

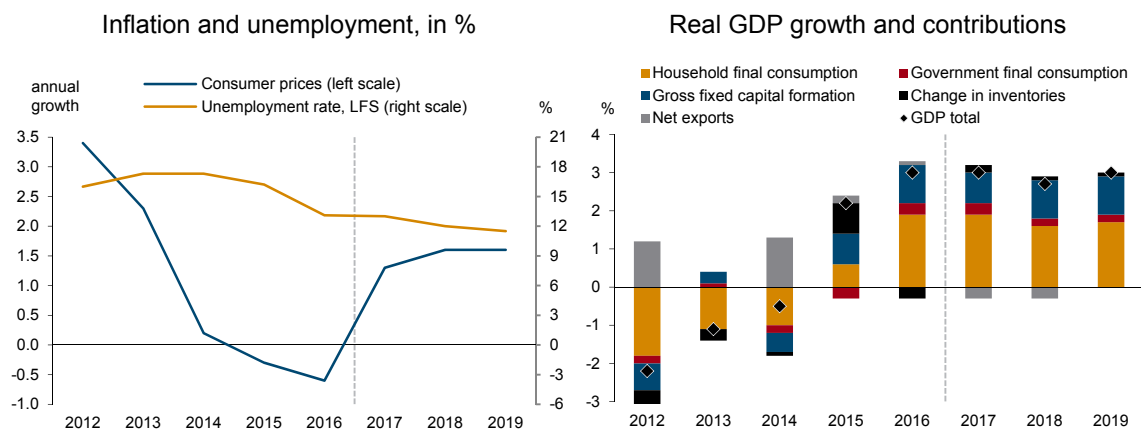


CROATIA: Reasonable growth prospects

HERMINE VIDOVIĆ

Croatia's economy continues on its path of recovery, with annual GDP growth of up to 3% in the period 2017-2019. Household consumption will remain the main driver, but investments, fuelled by EU funding, will play an important role as well. Demographic changes, coupled with continued emigration, will become a major challenge in the future.

Figure 34 / Croatia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Croatia's real GDP grew by 2.7% year on year in the first half of 2017, more than one might have expected after the failure of Agrokor, the country's largest company. Growth was backed by domestic demand: both private consumption and investments expanded. Private consumption growth was at its highest level since the onset of the global financial crisis, gaining momentum thanks to real wage increases. Gross fixed capital formation continued growing modestly. The contribution of net exports was negative due to rising imports. Industrial production grew less dynamically than in 2016, and was up by a meagre 2.3% during the first eight months of 2017 year on year.

The labour market situation has improved, but challenges remain. According to Pension Insurance data employment increased by 1.8% during the first half of the year, while based on the Labour Force Survey employment was up by less than 1% and the unemployment rate fell to 12.6% in the first half of 2017. Despite these improvements the unemployment rate is still among the highest in the EU. The reduction in unemployment is only partly a result of rising domestic employment; one of the major factors

behind the decline is continued outward migration – despite improving economic conditions in the country. In Germany alone, the number of Croatian workers increased by 75,800 between July 2013, when Croatia joined the EU, and July 2017; the stock of Croatian employees in Austria rose by about 9,700 persons in the same period. In addition, there is also some labour emigration of Croatian citizens to Ireland, Sweden and Norway. On the other hand, Croatian employers complain about labour and skills shortages in certain branches, such as shipbuilding, construction, tourism, transport and IT, but also in agriculture. Real net wages increased by almost 4% during the first half of 2017 due to income tax changes, but also as a result of public sector wage increases (2%) as of January. Further wage increases in the public sector took effect in August and November 2017.

External trade in goods performed well, with exports and imports growing by 12-13% in euro terms during the first half of the year. The trade deficit was about EUR 430 million higher than in 2016, while the surplus in the services trade rose, thanks to another record-breaking tourist season, and that partly offset the rise in the trade deficit. Earnings from tourism reached a record high in 2017, benefiting from political uncertainties in competitor countries in Northern Africa and Turkey. In addition, the income outflow of the (mostly foreign-owned) banking sector due to the loan loss provisioning for exposure to Agrokor is lower than a year earlier. Hence, the current account will remain in surplus in 2017, at an estimated 3% of GDP. The inflow of FDI remained at almost the same level as in 2016, at slightly over EUR 600 million.

