

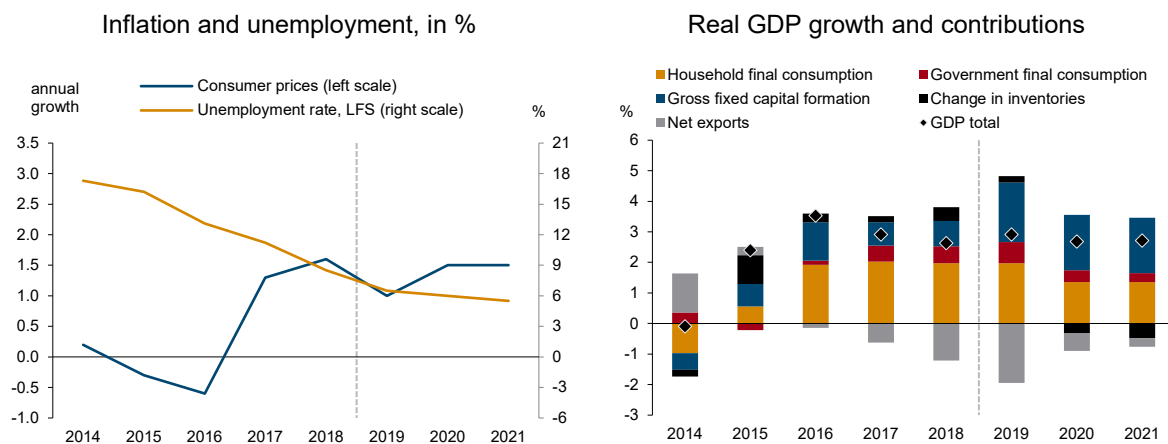


## CROATIA: Aiming at euro accession

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The economy will grow by 2.9% in 2019, an improvement the last year, mainly due to the strengthening of domestic demand (both consumption and investment). Assuming a deterioration of the external environment, domestic demand should remain the main driver of growth in 2020-21. The goal of adopting the euro will be an incentive to continue fiscal consolidation.

Figure 5.5 / Croatia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**Croatia's real GDP grew by 3.2% year on year in the first half of 2019.** Growth was backed by domestic demand: both private consumption and investments expanded. Private consumption growth, boosted by real wage increases and rising remittances from abroad, remained high at 3.5%. Gross fixed capital formation growth was at its highest level since the onset of the global financial crisis, gaining momentum most notably through EU-funding. High investment growth was reflected in a noticeable increase in construction output, e.g. in infrastructure (roads, railways and airports) as well as in buildings. The contribution of net exports was negative due to imports rising faster than exports.

**After the decline in 2018, industrial production remained very volatile in 2019 too.** Having grown only moderately at the beginning of the year and dropping again in June and August, industrial output grew by a mere 0.7% in the first eight months of 2019 along with declining employment. Within manufacturing, the most outstanding declines are reported for shipbuilding (-42%) and manufacture of coke and refined petroleum products (-35%) while the strongest increase was recorded in the production of computers, electronic and optical products (15%). The steady decline in shipbuilding is mainly due to the continuing difficulties of the two shipyards, 3. Maj and Uljanik. In May, the bankruptcy procedure was initiated against Uljanik in Pula. As for the 3. Maj shipyard in Rijeka, a member of the Uljanik group, the

Ministry of Finance issued a government guarantee for a loan to be taken from the Croatian Bank for Reconstruction and Development (HBOR) and/or other commercial banks in the amount of EUR 26 million in order to complete the construction of a ship at the dock. Overall, industrial output is likely to end up with a slightly positive annual growth in 2019.

**Employment continued to increase during the first seven months of 2019.** According to Pension Insurance data, employment rose by 2.3%. The LFS unemployment rate stood at 7.1% in July and remained fairly unchanged as compared to the beginning of the year. In order to address labour and skill shortages in certain sectors, such as construction, tourism and IT, the Croatian government has raised the quotas for foreign workers up to 68,100 in 2019, from 38,000 in 2018. Labour shortages, apart from rising minimum wages and rises in public sector wages, are among the major causes of wage increases: real gross wages increased by 2.8% in the first half of 2019, net wages by 2.5%.

**The trade deficit widened in the first half of 2019 as a result of the higher growth of goods imports (8.8%) ahead of exports (5.6%).** Export growth to the EU was below average, while imports from this area expanded above average; Croatia reports trade deficits with almost all EU countries. Trade dynamics with the Central European Free Trade Agreement, (CEFTA) countries were contrary to this, with goods exports rising by 17% along with stagnating imports in the first half of 2019. In services trade, exports grew moderately (4.5%), whereas imports expanded by 10.3%.

