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Croatia: EU membership within reach

GDP growth in 2011 should finally rebound, the proviso being that external demand, particularly the demand for tourism services, improves. High unemployment may hamper a more pronounced recovery in household consumption. The burdens associated with high foreign debt servicing and reducing the budget deficit will remain the most serious challenges in the years to come. Prospects of joining the EU in 2013 may stimulate foreign investment flows; a negative referendum on accession to the EU would be a clear setback

First signs of a fragile recovery in the third quarter of 2010 turned out to be misleading and Croatia's GDP continued to decline thereafter. In the first quarter of 2011 GDP was down by 0.8%. The main reason for this decrease was the poor performance of domestic demand: household consumption remained stagnant, government consumption was negative and investments continued to fall (-6.7%). In contrast to most other CESEE countries, external trade performed disappointingly, with Croatian exports even contracting and highlighting competitiveness problems. In construction, where output had shrunk in 2009-2010, the negative tendencies continued but slowed somewhat, with output down by 8%. Currently there is no evidence of recovery in the construction sector: there is still a high number of unsold apartments on the market, investments of the corporate sector are on the decline and a new cycle of infrastructure investments has not yet started. The slowdown in industrial production became even more pronounced in 2011, with output down by 2.6% during the first four months of the year. Within manufacturing (-2.7%), half of all sectors recorded a decline in production; the output of shipbuilding, the production of basic pharmaceutical products and electrical equipment decreased by 14% each. Signs of recovery are beginning to appear in the production of food and beverages, manufacture of coke, rubber and plastics and machinery and equipment. As a result of even more strongly declining employment, productivity in industry increased by 2%.

Foreign trade, based on customs statistics, showed low dynamics during the first quarter of the year, with goods exports contracting by 4% and imports rising modestly (1%). The main reason behind the decline in export growth was the steep fall (30%) in exports of

shipbuilding – the country's most important export sector. The resulting trade deficit increased by about EUR 200 million to EUR 1.5 billion compared to a year earlier. Taking into account the rising trade deficit and assuming no significant change in the services sector trade surplus, the current account deficit has slightly increased. At the end of February 2011 foreign debt stood at EUR 46 billion, thus remaining almost unchanged compared to December 2010. In the first two months of the year enterprises and banks increased their foreign debt, while the government has reduced its foreign obligations.

The situation on the Croatian labour market has not stabilized yet. Data from the Croatian Pension Institute (HZMO) indicate that the number of employed fell by 2.4% during the first quarter of 2011. This decline is also confirmed by information obtained from the Statistical Office: accordingly the number of employees contracted most strongly in real estate activities (-13.5%) and construction (-11%), while increases in employment are observed in the non-market services sectors, such as public administration, education, and health and social work activities. Registered unemployment jumped to 19.6% by the end of February – and fell slightly thereafter. Final Labour Force Survey data for 2010 indicate an unemployment rate of 11.8%. The downward pressure on wages that was felt in the past two years has continued in 2011; during the first quarter of the year real net wages fell by 0.4%.

Information about the general government deficit varies between 4.3% (according to the Ministry of Finance) and 5% of GDP (IMF). As for 2011 the deficit is targeted at 5% of GDP, but considering the sluggish economic recovery (translating into lower than anticipated revenues) and the fact that 2011 is an election year, the deficit may climb to about 6%. In 2011 about HRK 28 billion (close to EUR 4 billion) will be needed to cover the budget deficit and to refinance outstanding debt; this amount is envisaged to come from savings made last year, by taking loans from international financial institutions which are already agreed and by new bond issues. In March 2011 the Croatian government issued a ten-year bond worth USD 1.5 billion in a US private placement market. A Eurobond issue has been announced for later this year as well. Public debt has increased substantially over recent years, from 29% of GDP in 2008 to 41% in 2010. If including guarantees and obligations of the Croatian Bank for Reconstruction and Development, the debt to GDP ratio would have amounted to 58.6% in 2010.

