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Croatia: Waiting for the turnaround

Croatia is slipping again into recession in 2012 and should finally rebound in 2013 provided a strengthening of external demand and the picking up of investments. Households' disposable income being hit by high and persistent unemployment will keep domestic demand contracting. Reducing the budget deficit including structural reforms and servicing high foreign debt will remain the most challenging tasks for Croatian authorities. EU accession in 2013 may help to revive investments.

Having stagnated in 2011 after two years of economic downturn, Croatia's GDP dropped by 1.3% during the first quarter of 2012 owing to a decline in domestic demand. Gross fixed capital formation, which has been on the decline since 2009 continued to drop for yet another year. Both government and household consumption has declined due to fiscal consolidation and restricted access to credits, as well as high and ever-increasing unemployment. The contraction in investments was felt primarily in the construction sector, where output continued to decline (12%). The slowdown in industrial production in 2012 has become even more pronounced than in the two preceding years, with output dropping by 6.5% over the first four months of the year. In the manufacturing category more than half of all sectors recorded a decline in production; the worst drop in output (30%) occurred in the machinery and equipment sector, followed by the manufacture of fabricated metal products and the manufacture of basic metals, both of which registered a drop of about 20% each. On the positive side, the shipbuilding industry, Croatia's single most important exporter, increased production by 17%. During the first four months of 2012, labour productivity in industry was 4% lower than the year previous.

Based on customs statistics, external trade dynamics were low during the first quarter of the year imports of goods rose modestly by 2% and exports declined by 1%. The resultant trade deficit increased by about EUR 100 million to EUR 1.7 billion compared to a year earlier. Taking into account the rising trade deficit and assuming no significant change in the trade surplus in the services sector, the current account deficit can be seen to have increased slightly. At the end of January 2012, foreign debt stood at EUR 47.7 billion, thus remaining unchanged compared to December 2011.

In response to the continued downward pressure on the kuna against the euro and in an endeavour to support the domestic currency, the Croatian National Bank (CNB) intervened repeatedly on the foreign exchange market throughout 2011. It has already had to intervene four times in a like manner during the first few months of 2012. Having raised the minimum reserve requirement for banks from 14% to 15% in January 2012, the CNB reduced the same requirement to 13.5% only three months later. The latter step was designed to ease matters for the banks by releasing HRK 4.1 billion from the kuna component and EUR 110 million from the foreign exchange component of the reserve requirement. It is envisaged that the funds so released will be used in cooperation with the Croatian Bank for Reconstruction and Development (HBOR) to stimulate economic recovery.

Croatia's labour market deteriorated further during the first quarter of 2012. Data from the Croatian Pension Institute (HZMO) indicate that the number of employed fell by 1%. This decline is also confirmed by information obtained from the Statistical Office: based on those data, the number of employees contracted most markedly in the construction sector (-3.9%), while increases in employment were to be observed in agriculture and administrative support services, as well as in the non-market services sectors, such as education, health and social work. Registered unemployment leapt to 19.1% at the end of April. Final labour force survey data for 2011 indicate an unemployment rate of 14.3%, with youth unemployment standing at 35%. In the EU only Spain and Greece have higher rates than that. In response to the high rate of youth unemployment, the Minister of Labour proposed extending measures to support young people in their attempts to acquire work experience in the enterprise sector. Hitherto those initiatives had been limited to civil service institutions: now young unemployed are to be offered an opportunity to work in an enterprise for a year. Over that period, participants in the programme will be entitled to health and pension insurance, as well as a monthly allowance of about EUR 200.

According to final data, the general government deficit in 2011 amounted to 5% of the GDP. As for 2012, the deficit target is 3.8% based on a 0.8% growth of GDP. After years of steady expansion, the budget anticipates a reduction in expenditures, particularly in subsidies to agriculture and Croatian Rail, as well as in terms of public-sector wages. The assumptions underlying the budget (for example, a GDP growth rate of 0.8%) are far too optimistic, since all the forecasts published by international organizations and banks, as well as the Croatian National Bank and the country's main economic research institute EIZ, predict a GDP decline for 2012. Thus, achieving a decline in the deficit as set in the budget appears unrealistic.