**At the end of September the Croatian National Bank published revised external trade statistics starting from 2000.** Accordingly the most important methodological changes in the balance of payments relate to (i) a new calculation of earnings from tourism, (ii) the estimate of workers' informal remittances and (iii) the inclusion of imports of used vehicles by natural persons from the EU as well the inclusion of trade credits with an original maturity of up to six months in the external debt, both on liabilities and assets. The revision has partly resulted in significant changes in the respective time series. So, for example, the current account surplus was lower than originally reported, e.g. in 2018 it stood at EUR 987 million instead of EUR 1.3 billion prior to the revision. Foreign debt on the other hand was constantly higher than originally reported, amounting to EUR 48.2 billion in 2018 compared to EUR 45.4 billion before the revision. Informal workers' remittances, which were not included in the current account up to now, increased the net inflow of remittances by between EUR 178 million and EUR 326 million per year. The inclusion of imports of used vehicles from the EU has contributed to a reduction of the current account surplus. As for the first half of 2019, earnings from tourism, based on the new methodology, remained unchanged compared to a year ago, but might be somewhat lower in the rest of the year due to the return of competition from Northern Africa and particularly Turkey which was considered safe again. Thus, assuming that the services trade surplus will slightly narrow as compared to 2018 and the merchandise trade deficit will continue to widen the current account will close with a lower surplus in 2019 than a year earlier.

**In July Croatia sent a letter of intent expressing interest for entering the ERM II – a necessary step in the process of accession to the Euro Area.** In the Action Plan attached to the letter, Croatia committed itself to implement reforms in six policy areas prior to joining the ERM II as follows i) to further strengthen the supervision of the banking system by establishing close cooperation between the Croatian National Bank (CNB) and the ECB, ii) strengthen the macro-prudential policy framework by introducing an explicit mandate for borrower-based measures; iii) strengthen the anti-money laundering framework; iv) upgrade the system of statistical data collection, processing and publication; v) improve public-sector

management and vi) reduce the administrative and financial burden on the economy. All measures are envisaged to be implemented by mid-2020. However, it seems questionable whether the latter two reform steps can be implemented by 2020 in view of the rather unsuccessful attempts in the past. So far, Croatia has satisfied the criteria of price stability, public finance sustainability and interest rate convergence.

**Fiscal consolidation is continued in view of Croatia's aspiration to join the ERM II.** In the first half of the year, public revenues increased by 8.5% and expenditures went up by 8.3% as compared with the same period of the previous year, with the fiscal balance slightly negative. Assuming similar developments for the rest of the year including guarantee payments for the ailing shipyard Uljanik, the general government balance might end up with a small deficit of 0.4% of the GDP in 2019. The Ministry of Finance expects the public debt to GDP ratio to decline to 71.3% from 74.6% in 2018. The Economic and Fiscal Policy Guidelines 2020-2022 envisage a continuation of fiscal consolidation with the public debt to GDP ratio falling to 62% by 2022.

**The government bowed to trade union pressure and announced a lowering of the retirement age again.** Recently, the Prime Minister announced that the government would accept the demands of the trade unions initiative '67 is too much' – earlier this year signed by more than 700,000 people to force a national referendum to withdraw some provisions of the pension reform adopted by the end of 2018. Thus, the government forwarded a bill of amendments to the parliament to return the pension eligibility age to 65 and reduce the penalties for early retirement as well as amendments to the Labour Act that will enable people to continue working if they wish after they turn 65.

**Following the positive developments in the first half of the year, wiiw has slightly revised upwards its GDP growth forecast to 2.9% for 2019.** Considering a slowdown of foreign demand, for the period 2020 to 2021 we expect GDP to grow by some 2.7% annually, driven primarily by domestic demand. Revenues from tourism are expected to remain robust although probably below the levels reached in the past couple of years due to the return of competition from Turkey and Northern Africa. The current account should remain in positive territory, but declining gradually due to widening trade deficits. The government will make every effort to continue fiscal consolidation in order to join the ERM II in 2020 as a precondition for the euro adoption.

