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## **Croatia: Another critical year ahead**

Croatia's economy contracted strongly in 2009, with GDP down by 6%. The drop in output was mainly due to a significant decline in domestic demand: household consumption fell by 9% and gross fixed capital formation by 12%; by contrast, government consumption reported a 3% increase. The sharp decline in private consumption is among other things a consequence of the continuing decline in household lending, particularly with respect to car purchases. Though shrinking significantly, the contribution of foreign trade to GDP growth was still positive. Industrial production fell by 9.2% (manufacturing output by 10.6%). Output dropped in all manufacturing branches except for the production of paper and paper products, coke and refined petroleum products, and repair and installation of machinery and equipment. The decline was most pronounced in the production of basic pharmaceutical products (43%). In the shipbuilding industry, Croatia's major exporter, production plunged by 13%.<sup>1</sup>

The worsening situation of the real sector has translated into employment losses. Based on registration data the unemployment rate rose to over 16% by the end of December 2009. By comparison, the unemployment rate obtained from the Labour Force Survey indicates a rate of around 10%. The large discrepancy between the two measures may indicate rising informal sector activities. Manufacturing is hit hardest by job losses, which were most pronounced in the textile and wood industries. Trade, construction and tourism were heavily affected by employment cuts as well.

Facing the worsening of fiscal developments, Croatia's government adopted three budget revisions in 2009. In July the government decided to raise the VAT by one percentage point to 23% and introduced a crisis tax effective from 1 August. The tax takes 2% of all pensions, salaries and other incomes higher than HRK 3000 (EUR 409) a month and 4% of all amounts higher than HRK 6000 (EUR 819; the average wage was HRK 7700). In the year as a whole the general government deficit reached 2.9% of the GDP. The 2010 budget was adopted by the Croatian parliament at the beginning of December, envisaging a 2.9% general government deficit. Considering that the budget is based on the assumption of 0.5% GDP growth, this seems to be too ambitious. A Eurobond issue is planned in the first half of the year.

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<sup>1</sup> The first round of the privatization of Croatia's six state-owned shipyards closed with only two valid Croatian bids in an international tender. The second privatization tender was issued on 15 February 2010 and interested parties will have 60 days to submit their bids.

Because of companies' growing difficulties, the share of bad loans has been on the rise over the past couple of months; it reached 7.6% by the end of 2009. In order to provide the banking system with additional liquidity, the National Bank has announced to gradually reduce the mandatory reserve rate from 14% to 11% this year and lifted the credit growth limit (12% annually) which it had introduced in 2006 in counteracting the fast credit growth. In an attempt to stimulate economic growth, the Croatian government decided at the beginning of January 2010 to establish a special fund in order to provide companies with cheap loans, with the state and the private sector sharing the risk. In addition, the Prime Minister announced measures designed to support companies facing difficulties, particularly in the textile and construction sectors.

The downturn in foreign trade slowed somewhat during the final months of 2009. Nevertheless, data available from customs statistics indicate a drop in goods exports and imports by 22% and 27% respectively and the trade deficit fell significantly. Data on services trade available for the first nine months of the year indicate a declining surplus as against the same 2008 period. This is primarily due to shrinking earnings from tourism and transport. Owing to the sharp reduction of the trade deficit, the current account closed also with a significantly lower deficit than in previous years. As for FDI, inflows more than halved compared to the first nine months of 2008 and were almost exclusively directed towards the financial sector. The rise in external debt is largely a consequence of corporate borrowing and direct-investment related debt (borrowing of enterprises from their foreign owners), while banks' borrowing rose only modestly and government debt remained almost unchanged. According to the governor of the Croatian National Bank, Croatia has to repay (refinance) nearly EUR 10 billion in 2010; adding the amount required for financing the fiscal deficit, total borrowing requirements will amount to almost EUR 13 billion. Thus, the debt to GDP ratio is likely to reach or even exceed the 100% mark in 2010.

Ivo Josipovic from the Social Democratic Party, a law professor and composer, won overwhelmingly with 60.3% of the votes in the second round of the presidential elections held on 10 January 2010. His rival Milan Bandic, the mayor of Zagreb, took 39.7% of the vote as an independent candidate. In a first statement Mr. Josipovic emphasized to back the centre-right Prime Minister Jadranka Kosor in implementing reforms, fighting corruption and supporting the government efforts in joining the EU.

After the lifting of Slovenia's veto on Croatia's accession talks in September, Croatia may complete the negotiating process in the course of 2010. This would imply accession in 2012, or even only in 2013.

GDP will decline by another 1% in 2010. Fiscal constraints and high foreign debt obligations represent a major obstacle to financing public investment projects. Employment is expected to further contract, translating into rising unemployment or even inactivity. This may trigger a further decline in household consumption. Foreign demand will largely depend on the recovery of Croatia's most important trading partners, Germany, Italy, and Bosnia and Herzegovina. The current account deficit will remain at moderate levels, at about 6.5% of GDP, in 2010 and increase gradually thereafter. 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 foreseeable future might help to strengthen Croatia's standing vis-à-vis foreign creditors.

