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Croatia: Joining EU under difficult conditions

Croatia faces yet another year of recession extending throughout 2013. Growth should finally rebound in 2014, provided investments pick up and external demand strengthens. Owing to rising and persistently high unemployment, private consumption will remain suppressed. Fiscal consolidation and structural reforms will remain the major challenge in the years ahead. Joining the EU may help to increase foreign investor confidence, while regional trade will suffer.

Having declined or stagnated since 2008, Croatia's GDP dropped by another 1.5% during the first quarter of 2013 due to a fall in domestic demand. Gross fixed capital formation, which has been on the decline since 2009, continued to drop for yet another year. Household consumption fell as a consequence of shrinking disposable income due to rising unemployment and the high level of household indebtedness, while government consumption increased slightly. Industrial output showed a slight upward trend after having declined for four consecutive years. In manufacturing the worst drop in output occurred in shipbuilding – Croatia's single most important export sector – with production down by half as compared with the first quarter of 2012. On the positive side, the manufacturing of fabricated metal products and basic pharmaceuticals grew most, by 28% and 22% respectively.

Based on customs statistics, external trade contracted significantly during the first quarter of 2013 with exports of goods shrinking by 8.2% and imports by 2.7%. The resultant trade deficit increased by about EUR 100 million (to EUR 1.7 billion) compared to a year earlier. Taking into account the moderately rising trade deficit and assuming no significant change in the services trade surplus – tourist overnight stays developed very favourably during the first three months of the year – the current account deficit has probably remained unchanged or only slightly deteriorated. At the end of March 2013, foreign debt stood at EUR 45.1 billion, thus remaining unchanged compared to December 2012. Both Moody's and Standard & Poor's have downgraded Croatia's debt rating to junk during the first months of 2013, reflecting the stalled recovery, lack of budget discipline and vulnerability to external shocks. It is however interesting to note that the downgrade did not have any major impact on Croatian bond yields.

Labour market conditions have been further worsening during the first quarter of 2013: the number of employed fell by 2%. Registered unemployment soared to 20.9% at the end of April, while preliminary labour force survey data provided by Eurostat indicate an unemployment rate of 18% with youth unemployment standing at over 50%. In the EU only Spain and Greece have higher rates than that.

According to final data, the general government deficit in 2012 amounted to 3.8% of the GDP and the general government debt stood at 53.7% of GDP by the end of the year. As for 2013, the official deficit target of the revised budget adopted in April is 3.6% (assuming 0.7% growth of GDP; the initial version was based on 1.8% GDP growth). But considering rising interest payments as well as the assumption of shipyards' loans by the state, the deficit might reach close to 5% and the public debt may rise to 58%. Overall, even the assumption of a lower GDP growth underlying the budget is overly optimistic since all the forecasts published by international organisations and banks, as well as the country's main economic research institute EIZ, predict a GDP decline for 2013. Since the European Commission expects the public debt to exceed the threshold of 60% in 2014, Croatia may enter an excessive deficit procedure almost as soon as it joins the EU.

Since the beginning of the crisis there have been no large capital injections to the Croatian banking sector, and according to the National Bank there are none to be expected until the end of 2013.¹ At the end of March 2013 the ratio of non-performing loans to total loans was 14.6%. Out of loans provided to the corporate sector, about 26% of loans to trade companies were categorised as non-performing. The ratio of bad loans in total household loans was 9.7%.

Croatia joined the European Union on 1 July 2013. Unlike in the two recent accession waves when candidate countries gained substantial economic benefits already prior to their membership, this time both the EU and Croatia are struggling with the consequences of the economic crisis: shrinking or only modest GDP growth coupled with high and persistent unemployment. Thus, positive economic effects from EU accession, such as intensifying trade and attracting greenfield investments, can be expected only in the medium- and long-term perspective. In the short run Croatia will mainly benefit from its eligibility to structural and cohesion funds provided it develops a sufficient absorption capacity. Expected losses in trade due to leaving the Central European Free Trade Agreement (CEFTA) upon accession will be offset only over time. Croatia's goal of adopting the euro will depend first of all on meeting the Maastricht criteria.

¹ Croatian National Bank (2013), Financial Stability, No 10, Year 6, p. 42.

Based on the results for the first months of the year, wiiw has revised its previous GDP forecast for 2013 downwards (to -1%, from previously -0.5%) and expects a slight rebound only in 2014. Prospects have been dampened by the delayed recovery of domestic demand and the poor economic outlook in the EU (particularly in Italy, one of Croatia's most important trading partners, but also in Slovenia) as well as for the other Western Balkan countries. Household consumption will remain subdued as a consequence of high and still growing unemployment and weak credit activity; a certain relaxation on the labour market can be expected only from 2015 onwards. Fiscal consolidation and structural reforms against the background of high unemployment and servicing foreign debt will remain the major challenges for the years ahead. The country's accession to the EU may help to boost foreign investors' confidence.

