



CROATIA: Economic recovery further delayed

HERMINE VIDOVIC

Economic recovery in Croatia will be delayed by another year due to fiscal consolidation efforts. GDP growth should rebound only in 2015, provided investments pick up and external demand strengthens. Private consumption will remain suppressed due to high and persistent unemployment as well as household and enterprise deleveraging. Benefits of EU membership can be expected only in the medium run.

Croatia's GDP, declining since 2008, dropped by another 0.9% in 2013. This was largely due to a fall in foreign demand and, to a lesser extent, caused by a decline in domestic demand. Gross fixed capital formation continued to shrink, but at a slower pace than in the years before. Household consumption dropped as a result of diminishing disposable income due to rising unemployment and household deleveraging. Industrial output contracted for the fifth consecutive year. In manufacturing, the worst drop in output occurred in shipbuilding – Croatia's single most important export sector – with production down by 45% as compared to 2012. On the positive side, the manufacturing of basic metals grew most, by 16%. Owing to continued lay-offs in industrial enterprises, labour productivity increased by 3%.

In order to boost Croatia's underperforming industrial sector, the long-awaited industrial strategy for the period 2014-2020 was presented in February 2014. The very ambitious (draft) strategy – still a basis for discussion among major stakeholders – envisages an annual growth of industrial production by 2.85%, the creation of 85,600 new jobs (of which at least 30% highly educated) in the period under consideration, an increase in productivity of close to 70%, export growth of 30% as well as the development of high value added products. Among strategic industries the document lists the pharmaceutical industry, production of computers, electronic devices, metal production as well as computer programming.

External trade contracted significantly in 2013 with exports of goods shrinking by 6% and imports by 2% in nominal terms. The resulting trade deficit increased by about EUR 200 million (to EUR 6.3 billion) compared to a year earlier. Services trade reported a rising surplus due to enhanced earnings from tourism and a significant reduction of the deficit in the income balance resulting from a decline in profits of economic entities owned by non-residents. As a result the current account turned positive in 2013. Goods exports were negatively affected by the restructuring of the shipbuilding industry (one of the preconditions for EU membership), dropping by almost half as compared to a year earlier, as well as by the restructuring of the petrochemical industry. Moreover, trade with the CEFTA countries contracted (exports: -7%) not least because of the abolishment of preferential treatment after EU accession, while imports from other EU members face no barriers any more.

At the end of 2013 foreign debt stood at EUR 44.6 billion, by EUR 400 million less than a year earlier. FDI was lower than in the two preceding years when an annual inflow of about EUR 1 billion had been recorded; most of FDI was directed towards real estate, the production of food and beverages and trade. In January 2014 Standard & Poor's downgraded Croatia's long-term foreign and local currency sovereign ratings from BB+ to BB, while rating the outlook from negative to stable. The downgrade was explained by the fact that 'economic and budgetary policy measures so far have been insufficient to foster economic growth and place public finances on a more sustainable path'. Furthermore it highlighted Croatia's weak competitiveness.

Labour market conditions have further deteriorated during 2013: the number of employed fell by close to 5%. Registered unemployment soared to about 22% at the end of December, while preliminary labour force survey data provided by Eurostat indicate an unemployment rate of some 18%. The incidence of unemployment is particularly high for young people with their unemployment rate ranking among the highest in the EU.

Budgetary statistics were adjusted to European standards (ESA 95) in September 2013, resulting in higher deficits than reported for previous years. Those deficits were primarily caused by obligations under guaranteed debts of public enterprises (shipbuilding in particular). According to preliminary data, the general government deficit in 2013 amounted to 5.5% of the GDP and the general government debt stood at 62% of GDP. The increase is due to a shortfall in tax revenues and the covering of debts in the health care sector. Since the country's deficit has been exceeding the budgetary deficit ceiling imposed by the EU's stability and growth pact legislation, an excessive deficit procedure (EDP) was launched by the European Commission in January 2014. Accordingly Croatia should meet deficit targets of 4.6% of GDP in 2014, 3.5% of GDP in 2015 and 2.7% of GDP in 2016.

