



*Hermine Vidovic*

## **Croatia: Difficult to come out of the crisis**

After six quarters of economic downturn Croatia's GDP growth stabilized in the third quarter of 2010, but in the whole year GDP dropped by another 1.5%. Gross fixed capital formation performed even worse than a year earlier, dropping by 12% and household consumption continued to contract due to shrinking disposable incomes. Government consumption, having almost stagnated in 2009, fell in 2010. Foreign demand, by contrast, contributed positively to GDP growth. In construction, where output had shrunk in 2009, the negative tendencies even strengthened, with output down by 17% in 2010. The reasons behind this drop were declining demand of households for apartments due to falling disposable income and relatively high interest rates on housing loans. In addition, large public infrastructure projects as well as the construction of private production facilities were postponed due to problems of financing. Industrial production was down by 1.4% in 2010. Output fell in all sectors and was particularly strong in the production of intermediate goods. As a consequence of large lay-offs productivity in industry increased by 6%.

In foreign trade, growth of merchandise exports strengthened from quarter to quarter, but import growth remained negative. The main reason behind the relatively strong export growth was the steep increase of the shipbuilding industry, Croatia's main (but highly subsidized) export sector. In 2010 the trade deficit fell to about EUR 5.9 billion, compared to EUR 7.4 billion a year earlier. Services exports stagnated and services imports recorded negative growth rates, thus the trade surplus improved slightly compared to 2009. Owing to the reduction of the trade deficit in particular, the current account deficit continued to shrink, representing around 3% of the GDP. As for FDI, inflows were one third lower than in 2009 and were directed primarily towards the financial sector, the chemical industries and other business activities. At the end of 2010 foreign debt stood at EUR 45 billion, only slightly more than in December 2009.

Unlike in other European countries, where the fall in employment and the rise in unemployment moderated or stabilized during 2010, registered unemployment in Croatia jumped to 18.8% by the end of December – the highest rate since 2005. Based on Labour Force Survey data, employment fell by about 4% in 2010, while at the same time the

unemployment rate was close to 12%. Taking into account that a number of people decided to leave the labour market altogether, the unemployment rate may have been even higher. Since the beginning of the crisis about 141,000 jobs have been lost, most of which in manufacturing (67,000). This is approximately the same number of jobs that had been created in the period 2002-2008. The downward pressure on wages, which was felt already in 2009, has continued in 2010; real net wages were down by 1%.

Following the cuts in revenues as a consequence of the contracting economy and the simultaneous rise in public expenditures, the Croatian parliament approved a revision of the state budget in August 2010. Accordingly the general government deficit has been widened to 5.2% of the GDP from the earlier target of 3.3%. In October, the Croatian government presented the Economic and Fiscal Policy Guidelines 2011-2013, envisaging a gradual reduction of the general government deficit to 1.9% in 2013. Calculations are based on the assumption of 1.5%, 2% and 2.5% GDP increases in the respective years, driven primarily by foreign demand. According to the Minister of Finance about HRK 28 billion (slightly less than EUR 4 billion) will be needed to cover the budget deficit and to refinance outstanding debts in 2011. Additional financing should come from further privatizations. The fiscal responsibility law in force since January 2011 envisages the reduction of the general budget expenditures by 1 percentage point of the projected annual GDP every year until the primary fiscal balance becomes zero or positive. In addition the law stipulates that planned budgetary expenditures should be fully covered by revenues; this is to be ensured by the government.

In order to stimulate the economic growth the government presented ten large investment projects mainly in infrastructure which should start in March 2011. The funding for most of the projects is, however, still uncertain and the government is looking for investors. The growth impact of the programmes cannot be expected this year but only in the medium and longer run.

By the end of December 2010, 28 out of 35 chapters in the accession negotiations with the EU had been provisionally closed. Croatia's EU entry talks should be completed in (the first half of) 2011 – sensitive chapters like judiciary and competition are still in the negotiation process. Assuming that accession talks are going according to plan Croatia may join the European Union in 2013, considering the period needed for the ratification procedure in the parliaments of the current 27 EU member states. One of the still open issues will be fighting corruption, which has spread to all segments of society. (In December the former Prime Minister of Croatia, Ivo Sanader, was arrested in Austria on charges of corruption, money laundering and abuse of power.)

For 2011, wiiw expects GDP to rebound to 1% conditioned on a further improvement of external demand. In contrast to our earlier forecast, we expect a slower recovery of domestic demand mainly as a consequence of high unemployment. Considering 2011 is an election year there will be little room for essential reforms including an improvement of the fiscal situation – the compliance with the Fiscal Guidelines will become a big challenge. Employment will continue to contract as the labour market will react with a time lag to production growth and the unemployment rate is expected to stagnate or fall only slightly. This may trigger a further decline in household consumption. A more vigorous recovery of the labour market can be expected only from 2012 onwards. The current account deficit will remain within more moderate limits than before the crisis, ranging between 4-5% in the years to come. Restructuring and servicing the high foreign debt will remain one of the major challenges in the near future.