Table HR

Croatia: Selected Economic Indicators

	2009	2010	2011	2012 ¹⁾	2012 1st quarter	2013	2013	2014	2015
							Forecast		
Population, th pers., mid-year ²⁾	4429.1	4417.8	4280.6	4267.0	4267.0	.	4280	4280	4280
Gross domestic product, HRK mn, nom.	328672	323807	330171	330232	75358	75957	338400	350300	364500
annual change in % (real)	-6.9	-2.3	0.0	-2.0	-1.1	-1.5	-1.0	1.0	2.0
GDP/capita (EUR at exchange rate)	10100	10100	10400	10300	.	.	10500	10900	11400
GDP/capita (EUR at PPP)	14500	14300	15200	15200	.	.	.	.	.
Consumption of households, HRK mn, nom.	188859	189314	194518	195355	46427	47004	.	.	.
annual change in % (real)	-7.6	-1.3	0.2	-3.0	-0.9	-3.0	-2.6	-1.0	0.5
Gross fixed capital form., HRK mn, nom.	80367	67254	63286	60740	13887	13736	.	.	.
annual change in % (real)	-14.2	-15.0	-6.4	-4.6	-3.9	-2.3	-2.0	3.0	5.0
Gross industrial production ³⁾									
annual change in % (real)	-9.2	-1.4	-1.2	-5.5	-5.4	0.9	1.0	2.5	3.0
Gross agricultural production									
annual change in % (real)	-0.8	-8.2	-1.0	.	.	.	.	.	.
Construction output ³⁾									
annual change in % (real)	-6.6	-15.8	-8.5	-11.1	-11.7	-3.1	.	.	.
Employed persons, LFS, th, average	1605	1541	1493	1446	1394	.	1420	1420	1430
annual change in %	-1.8	-4.0	-3.2	-3.1	-5.6	.	-2.0	0.0	1.0
Unemployed persons, LFS, th, average	160	206	232	272	273	.	.	.	.
Unemployment rate, LFS, in %, average	9.1	11.8	13.5	15.8	16.4	.	17.5	17.0	17.5
Unemployment rate, reg., in %, end of period	16.7	18.8	18.7	21.1	20.0	21.6	21.5	21.0	20.0
Average gross monthly wages, HRK	7711	7679	7796	7875	7835	7941	7900	7950	8000
annual change in % (real, net)	0.2	-0.5	-0.4	-2.6	0.1	-3.4	.	.	.
Consumer prices, % p.a.	2.4	1.1	2.3	3.4	1.5	4.6	3.5	2.5	2.0
Producer prices in industry, % p.a. ⁴⁾	-0.4	4.3	7.0	5.4	5.6	2.6	2.5	2.5	2.5
General governm.budget, EU-def., % of GDP ⁵⁾									
Revenues	40.9	40.1	40.4	36.8	.	.	.	.	.
Expenditures	45.6	45.3	46.1	40.6	.	.	.	.	.
Net lending (+) / net borrowing (-)	-4.7	-5.2	-5.7	-3.8	.	.	-4.8	-3.5	-3.0
Public debt, EU-def., % of GDP	35.8	42.6	47.2	53.0	.	.	57.0	62.0	64.0
Central bank policy rate, % p.a., end of period ⁶⁾	9.0	9.0	7.0	7.0	7.0	7.0	.	.	.
Current account, EUR mn	-2281.8	-468.3	-385.2	35.4	-1585.2	.	50	-300	-500
Current account, % of GDP	-5.1	-1.1	-0.9	0.1	-15.9	.	0.1	-0.6	-1.0
Exports of goods, BOP, EUR mn	7674.5	9063.6	9772.6	9783.0	2287.9	.	9300	9700	10200
annual change in %	-21.3	18.1	7.8	0.1	2.2	.	-5.0	4.0	5.0
Imports of goods, BOP, EUR mn	14881.5	14809.1	15921.9	15804.4	3796.5	.	15500	16300	17300
annual change in %	-27.0	-0.5	7.5	-0.7	2.0	.	-2.0	5.0	6.0
Exports of services, BOP, EUR mn	8640.2	8651.2	9004.8	9317.5	807.3	.	9700	10200	10700
annual change in %	-14.4	0.1	4.1	3.5	6.4	.	4.0	5.0	5.0
Imports of services, BOP, EUR mn	2949.9	2875.7	2818.0	2924.6	-641.6	.	2900	3000	3200
annual change in %	-8.9	-2.5	-2.0	3.8	-1.2	.	0.0	3.0	5.0
FDI inflow, EUR mn	2403.6	326.3	1080.2	973.3	89.5	.	.	.	.
FDI outflow, EUR mn	887.3	-110.3	21.7	-77.3	-216.7	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	10376	10660	11195	11236	11340	11277	.	.	.
Gross external debt, EUR mn ⁷⁾	43745	46483	45734	44935	45916	45102	.	.	.
Gross external debt, % of GDP ⁷⁾	97.7	104.6	103.0	102.3	104.5	99.6	.	.	.
Exchange rate HRK/EUR, average	7.3396	7.2862	7.4339	7.5175	7.5552	7.5786	7.5	7.5	7.5
Purchasing power parity HRK/EUR	5.1169	5.1309	5.0661	5.0889	.	.	.	.	.

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

1) Preliminary. - 2) From 2011 according to census April 2011. - 3) Enterprises with 20 and more employees. - 4) Domestic output prices. From 2011 total output prices. - 5) According to ESA'95, excessive deficit procedure. - 6) Discount rate of NB. - 7) From 2009 new reporting system.

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