At the end of 2011 the ratio of non-performing loans to total loans increased to 12.2% from 11.2% in December 2010. Working on the assumption that the economy will not recover in 2012, the Croatian National Bank estimates that the share of non-performing loans may rise to 17% by the end of the year.

Until the country joins the EU on 1 July 2013, the European Commission will closely monitor Croatia's implementation of the commitments it has entered into, particularly those relating to the judiciary, competition (shipyards) and freedom of movement. Accordingly the Commission will issue six-monthly assessments up to the projected date of accession. The first report published on 24 April 2012 covering the period 1 September 2011 - 29 February 2012 concludes that 'overall, Croatia's preparations for EU membership are on track'. However, the Commission 'has identified a limited number of issues requiring further efforts'. In terms of competition policy, the report concentrates on the steel and shipbuilding sectors. With respect to the steel mill, CMS Sisak, the plant will have to reimburse the financial aid it received from the state; the steel mill has since been closed and is to be sold. As for the other steel mill, Zeljezara Split, the commercial court in Split initiated bankruptcy proceedings in 2011. As for the heavily subsidised shipbuilding industry, which has suffered losses over the past 20 years, a first round of decisions was taken in March 2012. Of the five shipyards, only Uljanik is profitable and is to be sold to the employees and management. The Croatian government accepted a bid for the shipyard Brodosplit tendered by the Split-based DIV group, but rejected bids for the shipyards Kraljevica and Brodotrogir. A bid for the shipyard 3.Maj was withdrawn by the bidder. The government decided to initiate bankruptcy proceedings for Kraljevica and seek new privatisation and restructuring arrangements for the 3.Maj and Brodotrogir shipyards by July 2012. In April the government announced the takeover of the government-backed credit liabilities of the three shipyards (3. Maj, Brodotrogir and Brodosplit), which amount to EUR 245 million. The sum will be transferred to public debt.

Based on the results for the first months of the year, wiiw has revised its previous GDP forecast for 2012 downwards to minus 1.5% (from -1%); we expect a slight recovery in 2013. Prospects have been dampened by the poor economic outlook in the EU (particularly in Italy, one of Croatia's most important trading partners, but also in Slovenia). It will have a negative effect not only on Croatia's exports of goods but also on its services sector, tourism in particular. Household consumption will remain flat as a consequence of high unemployment and weak credit activity; joining the EU in mid-2013 may help to boost foreign investor confidence. Employment will continue to contract along with a decline in GDP in 2012 and stabilise, if at all, in 2013. At the same time the unemployment rate established in the labour force survey is expected to remain at around 14.5% and will only

decrease slowly from 2014 onwards. The current account deficit will remain within moderate limits. Fiscal consolidation and structural reforms against the background of high unemployment and servicing foreign debt will remain the major challenge for the years to come.

