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Croatia: credit growth out of control?

During 2005 Croatia's economic growth gained momentum from quarter to quarter and the GDP was finally up close to 4% year on year. Growth was driven by private consumption supported by increased household lending and a modest revival of government consumption and investment growth. In addition, foreign trade again contributed positively to GDP growth (as in 2003). Construction output finally declined, after the favourable trend in the past several years, mainly due to the completion of big infrastructural projects. The relatively strong rise in consumer prices came as no surprise since inflation was pushed up by energy prices. Consumer price inflation averaged 3.3% in 2005 or 3.6% in December year on year. The labour market did not benefit from GDP growth: registered employment was stagnant (LFS data even suggest a decline) and unemployment, though somewhat declining, remained at high levels – 18% by registration and 13% by LFS data.

Industrial production growth, up 5.1% in 2005, was much more favourable than was to be expected after the weak performance at the beginning of the year. Output of capital goods developed quite well, expanding by nearly 15%. Manufacturing reported above-average growth; the most favourable results were achieved in machinery and equipment, publishing and printing, electrical machinery and apparatus, and the manufacture of rubber and plastics. Labour-intensive industries such as textiles and the manufacture of wearing apparel, leather, and the manufacture of furniture all suffered severe output declines. Due to continued layoffs labour productivity in industry has further increased, with a very uneven development however across individual branches.

In foreign trade overall imports again rose significantly faster than exports, resulting in a record trade deficit of about EUR 7.7 billion. A regional breakdown of trade derived from customs statistics shows that overall growth was driven by the strong export performance to the successor states of the former Yugoslavia (excluding Slovenia), while exports to the EU-25 developed far below average. The strong import growth was mainly due to a sharp rise in imports of oil, refined petroleum products and electricity. The poor trade performance again resulted in a deterioration of the current account, one of Croatia's most burning and persistent problems. After an improvement in 2004, owing partly to a one-off receipt of reinvested earnings, the current account closed with an estimated EUR 2.2 billion deficit or again more than 7% of the GDP in 2005. The widening trade deficit could only partly be offset by higher earnings from services, particularly from tourism, with overnight stays increasing by 8%. FDI data available for the first three quarters of the year indicate a significant upswing of inward FDI, primarily targeting sectors such as financing, oil and gas, retail trade and tourism.

Foreign debt grew at a slower pace than in the past couple of years. By the end of November 2005 it stood at EUR 24.8 billion or 82.7% of the GDP, and was EUR 2.2 billion higher than in December 2004. The bulk of this increase was due to enterprise borrowing and, to a lesser extent, to borrowing by banks, while the government could reduce its foreign liabilities. Consequently, the structure of the debt stock by debtors has changed remarkably, pointing to a high and growing portion of enterprises and banks while the government's share fell from 40% in 2002 to about 28% in November 2005. Borrowing abroad enabled banks to increase their domestic placements: loans to the government were up by almost 40% in October year on year, to households by 23% and to enterprises by 18%. In order to prevent a further credit expansion, which would entail increasing imports and a widening of the current account deficit, the National Bank decided to further raise marginal reserve requirements. Accordingly, as of 11 January 2006, banks are required to allocate 55% (instead of 40% earlier) of their foreign liabilities' increase to a foreign exchange account held with the National Bank. The effectiveness of this step is, however, questionable: even if there is some slowdown in banks' external borrowing this measure will have no noticeable impact on enterprise borrowing, which reports the fastest growth.

The structure of Croatia's public debt has changed remarkably over recent years. While up to 2003 the foreign debt portion was close to 60%, it diminished steadily thereafter and amounted to only 48.5% in October 2005. This turnaround came in the wake of an agreement with the IMF from August 2004 when the country's authorities committed themselves to 'reducing sharply the reliance on foreign borrowing'. Thus, Croatia's government has borrowed almost exclusively on the domestic market recently.¹ In October 2005 public debt (including guarantees) grew to 54% of the expected GDP in 2005. This figure does not include pension arrears, an inclusion of which into public debt would significantly increase the debt to GDP indicator.