In an immediate response the Croatian Minister of Finance announced a revision of the 2014 budget by the end of February, envisaging to cut spending and increase revenues. On the expenditure side it is planned to cut spending on intermediate consumption (use of goods and services), to reduce the public sector wage bill¹, lower agricultural, traffic and other subsidies and to reduce spending for health care and some capital investment projects. Revenues should come from transferring funds from the second to the first pension pillar of those with early reduced retirement rights such as army and police employees and fire-fighters; additional revenues are expected from taxing lottery profits, raising concession fees and collecting parts of the profits from public companies.

The budget revision will account for an expected 0.2% GDP growth forecast instead of the earlier 1.3% that is based on the assumption of lower public and household spending. Earnings from privatisation will be used for public debt reduction and will not go into the budget. Moreover, the Minister of Finance stated that the budgets for 2015 and 2016 will be revised as well and will be different from those presented earlier by the government in the economic policy guidelines. It is not clear yet whether or which public investment will be postponed as a consequence of these cost cutting measures. Earlier announced public sector investment plans included among others improvements in Croatia's infrastructure such as increasing the capacity of Zagreb airport or building two thermal power plants.

¹ According to the Minister of Finance salaries will not be reduced and there will be no dismissals, but better controls of overtime work and other benefits (*Privredni Vjesnik*, No. 233, p. 4). By contrast, Prime Minister Milanović announced the downsizing of personnel in public companies by 2000 employees in 2014.

Considering the poor outlook for GDP growth, uncertainties with regard to the actual amount of interest payments as well as the possible activation of state guarantees and, last but not least, the upcoming parliamentary elections in 2015, it will be difficult to achieve the Commission targets.

Although Croatia has a stable banking sector – the capital adequacy ratio is high by European standards – Croatian banks experienced significant declines of profitability and problems with the recapitalisation and bankruptcy of small banks in 2013. Data available for the first eleven months of the year show that both loans to households and non-financial corporations continued to decline by 2% and 3% respectively.² At the end of September 2013 the ratio of non-performing loans to total loans was 15% (up from 14% in September 2012). Out of loans provided to the corporate sector, 27% were categorised as non-performing. The ratio of bad loans in total household loans was 11%. On 1 January 2014 two new laws with regard to banking came into force: the Act on Consumer Credits and the Act on Credit Institutions. The most important change of the Consumer Credit Law is the reduction of interest rates to 3.23% for housing loans pegged to the Swiss franc. The reduction of the interest rate will be applied if the currency in question appreciated by over 20% from the day when the loan was taken. Currently there are 55,800 housing loans pegged to the Swiss franc. The Act on Credit Institutions harmonises Croatian regulations with EU regulations with regard to capital maintenance and the criteria for the management and supervision of credit institutions.

Given the announced budget consolidation measures, wiiw expects Croatia's GDP to further decline or stagnate at best in 2014. Public investment will still not be sufficient to boost economic recovery and drawing EU funds will take some time. In view of this, an improvement on the labour market has moved into the far distance. Thus, household consumption will remain suppressed due to high and still growing unemployment as well as ongoing household deleveraging. A slight recovery assuming the realisation of planned investment projects and increasing net transfers from the EU budget may start only in 2015 and continue in 2016. That recovery, however, will be too low to generate new jobs, and thus unemployment is bound to remain at high levels.

² By contrast, the Croatian National Bank, using a broader definition (claims), reports an increase of loans to corporations (2%) and a decline in household loans by 1.6%.