Table HR

## Croatia: Selected Economic Indicators

	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010	2011	2012
	Forecast								
Population, th pers., average	4439	4442	4440	4436	4435	4435	4435	4435	4435
Gross domestic product, HRK mn, nom.	245550	264368	286341	314223	342159	329300	334200	349400	365300
annual change in % (real)	4.2	4.2	4.7	5.5	2.4	-6	-1	2	2.5
GDP/capita (EUR at exchange rate)	7400	8000	8800	9700	10700	10100	10300	10800	11300
GDP/capita (EUR at PPP - wiiw)	12100	12700	13500	15000	15500	14800	.	.	.
Consumption of households, HRK mn, nom.	150341	162165	172744	188952	202194	188410	.	.	.
annual change in % (real)	4.3	4.4	3.5	6.2	0.8	-9	0	1.5	2
Gross fixed capital form., HRK mn, nom.	60512	65008	74792	82386	94281	84960	.	.	.
annual change in % (real)	5.0	4.8	10.9	6.5	8.2	-12	1	4	5
Gross industrial production <sup>2)</sup>									
annual change in % (real)	3.2	4.6	4.2	4.9	1.2	-9.2	1	3	3.5
Gross agricultural production									
annual change in % (real)	11.9	-8.7	4.4	-3.9	8.0	.	.	.	.
Construction industry, hours worked <sup>2)</sup>									
annual change in % (real)	1.9	-0.7	9.4	2.4	11.8	-6.0	.	.	.
Employed persons - LFS, th, average	1563	1573	1586	1615	1636	1600	1590	1590	1610
annual change in %	1.7	0.7	0.8	1.8	1.3	-2	-0.5	0	1
Unemployed persons - LFS, th, average	250	229	199	171	149	165	.	.	.
Unemployment rate - LFS, in %, average	13.8	12.7	11.1	9.6	8.4	9.3	10	10	9
Reg. unemployment rate in %, end of period	18.5	17.8	17.0	14.7	13.7	16.7	17.5	17	16.5
Average gross monthly wages, HRK	5985	6248	6634	7047	7544	7700	.	.	.
annual change in % (real, net)	3.7	1.5	1.9	2.2	0.8	0.7	.	.	.
Consumer prices, % p.a.	2.1	3.3	3.2	2.9	6.1	2.4	2.5	2.5	2
Producer prices in industry, % p.a. <sup>3)</sup>	3.5	3.0	2.9	3.4	8.4	-0.4	.	.	.
General governm.budget, nat.def., % GDP <sup>4)</sup>									
Revenues	39.3	38.9	39.2	40.3	39.4	40.1	.	.	.
Expenditures	43.4	42.3	41.6	41.5	40.3	43.0	.	.	.
Deficit (-) / surplus (+) <sup>5)</sup>	-4.2	-3.5	-2.6	-1.2	-1.0	-2.9	-3	-2.5	-2.5
Public debt, EU-def., in % of GDP <sup>6)</sup>	37.8	38.3	35.7	33.1	33.5	37.7	39	39	42
Discount rate of NB, % p.a., end of period	4.5	4.5	4.5	9.0	9.0	9.0	.	.	.
Current account, EUR mn	-1433.7	-1975.6	-2717.1	-3237.7	-4368.8	-2450	-3000	-3400	-3800
Current account in % of GDP	-4.4	-5.5	-6.9	-7.6	-9.2	-5.5	-6.5	-7	-7.5
Exports of goods, BOP, EUR mn	6606.8	7220.3	8463.6	9192.5	9814.0	7650	7800	8200	8800
annual growth rate in %	18.5	9.3	17.2	8.6	6.8	-22	2	5	7
Imports of goods, BOP, EUR mn	13330.9	14738.3	16807.8	18626.5	20607.8	15250	15700	16600	17800
annual growth rate in %	6.3	10.6	14.0	10.8	10.6	-26	3	6	7
Exports of services, BOP, EUR mn	7636.7	8052.6	8526.8	9114.7	10090.6	8580	8800	9100	9600
annual growth rate in %	0.9	5.4	5.9	6.9	10.7	-15	2	3	5
Imports of services, BOP, EUR mn	2867.8	2734.9	2824.2	2847.3	3132.7	2850	2900	3000	3100
annual growth rate in %	8.9	-4.6	3.3	0.8	10.0	-9	2	2	4
FDI inflow, EUR mn	949.6	1467.9	2764.8	3670.2	4190.2	1900	1900	.	.
FDI outflow, EUR mn	278.8	191.8	208.2	180.2	965.2	870	.	.	.
Gross reserves of NB excl. gold, EUR mn	6436.2	7438.4	8725.3	9307.4	9120.9	10372.7	.	.	.
Gross external debt, EUR mn <sup>7)</sup>	22933.0	25747.7	29273.9	32929.2	39124.6	43000	.	.	.
Gross external debt in % of GDP <sup>7)</sup>	71.6	71.8	75.1	76.8	83.8	95	.	.	.
Average exchange rate HRK/EUR	7.4957	7.4000	7.3228	7.3360	7.2232	7.3398	7.3	7.3	7.3
Purchasing power parity HRK/EUR	4.5804	4.6745	4.7861	4.7223	4.9838	5.0274	.	.	.

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

1) Preliminary and wiiw estimates. - 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 Eurostat and national statistics. Forecasts by wiiw.