The 2006 budget bill passed at the end of November is aimed at a reduction of the general government deficit to 3.3% of GDP in 2006 (the revised target rate for 2005 was 4.2%). Considering the past experience the budget target appears overoptimistic, particularly as concerns the cut of budgetary expenditures on subsidies, wages and social spending. Part of the deficit should be covered by privatization receipts. According to the second Pre-accession Programme for the period 2006-2008, adopted in December, the government expects some EUR 900 million from privatizations over that period. The bulk of privatization receipts is envisaged to accrue in 2006, first of all through the second stage of the privatization of the oil and gas company INA. In addition, further shares of Croatian Telecom and the country's biggest insurance company, Croatia Osiguranje, are to be sold.

¹ However, even domestic banks' loans granted to the government – a substantial part of the government debt increase – may in fact be considered as a form of foreign debt as the domestic banks in turn are borrowing abroad.

After several months of delay, the EU launched membership talks with Croatia on 3 October 2005 following a positive report by Carla del Ponte concerning Croatia's cooperation with the war crimes tribunal in The Hague. The capture of the fugitive war crimes suspect Ante Gotovina in Spain in December 2005 – the Croatian authorities' earlier failure to arrest him had been the main obstacle to starting negotiations as scheduled – has helped to smooth the country's integration process into the EU and NATO.

In 2006 GDP growth will slightly decelerate, considering the restrictive measures imposed by the National Bank at the beginning of the year and the further tightening of the fiscal policy. Thus, a decisive improvement on the labour market is not in sight. Despite some rise in inflation in 2005, the National Bank will adhere to its policy of stable prices and exchange rates. External imbalances will remain in the focus of economic policy makers. The beginning of negotiations with the EU may help to accelerate outstanding reforms and boost foreign investments.