Table HR

**Croatia: Selected Economic Indicators**

	2005	2006	2007	2008	2009	2010 <sup>1)</sup>	2011	2012	2013
	Forecast								
Population, th pers., average	4442	4440	4436	4435	4429	4435	4435	4435	4435
Gross domestic product, HRK mn, nom.	264368	286341	314223	342159	333063	332000	343700	357600	377500
annual change in % (real)	4.2	4.7	5.5	2.4	-5.8	-1.5	1	2	3
GDP/capita (EUR at exchange rate)	8000	8800	9700	10700	10200	10300	10600	11000	11700
GDP/capita (EUR at PPP - wiiw)	12700	13500	15000	15800	15000	14900	.	.	.
Consumption of households, HRK mn, nom.	162165	172744	188952	202194	189638	189000	.	.	.
annual change in % (real)	4.4	3.5	6.2	0.8	-8.5	-1.5	0.5	2	3
Gross fixed capital form., HRK mn, nom.	65008	74792	82386	94281	82259	73300	.	.	.
annual change in % (real)	4.8	10.9	6.5	8.2	-11.8	-12	2	5	5
Gross industrial production <sup>2)</sup>									
annual change in % (real)	4.6	4.2	4.9	1.2	-9.2	-1.4	3	3.5	4
Gross agricultural production									
annual change in % (real)	-8.7	4.4	-3.9	8.0	-0.8	.	.	.	.
Construction industry, hours worked <sup>2)</sup>									
annual change in % (real)	-0.7	9.4	2.4	11.8	-6.6	-17	.	.	.
Employed persons - LFS, th, average	1573	1586	1615	1636	1605	1540	1525	1530	1550
annual change in %	0.7	0.8	1.8	1.3	-1.8	-4.1	-1	0.5	1
Unemployed persons - LFS, th, average	229	199	171	149	160	210	.	.	.
Unemployment rate - LFS, in %, average	12.7	11.1	9.6	8.4	9.1	12.0	11.5	10	9.5
Reg. unemployment rate in %, end of period	17.8	17.0	14.7	13.7	16.7	18.8	17	16.5	15.5
Average gross monthly wages, HRK	6248	6634	7047	7544	7711	7670	7700	7750	7800
annual change in % (real, net)	1.5	1.9	2.2	0.8	0.2	.	.	.	.
Consumer prices, % p.a.	3.3	3.2	2.9	6.1	2.4	1.1	2.5	2	2.5
Producer prices in industry, % p.a. <sup>3)</sup>	2.7	2.7	3.5	8.3	-0.4	4.3	4	3.5	3
General government budget, nat. def., % GDP <sup>4)</sup>									
Revenues	38.9	39.2	40.3	39.4	38.5	37.8	37.3	37.0	37.0
Expenditures	42.3	41.6	41.5	40.8	42.6	43.5	43.4	42.5	42.0
Deficit (-) / surplus (+) <sup>5)</sup>	-3.5	-2.6	-1.2	-1.4	-4.1	-5.7	-6.1	-5.6	-5.0
Public debt, EU-def., in % of GDP <sup>6)</sup>	38.3	35.5	32.9	28.9	35.3	40.9	45.9	49.9	52.0
Central bank policy rate, % p.a., end of period <sup>7)</sup>	3.5	3.5	4.1	6.0	6.0	6.0	.	.	.
Current account, EUR mn	-1975.6	-2726.2	-3236.1	-4337.8	-2477.0	-1400	-2000	-2400	-2600
Current account in % of GDP	-5.5	-7.0	-7.6	-9.2	-5.5	-3.1	-4	-5	-5
Exports of goods, BOP, EUR mn	7220.3	8463.6	9192.5	9814.0	7703.2	8900	9600	10500	11400
annual growth rate in %	9.3	17.2	8.6	6.8	-21.5	15.5	8	9	9
Imports of goods, BOP, EUR mn	14738.3	16807.8	18626.5	20607.8	15090.1	14800	15500	16600	18300
annual growth rate in %	10.6	14.0	10.8	10.6	-26.8	-1.9	5	7	10
Exports of services, BOP, EUR mn	8052.6	8526.8	9114.8	10090.6	8453.9	8400	8700	9100	9600
annual growth rate in %	5.4	5.9	6.9	10.7	-16.2	-0.6	3	5	6
Imports of services, BOP, EUR mn	2734.9	2824.1	2847.4	3132.7	2778.3	2600	2700	2800	2900
annual growth rate in %	-4.6	3.3	0.8	10.0	-11.3	-6.4	2	3	3
FDI inflow, EUR mn	1467.9	2768.3	3679.0	4209.0	2128.6	1500	2300	2500	3000
FDI outflow, EUR mn	191.8	206.8	211.2	972.8	918.7	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	7438.4	8725.3	9307.4	9120.9	10375.8	10660.3	.	.	.
Gross external debt, EUR mn <sup>8)</sup>	25761.1	29273.9	32929.2	39950.2	44605.2	45000	.	.	.
Gross external debt in % of GDP <sup>8)</sup>	71.9	75.1	76.8	85.5	97.8	100.1	.	.	.
Average exchange rate HRK/EUR	7.4000	7.3228	7.3360	7.2232	7.3398	7.2857	7.3	7.3	7.3
Purchasing power parity HRK/EUR	4.6756	4.7861	4.7280	4.8967	5.0111	5.0206	.	.	.

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

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) Domestic output prices. - 4) On accrual basis. - 5) Including change in arrears and non-recorded expenditures. - 6) According to ESA'95, excessive deficit procedure. - 7) Average weighted repo rates. - 8) From 2008 new reporting system (estimated data for non-financial enterprises).

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