Fiscal consolidation continues. In the first half of 2017 the general government budget closed even with a small surplus, mostly on account of higher than expected revenues from taxes (VAT in particular) and social security contributions. Spending on public sector wages, increases of which were gradually introduced during 2017, is likely to be offset by higher revenues than anticipated. For the whole year the government expects a lower than the originally planned 1.3% deficit-to-GDP ratio. The reduction in the deficit will also translate into a reduction in public debt to about 81% of GDP. Recent announcements by the Croatian government to raise benefit payments for war veterans and to purchase 12 military jets as well as to cover health sector arrears give rise to concerns that the deficit may increase again in the coming years.

The introduction of the euro remains an important goal in Croatia. According to Boris Vujčić, governor of the Croatian National Bank, a public discussion on the costs and benefits of euro introduction will start in autumn 2017. The central bank itself has been in favour of euro adoption for years, as the Croatian economy has been heavily euroised; about three quarters of savings deposits in Croatian banks are in euro, also loans are mainly in euro or indexed to the euro. Hence, there is little room for using the exchange rate as a policy instrument. With respect to the convergence criteria, Croatia currently satisfies the criteria on price stability and long-term interest rates but it does not fulfil the criterion on sustainable public finances (the debt-to-GDP ratio is above 60%). Results of a Eurobarometer survey carried out in April 2017 suggest that about 47% of Croatian citizens believed that the euro will be introduced within five years and that the personal consequences of the euro introduction would be rather positive than negative.

At the beginning of October Ante Ramljak, the state manager of Agrokor, Croatia's biggest retailer and food producer, presented the audit report on the financial situation of the company which fell into trouble in March this year. Accordingly, in 2016 total liabilities amounted to EUR 7.6 billion, exceeding total assets by about EUR 2 billion; in addition, financial irregularities were reported for 2015

and 2016. Mr Ramljak said that he had filed a criminal charge against the responsible persons in the former management. Also, the Croatian parliament will set up a committee of inquiry to shed light on the matter. The total amount of debt claims against the company is not known yet. Creditors include suppliers, bondholders and banks, with the biggest share, about EUR 1.1 billion, owed to Russian Sberbank. Along with the adoption of an emergency law (Lex Agrokor), which is to prevent the company from starting bankruptcy procedures, the management of the company was handed over to a government-appointed manager in April 2017. So far new loans have been provided to pay out old debt of small suppliers and to ensure the continuation of regular business operations. Subsidiaries of Agrokor will have to be sold, but further details are yet unknown.

wiiw has revised its GDP growth for 2017 slightly upwards from 2.7% to 3%. Driven by household consumption and a continued recovery in investments, GDP growth may come close to 3% p.a. also in the coming two years. Private consumption will continue to rise at comparatively high rates, thanks to growing employment along with rising wages and pensions. Credit to households will play only a minor role in boosting consumption as households are still deleveraging. The expected rise in investments will be spurred by transfers from the EU budget, provided that absorption capacity increases. The strengthening of domestic demand will lead to rising imports and consequently result in higher trade deficits. The services trade surplus, by contrast, may remain at high levels due to high earnings from tourism, since tourism in the main competitor markets will recover only slowly. As a result, the current account surplus is expected to gradually decrease from an estimated 3% in 2017 to 1.9% in 2019. Assuming further reductions in the general government deficit or even a slight surplus, public debt is expected to continue its downward path in the coming two years, but downside risks are related to rising expenses on war veterans and spending on the health sector. Demographic issues – ageing of the population, coupled with a shrinking working-age population and continued emigration – are becoming increasing challenges for the future. The potential impact of the Agrokor crisis and political uncertainty – the current government has only a thin majority in the parliament – constitute additional downside risks.