In 2010 the ratio of non-performing loans to total loans increased to 11.2% from 7.8% a year earlier, while at the same time bad corporate loans rose from 13% to 18%; in this context the situation of small firms is very critical. According to the IMF non-performing loans will continue to increase in 2011 and the total non-performing loan share may reach

about 15%. Overall, the banking sector still appears to be well capitalized and profitable: at the end of 2010 the capital adequacy ratio amounted to 18% and was higher than before the crisis. The Croatian National Bank expects credits to enterprises and the population to grow by about 7% each in 2011. In 2010 total deposits increased by 4.5%, of which deposits held in foreign currencies rose by 9%, while kuna deposits contracted by 11%. This has further increased the level of euroization: the share of foreign currency deposits increased from 70% in 2008 to 81% in 2010.

After the European Commission's announcement that it had completed the membership negotiations with Croatia on 10 June, the EU member states decided to close the remaining four chapters by the end of June. This should allow the signature of the accession treaty by the end of 2011 and Croatia could theoretically join the EU on 1 July 2013. After the signature, the accession treaty has to be ratified by the parliaments of all 27 current EU member states and by the European Parliament; it also has to pass a referendum in Croatia. Until accession, the EU will closely monitor the implementation of the commitments Croatia has to achieve – particularly in the areas of judiciary, competition (shipyards) and freedom of movement – before becoming an EU member. The date for the referendum in Croatia has not yet been fixed: the government would prefer to organize the referendum before the forthcoming parliamentary elections in autumn 2011, while the opposition is in favour of holding the referendum only after the elections. Current opinion polls show no clear majority for Croatia's EU accession.

For 2011, wiiw sticks to its earlier forecast, expecting the GDP growth to rebound to 1% conditioned on an improvement of external demand, tourism in particular. Domestic demand will recover only gradually as a consequence of high unemployment. A somewhat stronger recovery of GDP expected for 2012 and 2013 will result in a narrowing of the budget deficit. Considering 2011 is an election year, the outlook for essential reforms including an improvement of the fiscal situation is poor. Decisive political action can be expected only in 2012 after the formation of a new government. Employment will continue to contract as the labour market will react with a time lag to production growth; the unemployment rate is expected to stagnate in 2011 and decrease only slowly thereafter. This may hamper a more pronounced recovery in household consumption. The current account deficit will remain within more moderate limits than before the crisis, ranging between 3% and 4% in the years to come. Servicing high foreign debt and bringing down the budget deficit will remain the most serious challenges in the coming years. The prospect of joining the EU in 2013 may stimulate foreign investment flows to Croatia; a negative referendum would be a clear setback.