Table HR

Croatia: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 ¹⁾	2006	2007
	forecast								
Population, th pers., mid-year ²⁾	4554	4437	4437	4443	4442	4439	4439	.	.
Gross domestic product, HRK mn, nom.	141579	152519	165640	179390	193067	207082	222260	237400	252580
annual change in % (real)	-0.9	2.9	4.4	5.2	4.3	3.8	3.9	3.7	3.8
GDP/capita (EUR at exchange rate)	4102	4502	4998	5451	5747	6224	6770	.	.
GDP/capita (EUR at PPP - wiiw)	7460	8120	8630	9280	9710	10320	11000	.	.
Gross industrial production ³⁾									
annual change in % (real)	-1.4	1.7	6.0	5.4	4.1	3.7	5.1	4	4
Gross agricultural production									
annual change in % (real)	-3.5	-10.0	8.5	7.7	-15.9	11.9	.	.	.
Construction industry, hours worked ³⁾									
annual change in % (real)	-7.7	-9.1	3.6	12.8	22.8	2.0	-1.2 ^{I-XI}	.	.
Consumption of households, HRK mn, nom.	81546	89637	98054	107427	113396	120312	128630	.	.
annual change in % (real)	-2.9	4.2	4.5	7.6	4.1	3.9	3.5	4	4
Gross fixed capital form., HRK mn, nom.	33025	33281	36984	44114	53168	57141	61090	.	.
annual change in % (real)	-3.9	-3.8	7.1	12.0	16.8	4.4	3.5	4	4.5
LFS - employed persons, th, avg.	1492	1553	1469	1528	1537	1563	1566 ^{I-VI}	.	.
annual change in %	-3.4	4.1	-5.4	4.0	0.6	1.7	-1.1 ^{I-VI}	.	.
Reg. employees in industry, th pers., avg.	299.5	291.9	287.2	281.0	282.6	281.7	276.3 ^{I-XI}	.	.
annual change in %	-3.0	-2.5	-1.6	-2.2	0.6	-0.3	-2.0 ^{I-XI}	.	.
LFS - unemployed, th pers., average	234.0	298.0	277.0	266.0	256.0	249.5	236 ^{I-VI}	.	.
LFS - unemployment rate in %, average	13.6	16.1	15.9	14.8	14.3	13.8	13.1 ^{I-VI}	13	12.8
Reg. unemployment rate in %, end of period	20.4	22.3	23.1	21.3	19.1	18.7	18.0	17.5	17
Average gross monthly wages, HRK	4551	4869	5061	5366	5623	5985	6250	.	.
annual change in % (real, net)	10.1	3.4	1.6	3.1	3.8	3.7	1.6	.	.
Consumer prices, % p.a. ⁴⁾	4.2	6.2	4.9	1.7	1.8	2.1	3.3	3	2.5
Producer prices in industry, % p.a.	2.6	9.7	3.6	-0.4	1.9	3.5	3.0	2.7	2.4
General governm.budget, IMF-def., % GDP									
Revenues	48.4	46.2	44.7	45.2	44.9
Expenditures	56.6	52.7	51.5	50.0	49.5
Deficit (-) / surplus (+), % GDP	-8.2	-6.5	-6.8	-4.8	-6.3	-4.9	-4.5	-4	-3.8
Public debt in % of GDP	42.3	48.9	50.3	50.4	51.7	53.2	54.5	55	56
Discount rate % p.a., end of period	7.9	5.9	5.9	4.5	4.5	4.5	4.5	.	.
Current account, EUR mn	-1312.9	-489.9	-817.7	-2097.2	-1866.2	-1446.7	-2200	-1900	-1800
Current account in % of GDP	-7.0	-2.5	-3.7	-8.7	-7.3	-5.2	-7.3	-6.0	-5.3
Gross reserves of NB excl. gold, EUR mn	3012.6	3783.2	5333.6	5651.3	6554.1	6436.2	7220.4 ^{XI}	.	.
Gross external debt, EUR mn	10101.3	12109.3	13458.3	15054.8	19810.6	22675.4	24837.2 ^{XI}	.	.
FDI inflow, EUR mn	1369.1	1142.1	1502.5	1195.1	1788.4	980.0	1500	.	.
FDI outflow, EUR mn	54.4	1.5	175.7	598.3	93.0	285.8	100	.	.
Exports of goods, BOP, EUR mn	4134.1	4969.3	5318.8	5293.1	5571.7	6603.1	7200	7600	8100
annual growth rate in %	1.2	20.2	7.0	-0.5	5.3	18.5	9	6	7
Imports of goods, BOP, EUR mn	7240.0	8468.6	9922.6	11253.5	12545.9	13330.9	14900	15900	16900
annual growth rate in %	-6.1	17.0	17.2	13.4	11.5	6.3	12	7	6
Exports of services, BOP, EUR mn	3509.6	4442.0	5481.3	5832.3	7565.9	7636.7	8000	.	.
annual growth rate in %	-0.7	26.6	23.4	6.4	29.7	0.9	5	.	.
Imports of services, BOP, EUR mn	1965.1	1971.5	2178.5	2547.5	2632.8	2921.7	2700	.	.
annual growth rate in %	16.8	0.3	10.5	16.9	3.3	11.0	-8	.	.
Average exchange rate HRK/USD	7.11	8.28	8.34	7.86	6.70	6.04	5.95	.	.
Average exchange rate HRK/EUR (ECU)	7.58	7.63	7.47	7.41	7.56	7.50	7.40	7.45	7.5
Purchasing power parity HRK/USD	3.65	3.73	3.77	3.75	3.82	3.86	3.85	.	.
Purchasing power parity HRK/EUR	4.17	4.23	4.33	4.35	4.47	4.52	4.55	.	.

Notes: 1) Preliminary. - 2) From 2000 according to census March 2001. - 3) Enterprises with more than 20 employees. - 4) Up to 2001 retail prices.

Source: wiiw Database incorporating national statistics; IMF; wiiw forecasts.