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Croatia: stubborn external imbalances

During 2004 Croatia's growth lost momentum from quarter to quarter, and the GDP was finally up by less than 4% for the year as a whole. The deceleration went hand in hand with a slowdown of (public) investment growth, which in turn resulted in a remarkable slowdown of construction activities. On the other hand, the weakening of domestic demand could be partly offset by rising external demand. After a 5.4% increase in the first quarter of the year industrial production growth slowed down to 3.7% in 2004 as a whole. Within manufacturing, reporting slightly higher than average growth, the most favourable results were achieved in 'other transport equipment' (ships), machinery and equipment, chemicals and chemical products, manufacturing of wood and wood products and publishing and printing. Labour-intensive industries such as textiles and manufacturing of wearing apparel, but also office machinery, computers, television and communication equipment, suffered all severe output declines.

Foreign trade performed dynamically in 2004, with overall exports expanding by nearly 18% (based on customs statistics expressed in euro terms) whereas imports increased only moderately, by 6%. These developments resulted in a lowering of the foreign trade deficit. Exports to and imports from the EU reported below-average growth rates, while trade with the successors of Yugoslavia, particularly Bosnia and Herzegovina and Serbia and Montenegro, speeded up significantly. A breakdown by individual industrial segments shows a strong export expansion of ships and radio, television and communication equipment. The slowdown of import growth is partially attributed to the decline in car imports after years of strong increases. FDI data available for the first three quarters of 2004 indicate a considerable decline of inward FDI compared with a year earlier. The current account closed with an estimated EUR 1.7 billion deficit or more than 6% of the expected GDP.

Foreign debt continued to grow, but at a lower rate than in 2003. By the end of December 2004 it stood at EUR 22.2 billion (81% of the GDP) as against EUR 18.8 billion in December 2003. The increase resulted mainly from banks' and state borrowing, followed by other sectors (such as enterprises and the population). The banks' share in the foreign debt is, for the first time, the highest (33.7%), whereas the state accounts for 32.9% and enterprises for 25.9% of total foreign debt. Croatia's debt service burden is expected to increase significantly in the years to come. According to the most recent projections of the Croatian National Bank, in 2005 the debt service will amount to USD 4.5 billion, of which USD 3.6 billion in principal and USD 900 million in interest payments. The bulk will be due in the first and third quarters of the year.

Reducing the fiscal deficit has been one of the primary tasks of the old and new Croatian governments. In 2003 alone the deficit of the consolidated general government amounted to 6.3% of GDP. The target rate for 2004 was set at 4.5%, but it is more than questionable whether this goal could be achieved. In accordance with the targets agreed upon with the IMF in August last year, the Croatian parliament passed the 2005 budget bill in November 2004. The budget is aiming at a further reduction of the consolidated general government deficit to 3.7% in 2005; in the following two years the deficit is envisaged to fall to 3.3% (2006) and finally to 2.9% of the GDP (2007). The 2005 budget is based on a projected 2.5% inflation rate and 4.4% GDP growth; the latter is quite optimistic compared to available forecasts (from various research institutes and the EU) that range from 3.5% to 4%.

Depending on the respective data source, labour market developments show a diverging picture. According to registration data, employment remained stagnant in 2004, while unemployment fell below 19%. A decrease in unemployment (below 14%) is also confirmed by labour force survey data for the first half of the year. The same data set points to a 3% increase in employment as compared to the first half of 2003. Data obtained from the Croatian Pension Insurance Institute (CPPI) also indicate a (less pronounced) rise in employment, based on the number of insured persons.

EU membership negotiations are scheduled to start on 17 March – provided that the country continues to cooperate with the International Criminal Tribunal for the Former Yugoslavia (ICTY) in particular concerning the fugitive general A. Gotovina. Only recently has EU Enlargement Commissioner Olli Rehn put additional pressure on Croatia to give up the general, by stating that otherwise he could not recommend the start of accession negotiations.

Contrary to earlier announcements by Croatian officials that the country may join the EU already in 2007, the current wording is that Croatia aims to conclude accession talks by that date. The president of the European Commission stated recently that he 'hopes Croatia will become an EU member in November 2009'. Accession talks with Croatia will be conducted in the framework of 35 chapters (not 31 as during the previous enlargement round) as some policy areas will be split. The Stabilization and Association Agreement (SAA) signed between the EU and Croatia in 2001 came into force on 1 February 2005. Croatia's first pre-accession programme was adopted by the government by the end of November, focusing *inter alia* on reforms of public financing (reduction of the fiscal deficit, improvement of fiscal transparency etc.) and on structural reforms, relating to privatization, agricultural policy or the social security and health care systems.

On 16 January 2005 Croatia's incumbent president Stipe Mesić was re-elected for a new five-year mandate; in the second round of the elections he won 66% of the vote against 34% for his competitor Jadranka Kosor from the ruling Croatian Democratic Union (HDZ).

Assuming a further decline in domestic demand due to the cuts in public investments, wiiw expects a slowdown of Croatia's GDP growth to some 3.5% in both 2005 and 2006. Thus, the situation on the labour market will not change significantly: employment will grow only moderately or even stagnate, whereas the number of unemployed will decrease only slightly. Despite some rise in inflation in 2004, the National Bank will adhere to its policy of stable prices and exchange rates. The current account deficits will remain at high levels and diminish only slightly over the next two years.

