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Croatia: meeting financial obligations – a major challenge

GDP growth moderated noticeably in the second half of 2008. Latest figures (third quarter 2008) show a marked slowdown of private consumption and a drop in investment activities. Starting from the second half of the year, private lending, particularly housing credits, declined significantly. In all likelihood, GDP growth turned negative in the final quarter of 2008, thus GDP for the whole year rose only 2.5%. The construction industry maintained high growth; industrial production decelerated from month to month and rose by a mere 1.6% in 2008. Inflation continued to decelerate from its peak level in July and reached 2.9% in December (over December 2007).

The impact of the economic downturn on the labour market remained limited during the first three quarters of the year, but registered unemployment started to rise in the last quarter. Over the first eleven months, employment increased by 1.4% year-on-year and unemployment, though increasing, was still lower than the year previous.

Foreign trade lost momentum towards the end of 2008. Based on customs statistics, exports of goods measured in euro terms were up by 6.3% and imports rose by 10.5%. Thus, the foreign trade deficit continued to widen, reaching about 27% of the GDP. Trade in both directions was very dynamic in 'other transport equipment': the main exports under that item were ships, while on the import side fishing boats, helicopters and aeroplanes played the most important role. By no means did earnings from tourism suffice to offset the deterioration in the trade balance. The current account closed with an unparalleled record deficit equivalent to about 11% of the GDP. As for FDI, inflows valued at EUR 3.6 billion reached almost the same level as in 2007 – covering about 80% of the current account deficit. Experts from the National Bank expect a drop in FDI inflows of the order of 30-60% in 2009.

Croatia's gross foreign indebtedness has continued to grow. At the end of October, it had reached EUR 37.7 billion; EUR 4.4 billion higher than in December 2007. The bulk of that increase was due to the corporate sector borrowing more. By contrast, the banking sector's foreign debt declined, while that of the government remained unchanged. Debt servicing appears to have become a serious problem in 2009, with some EUR 11 billion reportedly due to be repaid over the year as a whole. Restricted access to international credit markets will aggravate debt repayment, particularly in the corporate sector. The government has requested a syndicated loan (from six banks) worth EUR 1 billion in order to: (i) repay debt falling due in the first half of the year; and (ii) finance current obligations, such as salaries, pensions and social welfare expenses. Representatives of the enterprises, however, expressed concern that there might be too little money left for the corporate

sector. In response the Minister of Finance announced that the state would seek additional fresh money from abroad in the second half of the year. Assistance from the IMF has been mentioned by various sources but it is still an open issue whether Croatia will have to resort to that support.

In October 2008, in an attempt to boost liquidity, the National Bank abolished the application of its ruling on the marginal reserve requirement which had been in force for four years. As of mid-January 2009, the National Bank has increased the commercial banks' calculated foreign exchange component of the reserve requirement (allocated in kuna) from 50 to 75 per cent to limit the depreciation pressure on the Croatian kuna and maintain exchange rate stability. In a further step the National Bank has intervened heavily on the foreign exchange market by selling EUR 328 million and EUR 182 million.

In January, the Croatian prime minister announced that the Economic Institute together with the Ministries of Economy and Finance will prepare a set of short-term anti-recession measures to preserve macro-economic stability and budget sustainability and boost economic activity and exports.

In late December, parliament adopted the 2009 budget, which envisaged the deficit declining further to 0.9% of the GDP (from about 2% in 2008) in order to reduce the need for fresh borrowing. However, taking into account that the budget is based on a GDP growth rate of 2%, achieving this goal seems to be a rather optimistic proposition. A revision of the budget in the months to come seems highly likely.

Croatia's EU accession talks are currently blocked. Slovenia vetoed the opening of nine of the 35 policy negotiating chapters in December 2008 owing to intractable border disputes over territory and accession to the sea. Attempts at mediation are being made by various parties to get the negotiations going again and so complete them by the end of 2009 as envisaged by the roadmap suggested by the Commission. (Croatia's entry to the EU is planned for 2011.)

The slowdown in economic activity is expected to continue throughout 2009, driven by decreasing exports (of both goods and services) and a slowdown in domestic demand. A decline in the exports of goods is not only to be expected in trade with the EU, but also with the Western Balkan countries, in particular Bosnia and Herzegovina. Thus, the negative trends in industrial production that prevailed over the final months of 2008 will continue or even worsen. A decline in production might be expected most in labour-intensive sectors, which had already been dipping downwards over the past few years, as well as in shipbuilding, Croatia's most important export industry. Those developments will translate into a drop in employment and a rise in unemployment – or even a rise in inactivity. In addition, tourism is extremely vulnerable to external shocks: it will, therefore, be significantly affected by the deteriorating economic situation in Western Europe. Shrinking foreign trade may trigger a reduction in the trade and current account deficits. Given the deterioration of the overall financial environment, servicing (or restructuring) the high foreign debt and maintaining the exchange rate of the Croatian kuna will remain the most challenging tasks in the near future. A recovery might only come about by mid-2010, assuming that the international environment also experiences a recovery.