Table HR

Croatia: Selected Economic Indicators

	2008	2009	2010	2011 ¹⁾	2011 1st quarter	2012	2012	2013	2014
							Forecast		
Population, th pers., mid-year	4434.5	4429.1	4417.8	4401.9	4401.9	.	4435	4435	4435
Gross domestic product, HRK mn, nom.	343412	328672	326980	333956	75813	75716	337200	348700	362800
annual change in % (real)	2.1	-6.9	-1.4	0.0	-1.2	-1.3	-1.5	1	2
GDP/capita (EUR at exchange rate)	10700	10100	10200	10200	.	.	10100	10500	11000
GDP/capita (EUR at PPP - wiiw)	15800	14600	14500	14800	.	.	.	.	.
Consumption of households, HRK mn, nom.	197936	188859	189314	194318	46005	46557	.	.	.
annual change in % (real)	1.3	-7.6	-0.9	0.2	-0.1	-0.3	-0.5	0.5	1
Gross fixed capital form., HRK mn, nom.	93930	80367	67254	62746	14322	13975	.	.	.
annual change in % (real)	8.7	-14.2	-15.0	-7.2	-6.9	-2.8	-3.5	2.5	3
Gross industrial production ²⁾									
annual change in % (real)	1.2	-9.2	-1.4	-1.2	-3.6	-5.3	-4	2.5	3
Gross agricultural production									
annual change in % (real)	8.0	-0.8	-8.2	.	.	.	.	.	.
Construction output ²⁾									
annual change in % (real)	11.8	-6.5	-15.9	-9.1	-8.5	-12.0	.	.	.
Employed persons - LFS, th, average	1636	1605	1541	1493	1476	.	1480	1480	1490
annual change in %	1.3	-1.8	-4.0	-3.2	-5.6	.	-1	0	1
Unemployed persons - LFS, th, average	149	160	206	232	246	.	.	.	.
Unemployment rate - LFS, in %, average	8.4	9.1	11.8	13.5	14.3	.	14.5	14.5	13.5
Unemployment rate, reg., in %, end of period	13.7	16.7	18.8	18.7	19.3	20.0	20	19.5	18
Average gross monthly wages, HRK	7544	7711	7679	7796	7672	7835	7750	7800	7850
annual change in % (real, net)	0.8	0.2	-0.5	-0.4	-0.4	0.1	.	.	.
Consumer prices, % p.a.	6.1	2.4	1.1	2.3	2.2	1.5	2.5	2.4	2
Producer prices in industry, % p.a. ³⁾	8.3	-0.4	4.3	6.3	6.3	6.1	4	3	3
General governm.budget, EU-def., % GDP ⁴⁾									
Revenues	39.1	36.4	35.0	34.7	.	.	34.5	35.5	35.5
Expenditures	40.4	40.5	39.9	39.7	.	.	39.0	39.5	39
Deficit (-) / surplus (+)	-1.4	-4.1	-4.9	-5.0	.	.	-4.5	-4.0	-3.5
Public debt, EU-def., in % of GDP ⁴⁾	29.3	35.8	42.2	46.0	.	.	50	55	58
Central bank policy rate, % p.a., end of period ⁵⁾	6.0	6.0	6.0	6.0	6.0	6.0	.	.	.
Current account, EUR mn	-4258.1	-2292.5	-472.2	-446.3	-1644.0	.	-300	-500	-600
Current account in % of GDP	-9.0	-5.1	-1.1	-1.0	-16.0	.	-0.7	-1.1	-1.2
Exports of goods, BOP, EUR mn	9752.7	7674.5	9063.6	9784.2	2238.7	.	9900	10300	10900
annual growth rate in %	6.5	-21.3	18.1	8.0	10.3	.	1	4	6
Imports of goods, BOP, EUR mn	20607.8	15090.1	15054.3	16142.8	3774.3	.	16100	16600	17400
annual growth rate in %	10.6	-26.8	-0.2	7.2	13.8	.	0	3	5
Exports of services, BOP, EUR mn	10090.6	8640.2	8649.3	9016.5	761.7	.	9200	9500	10000
annual growth rate in %	10.7	-14.4	0.1	4.2	-7.3	.	2	3	5
Imports of services, BOP, EUR mn	3016.0	2754.5	2662.7	2607.8	596.2	.	2700	2550	2700
annual growth rate in %	9.7	-8.7	-3.3	-2.1	-9.5	.	2	2	6
FDI inflow, EUR mn	4218.6	2414.8	295.3	1048.4	341.2	.	1500	.	.
FDI outflow, EUR mn	970.2	888.2	-112.9	25.8	-295.5	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	9121	10376	10660	11195	11424	11340	.	.	.
Gross external debt, EUR mn ⁶⁾	39764	43745	46496	45733	47485	45751 ^{Feb}	.	.	.
Gross external debt in % of GDP ⁶⁾	83.6	97.7	103.6	101.8	105.7	.	.	.	.
Exchange rate HRK/EUR, average	7.2232	7.3396	7.2862	7.4339	7.4003	7.5552	7.5	7.5	7.45
Purchasing power parity HRK/EUR	4.9004	5.0664	5.0929	5.1216	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices in industry refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) Domestic output prices. - 4) According to ESA'95, excessive deficit procedure. - 5) Average weighted repo rates. - 6) From 2009 new reporting system.

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