Table 1 / Croatia: Selected Economic Indicators

	2009	2010	2011	2012	2013 ¹⁾	2014	2015	2016
						Forecast		
Population, th pers., average ²⁾	4306.3	4296.4	4282.9	4269.1	4260.0	4260	4260	4260
Gross domestic product, HRK mn, nom.	328672	323807	328737	328562	333200	338200	346700	357200
annual change in % (real)	-6.9	-2.3	-0.2	-1.9	-0.9	0.0	1.0	1.5
GDP/capita (EUR at exchange rate)	10400	10300	10300	10200	10300	10400	10700	11000
GDP/capita (EUR at PPP)	14900	14700	15200	15700	15800	.	.	.
Consumption of households, HRK mn, nom.	188859	189314	194518	195355	198500	.	.	.
annual change in % (real)	-7.6	-1.3	0.3	-3.0	-0.7	0.0	0.5	1.0
Gross fixed capital form., HRK mn, nom.	80367	67254	64444	61119	62400	.	.	.
annual change in % (real)	-14.2	-15.0	-3.4	-4.7	-0.3	1.0	3.0	3.5
Gross industrial production ³⁾								
annual change in % (real)	-9.2	-1.4	-1.2	-5.5	-1.8	1.5	2.0	2.5
Gross agricultural production								
annual change in % (real)	-0.8	-8.2	-1.0	-9.9	1.4	.	.	.
Construction output ³⁾								
annual change in % (real)	-6.6	-15.8	-8.5	-11.1	-4.5	.	.	.
Employed persons, LFS, th, average	1605	1541	1493	1446	1380	1400	1400	1400
annual change in %	-1.8	-4.0	-3.2	-3.1	-4.6	-1.0	0.0	0.5
Unemployed persons, LFS, th, average	160	206	232	272	293	.	.	.
Unemployment rate, LFS, in %, average	9.1	11.8	13.5	15.9	17.5	17.5	17.5	17.0
Unemployment rate, reg., in %, end of period	16.7	18.8	18.7	21.1	21.6	21.5	21.5	21.0
Average monthly gross wages, HRK	7711	7679	7796	7875	7900	.	.	.
annual change in % (real, gross)	-0.2	-1.5	-0.8	-2.3	-1.8	.	.	.
Average monthly net wages, HRK	5311	5343	5441	5478	5500	.	.	.
annual change in % (real, net)	0.2	-0.5	-0.4	-2.6	-1.8	.	.	.
Consumer prices (HICP), % p.a.	2.2	1.1	2.2	3.4	2.3	1.5	1.5	1.5
Producer prices in industry, % p.a. ⁴⁾	-0.4	4.3	7.0	5.4	-0.3	1.0	1.0	1.0
General governm.budget, EU-def., % of GDP ⁵⁾								
Revenues	40.8	40.5	40.3	40.8	40.3	.	.	.
Expenditures	46.1	46.9	48.1	45.7	45.8	.	.	.
Net lending (+) / net borrowing (-)	-5.3	-6.4	-7.8	-5.0	-5.5	-5.0	-4.5	-3.5
Public debt, EU-def., % of GDP	36.6	44.9	51.9	55.8	62.0	65.0	67.0	70.0
Central bank policy rate, % p.a., end of period ⁶⁾	9.0	9.0	7.0	7.0	7.0	.	.	.
Current account, EUR mn	-2334	-523	-392	-13	600	400	350	320
Current account, % of GDP	-5.2	-1.2	-0.9	0.0	1.4	0.9	0.8	0.7
Exports of goods, BOP, EUR mn	7675	9064	9774	9811	9200	9500	9800	10000
annual change in %	-21.3	18.1	7.8	0.4	-6.2	3.5	3.5	2.5
Imports of goods, BOP, EUR mn	14882	14809	15922	15856	15500	15800	15900	16000
annual change in %	-27.0	-0.5	7.5	-0.4	-2.2	2.0	0.5	0.5
Exports of services, BOP, EUR mn	8695	8651	8992	9316	9500	9600	9800	9900
annual change in %	-14.2	-0.5	3.9	3.6	2.0	1.5	2.0	1.5
Imports of services, BOP, EUR mn	3046	2876	2793	2856	2800	2900	3000	3100
annual change in %	-7.1	-5.6	-2.9	2.3	-2.0	2.0	3.0	3.0
FDI inflow, EUR mn	2567	389	1087	1066	700	.	.	.
FDI outflow, EUR mn	896	-114	38	-28	150	.	.	.
Gross reserves of NB excl. gold, EUR mn	10376	10660	11195	11236	12908	.	.	.
Gross external debt, EUR mn	43928	46685	46059	45019	44600	.	.	.
Gross external debt, % of GDP	98.1	105.0	104.2	103.0	101.4	.	.	.
Average exchange rate HRK/EUR	7.3396	7.2862	7.4339	7.5175	7.5737	7.6	7.6	7.6
Purchasing power parity HRK/EUR	5.1255	5.1340	5.0546	4.9163	4.9530	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census April 2011. - 3) Enterprises with 20 and more employees. - 4) Until 2010 domestic output prices. - 5) According to ESA'95, excessive deficit procedure. - 6) Discount rate of NB.

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