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## **Croatia: servicing foreign debt remains major weak point**

Economic activities have continued to contract in 2009. GDP fell by 6.7% in the first quarter of the year resulting primarily from a strong decline in domestic demand, with household consumption down by almost 10% and investments by 12.4%. Retail trade turnover was declining for seven months in a row and shrank by 16% in real terms, of which most markedly in the sale of cars (down by more than half). Government consumption by contrast was up by almost 4%. Industrial output shrank by 10% during the first four months of the year, construction by 4%. Consumer price inflation continued to decelerate, reaching 3.8% in March, and real wage growth was only moderate.

The impact of the overall economic downturn is already visible in labour market indicators. Unemployment (based on registration) has been growing from month to month; in March the unemployment rate reached 15%. The sectors hit hardest by employment cuts were manufacturing, where 15 thousand jobs were lost in the first four months of the year alone, followed by construction, trade and public administration. At the same time job gains were reported in the health and education sectors. Final Labour Force Survey data for 2008 indicate a decline in the overall unemployment rate to 8.4%.

In February the Croatian government launched a package of ten anti-recession measures, including a revision of the state budget, the strengthening of the Croatian Bank for Reconstruction and Development (HBOR) and support to the tourism sector and the real estate market. So far only some of these measures, e.g. the budget revision and the action plan for tourism have been fully implemented. The revision of the budget foresees a reduction of expenditures, particularly by cutting civil servants' salaries, and a reduction of subsidies and investments. At the same time revenues were revised downwards to the previous year's level. According to the revised budget, the general government deficit will rise to 2.7% of the GDP (from 2.6% in 2008). However, taking into account that the budget is based on a GDP decline of 2%, the deficit target appears over-optimistic. Thus, a further revision of the budget is quite likely.

The growth of bank lending continued to slow and amounted to 9.2% in March, year on year. Lending to the household sector decelerated to 8.3% with respect to almost all types of loans. At the end of March housing loans accounted for almost 42% of total household loans. At the same time corporate sector loans were up 10.8%, indicating a rising demand for domestic loans due to the more limited access to foreign sources of funding. Because of companies' growing difficulties, the share of bad loans has been on the rise over the past couple of months, to 5.1% as compared to

4.8% last year. According to expectations of Croatian bankers, this percentage may rise up to 9% by the end of the year.

Based on balance of payments statistics, both exports and imports of goods shrank considerably during the first quarter of the year, by 14% and 24% respectively. Thus, the foreign trade deficit fell by EUR 836 million compared with the same period a year earlier. A breakdown of exports by commodity groups shows a strong drop in exports of oil derivatives, chemical products and machinery, while exports of agricultural products nearly doubled. On the import side, the most pronounced decline was registered in imports of ships, cars and fuel. Considering the narrowing of the trade deficit, the current account deficit fell to EUR 1.8 billion during the first quarter of the year. The overall economic crisis has already translated into a downturn in tourism, with the number of tourists declining by 14% and overnight stays down by 17%.

In March 2009 foreign debt stood at EUR 39 billion, almost the same level as in December last year. Enterprises account for more than half of the debt, about one quarter is owed by banks. The share of government debt fell for the first time below 10%. In order to secure the repayment of debts, the Ministry of Finance borrowed money on the domestic but also on the foreign market. At the end of May Croatia issued a five-year Eurobond worth EUR 750 million with a fixed interest rate of 6.5%, out of which the biggest part (EUR 550 million) will be used for debt repayment and the remainder for covering part of the budget deficit. Another Eurobond issue may follow in autumn. 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.

The high foreign debt service has put the Croatian currency under devaluation pressure in the first quarter of 2009. In response, the National Bank has increased the commercial banks' calculated foreign exchange component of the reserve requirement (allocated in kuna) from 50% to 75% in January and, in addition, intervened heavily on the foreign exchange market by selling more than EUR 500 million. Since April the Croatian kuna has slightly appreciated.

In April 2009 Croatia, together with Albania, became a member of NATO. Croatia's EU accession talks are currently blocked because of a Slovenian veto based on border disputes over territory and access to the sea. Attempts by the Commission at mediation have failed so far. Hence, plans completing the negotiations by the end of 2009 – as envisaged by the roadmap suggested by the Commission – and entering the EU by 2011 moved beyond reach.

On 1 July 2009 Croatia's prime minister Ivo Sanader resigned unexpectedly and was succeeded by his deputy Jadranka Kosor.

For the full year 2009 wiiw expects GDP to contract by about 4%, caused by a slowdown in domestic demand and a decline of both goods and services exports. These developments have already translated into a drop of industrial production and consequently in declining industrial employment – a trend we expect to continue. In addition, tourism is highly vulnerable to external shocks: it will, therefore, be significantly affected by the deteriorating economic situation in Western

Europe. Shrinking foreign trade will trigger a reduction in the trade and current account deficits. Considering the slowdown in tourism and the worsening labour market situation, private consumption is also set to further decline. In view of the deterioration of the overall financial environment, the main challenges for the near future will be to service (or restructure) the high foreign debt and maintain the exchange rate of the Croatian kuna. Assuming an international economic turnaround by mid/end-2010, exports may gradually improve.