Table HR

Croatia: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 ¹⁾	2005	2006
	forecast								
Population, th pers., mid-year ²⁾	4501	4554	4437	4437	4443	4442	.	.	.
Gross domestic product, HRK mn, nom.	137604	141579	152519	165640	179390	193067	207300	218900	231200
annual change in % (real)	2.5	-0.9	2.9	4.4	5.2	4.3	3.7	3.5	3.5
GDP/capita (EUR at exchange rate)	4284	4102	4502	4998	5451	5747	6225	.	.
GDP/capita (EUR at PPP - wiiw)	7470	7450	8110	8640	9300	9720	10270	.	.
Gross industrial production ³⁾									
annual change in % (real)	3.7	-1.4	1.7	6.0	5.4	4.1	3.7	3.5	3.5
Gross agricultural production									
annual change in % (real)	10.2	-3.5	-10.0	8.5	7.7	-15.9	.	.	.
Construction industry, hours worked ³⁾									
annual change in % (real)	0.7	-7.7	-9.1	3.6	12.8	22.8	2.6 ^{I-XI}	.	.
Consumption of households, HRK mn, nom.	81067	81546	89637	98054	107427	113396	87455 ^{I-X}	.	.
annual change in % (real)	-0.6	-2.9	4.2	4.5	7.6	4.1	3.9 ^{I-X}	3	3
Gross fixed capital form., HRK mn, nom.	32066	33025	33281	36984	44114	53168	43701 ^{I-X}	.	.
annual change in % (real)	2.5	-3.9	-3.8	7.1	12.0	16.8	5.5 ^{I-X}	5	4
LFS - employed persons, th, avg.	1544	1492	1553	1469	1528	1537	1583 ^{I-VI}	.	.
annual change in %	-3.1	-3.4	4.1	-5.4	4.0	0.6	3.0 ^{I-VI}	.	.
Reg. employees in industry, th pers., avg.	308.9	299.5	291.9	287.2	281.0	282.6	276.6 ^{I-XI}	.	.
annual change in %	-3.4	-3.0	-2.5	-1.6	-2.2	0.6	-2.2 ^{I-XI}	.	.
LFS - unemployed, th pers., average	199.0	234.0	298.0	277.0	266.0	256.0	253	.	.
LFS - unemployment rate in %, average	11.4	13.6	16.1	15.9	14.8	14.3	13.8	13.5	13
Reg. unemployment rate in %, end of period	18.1	20.4	22.3	23.1	21.3	19.1	18.7	18	17.5
Average gross monthly wages, HRK	4131	4551	4869	5061	5366	5623	5971 ^{I-XI}	.	.
annual change in % (real, net)	6.0	10.1	3.4	1.6	3.1	3.8	3.8 ^{I-XI}	.	.
Consumer prices, % p.a. ⁴⁾	5.7	4.2	6.2	4.9	1.7	1.8	2.1	2	2
Producer prices in industry, % p.a.	-1.2	2.6	9.7	3.6	-0.4	1.9	3.5	2	.
General governm.budget, IMF-def., % GDP									
Revenues	51.1	48.4	46.2	44.7	45.2	44.9	.	.	.
Expenditures	54.6	56.6	52.7	51.5	50.0	49.5	.	.	.
Deficit (-) / surplus (+), % GDP	-3.5	-8.2	-6.5	-6.8	-4.8	-6.3	.	-4	.
Public debt in % of GDP	.	.	51.1	51.6	51.6	52.7	53	54	55
Discount rate % p.a., end of period	5.9	7.9	5.9	5.9	4.5	4.5	4.5	.	.
Current account, EUR mn ⁵⁾	-1295	-1311	-499	-809	-2066	-1853	-1700	-1600	-1600
Current account in % of GDP	-6.7	-7.0	-2.5	-3.6	-8.5	-7.3	-6.1	-5.6	-5.3
Gross reserves of NB excl. gold, EUR mn	2400.2	3012.6	3783.2	5333.6	5651.3	6554.1	6436.2	.	.
Gross external debt, EUR mn	8254.3	9937.2	11865.2	12827.6	14795.3	18841.5	22207.4	.	.
FDI inflow, EUR mn ⁵⁾	831	1377	1181	1740	1193	1748	800 ⁶⁾	.	.
FDI outflow, EUR mn ⁵⁾	87	44	4	173	566	82	100 ⁶⁾	.	.
Exports of goods, BOP, EUR mn ⁵⁾	4084	4124	4951	5313	5312	5589	6600	7100	7500
annual growth rate in %	14.8	1.0	20.1	7.3	0.0	5.2	18.1	8	6
Imports of goods, BOP, EUR mn ⁵⁾	7713	7219	8424	9892	11309	12596	13400	14100	14800
annual growth rate in %	-7.3	-6.4	16.7	17.4	14.3	11.4	6.4	5	5
Exports of services, BOP, EUR mn ⁵⁾	3534	3494	4440	5444	5911	7639	7700	.	.
annual growth rate in %	-0.2	-1.1	27.1	22.6	8.6	29.2	0.8	.	.
Imports of services, BOP, EUR mn ⁵⁾	1683	1969	1982	2175	2562	2640	3000	.	.
annual growth rate in %	-3.9	17.0	0.7	9.8	17.8	3.1	13.6	.	.
Average exchange rate HRK/USD	6.36	7.11	8.28	8.34	7.86	6.70	6.04	.	.
Average exchange rate HRK/EUR (ECU)	7.14	7.58	7.63	7.47	7.41	7.56	7.50	7.6	7.6
Purchasing power parity HRK/USD, wiiw	3.55	3.65	3.74	3.80	3.85	3.89	3.99	.	.
Purchasing power parity HRK/EUR, wiiw	4.09	4.18	4.24	4.32	4.34	4.47	4.49	.	.

Notes: 1) Preliminary. - 2) From 2000 according to census March 2001. - 3) Enterprises with more than 20 employees. - 4) Up to 2001 retail prices, % p.a. - 5) wiiw calculated from USD. - 6) wiiw estimate.

Source: wiiw Database incorporating national statistics; IMF; wiiw forecasts.