ratio of non-performing loans in total household loans was 11.6%. During the first seven months of 2014 bank lending fell both to the non-financial corporate sector and to private households, in the latter case reflecting the long-lasting deleveraging process but also the tight labour market situation.

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<sup>1</sup> Since the EU accession data on foreign trade in goods are acquired from two different sources: Intrastat for the trade in goods between EU Member States and the Single Administrative Document for trade in goods with non-EU countries (Extrastat).

Based on the results for the first half of the year, wiiw has revised its GDP growth forecast downwards from minus 0.5% to minus 0.8% for the whole year 2014. The revision became necessary due to lower than expected investment activities of the corporate sector in particular, but also as a consequence of fiscal consolidation measures. Given a continuation of the latter and lower growth in the EU, wiiw expects the GDP to stagnate in 2015, while a modest economic recovery in 2016 will primarily depend on a revival of external demand and private sector investment and increased absorption of EU funds. Downside risks remain high: household consumption will remain subdued because of high and persistent unemployment and private sector deleveraging may last longer than currently projected.

Table 1 / Croatia: Selected Economic Indicators

	2010	2011	2012	2013 <sup>1)</sup>	2013 January-June	2014	2014 Forecast	2015 Forecast	2016 Forecast
Population, th pers., average <sup>2)</sup>	4,296	4,283	4,269	4,254	4,253	.	4,250	4,250	4,250
Gross domestic product, HRK mn, nom. <sup>3)</sup>	328,041	332,587	330,456	330,135	158,864	157,098	329,100	332,400	339,100
annual change in % (real) <sup>3)</sup>	-1.7	-0.3	-2.2	-0.9	-1.1	-0.7	-0.8	0.0	1.0
GDP/capita (EUR at exchange rate)	10,500	10,400	10,300	10,200	.	.	10,100	10,200	10,400
GDP/capita (EUR at PPP)	14,900	15,400	15,700	15,700	.	.	.	.	.
Consumption of households, HRK mn, nom. <sup>3)</sup>	190,237	195,325	195,623	196,885	97,713	96,695	.	.	.
annual change in % (real) <sup>3)</sup>	-1.5	0.3	-3.0	-1.3	-1.5	-0.5	-0.6	-0.3	0.5
Gross fixed capital form., HRK mn, nom. <sup>3)</sup>	69,784	67,471	64,820	63,732	31,791	30,146	.	.	.
annual change in % (real) <sup>3)</sup>	-15.2	-2.7	-3.3	-1.0	-0.7	-4.5	-4.0	1.0	3.0
Gross industrial production <sup>4)</sup>									
annual change in % (real)	-1.4	-1.2	-5.5	-1.8	-0.5	0.1	0.0	2.0	2.5
Gross agricultural production									
annual change in % (real)	-8.2	-1.0	-9.9	1.4	.	.	.	.	.
Construction output <sup>4)</sup>									
annual change in % (real)	-15.8	-8.5	-11.1	-4.1	-3.9	-7.8	.	.	.
Employed persons, LFS, th, average <sup>5)</sup>	1,541	1,493	1,446	1,390	1,507	1,538	1,550	1,550	1,560
annual change in %	-4.0	-3.2	-3.1	-3.9	.	2.1	.	0.0	0.5
Unemployed persons, LFS, th, average <sup>5)</sup>	206	232	272	288	316	329	.	.	.
Unemployment rate, LFS, in %, average <sup>5)</sup>	11.8	13.5	15.9	17.2	17.4	17.8	17.5	17.5	17.0
Reg. unemployment rate, in %, end of period	18.8	18.7	21.1	21.6	18.6	18.3	21.3	21.0	20.5
Average monthly gross wages, HRK	7,679	7,796	7,875	7,939	7,946	7,939	.	.	.
annual change in % (real, gross)	-1.5	-0.8	-2.3	-1.4	-2.1	-0.2	.	.	.
Average monthly net wages, HRK	5,343	5,441	5,478	5,515	5,506	5,506	.	.	.
annual change in % (real, net)	-0.5	-0.4	-2.6	-1.5	-2.3	-0.2	.	.	.
Consumer prices (HICP), % p.a.	1.1	2.2	3.4	2.3	3.2	0.2	0.5	1.0	1.0
Producer prices in industry, % p.a. <sup>6)</sup>	4.3	7.0	5.4	-0.3	1.4	-2.6	1.0	1.0	1.0
General governm.budget, EU-def., % of GDP									
Revenues	40.0	39.8	40.5	40.8	.	.	.	.	.
Expenditures	46.3	47.5	45.5	45.7	.	.	.	.	.
Net lending (+) / net borrowing (-)	-6.3	-7.7	-4.9	-4.9	.	.	-5.0	-4.5	-3.5
Public debt, EU-def., % of GDP	44.4	51.4	55.6	66.7	.	.	72.0	74.0	75.0
Central bank policy rate, % p.a., end of period <sup>7)</sup>	9.0	7.0	7.0	7.0	7.0	7.0	.	.	.
Current account, EUR mn	-502	-388	-86	381	-1,635	-1,825	200	100	0
Current account, % of GDP	-1.1	-0.9	-0.2	0.9	-7.8	-8.9	0.5	0.2	0.0
Exports of goods, BOP, EUR mn	9,064	9,773	9,803	9,790	4,450	5,030	10,900	11,700	12,500
annual change in %	18.1	7.8	0.3	-0.1	-4.4	13.0	11.0	7.0	7.0
Imports of goods, BOP, EUR mn	14,809	15,922	15,856	16,137	7,916	8,257	16,800	17,500	18,200
annual change in %	-0.5	7.5	-0.4	1.8	-0.5	4.3	4.3	4.0	4.0
Exports of services, BOP, EUR mn	8,651	8,989	9,256	9,508	3,159	3,146	9,500	9,700	9,800
annual change in %	0.1	3.9	3.0	2.7	3.5	-0.4	0.0	2.0	1.5
Imports of services, BOP, EUR mn	2,876	2,787	2,848	2,754	-1,311	-1,266	2,700	2,800	2,900
annual change in %	-2.5	-3.1	2.2	-3.3	-2.6	-3.4	-3.0	2.0	3.0
FDI inflow (liabilities), EUR mn	378	1,070	1,076	525	572	2,176	.	.	.
FDI outflow (assets), EUR mn	-119	36	-39	-131	42	1,706	.	.	.
Gross reserves of NB excl. gold, EUR mn	10,660	11,195	11,236	12,908	12,021	12,335	.	.	.
Gross external debt, EUR mn	46,527	45,901	44,861	45,631	45,956	45,957	.	.	.
Gross external debt, % of GDP	103.3	102.6	102.1	104.7	105.4	106.1	.	.	.
Average exchange rate HRK/EUR	7.2862	7.4342	7.5173	7.5735	7.57	7.62	7.63	7.64	7.64
Purchasing power parity HRK/EUR	5.1340	5.0537	4.9167	4.9168	.	.	.	.	.

1) Preliminary. - 2) According to census April 2011. - 3) According to ESA10. - 4) Enterprises with 20 and more employees. - 5) Half-year data and forecast according to census April 2011. - 6) Domestic output prices. From 2011 total output prices. - 7) Discount rate of NB.

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