Table HR

**Croatia: Selected Economic Indicators**

	2005	2006	2007	2008 <sup>1)</sup>	2008 1st quarter	2009	2009	2010	2011
							Forecast		
Population, th pers., average	4442	4440	4436	4435	.	.	.	.	.
Gross domestic product, HRK mn, nom. <sup>2)</sup>	264368	286341	314223	342159	79068	77867	338300	348500	364400
annual change in % (real) <sup>2)</sup>	4.2	4.7	5.5	2.4	4.3	-6.7	-4	0.5	2
GDP/capita (EUR at exchange rate)	8000	8800	9700	10700	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	12700	13800	15200	15600	.	.	.	.	.
Consumption of households, HRK mn, nom. <sup>2)</sup>	162165	172744	188952	202194	49382	46474	.	.	.
annual change in % (real) <sup>2)</sup>	4.4	3.5	6.2	0.8	4.2	-9.9	-6	0	2
Gross fixed capital form., HRK mn, nom. <sup>2)</sup>	65008	74792	82386	94281	22410	19644	.	.	.
annual change in % (real) <sup>2)</sup>	4.8	10.9	6.5	8.2	9.8	-12.4	-8	2	5
Gross industrial production <sup>3(4)</sup>									
annual change in % (real)	5.1	4.5	5.6	1.6	3.6	-10.9	-8	1	3.5
Gross agricultural production									
annual change in % (real)	-8.7	4.4	-3.9	.	.	.	.	.	.
Construction industry, hours worked <sup>3(4)</sup>									
annual change in % (real)	-0.8	9.3	2.4	11.8	10.2	-3.7	.	.	.
Employed persons - LFS, th, average	1573	1586	1615	1636	1591	.	.	.	.
annual change in %	0.7	0.8	1.8	1.3	1.8	.	.	.	.
Unemployed persons - LFS, th, average	229	199	171	149	176	.	.	.	.
Unemployment rate - LFS, in %, average	12.7	11.1	9.6	8.4	10.0	.	10.5	11	10
Reg. unemployment rate in %, end of period	17.8	17.0	14.7	13.7	14.5	15.0	.	.	.
Average gross monthly wages, HRK	6248	6634	7047	7544	7367	7708	.	.	.
annual change in % (real, net)	1.5	1.9	2.2	0.8	0.3	1.8	.	.	.
Consumer prices, % p.a.	3.3	3.2	2.9	6.1	5.9	3.8	3	2.5	2.5
Producer prices in industry, % p.a. <sup>4(5)</sup>	3.0	2.9	3.4	8.4	7.6	1.1	.	.	.
General governm.budget, nat.def., % GDP <sup>6)</sup>									
Revenues	38.9	39.2	40.3	.	.	.	.	.	.
Expenditures	42.3	41.6	42.3	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP <sup>7)</sup>	-3.5	-2.6	-2.0	-2.6	.	.	-3.5	-3	-2.5
Public debt in % of GDP <sup>8)</sup>	45.7	43.3	41.7	40.3 <sup>xi)</sup>	38.3	.	.	.	.
Discount rate of NB, % p.a., end of period	4.5	4.5	9.0	9.0	9.0	9.0	.	.	.
Current account, EUR mn	-1975.6	-2715.2	-3236.7	-4454.2	-2555.5	-1819.8	-2700	-2800	-3200
Current account in % of GDP	-5.5	-6.9	-7.6	-9.4	-23.6	-17.3	-6	-6	-6.5
Exports of goods, BOP, EUR mn	7220.3	8463.6	9192.5	9743.4	2226.2	1921.6	8800	9000	9500
annual growth rate in %	9.3	17.2	8.6	6.0	8.8	-13.7	-10	2	5
Imports of goods, BOP, EUR mn	14738.3	16807.8	18626.5	20609.6	4791.2	3651.1	16500	17000	18000
annual growth rate in %	10.6	14.0	10.8	10.6	13.9	-23.8	-20	3	6
Exports of services, BOP, EUR mn	8052.6	8528.5	9124.8	10091.2	846.5	761.9	9600	9800	10000
annual growth rate in %	5.4	5.9	7.0	10.6	9.7	-10.0	-5	2	2
Imports of services, BOP, EUR mn	2734.9	2823.9	2858.9	3129.5	747.4	634.5	3000	3100	3200
annual growth rate in %	-4.6	3.3	1.2	9.5	11.3	-15.1	-3	2	4
FDI inflow, EUR mn	1467.9	2764.8	3666.9	2930.1	1005.3	399.0	.	.	.
FDI outflow, EUR mn	191.8	208.2	184.1	118.9	132.7	10.9	.	.	.
Gross reserves of NB excl. gold, EUR mn	7438.4	8725.3	9307.4	9120.9	9841.7	8869.5	.	.	.
Gross external debt, EUR mn <sup>9)</sup>	25747.7	29273.9	32929.2	39124.6	34963.2	39224.2	.	.	.
Gross external debt in % of GDP <sup>9)</sup>	71.8	75.1	76.8	83.8	74.8	85.8	.	.	.
Average exchange rate HRK/EUR	7.4002	7.3226	7.3362	7.2230	7.2867	7.4071	7.4	7.4	7.4
Purchasing power parity HRK/EUR	4.6746	4.6748	4.6559	4.9475	.	.	.	.	.

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 20 employees. - 4) Quarterly data and forecasts according to NACE Rev. 2. - 5) Based on domestic output prices. - 6) On accrual basis. - 7) Including change in arrears and non-recorded expenditures. - 8) Including guarantees. - 9) From 2008 new reporting system.

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