Table 9 / Croatia: Selected economic indicators

	2013	2014	2015	2016 ¹⁾	2016 January-June	2017	2017 Forecast	2018 Forecast	2019
Population, th pers., average	4,254	4,236	4,208	4,172	.	.	4,100	4,050	4,000
Gross domestic product, HRK mn, nom.	329,571	328,109	335,521	345,166	163,272	168,776	360,000	375,500	393,000
annual change in % (real)	-1.1	-0.5	2.2	3.0	2.7	2.7	3.0	2.7	3.0
GDP/capita (EUR at PPP)	15,900	16,100	16,900	17,300	.	.	.	.	.
Consumption of households, HRK mn, nom.	195,623	191,407	192,250	196,105	96,246	100,717	.	.	.
annual change in % (real)	-1.9	-1.6	1.0	3.3	3.0	3.6	3.4	2.8	3.0
Gross fixed capital form., HRK mn, nom.	65,257	63,797	66,401	69,317	34,212	35,654	.	.	.
annual change in % (real)	1.4	-2.8	3.9	5.1	6.5	4.2	4.0	5.0	5.0
Gross industrial production ²⁾									
annual change in % (real)	-1.8	1.2	2.7	5.3	6.4	1.8	2.3	2.5	3.5
Gross agricultural production									
annual change in % (real)	4.2	-7.0	2.9	-2.7	.	.	.	.	.
Construction output ²⁾									
annual change in % (real)	-4.6	-7.3	-0.6	2.6	3.9	1.7	.	.	.
Employed persons, LFS, th, average	1,524	1,566	1,585	1,590	1,576	1,589	1,590	1,610	1,630
annual change in %	-2.7	2.7	1.3	0.3	0.2	0.8	0.0	1.0	1.0
Unemployed persons, LFS, th, average	318	327	306	240	258	227	240	220	210
Unemployment rate, LFS, in %, average	17.3	17.3	16.2	13.1	14.1	12.6	13.0	12.0	11.5
Reg. unemployment rate, in %, eop	21.5	19.4	17.6	14.7	13.4	10.8	.	.	.
Average monthly gross wages, HRK ³⁾	7,939	7,953	8,055	7,753	7,751	8,014	8,000	8,300	8,600
annual change in % (real, gross)	-1.4	0.4	1.8	3.0	3.5	2.3	2.0	2.0	2.0
Average monthly net wages, HRK ³⁾	5,515	5,533	5,711	5,685	5,674	5,959	6,000	6,300	6,600
annual change in % (real, net)	-1.5	0.5	3.7	2.7	3.1	3.9	3.5	3.0	3.0
Consumer prices (HICP), % p.a.	2.3	0.2	-0.3	-0.6	-0.8	1.1	1.3	1.6	1.6
Producer prices in industry, % p.a.	-0.4	-2.7	-3.9	-4.3	-5.4	2.0	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP									
Revenues	42.6	43.1	45.0	47.3	.	.	45.6	43.3	43.3
Expenditures	48.0	48.5	48.4	48.1	.	.	46.6	44.3	44.3
Net lending (+) / net borrowing (-)	-5.3	-5.4	-3.4	-0.8	.	.	-1.0	-1.0	-1.0
Public debt, EU-def., % of GDP	82.2	86.6	86.3	83.7	.	.	82.5	81.0	80.0
Stock of loans of non-fin.private sector, % p.a.	-1.5	-2.0	-3.1	-4.3	-6.2	-1.3	.	.	.
Non-performing loans (NPL), in %, eop	15.7	17.1	16.7	13.8	15.0	13.2	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	7.0	7.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR mn	415	861	2,019	1,158	-1,477	-1,398	1,420	1,000	980
Current account, % of GDP	1.0	2.0	4.6	2.5	-6.8	-6.2	3.0	2.0	1.9
Exports of goods, BOP, EUR mn	8,924	9,440	10,193	10,511	4,965	5,605	11,500	12,200	12,900
annual change in %	2.9	5.8	8.0	3.1	3.0	12.9	9.0	6.0	6.0
Imports of goods, BOP, EUR mn	15,511	15,952	17,168	17,848	8,810	9,879	19,100	20,400	21,700
annual change in %	3.6	2.8	7.6	4.0	4.1	12.1	7.0	7.0	6.5
Exports of services, BOP, EUR mn	9,844	10,238	11,279	12,264	4,047	4,354	12,800	13,500	14,200
annual change in %	2.1	4.0	10.2	8.7	5.9	7.6	4.0	5.5	5.5
Imports of services, BOP, EUR mn	3,088	2,897	3,271	3,581	1,606	1,723	3,800	4,000	4,200
annual change in %	-2.2	-6.2	12.9	9.5	5.6	7.3	6.0	5.8	5.0
FDI liabilities, EUR mn	737	2,297	196	1,694	663	617	1,500	.	.
FDI assets, EUR mn	-111	1,600	-54	-249	-102	254	500	.	.
Gross reserves of NB excl. gold, EUR mn	12,908	12,688	13,707	13,514	12,937	14,028	.	.	.
Gross external debt, EUR mn	45,803	46,416	45,384	41,668	43,440	40,383	41,600	42,600	43,000
Gross external debt, % of GDP	105.3	108.0	103.0	90.9	94.8	84.1	86.7	85.2	82.0
Average exchange rate HRK/EUR	7.5786	7.6344	7.6137	7.5333	7.5610	7.4488	7.50	7.50	7.50

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) From 2016 based on new data sources. - 4) Discount rate of NB.

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