**Table 5.5 / Croatia: Selected economic indicators**

	2015	2016	2017	2018 <sup>1)</sup>	2018	2019	2019	2020	2021
					January-June		Forecast		
Population, th pers., average	4,208	4,172	4,130	4,091	.	.	4,050	4,000	4,000
Gross domestic product, HRK bn, nom.	339.6	351.3	365.6	381.8	180.2	188.6	397	414	431
annual change in % (real)	2.4	3.5	2.9	2.6	2.7	3.1	2.9	2.7	2.7
GDP/capita (EUR at PPP)	17,200	17,800	18,400	19,400	.	.	.	.	.
Consumption of households, HRK bn, nom.	192.3	196.4	205.5	215.3	105.8	110.2	.	.	.
annual change in % (real)	1.0	3.4	3.6	3.5	3.7	3.5	3.5	2.4	2.4
Gross fixed capital form., HRK bn, nom.	66.4	70.4	73.3	76.7	37.7	41.4	.	.	.
annual change in % (real)	3.8	6.5	3.8	4.1	3.3	9.7	9.7	9.0	9.0
Gross industrial production <sup>2)</sup>									
annual change in % (real)	2.7	5.3	1.4	-1.0	0.5	0.7	1.0	2.0	2.0
Gross agricultural production									
annual change in % (real)	2.9	6.9	-4.9	2.6	.	.	.	.	.
Construction output <sup>2)</sup>									
annual change in % (real)	-0.5	3.3	1.7	4.9	3.1	9.6	.	.	.
Employed persons, LFS, th, average	1,585	1,590	1,625	1,655	1,644	1,669	1,680	1,700	1,720
annual change in %	1.3	0.3	2.2	1.8	3.4	1.6	1.5	1.0	1.0
Unemployed persons, LFS, th, average	306	240	205	152	161	122	120	110	100
Unemployment rate, LFS, in %, average	16.2	13.1	11.2	8.5	9.0	6.9	6.5	6.0	5.5
Reg. unemployment rate, in %, eop <sup>3)</sup>	17.6	14.1	11.2	8.9	8.2	6.7	8.0	.	.
Average monthly gross wages, HRK <sup>4)</sup>	8,055	7,752	8,055	8,448	8,441	8,736	8,770	9,200	9,600
annual change in % (real, gross)	1.8	3.0	2.8	3.3	3.8	2.8	2.8	2.8	2.5
Average monthly net wages, HRK <sup>4)</sup>	5,711	5,685	5,985	6,242	6,236	6,436	6,460	6,700	7,000
annual change in % (real, net)	3.7	2.7	4.1	2.8	3.2	2.5	2.4	2.3	2.3
Consumer prices (HICP), % p.a.	-0.3	-0.6	1.3	1.6	1.5	0.8	1.0	1.5	1.5
Producer prices in industry, % p.a.	-3.8	-4.3	2.0	2.2	1.8	1.5	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP									
Revenues	45.2	46.3	46.1	46.6	.	.	44.4	43.9	43.9
Expenditures	48.3	47.3	45.3	46.4	.	.	44.8	43.8	43.9
Net lending (+) / net borrowing (-)	-3.2	-1.0	0.8	0.2	.	.	-0.4	0.1	0.0
General gov.gross debt, EU def., % of GDP	83.7	80.5	77.8	74.6	.	.	71.3	68.0	66.5
Stock of loans of non-fin.private sector, % p.a.	-3.1	-4.3	-0.1	2.3	2.2	2.6	.	.	.
Non-performing loans (NPL), in %, eop	16.7	13.8	11.4	9.8	11.2	9.2	.	.	.
Central bank policy rate, % p.a., eop <sup>5)</sup>	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR mn	1,436	983	1,660	970	-1,953	-2,617	300	100	50
Current account, % of GDP	3.2	2.1	3.4	1.9	-8.0	-10.3	0.6	0.2	0.1
Exports of goods, BOP, EUR mn	10,197	10,512	11,707	12,240	5,864	6,174	13,200	14,100	14,800
annual change in %	8.1	3.1	11.4	4.6	3.5	5.3	8.0	6.5	5.0
Imports of goods, BOP, EUR mn	17,319	18,119	20,152	21,882	10,787	11,704	23,800	25,500	27,000
annual change in %	7.9	4.6	11.2	8.6	6.6	8.5	8.9	7.0	6.0
Exports of services, BOP, EUR mn	10,523	11,725	12,885	13,848	4,531	4,737	14,700	15,600	16,500
annual change in %	12.3	11.4	9.9	7.5	6.6	4.5	6.0	6.0	6.0
Imports of services, BOP, EUR mn	3,282	3,562	4,109	4,634	2,172	2,395	5,000	5,400	5,800
annual change in %	13.1	8.5	15.4	12.8	18.3	10.3	7.5	7.0	7.0
FDI liabilities, EUR mn	33	356	462	995	1,060	314	600	.	.
FDI assets, EUR mn	-189	-1,631	-679	264	207	86	120	.	.
Gross reserves of NB excl. gold, EUR mn	13,707	13,514	15,706	17,438	16,694	19,880	.	.	.
Gross external debt, EUR mn <sup>6)</sup>	48,230	44,714	43,683	42,710	44,107	44,564	44,500	44,700	43,700
Gross external debt, % of GDP <sup>6)</sup>	108.1	95.9	89.2	83.0	85.7	83.1	83.0	80.0	75.0
Average exchange rate HRK/EUR	7.6137	7.5333	7.4637	7.4182	7.4181	7.4199	7.4	7.4	7.4

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) From 2016 new source for labour force. - 4) From 2016 data are based on tax records (survey JOPPD); prior to that data are based on a monthly survey. - 5) Discount rate of NB. - 6) Including trade credits less than 6 months.

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