Table HR

Croatia: Selected Economic Indicators

	2007	2008	2009	2010 ¹⁾	2010 1st quarter	2011	2011	2012	2013
								Forecast	
Population, th pers., average	4436.0	4434.5	4429.1	4416.9	4416.9	.	.	4435	4435
Gross domestic product, HRK mn, nom.	318308	345015	335189	334564	77565	78956	.	346400	360400
annual change in % (real)	5.1	2.2	-6.0	-1.2	-2.3	-0.8	.	1	2
GDP/capita (EUR at exchange rate)	9800	10800	10300	10400	.	.	.	10700	11100
GDP/capita (EUR at PPP - wiiw)	15200	15900	15100	15100	.	.	.	.	.
Consumption of households, HRK mn, nom.	184979	197943	185651	186098	44129	45223	.	.	.
annual change in % (real)	6.3	0.8	-8.5	-0.9	-4.0	-0.1	.	0.4	2
Gross fixed capital form., HRK mn, nom.	83514	95572	83386	72373	16296	15291	.	.	.
annual change in % (real)	7.1	8.2	-11.8	-11.3	-13.9	-6.7	.	-6	3
Gross industrial production ²⁾									
annual change in % (real)	4.9	1.2	-9.2	-1.4	-0.5	-3.6	.	-2	3
Gross agricultural production									
annual change in % (real)	-3.9	8.0	-0.8	.	.	.	.	.	.
Construction industry ³⁾									
annual change in % (real)	2.4	11.8	-6.5	-15.9	-18.6	-8.5	.	.	.
Employed persons - LFS, th, average	1615	1636	1605	1541	1563	.	.	1510	1520
annual change in %	1.8	1.3	-1.8	-4.0	-2.8	.	.	-2	0.5
Unemployed persons - LFS, th, average	171	149	160	206	197	.	.	.	.
Unemployment rate - LFS, in %, average	9.6	8.4	9.1	11.8	11.2	.	.	12	11
Reg. unemployment rate in %, end of period	14.7	13.7	16.7	18.8	18.4	19.3	.	18.5	18
Average gross monthly wages, HRK	7047	7544	7711	7679	7634	7675	.	7700	7750
annual change in % (real, net)	2.2	0.8	0.2	-0.5	-1.7	-0.4	.	.	.
Consumer prices, % p.a.	2.9	6.1	2.4	1.1	0.9	2.2	.	2.5	2
Producer prices in industry, % p.a. ³⁾	3.5	8.3	-0.4	4.3	3.5	6.4	.	5	3.5
General governm. budget, nat. def., % GDP ⁴⁾									
Revenues	39.8	39.1	38.2	37.0	.	.	.	35.8	35.4
Expenditures	41.0	39.9	41.3	41.4	.	.	.	41.8	40
Deficit (-) / surplus (+) ⁵⁾	-1.2	-0.9	-3.2	-4.3	.	.	.	-6.0	-5.0
Public debt, EU-def., in % of GDP ⁶⁾	32.5	29.0	35.2	40.1	.	.	.	45.2	48.4
Central bank policy rate, % p.a., end of period ⁷⁾	4.1	6.0	6.0	6.0	6.0	6.0	.	.	.
Current account, EUR mn	-3236.1	-4335.5	-2506.0	-654.3	-1362.4	.	.	-1200	-1600
Current account in % of GDP	-7.5	-9.1	-5.5	-1.4	-12.8	.	.	-2.5	-3.2
Exports of goods, BOP, EUR mn	9192.5	9814.0	7703.2	9099.5	2033.3	.	.	9100	9600
annual growth rate in %	8.6	6.8	-21.5	18.1	5.4	.	.	0	6
Imports of goods, BOP, EUR mn	18626.5	20607.8	15090.1	15044.8	3316.6	.	.	15300	16400
annual growth rate in %	10.8	10.6	-26.8	-0.3	-9.4	.	.	2	7
Exports of services, BOP, EUR mn	9114.8	10090.6	8453.9	8496.3	787.9	.	.	8800	9200
annual growth rate in %	6.9	10.7	-16.2	0.5	1.9	.	.	3	5
Imports of services, BOP, EUR mn	2847.4	3132.7	2778.3	2694.1	664.3	.	.	2700	2800
annual growth rate in %	0.8	10.0	-11.3	-3.0	4.0	.	.	2	3
FDI inflow, EUR mn	3679.0	4218.4	2095.6	439.9	591.2	.	.	1000	.
FDI outflow, EUR mn	211.2	972.8	888.8	-153.4	62.0	.	.	.	.
Gross reserves of NB excl. gold, EUR mn	9307.4	9120.9	10375.8	10660.3	10008.1	11423.8	.	.	.
Gross external debt, EUR mn ⁸⁾	33720.8	40590.0	45244.3	46440.2	45039.4	46433.0	Feb	.	.
Gross external debt in % of GDP ⁸⁾	77.7	85.0	99.1	101.1	98.1	97.9	.	.	.
Average exchange rate HRK/EUR	7.3360	7.2232	7.3396	7.2862	7.2854	7.4003	.	7.3	7.3
Purchasing power parity HRK/EUR	4.7284	4.8975	5.0130	5.0237	.	.	.	.	.

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

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) Domestic output prices. - 4) On accrual basis. - 5) Including change in arrears and non-recorded expenditures. - 6) According to ESA'95, excessive deficit procedure. - 7) Average weighted repo rates. - 8) From 2008 new reporting system (estimated data for non-financial enterprises).

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