Table HR

Croatia: Selected Economic Indicators

	2003	2004	2005	2006	2007	2008 ¹⁾	2009	2010	2011
	Forecast								
Population, th pers., average	4442	4439	4442	4440	4436	4435	.	.	.
Gross domestic product, HRK mn, nom.	198422	214983	231349	250590	275078	299150	304900	317200	336500
annual change in % (real)	5.3	4.3	4.3	4.8	5.6	2.5	-2	1	4
GDP/capita (EUR at exchange rate)	5900	6500	7000	7700	8500	9300	.	.	.
GDP/capita (EUR at PPP - wiiw)	9800	10600	11100	12100	13300	13600	.	.	.
Consumption of households, HRK mn, nom.	115081	123123	131671	140261	153421	166000	.	.	.
annual change in % (real)	4.6	4.8	3.4	3.5	6.2	2	-1	1	3
Gross fixed capital form., HRK mn, nom.	56662	60512	65008	74792	82386	92700	.	.	.
annual change in % (real)	24.7	5.0	4.8	10.9	6.5	6	-2	3	6
Gross industrial production ²⁾									
annual change in % (real)	4.1	3.7	5.1	4.5	5.6	1.6	-2	2	3.5
Gross agricultural production									
annual change in % (real)	-15.9	11.9	-8.7	4.4	-3.9
Construction industry, hours worked ²⁾									
annual change in % (real)	22.8	2.0	-0.8	9.4	2.3	11	.	.	.
Employed persons - LFS, th, average	1537	1563	1573	1586	1615	1615	.	.	.
annual change in %	0.6	1.7	0.7	0.8	1.8	0.0	.	.	.
Unemployed persons - LFS, th, average	256	250	229	199	171	158	.	.	.
Unemployment rate - LFS, in %, average	14.3	13.8	12.7	11.1	9.6	9.0	10.5	11	10
Reg. unemployment rate in %, end of period	18.7	18.5	17.8	17.0	14.7	13.7	.	.	.
Average gross monthly wages, HRK	5623	5985	6248	6634	7047	7500	.	.	.
annual change in % (real, net)	3.8	3.7	1.5	1.9	2.2	0.4	.	.	.
Consumer prices, % p.a.	1.8	2.1	3.3	3.2	2.9	6.1	4	3	2
Producer prices in industry, % p.a. ³⁾	1.9	3.5	3.0	2.9	3.4	8.4	.	.	.
General governm.budget, nat.def., % GDP ⁴⁾									
Revenues	45.1	44.9	44.5	44.8	46.3	45.2	.	.	.
Expenditures	50.1	49.5	48.3	47.6	48.6	47.6	.	.	.
Deficit (-) / surplus (+), % GDP ⁵⁾	-6.2	-4.8	-4.0	-3.0	-2.3	-2.3	-2.5	-3	-2.5
Public debt in % of GDP ⁶⁾	51.2	52.0	52.7	50.0	53	54.5	.	.	.
Discount rate of NB, % p.a., end of period	4.5	4.5	4.5	4.5	9.0	9.0	.	.	.
Current account, EUR mn	-1888.8	-1433.7	-1975.6	-2702.1	-3233.4	-4500	-2900	-3400	-3600
Current account in % of GDP	-7.2	-5.0	-6.3	-7.9	-8.6	-10.9	-7	-8	-8
Exports of goods, BOP, EUR mn	5574.7	6606.8	7220.3	8463.6	9192.5	9740	9600	9800	10300
annual growth rate in %	5.3	18.5	9.3	17.2	8.6	6.0	-1	2	5
Imports of goods, BOP, EUR mn	12545.9	13330.9	14738.3	16807.8	18626.5	20580	20800	21400	22700
annual growth rate in %	11.5	6.3	10.6	14.0	10.8	10.5	1	3	6
Exports of services, BOP, EUR mn	7565.9	7636.7	8052.6	8528.5	9152.1	10070	10000	10200	10600
annual growth rate in %	29.7	0.9	5.4	5.9	7.3	10.0	-1	2	4
Imports of services, BOP, EUR mn	2632.9	2867.8	2734.9	2823.9	2858.9	3190	3100	3200	3400
annual growth rate in %	3.4	8.9	-4.6	3.3	1.2	11.6	-2	2	5
FDI inflow, EUR mn	1762.4	949.6	1467.9	2745.2	3648.9	3600	.	.	.
FDI outflow, EUR mn	105.5	278.8	191.8	174.5	180.4	100	.	.	.
Gross reserves of NB excl. gold, EUR mn	6554.1	6436.2	7438.4	8725.3	9307.4	9120.9	.	.	.
Gross external debt, EUR mn ⁷⁾	19883.7	22933.0	25747.7	29273.9	32929.2	39000	.	.	.
Gross external debt in % of GDP ⁷⁾	76.6	81.8	82.1	85.8	87.7	95.5	.	.	.
Average exchange rate HRK/EUR	7.5634	7.4952	7.4002	7.3226	7.3362	7.2230	7.4	7.4	7.4
Purchasing power parity HRK/EUR	4.5448	4.5803	4.6746	4.6748	4.6559	4.9700	.	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Enterprises with more than 20 employees. - 3) Based on domestic output prices. - 4) On accrual basis. - 5) Including change in arrears and non-recorded expenditures. - 6) Including guarantees. - 7) From 2008 new reporting system.

Source: wiiw Database incorporating Eurostat, IMF and national statistics. Forecasts by wiiw.